FIRST FINANCIAL BANKSHARES INC
Form 10-K
February 19, 2019

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

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

For the fiscal year ended December 31, 2018

Commission file number 0-7674

First Financial Bankshares, Inc.

(Exact Name of Registrant as Specified in Its Charter)

Texas	**75-0944023**
(State or Other Jurisdiction of Incorporation or Organization)	**(I.R.S. Employer Identification No.)**

400 Pine Street, Abilene, Texas	**79601**
(Address of Principal Executive Offices)	**(Zip Code)**

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

Securities registered pursuant to Section 12(b) of the Act:

Title of Class	**Name of Exchange on Which Registered**
Common Stock, par value $0.01 per share	**Nasdaq Global Select Market**

Securities registered pursuant to Section 12(g) of the Act:

None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes No

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 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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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 file , 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

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

As of June 30, 2018, the last business day of the registrant s most recently completed second fiscal quarter, the aggregate market value of the registrant s voting and non-voting common stock held by non-affiliates was

$3.28 billion.

As of February 19, 2019, there were 67,816,714 shares of common stock outstanding.

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Documents Incorporated by Reference

Certain information called for by Part III is incorporated by reference to the proxy statement for our 2019 annual meeting of shareholders, which will be filed with the Securities and Exchange Commission not later than 120 days after December 31, 2018.

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CAUTIONARY STATEMENT REGARDING

FORWARD-LOOKING STATEMENTS

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

- general economic conditions, including our local, state and national real estate markets and employment trends;

- effect of severe weather conditions, including hurricanes, tornadoes, flooding and droughts;

- volatility and disruption in national and international financial and commodity markets;

- government intervention in the U.S. financial system, including the effects of recent legislative, tax, accounting and regulatory actions and reforms, including the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act), the Jumpstart Our Business Startups Act, the Consumer Financial Protection Bureau, the capital ratios of Basel III as adopted by the federal banking authorities and the Tax Cuts and Jobs Act;

- political instability;

- the ability of the Federal government to address the national economy;

- changes in our competitive environment from other financial institutions and financial service providers;

- the effects of and changes in trade, monetary and fiscal policies and laws, including interest rate policies of the Board of Governors of the Federal Reserve System (the Federal Reserve Board);

- the effect of changes in accounting policies and practices, as may be adopted by the regulatory agencies, as well as the Public Company Accounting Oversight Board, the Financial Accounting Standards Board and other accounting standard setters;

the effect of changes in laws and regulations (including laws and regulations concerning taxes, banking, securities and insurance) with which we and our subsidiaries must comply;

changes in the demand for loans;

fluctuations in the value of collateral securing our loan portfolio and in the level of the allowance for loan losses;

the accuracy of our estimates of future loan losses;

the accuracy of our estimates and assumptions regarding the performance of our securities portfolio;

soundness of other financial institutions with which we have transactions;

inflation, interest rate, market and monetary fluctuations;

changes in consumer spending, borrowing and savings habits;

changes in commodity prices (e.g., oil and gas, cattle, and wind energy);

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- our ability to attract deposits and increase market share;
- changes in our liquidity position;
- changes in the reliability of our vendors, internal control system or information systems;
- cyber attacks on our technology information systems, including fraud from our customers and external third party vendors;
- our ability to attract and retain qualified employees;
- acquisitions and integration of acquired businesses;
- the possible impairment of goodwill associated with our acquisitions;
- consequences of continued bank mergers and acquisitions in our market area, resulting in fewer but much larger and stronger competitors;
- expansion of operations, including branch openings, new product offerings and expansion into new markets;
- changes in our compensation and benefit plans; and
- acts of God or of war or terrorism.

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

PART I

ITEM 1. BUSINESS

General

First Financial Bankshares, Inc., a Texas corporation (the Company), is a financial holding company registered under the Bank Holding Company Act of 1956, as amended, or BHCA. As such, we are supervised by the Federal Reserve Board, as well as several other bank regulators. We were formed as a bank holding company in 1956 under the original name F & M Operating Company, but our banking operations date back to 1890, when Farmers and Merchants National Bank opened for business in Abilene, Texas. On January 1, 2018, we acquired Commercial Bancshares, Inc. and its wholly owned subsidiary, Commercial State Bank, Kingwood, Texas and merged these entities with and into the Company and our subsidiary bank, respectively. As of December 31, 2018, our subsidiaries are:

First Financial Bank, National Association, Abilene, Texas;

First Technology Services, Inc., Abilene, Texas, a wholly owned subsidiary of First Financial Bank, National Association, Abilene, Texas;

First Financial Trust & Asset Management Company, National Association, Abilene, Texas;

First Financial Insurance Agency, Inc., Abilene, Texas; and

First Financial Investments, Inc., Abilene, Texas.

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Through our subsidiaries, we conduct a full-service commercial banking business. Our banking centers are located primarily in Central, North Central, Southeast and West Texas. As of December 31, 2018, we had 73 financial centers across Texas, with eleven locations in Abilene, three locations in Weatherford, two locations in Cleburne, Conroe, San Angelo, Stephenville, and Granbury, and one location each in Acton, Albany, Aledo, Alvarado, Beaumont, Boyd, Bridgeport, Brock, Burleson, Cisco, Clyde, Cut and Shoot, Decatur, Eastland, El Campo, Fort Worth, Fulshear, Glen Rose, Grapevine, Hereford, Huntsville, Keller, Kingwood, Magnolia, Mauriceville, Merkel, Midlothian, Mineral Wells, Montgomery, Moran, New Waverly, Newton, Odessa, Orange, Palacios, Port Arthur, Ranger, Rising Star, Roby, Southlake, Spring, Sweetwater, Tomball, Trent, Trophy Club, Vidor, Waxahachie, Willis and Willow Park, all in Texas. On January 1, 2018, we completed our acquisition of Commercial Bancshares, Inc. and its wholly owned bank subsidiary, Commercial State Bank and, as a result, added branch locations in Kingwood, Fulshear, El Campo and Palacios.

Even though we operate in a growing number of Texas markets, we continue to believe that decisions are best made at the local level. Although we consolidated our bank charters into one charter in 2013, we continue to regionally manage our operations with local advisory boards of directors, local bank region presidents and local decision-makers. We have consolidated substantially all of the backroom operations, such as investment securities, accounting, check processing, technology and employee benefits, which improved our efficiency and freed management of our bank regions to concentrate on serving the banking needs of their local communities. On January 1, 2016, we combined our Huntsville and Conroe Regions and our Abilene, Sweetwater and Eastland Regions and established a Fort Worth Region that previously was a branch of our Weatherford Region. On January 1, 2018, we combined our Mineral Wells and Stephenville Regions.

In the past, we have chosen to keep our Company focused on the State of Texas, one of the nation s largest, fastest-growing and most economically diverse states. With approximately 28.8 million residents, Texas has more people than any other state except California. The population of Texas grew 20.5% from 2007-2017 according to the U.S. Census Bureau. Many of the communities in which we operate are also experiencing positive growth as shown below:

Population Growth 2007-2017*

Bridgeport and Wise County	20.4%	Weatherford, Willow Park, Aledo and Parker County	33.1%
Fort Worth and Tarrant County	19.1%	Stephenville and Erath County	14.8%
Cleburne and Johnson County	13.4%	Conroe and Montgomery County	41.7%
Granbury and Hood County	15.9%	*Source: U. S. Census Bureau	

These economies include dynamic centers of higher education, agriculture, wind energy and natural resources, retail, military, healthcare, tourism, retirement living, manufacturing and distribution.

We believe our community approach to doing business works best for us in small and mid-size markets, where we can play a prominent role in the economic, civic and cultural life of the community. Our goal is to serve these communities well and to experience growth as these markets continue to expand. In many instances, banking competition is less intense in smaller markets, making it easier for us to operate rationally and attract and retain high-caliber employees who prefer not only our community-banker concept but the high quality of life in smaller cities.

Over the years, we have grown in three ways: by growing organically, by opening new branch locations and by acquiring other banks. Since 1997, we have completed thirteen bank acquisitions and have increased our total assets from $1.57 billion to $7.73 billion as of December 31, 2018. We also established a trust and asset management company and a technology services company. First Financial Trust and Asset Management Company, National Association operates as a subsidiary of First Financial Bankshares, Inc. and First Technology Services, Inc. operates as a subsidiary of First Financial Bank, National Association, Abilene, Texas. Looking ahead, we intend to continue to grow organically by better serving the needs of our customers and putting them first in all of our decisions. We continually look for new branch locations, such as our newest branch in Spring, Texas which opened in January 2019, so we can provide more convenient service to our customers. We are actively pursuing acquisition opportunities by calling on banks that we are interested in possibly acquiring.

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When targeting a bank for acquisition, the subject bank generally needs to be well managed and profitable, while being located in the type of community that fits our profile. We seek to enter growing communities with good amenities schools, infrastructure, commerce and lifestyle. We prefer non-metropolitan markets, either around Dallas/Fort Worth, Houston, San Antonio or Austin or along the Interstate 35, 45, 10 and 20 corridors in Texas. We might also consider the acquisition of banks in East Texas, the Texas Hill Country area or in states contiguous to Texas. Banks between $300 million and $1.0 billion in asset size fit our sweet spot for acquisition, but we would consider banks that are larger or smaller, or that are in other areas of Texas if we believe they would be a good fit for our Company.

Information on our revenues, profits and losses and total assets appears in Management s Discussion and Analysis of Financial Condition and Results of Operations contained in Item 7 hereof.

First Financial Bankshares, Inc.

We provide management, technical resources and policy direction to our subsidiaries, which enable them to improve or expand their services while continuing their local activity and identity. Each of our subsidiaries operates under the day-to-day management of its own board of directors and officers, including advisory boards of directors for our bank regions. We provide resources and policy direction in, among other things, the following areas:

- asset and liability management;
- investments;
- accounting;
- budgeting;
- training;
- marketing;
- planning;
- risk management;
- loan review;

- loan analysis;
- human resources;
- insurance;
- capitalization;
- regulatory compliance; and
- internal audit.

In particular, we assist our subsidiaries with, among other things, decisions concerning major capital expenditures, employee fringe benefits, including retirement plans and group medical coverage, dividend policies, and appointment of officers and directors, including advisory directors, and their compensation. We also perform, through corporate staff groups or by outsourcing to third parties, internal audits, compliance oversight and loan reviews of our subsidiaries. We provide advice and specialized services for our bank regions related to lending, investing, purchasing, advertising, public relations, and technology services.

We evaluate various potential financial institution acquisition opportunities and approve potential locations for new branch offices. We anticipate that funding for any acquisitions or expansions would be provided from our existing cash balances, available dividends from our subsidiaries, utilization of available lines of credit and future debt or equity offerings.

Services Offered by Our Subsidiaries

Our subsidiary bank, First Financial Bank, National Association, is a separate legal entity that operates under the day-to-day management of its board of directors and officers. Our multiple banking regions, which operate under our subsidiary bank, each have separate advisory boards that make recommendations and provide assistance to regional management of the bank regarding the operations of their respective region. Each of our bank regions provides general commercial banking services, which include accepting and holding checking, savings and time deposits, making loans, automated teller machines, drive-in and night deposit services, safe deposit facilities, remote deposit capture, internet banking, mobile banking, payroll cards, transmitting funds, and performing other customary commercial banking services. We also conduct full service trust and wealth management activities through First Financial Trust & Asset Management Company, National Association, our trust company. Our trust company has eight locations which are located in Abilene, Fort Worth, Kingwood, Odessa, Beaumont, San Angelo, Stephenville and Sweetwater, all in Texas. Through our trust company, we offer personal trust services, which include wealth management, the administration of estates, testamentary trusts, revocable and irrevocable trusts and agency accounts. We also administer all types of retirement and employee benefit accounts, which include 401(k) profit sharing plans and IRAs. In addition, we provide securities brokerage services through arrangements with an unrelated third party in our Abilene, San Angelo and Weatherford banking regions.

Competition

Commercial banking in Texas is highly competitive, and because we hold less than 1% of the state s deposits, we represent only a minor segment of the industry. To succeed in this industry, we believe that we must have the capability to compete effectively in the areas of (1) interest rates paid or charged; (2) scope of services offered; and (3) prices charged for such services. Our bank regions compete in their respective service areas against highly competitive banks, thrifts, savings and loan associations, small loan companies, credit unions, mortgage companies, insurance companies, and brokerage firms, all of which are engaged in providing financial products and services and some of which are larger than us in terms of capital, resources and personnel.

Our business does not depend on any single customer or any few customers, and the loss of any one would not have a materially adverse effect upon our business. Although we have a broad base of customers that are not related to us, our customers also occasionally include our officers and directors, as well as other entities with which we are affiliated. Through our bank regions we may make loans to our officers and directors, and entities with which we are affiliated, in the ordinary course of business. We make these loans on substantially the same terms, including interest rates and collateral, as those prevailing at the time for comparable transactions with other persons. Loans to our directors, officers and their affiliates are also subject to numerous restrictions under federal and state banking laws, which we describe in greater detail below, under the heading Supervision and Regulation Loans to Directors, Executive Officers and Principal Shareholders.

Employees

Including all of our subsidiaries, we employed approximately 1,350 full-time equivalent employees at December 31, 2018. Our management believes that our employee relations have been and will continue to be good.

Supervision and Regulation

Both federal and state laws extensively regulate bank holding companies, financial holding companies and banks. These laws (and the regulations promulgated thereunder) are primarily intended to protect depositors and the deposit insurance fund (the DIF) of the Federal Deposit Insurance Corporation, or the FDIC. The following information describes particular laws and regulatory provisions relating to financial holding companies and banks. This discussion is qualified in its entirety by reference to the particular laws and regulatory provisions. A change in any of these laws or regulations may have a material effect on our business and the business of our subsidiaries. Recent political developments, including the change in administration of the United States federal government, have added additional uncertainty in the implementation, scope and timing of regulatory reforms.

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Bank Holding Companies and Financial Holding Companies

Historically, the activities of bank holding companies were limited to the business of banking and activities closely related or incidental to banking. Bank holding companies were generally prohibited from acquiring control of any company that was not a bank and from engaging in any business other than the business of banking or managing and controlling banks. The Gramm-Leach-Bliley Act, which took effect on March 12, 2000, dismantled many Depression-era restrictions against affiliations between banking, securities and insurance firms by permitting bank holding companies to engage in a broader range of financial activities, so long as certain safeguards are observed. Specifically, bank holding companies may elect to become financial holding companies that may affiliate with securities firms and insurance companies and engage in other activities that are financial in nature or incidental to a financial activity. Thus, with the enactment of the Gramm-Leach-Bliley Act, banks, security firms and insurance companies find it easier to acquire or affiliate with each other and cross-sell financial products. The Gramm-Leach-Bliley Act permits a single financial services organization to offer a more complete array of financial products and services than historically was permitted.

A financial holding company is essentially a bank holding company with significantly expanded powers. Under the Gramm-Leach-Bliley Act, in addition to traditional lending activities, the following activities are among those that are deemed financial in nature for financial holding companies: securities underwriting, dealing in or making a market in securities, sponsoring mutual funds and investment companies, insurance underwriting and agency activities, activities which the Federal Reserve Board determines to be closely related to banking, and certain merchant banking activities.

We elected to become a financial holding company in September 2001. As a financial holding company, we have very broad discretion to affiliate with securities firms and insurance companies, provide merchant banking services, and engage in other activities that the Federal Reserve Board has deemed financial in nature. In order to continue as a financial holding company, we must continue to be well-capitalized, well-managed and maintain compliance with the Community Reinvestment Act. Depending on the types of financial activities that we may elect to engage in, under the Gramm-Leach-Bliley Act s functional regulation principles, we may become subject to supervision by additional government agencies. The election to be treated as a financial holding company increases our ability to offer financial products and services that historically we were either unable to provide or were only able to provide on a limited basis. As a result, we will face increased competition in the markets for any new financial products and services that we may offer. Likewise, an increased amount of consolidation among banks and securities firms or banks and insurance firms could result in a growing number of large financial institutions that could compete aggressively with us.

Mergers and Acquisitions

We generally must obtain approval from the banking regulators before we can acquire other financial institutions. We may not engage in certain acquisitions if we are undercapitalized. Furthermore, the BHCA provides that the Federal Reserve Board cannot approve any acquisition, merger or consolidation that may substantially lessen competition in the banking industry, create a monopoly in any section of the country, or be a restraint of trade. However, the Federal Reserve Board may approve such a transaction if the convenience and needs of the community clearly outweigh any anti-competitive effects. Specifically, the Federal Reserve Board would consider, among other factors, the expected benefits to the public (greater convenience, increased competition, greater efficiency, etc.) against the risks of possible adverse effects (undue concentration of resources, decreased or unfair competition, conflicts of interest, unsound banking practices, etc.).

Under the BHCA, the Company must obtain the prior approval of the Federal Reserve Board, or acting under delegated authority, the Federal Reserve Bank of Dallas before (1) acquiring direct or indirect ownership or control of any class of voting securities of any bank or bank holding company if, after the acquisition, the Company would directly or indirectly own or control 5% or more of the class; (2) acquiring all or substantially all of the assets of another bank or bank holding company; or (3) merging or consolidating with another bank holding company.

The Change in Bank Control Act of 1978, as amended, or the CIBCA, and the related regulations of the Federal Reserve Board require any person or groups of persons acting in concert (except for companies required to make application under the BHCA), to file a written notice with the Federal Reserve Board before the person or group acquires control of the Company. The CIBCA defines control as the direct or indirect power to vote 25% or more of any class of voting securities or to direct the management or policies of a bank holding company or an insured bank. A rebuttable presumption of control arises under the CIBCA where a person or group controls 10% or more, but less than 25%, of a class of the voting stock of a company or insured bank which is a reporting company under the Securities Exchange Act of 1934, as amended, such as the Company, or such ownership interest is greater than the ownership interest held by any other person or group.

Banks

Federal and state laws and regulations that govern banks have the effect of, among other things, regulating the scope of business, investments, cash reserves, the purpose and nature of loans, the maximum interest rate chargeable on loans, the amount of dividends declared, and required capitalization ratios.

Banks organized as national banking associations under the National Bank Act are subject to regulation and examination by the Office of the Comptroller of the Currency, or OCC. Effective December 30, 2012, we consolidated our then eleven bank charters into one, that being our Abilene charter. As a result, the OCC now supervises, regulates and regularly examines the following subsidiaries:

- First Financial Bank, National Association, Abilene, Texas;
- First Financial Trust & Asset Management Company, National Association; and
- First Technology Services, Inc. (a wholly owned subsidiary of First Financial Bank, National Association)

The OCC s supervision and regulation of banks is primarily intended to protect the interests of depositors. The National Bank Act:

- requires each national banking association to maintain reserves against deposits;
- restricts the nature and amount of loans that may be made and the interest that may be charged; and
- restricts investments and other activities.

Deposit Insurance Coverage and Assessments

Our subsidiary bank is a member of the FDIC. Through the DIF, the FDIC provides deposit insurance protection that covers all deposit accounts in FDIC-insured depository institutions up to applicable limits (currently, $250,000 per depositor).

Our subsidiary bank must pay assessments to the FDIC under a risk-based assessment system for this federal deposit insurance protection. FDIC-insured depository institutions that are members of the Bank Insurance Fund pay insurance premiums at rates based on their risk classification. Institutions assigned to higher risk classifications (i.e., institutions that pose a greater risk of loss to the DIF) pay assessments at higher rates than institutions assigned to lower risk classifications. An institution s risk classification is assigned based on its capital levels and the level of supervisory concern the institution poses to bank regulators. Through December 31, 2018, the assessment rate for our subsidiary bank was at the lowest risk-based premium available, which was 3.00% of the assessment base per annum. In addition, the FDIC can impose special assessments to cover shortages in the DIF and has imposed special assessments in the past.

In October 2010, the FDIC adopted a new Restoration Plan for the DIF to ensure that the fund reserve ratio reaches 1.35% by September 30, 2020, as required by the Dodd-Frank Act. On April 26, 2016, the FDIC adopted a rule amending pricing for deposit insurance for institutions with less than $10 billion in assets effective the quarter after the fund reserve ratio reached 1.15%. As of June 30, 2016, the FDIC announced that the fund reserve ratio had reached 1.15%. As a result, the Company s assessment rate was decreased to the rate stated above. The Dodd-Frank Act also eliminated the requirement that the FDIC pay dividends to insured depository institutions when the reserve ratio exceeds certain thresholds. The Dodd-Frank Act required the FDIC to offset the effect of increasing the reserve ratio on institutions with total consolidated assets of less than $10 billion, such as the Company.

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As required by the Dodd-Frank Act, the FDIC also revised the deposit insurance assessment system, effective April 1, 2011, to base assessments on the average total consolidated assets of insured depository institutions during the assessment period, less the average tangible equity of the institution during the assessment period as opposed to solely bank deposits at an institution. This base assessment change necessitated that the FDIC adjust the assessment rates to ensure that the revenue collected under the new assessment system will approximately equal that under the existing assessment system.

Under the Financial Institutions Reform, Recovery, and Enforcement Act of 1989, or FIRREA, an FDIC-insured depository institution can be held liable for any losses incurred by the FDIC in connection with (1) the default of one of its FDIC-insured subsidiaries or (2) any assistance provided by the FDIC to one of its FDIC-receivers, and in danger of default is defined generally as the existence of certain conditions indicating that a default is likely to occur in the absence of regulatory assistance.

The FDIC is also empowered to regulate interest rates paid by insured banks. Approval of the FDIC is also required before an insured bank retires any part of its common or preferred stock, or any capital notes or debentures.

Payment of Dividends

We are a legal entity separate and distinct from our banking and other subsidiaries. We receive most of our revenue from dividends paid to us by our bank and trust company subsidiaries. Described below are some of the laws and regulations that apply when either we or our subsidiaries pay or paid dividends.

The Federal Reserve Board, the OCC and the FDIC have issued policy statements that recommend that bank holding companies and insured banks should generally only pay dividends to the extent net income is sufficient to cover both cash dividends and a rate of earnings retention consistent with capital needs, asset quality and overall financial condition. Further, the Federal Reserve Board s policy provides that bank holding companies should not maintain a level of cash dividends that undermines the bank holding company s ability to serve as a source of strength to its banking subsidiaries. In addition, the Federal Reserve Board has indicated that each bank holding company should carefully review its dividend policy, and has discouraged payment ratios that are at maximum allowable levels, which is the maximum dividend amount that may be issued and allow the company to still maintain its target Tier 1 capital ratio, unless both asset quality and capital are very strong.

To pay dividends, our subsidiaries must maintain adequate capital above regulatory guidelines. Under federal law, our subsidiary bank cannot pay a dividend if, after paying the dividend, the bank would be undercapitalized. In addition, if the FDIC believes that a bank under its jurisdiction is engaged in, or is about to engage in, an unsafe or unsound practice (which, depending on the financial condition of the bank, could include the payment of dividends), the FDIC may require, after notice and hearing, that such bank cease and desist from the unsafe practice. The FDIC and the OCC have each indicated paying dividends that deplete a bank s capital base to an inadequate level would be an unsafe and unsound banking practice.

National banks are required by federal law to obtain the prior approval of the OCC in order to declare and pay dividends if the total of all dividends declared in any calendar year would exceed the total of (1) such bank s net profits (as defined and interpreted by regulation) for that year plus (2) its retained net profits (as defined and interpreted by regulation) for the preceding two calendar years, less any required transfers to surplus. In addition, these banks may only pay dividends to the extent that retained net profits (including the portion transferred to surplus) exceed bad debts (as defined by regulation).

Our subsidiaries paid aggregate dividends to us of $74.10 million in 2018 and $30.08 million in 2017. Under the dividend restrictions discussed above, as of December 31, 2018, our subsidiaries could have declared in the aggregate additional dividends of approximately $233.96 million from retained net profits, without obtaining regulatory approvals.

Federal Income Tax

On December 22, 2017, the Tax Cuts and Jobs Act was signed into law with sweeping modifications to the Internal Revenue Code. The primary change for the Company was to lower the corporate income tax rate to 21% from 35%. The Company s deferred tax assets and liabilities were re-measured based on the income tax rates at which they are expected to reverse in the future, which is generally 21%. The provisional amount recorded related to the re-measurement of the Company s deferred tax balance was $7.65 million, a reduction of income tax expense for the year ended December 31, 2017. In 2018, the Company continued to analyze certain aspects of the Tax Cuts and Jobs Act resulting in refinement of the calculation and recorded an additional reduction in its deferred tax balance of $664 thousand, a reduction of income tax expense for year ended December 31, 2018.

Affiliate Transactions

The Federal Reserve Act, the Federal Deposit Insurance Act (FDIA) and the rules adopted under these statutes restrict the extent to which we can borrow or otherwise obtain credit from, or engage in certain other transactions with, our subsidiaries. These laws regulate covered transactions between insured depository institutions and their subsidiaries, on the one hand, and their nondepository affiliates, on the other hand. The Dodd-Frank Act expanded the definition of affiliate to make any investment fund, including a mutual fund, for which a depository institution or its affiliates serve as investment advisor an affiliate of the depository institution. Covered transactions include a loan or extension of credit to a non-depository affiliate, a purchase of securities issued by such an affiliate, a purchase of assets from such an affiliate (unless otherwise exempted by the Federal Reserve Board), an acceptance of securities issued by such an affiliate as collateral for a loan, and an issuance of a guarantee, acceptance, or letter of credit for the benefit of such an affiliate. The Dodd-Frank Act extended the limitations to derivative transactions, repurchase agreements and securities lending and borrowing transactions that create credit exposure to an affiliate or an insider. The covered transactions that an insured depository institution and its subsidiaries are permitted to engage in with their non-depository affiliates are limited to the following amounts: (1) in the case of any one such affiliate, the aggregate amount of covered transactions cannot exceed ten percent of the capital stock and the surplus of the insured depository institution; and (2) in the case of all affiliates, the aggregate amount of covered transactions cannot exceed twenty percent of the capital stock and surplus of the insured depository institution. In addition, extensions of credit that constitute covered transactions must be collateralized in prescribed amounts. Further, a bank holding company and its subsidiaries are prohibited from engaging in certain tie-in arrangements in connection with any extension of credit, lease or sale of property or furnishing of services. Finally, when we and our subsidiaries conduct transactions internally among us, we are required to do so at arm s length.

Loans to Directors, Executive Officers and Principal Shareholders

The authority of our subsidiary bank to extend credit to our directors, executive officers and principal shareholders, including their immediate family members, corporations and other entities that they control, is subject to substantial restrictions and requirements under Sections 22(g) and 22(h) of the Federal Reserve Act and Regulation O promulgated thereunder, as well as the Sarbanes-Oxley Act of 2002. These statutes and regulations impose specific limits on the amount of loans our subsidiary bank may make to directors and other insiders, and specified approval procedures must be followed in making loans that exceed certain amounts. In addition, all loans our subsidiary bank makes to directors and other insiders must satisfy the following requirements:

- the loans must be made on substantially the same terms, including interest rates and collateral, as those prevailing at the time for comparable transactions with persons not affiliated with us or our subsidiary bank;

- the subsidiary bank must follow credit underwriting procedures at least as stringent as those applicable to comparable transactions with persons who are not affiliated with us or our subsidiary bank; and

- the loans must not involve a greater than normal risk of non-payment or include other features not favorable to our subsidiary bank.

Furthermore, our subsidiary bank must periodically report all loans made to directors and other insiders to the bank regulators, and these loans are closely scrutinized by the regulators for compliance with Sections 22(g) and 22(h) of the Federal Reserve Act and Regulation O. Each loan to directors or other insiders must be pre-approved by the bank s board of directors with the interested director abstaining from voting.

Capital

We and our bank subsidiary are each required to comply with applicable capital adequacy standards established by the Federal Reserve Board and the OCC, respectively. The current risk-based capital standards applicable to us and our bank subsidiary, parts of which are currently in the process of being phased-in, are based on the December 2010 final capital framework for strengthening international capital standards, known as Basel III, of the Basel Committee on Banking Supervision (the Basel Committee).

In July 2013, the federal bank regulators approved final rules (the Basel III Rules) implementing the Basel III framework as well as certain provisions of the Dodd-Frank Act. The Basel III Rules substantially revised the risk-based capital requirements applicable to bank holding companies and their depository institution subsidiaries. The Basel III Rules became effective for us and our subsidiary bank on January 1, 2015 (subject to a phase-in period for certain provisions).

The Basel III Rules established three components of regulatory capital: (1) common equity tier 1 capital (CET1), (2) additional tier 1 capital, and (3) tier 2 capital. Tier 1 capital is the sum of CET1 and additional tier 1 capital instruments meeting certain revised requirements. Total capital is the sum of tier 1 capital and tier 2 capital. Under the Basel III Rules, for most banking organizations, the most common form of additional tier 1 capital is non-cumulative perpetual preferred stock and the most common form of tier 2 capital is subordinated notes and a portion of the allocation for loan and lease losses, in each case, subject to the Basel III Rules specific requirements. As of December 31, 2018, we do not have any non-cumulative perpetual preferred stock or subordinated notes. CET1, tier 1 capital, and total capital serve as the numerators for three prescribed regulatory capital ratios. Risk-weighted assets, calculated using the standardized approach in the Basel III Capital Rules for us and our subsidiary bank, provide the denominator for such ratios. There is also a leverage ratio that compares tier 1 capital to average total assets.

Pursuant to the Basel III Rules, the effects of certain accumulated other comprehensive income or loss (AOCI) items are not excluded; however, non-advanced approaches banking organizations, including us and our subsidiary bank, could make a one-time permanent election to continue to exclude these items. The Company made its a one-time, permanent election to continue to exclude AOCI from capital in its filing with the Federal Reserve Board for the quarter ended March 31, 2015. If the Company would not have made this election, unrealized gains and losses would have been included in the calculation of its regulatory capital. The Basel III Rules also preclude certain hybrid securities, such as trust preferred securities issued prior to May 19, 2010, from inclusion in our Tier 1 capital, subject to grandfathering in the case of companies, such as us, that had less than $15 billion in total consolidated assets as of December 31, 2009.

Under the Basel III Rules, the minimum capital ratios effective as of January 1, 2015 are:

- 4.5% CET1 to risk-weighted assets;
- 6.0% Tier 1 capital to risk-weighted assets;
- 8.0% Total capital to risk-weighted assets; and

4.0% Tier 1 capital to average consolidated assets as reported on consolidated financial statements (known as the leverage ratio).

The Basel III Rules established a fully-phased capital conservation buffer of 2.5% above the new regulatory minimum risk-based capital requirements. The conservation buffer, when added to the capital requirements, resulted in the following minimum ratios: (i) a CET1 risk-based capital ratio of 7.0%, (ii) a Tier 1 risk-based capital ratio of 8.5%, and (iii) a total risk-based capital ratio of 10.5%. The new capital conservation buffer requirement began being phased in beginning in January 2016 at 0.625% of risk-weighted assets and increased by that amount each year until fully implemented in January 2019. At December 31, 2018, the required capital conservation buffer was 1.875%. An institution is subject to limitations on certain activities including payment of dividends, share repurchases and discretionary bonuses to executive officers if its capital level is below the buffer amount.

The Basel III Rules prescribed a standardized approach for risk weightings that expanded the risk-weighting categories from the general risk-based capital rules to a much larger and more risk-sensitive number of categories, depending on the nature of the assets, generally ranging from 0% for U.S. government and agency securities, to 600% for certain equity exposures, and resulting in higher risk weights for a variety of asset categories.

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With respect to our bank subsidiary, the Basel III Rules also revised the prompt corrective action regulations pursuant to Section 38 of the Federal Deposit Insurance Act, as discussed below under Prompt Corrective Action.

As of December 31, 2018, we had a total risk-based capital ratio of 20.61%, a Tier 1 capital to risk-weighted asset ratio of 19.47%, a common equity Tier 1 to risk-weighted assets ratio of 19.47% and a Tier 1 leverage ratio of 11.85%. These regulatory capital ratios were calculated under the Basel III rules.

In November 2018, the banking regulators issued a proposal for a depository institution with assets less than $10 billion. The proposal would establish a Community Bank Leverage Ratio (CBLR) defined as total bank equity capital, excluding accumulated other comprehensive income, deferred tax assets and other intangible assets, divided by the average total consolidated assets. If the CBLR ratio is maintained at greater than nine percent, the depository organization will be considered to be in compliance with the Basel III capital requirements and exempt from calculating existing risk-based capital ratio requirements.

Prompt Corrective Action.

A banking organization s capital plays an important role in connection with regulatory enforcement as well. Federal law provides the federal banking regulators with broad power to take prompt corrective action to resolve the problems of undercapitalized institutions. The extent of the regulators powers depends on whether the institution in question is adequately capitalized, undercapitalized, significantly undercapitalized or critically undercapitalized, in each case a defined by regulation. Depending upon the capital category to which an institution is assigned, the regulators corrective powers include: (i) requiring the institution to submit a capital restoration plan; (ii) limiting the institution s asset growth and restricting its activities; (iii) requiring the institution to issue additional capital stock (including additional voting stock) or to be acquired; (iv) restricting transactions between the institution and its affiliates; (v) restricting the interest rate that the institution may pay on deposits; (vi) ordering a new election of directors of the institution; (vii) requiring that senior executive officers or directors be dismissed; (viii) prohibiting the institution from accepting deposits from correspondent banks; (ix) requiring the institution to divest certain subsidiaries; (x) prohibiting the payment of principal or interest on subordinated debt; and (xi) ultimately, appointing a receiver for the institution.

Under current regulations, our subsidiary bank was well capitalized as of December 31, 2018.

Our Support of Our Subsidiaries

Under Federal Reserve Board policy, we are expected to commit resources to act as a source of strength to support each of our subsidiaries. The Dodd-Frank Act codified this policy as a statutory requirement. This support may be required at times when, absent such Federal Reserve Board policy, we would not otherwise be required to provide it. In addition, any loans we make to our subsidiaries would be subordinate in right of payment to deposits and to other indebtedness of our subsidiaries. In the event of a bank holding company s bankruptcy, any commitment by the bank holding company to a federal bank regulatory agency to maintain the capital of a subsidiary bank will be assumed by the bankruptcy trustee and be subject to a priority of payment.

Under the Federal Deposit Insurance Act, in the event of a loss suffered or anticipated by the FDIC (either as a result of the default of a banking subsidiary or related to FDIC assistance provided to a subsidiary in danger of default) our other subsidiaries may be assessed for the FDIC s loss.

Safe and Sound Banking Practices.

Bank holding companies are not permitted to engage in unsafe and unsound banking practices. The Federal Reserve Board s Regulation Y, for example, generally requires a holding company to give the Federal Reserve Board prior notice of any redemption or repurchase of its own equity securities, if the consideration to be paid, together with the consideration paid for any repurchases or redemptions in the preceding year, is equal to 10% or more of the bank holding company s consolidated net worth. The Federal Reserve Board may oppose the transaction if it believes that the transaction would constitute an unsafe or unsound practice or would violate any law or regulation. Depending upon the circumstances, the Federal Reserve Board could take the position that paying a dividend would constitute an unsafe or unsound banking practice.

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The Federal Reserve Board has broad authority to prohibit activities of bank holding companies and their nonbanking subsidiaries which represent unsafe and unsound banking practices or which constitute violations of laws or regulations, and can assess civil money penalties for certain activities conducted on a knowing and reckless basis, if those activities caused a substantial loss to a depository institution. The penalties can be as high as $1.0 million for each day the activity continues.

Interstate Banking and Branching

Effective June 1, 1997, the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 amended the Federal Deposit Insurance Act and certain other statutes to permit state and national banks with different home states to merge across state lines, with approval of the appropriate federal banking agency, unless the home state of a participating bank had passed legislation prior to May 31, 1997 expressly prohibiting interstate mergers. Under the Riegle-Neal Act amendments, once a state or national bank has established branches in a state, that bank may establish and acquire additional branches at any location in the state at which any bank involved in the interstate merger transaction could have established or acquired branches under applicable federal or state law. If a state opted out of interstate branching within the specified time period, no bank in any other state may establish a branch in the state which has opted out, whether through an acquisition or de novo.

However, under the Dodd-Frank Act, the national branching requirements have been relaxed and national banks and state banks are able to establish branches in any state if that state would permit the establishment of the branch by a state bank chartered in that state.

The Federal Deposit Insurance Act, or FDIA, requires that the FDIC review (1) any merger or consolidation by or with an insured bank, or (2) any establishment of branches by an insured bank. Additionally, the Texas Department of Banking accepts applications for interstate merger and branching transactions, subject to certain limitations on ages of the banks to be acquired and the total amount of deposits within the state a bank or financial holding company may control. Since our primary service area is Texas, we do not expect that the ability to operate in other states will have any material impact on our growth strategy. We may, however, face increased competition from out-of-state banks that branch or make acquisitions in our primary markets in Texas.

Community Reinvestment Act of 1977

The Community Reinvestment Act of 1977, or CRA, subjects a bank to regulatory assessment to determine if the institution meets the credit needs of its entire community, including low- and moderate-income neighborhoods served by the bank, and to take that determination into account in its evaluation of any application made by such bank for, among other things, approval of the acquisition or establishment of a branch or other depository facility, an office relocation, a merger, or the acquisition of shares of capital stock of another financial institution. The regulatory authority prepares a written evaluation of an institution s record of meeting the credit needs of its entire community and assigns a rating. These ratings are Outstanding, Satisfactory, Needs Improvement and Substantial Non-Compliance. Institutions with ratings lower than Satisfactory may be restricted from engaging in the aforementioned activities. We believe our subsidiary bank has taken and takes significant actions to comply with the CRA, and received a satisfactory rating in its most recent review by federal regulators with respect to its compliance with the CRA.

Monitoring and Reporting Suspicious Activity

Under the Bank Secrecy Act, or BSA, we are required to monitor and report unusual or suspicious account activity that might signify money laundering, tax evasion or other criminal activities, as well as transactions involving the transfer or withdrawal of amounts in excess of prescribed limits. The BSA is sometimes referred to as an anti-money laundering law (AML). Several AML acts, including provisions in Title III of the USA PATRIOT Act of 2001, have been enacted up to the present to amend the BSA. Under the USA PATRIOT Act, financial institutions are subject to prohibitions against specified financial transactions and account relationships as well as enhanced due diligence and know your customer standards in their dealings with financial institutions and foreign customers. For example, the enhanced due diligence policies, procedures and controls generally require financial institutions to take reasonable steps:

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to conduct enhanced scrutiny of account relationships to guard against money laundering and report any suspicious transaction;

to ascertain the identity of the nominal and beneficial owners of, and the source of funds deposited into, each account as needed to guard against money laundering and report any suspicious transactions;

to ascertain for any foreign bank, the shares of which are not publicly traded, the identity of the owners of the foreign bank, and the nature and extent of the ownership interest of each such owner; and

to ascertain whether any foreign bank provides correspondent accounts to other foreign banks and, if so, the identity of those foreign banks and related due diligence information.

Under the USA PATRIOT Act, financial institutions are also required to establish anti-money laundering programs. The USA PATRIOT Act sets forth minimum standards for these programs, including:

the development of internal policies, procedures, and controls;

the designation of a compliance officer;

an ongoing employee training program; and

an independent audit function to test the programs.

In addition, under the USA PATRIOT Act, the Secretary of the U.S. Department of the Treasury, or Treasury, has adopted rules addressing a number of related issues, including increasing the cooperation and information sharing between financial institutions, regulators, and law enforcement authorities regarding individuals, entities and organizations engaged in, or reasonably suspected based on credible evidence of engaging in, terrorist acts or money laundering activities. Any financial institution complying with these rules will not be deemed to violate the privacy provisions of the Gramm-Leach-Bliley Act that are discussed below. Finally, under the regulations of the Office of Foreign Asset Control, or OFAC, we are required to monitor and block transactions with certain specially designated nationals who OFAC has determined pose a risk to U.S. national security.

Incentive Compensation

In June 2010, the Federal Reserve Board, OCC and FDIC issued comprehensive final guidance on incentive compensation policies intended to ensure that the incentive compensation policies of banking organizations do not undermine the safety and soundness of such organizations by encouraging excessive risk-taking. The guidance, which covers all employees that have the ability to materially affect the risk profile of an organization, either individually or as part of a group, is based upon the key principles that a banking organization s incentive compensation arrangements should (i) provide incentives that do not encourage risk-taking beyond the organization s ability to effectively identify and manage risks, (ii) be compatible with effective internal controls and risk management, and (iii) be supported by strong corporate governance, including active and effective oversight by the organization s board of directors.

The Federal Reserve Board will review, as part of the regular, risk-focused examination process, the incentive compensation arrangements of banking organizations, such as the Company, that are not large, complex banking organizations. These reviews will be tailored to each organization based on the scope and complexity of the organization s activities and the prevalence of incentive compensation arrangements. The findings of the supervisory initiatives will be included in reports of examination. Deficiencies will be incorporated into the organization s supervisory ratings, which can affect the organization s ability to make acquisitions and take other actions. Enforcement actions may be taken against a banking organization if its incentive compensation arrangements, or related risk-management control or governance processes, pose a risk to the organization s safety and soundness and the organization is not taking prompt and effective measures to correct the deficiencies.

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In addition, Section 956 of the Dodd-Frank Act required certain regulators (including the FDIC, SEC and Federal Reserve Board) to adopt requirements or guidelines prohibiting excessive compensation. In April and May 2016, the Federal Reserve, jointly with five other federal regulators, published a proposed rule in response to Section 956 of the Dodd-Frank Act, which requires implementation of regulations or guidelines to: (1) prohibit incentive-based payment arrangements that encourage inappropriate risks by certain financial institutions by providing excessive compensation or that could lead to material financial loss, and (2) require those financial institutions to disclose information concerning incentive-based compensation arrangements to the appropriate federal regulator.

The proposed rule identifies three categories of institutions that would be covered by these regulations based on average total consolidated assets, applying less prescriptive incentive-based compensation program requirements to the smallest covered institutions (Level 3) and progressively more rigorous requirements to the larger covered institutions (Level 1). Under the proposed rule, we would fall into the smallest category (Level 3), which applies to financial institutions with average total consolidated assets greater than $1 billion and less than $50 billion. The proposed rules would establish general qualitative requirements applicable to all covered entities, which would include (i) prohibiting incentive arrangements that encourage inappropriate risks by providing excessive compensation; (ii) prohibiting incentive arrangements that encourage inappropriate risks that could lead to a material financial loss; (iii) establishing requirements for performance measures to appropriately balance risk and reward; (iv) requiring board of director oversight of incentive arrangements; and (v) mandating appropriate recordkeeping. Under the proposed rule, larger financial institutions with total consolidated assets of at least $50 billion would also be subject to additional requirements applicable to such institutions senior executive officers and significant risk-takers. These additional requirements would not be applicable to us because we currently have less than $50 billion in total consolidated assets. Comments on the proposed rule were due by July 22, 2016. As of the date of this document, the final rule has not yet been published by these regulators.

In addition, the Dodd-Frank Act requires publicly traded companies to give stockholders a non-binding vote on executive compensation at their first annual meeting taking place six months after the date of enactment and at least every three years thereafter and on so-called golden parachute payments in connection with approvals of mergers and acquisitions unless previously voted on by shareholders. The new legislation also authorizes the Securities and Exchange Commission (SEC) to promulgate rules that would allow stockholders to nominate their own candidates using a company s proxy materials. Additionally, the Dodd-Frank Act directs the federal banking regulators to promulgate rules prohibiting excessive compensation paid to executives of depository institutions and their holding companies with assets in excess of $1.0 billion, regardless of whether the company is publicly traded or not. The Dodd-Frank Act gives the SEC authority to prohibit broker discretionary voting on elections of directors and executive compensation matters.

Consumer Laws and Regulations

We are also subject to certain consumer laws and regulations that are designed to protect consumers in transactions with banks. While the following list is not exhaustive, these laws and regulations include the Truth in Lending Act, the Truth in Savings Act, the Electronic Funds Transfer Act, the Expedited Funds Availability Act, the Equal Credit Opportunity Act, The Fair and Accurate Credit Transactions Act, The Real Estate Settlement Procedures Act and the Fair Housing Act, among others. These laws and regulations, among other things, prohibit discrimination on the basis of race, gender or other designated characteristics and mandate various disclosure requirements and regulate the manner in which financial institutions must deal with customers when taking deposits or making loans to such customers. These and other laws also limit finance charges or other fees or charges earned in our activities. We must comply with the applicable provisions of these consumer protection laws and regulations as part of our ongoing customer relations.

Consumer Financial Protection Bureau

The Dodd-Frank Act created a new, independent federal agency called the Consumer Financial Protection Bureau (CFPB), which is granted broad rulemaking, supervisory and enforcement powers under various federal consumer financial protection laws, including the Equal Credit Opportunity Act, Truth in Lending Act, Real Estate Settlement Procedures Act, Fair Credit Reporting Act, Fair Debt Collection Act, the Consumer Financial Privacy provisions of the Gramm-Leach-Bliley Act and certain other statutes. The CFPB has examination and primary enforcement authority with respect to depository institutions with $10 billion or more in assets. Smaller institutions are subject to rules promulgated by the CFPB but continue to be examined and supervised by federal banking regulators for consumer compliance purposes. The CFPB has authority to prevent unfair, deceptive or abusive practices in connection with the offering of consumer financial products. The Dodd-Frank Act permits states to adopt consumer protection laws and standards that are more stringent than those adopted at the federal level and, in certain circumstances, permits the state attorney general to enforce compliance with both the state and federal laws and regulations.

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The CFPB has finalized rules relating to, among other things, remittance transfers under the Electronic Fund Transfer Act, which requires companies to provide consumers with certain disclosures before the consumer pays for a remittance transfer. These rules became effective in October 2013. The CFPB has also amended certain rules under Regulation C relating to home mortgage disclosure to reflect a change in the asset-size exemption threshold for depository institutions based on the annual percentage change in the Consumer Price Index for Urban Wage Earners and Clerical Workers. In addition, on January 10, 2013, the CFPB released its final Ability-to-Repay/Qualified Mortgage rules, which amended the Truth in Lending Act (Regulation Z). Regulation Z prohibits a creditor from making a higher-priced mortgage loan without regard to the consumer s ability to repay the loan. The final amended rule implemented sections 1411 and 1412 of the Dodd-Frank Act, which generally require creditors to make a reasonable, good faith determination of a consumer s ability to repay any consumer credit transaction secured by a dwelling (excluding an open-end credit plan, timeshare plan, reverse mortgage, or temporary loan) and establishes certain protections from liability under this requirement for qualified mortgages. The final rule also implemented section 1414 of the Dodd-Frank Act, which limits prepayment penalties. Finally, the final rule requires creditors to retain evidence of compliance with the rule for three years after a covered loan is consummated. This rule became effective January 10, 2014.

Technology Risk Management and Consumer Privacy

State and federal banking regulators have issued various policy statements emphasizing the importance of technology risk management and supervision in evaluating the safety and soundness of depository institutions with respect to banks that contract with outside vendors to provide data processing and core banking functions. The use of technology-related products, services, delivery channels and processes exposes a bank to various risks, particularly operational, privacy, security, strategic, reputation and compliance risk. Banks are generally expected to prudently manage technology-related risks as part of their comprehensive risk management policies by identifying, measuring, monitoring and controlling risks associated with the use of technology.

Under Section 501 of the Gramm-Leach-Bliley Act, the federal banking agencies have established appropriate standards for financial institutions regarding the implementation of safeguards to ensure the security and confidentiality of customer records and information, protection against any anticipated threats or hazards to the security or integrity of such records and protection against unauthorized access to or use of such records or information in a way that could result in substantial harm or inconvenience to a customer. Among other matters, the rules require each bank to implement a comprehensive written information security program that includes administrative, technical and physical safeguards relating to customer information.

Under the Gramm-Leach-Bliley Act, a financial institution must also provide its customers with a notice of privacy policies and practices. Section 502 prohibits a financial institution from disclosing nonpublic personal information about a customer to nonaffiliated third parties unless the institution satisfies various notice and opt-out requirements and the customer has not elected to opt out of the disclosure. Under Section 504, the agencies are authorized to issue regulations as necessary to implement notice requirements and restrictions on a financial institution s ability to disclose nonpublic personal information about customers to nonaffiliated third parties. Under the final rule the regulators adopted, all banks must develop initial and annual privacy notices which describe in general terms the bank s information sharing practices. Banks that share nonpublic personal information about customers with nonaffiliated third parties must also provide customers with an opt-out notice and a reasonable period of time for the customer to opt out of any such disclosure (with certain exceptions). Limitations are placed on the extent to which a bank can disclose an account number or access code for credit card, deposit or transaction accounts to any nonaffiliated third party for use in marketing.

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Concentrated Commercial Real Estate Lending Regulations

The federal banking agencies, including the FDIC, have promulgated guidance governing financial institutions with concentrations in commercial real estate lending. The guidance provides that a bank has a concentration in commercial real estate lending if (i) total reported loans for construction, land development, and other land represent 100% or more of total capital or (ii) total reported loans secured by multifamily and non-farm residential properties and loans for construction, land development, and other land represent 300% or more of total capital and the bank s commercial real estate loan portfolio has increased 50% or more during the prior 36 months. Owner occupied loans are excluded from this second category. If a concentration is present, management must employ heightened risk management practices that address the following key elements: including board and management oversight and strategic planning, portfolio management, development of underwriting standards, risk assessment and monitoring through market analysis and stress testing, and maintenance of increased capital levels as needed to support the level of commercial real estate lending.

UDAP and UDAAP

Banking regulatory agencies have increasingly used a general consumer protection statute to address unethical or otherwise bad business practices that may not necessarily fall directly under the purview of a specific banking or consumer finance law. The law of choice for enforcement against such business practices has been Section 5 of the Federal Trade Commission Act, referred to as the FTC Act, which is the primary federal law that prohibits unfair or deceptive acts or practices, referred to as UDAP, and unfair methods of competition in or affecting commerce. Unjustified consumer injury is the principal focus of the FTC Act. Prior to the Dodd-Frank Act, there was little formal guidance to provide insight to the parameters for compliance with UDAP laws and regulations. However, UDAP laws and regulations have been expanded under the Dodd-Frank Act to apply to unfair, deceptive or abusive acts or practices, referred to as UDAAP, which have been delegated to the CFPB for supervision. The CFPB has published its first Supervision and Examination Manual that addresses compliance with and the examination of UDAAP.

Monetary Policy

Banks are affected by the credit policies of monetary authorities, including the Federal Reserve Board, that affect the national supply of credit. The Federal Reserve Board regulates the supply of credit in order to influence general economic conditions, primarily through open market operations in United States government obligations, varying the discount rate on financial institution borrowings, varying reserve requirements against financial institution deposits, and restricting certain borrowings by financial institutions and their subsidiaries. The monetary policies of the Federal Reserve Board have had a significant effect on the operating results of banks in the past and are expected to continue to do so in the future.

Enforcement Powers of Federal Banking Agencies

The Federal Reserve Board and other state and federal banking agencies and regulators have broad enforcement powers, including the power to terminate deposit insurance, issue cease-and-desist orders, impose substantial fines and other civil and criminal penalties and appoint a conservator or receiver. Our failure to comply with applicable laws, regulations and other regulatory pronouncements could subject us, as well as our officers and directors, to administrative sanctions and potentially substantial civil penalties.

Regulatory Reform and Legislation

From time to time, various legislative and regulatory initiatives are introduced in Congress and state legislatures, as well as by regulatory agencies. Such initiatives may include proposals to expand or contract the powers of bank holding companies and depository institutions or proposals to substantially change the financial institution regulatory system. Such legislation could change banking statutes and the operating environment of the Company in substantial and unpredictable ways. If enacted, such legislation could increase or decrease the cost of doing business, limit or expand permissible activities or affect the competitive balance among banks, savings associations, credit unions, and other financial institutions. The Company cannot predict whether any such legislation will be enacted, and, if enacted, the effect that it, or any implementing regulations, would have on the financial condition or results of operations of the Company. A change in statutes, regulations or regulatory policies applicable to the Company or our subsidiaries could have a material effect on the Company s business, financial condition and results of operations.

Dodd-Frank Wall Street Reform and Consumer Protection Act

The Dodd-Frank Act, which was enacted in July 2010, effected a fundamental restructuring of federal banking regulation. In addition to those provisions discussed above, among the Dodd-Frank Act provisions that have affected us are the following:

- creation of a new Financial Stability Oversight Council to identify systemic risks in the financial system and gives federal regulators new authority to take control of and liquidate financial firms;

- elimination of the federal statutory prohibition against the payment of interest on business checking accounts;

- prohibition on state-chartered banks engaging in derivatives transactions unless the loans to one borrower of the state in which the bank is chartered takes into consideration credit exposure to derivative transactions. For this purpose, derivative transactions include any contract, agreement, swap, warrant, note or option that is based in whole or in part on the value of, any interest in, or any quantitative measure or the occurrence of any event relating to, one or more commodity securities, currencies, interest or other rates, indices or other assets;

- requirement that the amount of any interchange fee charged by a debit card issuer with respect to a debit card transaction must be reasonable and proportional to the cost incurred by the issuer. On June 29, 2011, the Federal Reserve Board set the interchange rate cap at $0.21 per transaction and 5 basis points multiplied by the value of the transaction. While the restrictions on interchange fees do not apply to banks that, together with their affiliates, have assets of less than $10 billion, the rule could affect the competitiveness of debit cards issued by smaller banks; and

- restrictions under the Volcker Rule of the Company s ability to engage in proprietary trading and to invest in, sponsor and engage in certain types of transactions with certain private funds. The Company had until July 15, 2015 to fully conform to the Volcker Rules restrictions.

Many of the Dodd-Frank Act s provisions are still subject to the final rulemaking by federal banking agencies, and the implication of the Dodd-Frank Act for the Company s business will depend to a large extent on how such rules are adopted and implemented. The Company s management continues to review actively the provisions of the Dodd Frank Act and assess its probable impact on its business, financial condition, and results of operations.

Available Information

We file annual, quarterly and current reports, proxy statements and other information with the SEC. You may read and copy any document we file at the SEC s Public Reference Room at 100 F Street, N.E., Washington, D.C. 20549. Please call the SEC at 1-800-SEC-0330 for further information on the public reference room. Our SEC filings are also available to the public at the SEC s web site at http://www.sec.gov. Our web site is http://www.ffin.com. You may also obtain copies of our annual, quarterly and special reports, proxy statements and certain other information filed with the SEC, as well as amendments thereto, free of charge from our web site. These documents are posted to our web site after we have filed them with the SEC. Our corporate governance guidelines, including our code of conduct applicable to all our employees, officers and directors, as well as the charters of our audit and nominating committees, are available at www.ffin.com. The foregoing information is also available in print to any shareholder who requests it. Except as explicitly provided, information on any web site is not incorporated into this Form 10-K or our other securities filings and is not a part of them.

ITEM 1A. RISK FACTORS

Our business, financial condition, operating results and cash flows can be impacted by a number of factors, including but not limited to those set forth below, any one of which could cause our actual results to vary materially from recent results or from our anticipated future results and other forward-looking statements that we make from time to time in our news releases, annual reports and other written communications, as well as oral forward-looking statements, and other statements made from time to time by our representatives.

Our business faces unpredictable economic conditions, which could have an adverse effect on us.

General economic conditions impact the banking industry. The credit quality of our loan portfolio necessarily reflects, among other things, the general economic conditions in the areas in which we conduct our business. Our continued financial success depends somewhat on factors beyond our control, including:

- general economic conditions, including national and local real estate markets and the price of oil and gas, wind farm subsidies from the federal government and other commodity prices;
- the supply of and demand for investable funds;
- demand for loans and access to credit;
- interest rates; and
- federal, state and local laws affecting these matters.

Any substantial deterioration in any of the foregoing conditions could have a material adverse effect on our financial condition, results of operations and liquidity, which would likely adversely affect the market price of our common stock.

Our business is concentrated in Texas and a downturn in the economy of Texas may adversely affect our business.

Our network of bank regions is concentrated in Texas, primarily in the Central, North Central, Southeast and Western regions of the state. Most of our customers and revenue are derived from this area. These economies include dynamic centers of higher education, agriculture, energy and natural resources, retail, military, healthcare, tourism, retirement living, manufacturing and distribution. Because we generally do not derive revenue or customers from other parts of the state or nation, our business and operations are dependent on economic conditions in our Texas markets. Any significant decline in one or more segments of the local economies could adversely affect our business, revenue, operations and properties.

The significant volatility in oil and gas prices has resulted in uncertainty about the Texas economy. While we consider our exposure to credits related to the oil and gas industry to not be significant, at approximately 2.86% of total loans as of December 31, 2018, should the price of oil and gas decline further and/or remain at low prices for an extended period, the general economic conditions in our Texas markets could be negatively affected, which could have a material adverse affect on our business, financial condition and results of operations.

Our Company lends primarily to small to medium-sized businesses that may have fewer resources to weather a downturn in the economy, which could adversely impact the Company s operating results.

The Company makes loans to privately-owned businesses, many of which are considered to be small to medium-sized businesses. Small to medium-sized businesses frequently have smaller market share than their competition, may be more vulnerable to economic downturns, often need additional capital to expand or compete and may experience more volatility in operating results. Any one or more of these factors may impair the borrower s ability to repay a loan. In addition, the success of a small to medium-sized businesses often depends on the management talents and efforts of a small group of persons, and the death, disability or resignation of one or more of these persons could have adverse impact on the business and its ability to repay our loans. Economic downturns, a sustained decline in commodity prices and other events that could negatively impact the businesses could cause the Company to incur credit losses that could negatively affect the Company s results of operations and financial condition.

In our business, we must effectively manage our credit risk.

As a lender, we are exposed to the risk that our loan customers may not repay their loans according to the terms of these loans and the collateral securing the payment of these loans may be insufficient to fully compensate us for the outstanding balance of the loan plus the costs to dispose of the collateral. We may experience significant loan losses, which could have a material adverse effect on our operating results and financial condition. Management makes various assumptions and judgments about the collectability of our loan portfolio, including the diversification by industry of our commercial loan portfolio, the amount of nonperforming loans and related collateral, the volume, growth and composition of our loan portfolio, the effects on the loan portfolio of current economic indicators and their probable impact on borrowers and the evaluation of our loan portfolio through our internal loan review process and other relevant factors.

We maintain an allowance for credit losses, which is an allowance established through a provision for loan losses charged to expense that represents management s best estimate of probable losses inherent in our loan portfolio. Additional credit losses will likely occur in the future and may occur at a rate greater than we have experienced to date. In determining the amount of the allowance, we rely on an analysis of our loan portfolio, our experience and our evaluation of general economic conditions. If our assumptions prove to be incorrect, our current allowance may not be sufficient and adjustments may be necessary to allow for different economic conditions or adverse developments in our loan portfolio. Material additions to the allowance could materially decrease our net income.

In addition, banking regulators periodically review our allowance for credit losses and may require us to increase our provision for credit losses or recognize further charge-offs, based on judgments different than those of our management. Any increase in our allowance for credit losses or charge-offs as required by these regulatory agencies could have a material negative effect on our operating results, financial condition and liquidity.

Hurricanes, extended drought conditions, severe weather and natural disasters could significantly impact the Company s business.

Hurricanes, extended drought conditions, severe weather and natural disasters and other adverse external events could have a significant impact on the Company s ability to conduct business. In late August 2017 and continuing into the fourth quarter of 2017, Houston and the surrounding area around the Gulf Coast were significantly affected by Hurricane Harvey. Our Southeast Texas and Conroe regions of the Company are in these areas and were impacted by the severe winds and floods. See Management s Discussion and Analysis of Financial Condition and Results of Operations beginning on page 34 for specific information of the impact of Hurricane Harvey on our Company. Such events affect the stability of the Company s deposit base, impair the ability of borrowers to repay outstanding loans, impair the value of the collateral securing our loans, cause significant property damage, result in loss of revenue and/or cause the Company to incur additional expenses. The occurrence of any such event in the future could have a material adverse effect on the Company s business, which in turn, could have a material adverse effect on the Company s business, financial condition and result of operations.

Changes in economic conditions could cause an increase in delinquencies and non-performing assets, including loan charge-offs, which could depress our net income and growth.

Our loan portfolio includes many real estate secured loans, demand for which may decrease during economic downturns as a result of, among other things, an increase in unemployment, a decrease in real estate values and a slowdown in housing. If we see negative economic conditions develop in the United States as a whole or in the portions of Texas that we serve, we could experience higher delinquencies and loan charge-offs, which would reduce our net income and adversely affect our financial condition. Furthermore, to the extent that real estate collateral is obtained through foreclosure, the costs of holding and marketing the real estate collateral, as well as the ultimate values obtained from disposition, could reduce our earnings and adversely affect our financial condition.

The value of real estate collateral may fluctuate significantly resulting in an under-collateralized loan portfolio.

The market value of real estate, particularly real estate held for investment, can fluctuate significantly in a short period of time as a result of market conditions in the geographic area in which the real estate is located. If the value of the real estate serving as collateral for our loan portfolio were to decline materially, a significant part of our loan portfolio could become under-collateralized. If the loans that are collateralized by real estate become troubled during a time when market conditions are declining or have declined, then, in the event of foreclosure, we may not be able to realize the amount of collateral that we anticipated at the time of originating the loan. This could have a material adverse effect on our provision for loan losses and our operating results and financial condition.

New lines of business or new products and services may subject the Company to additional risks.

From time to time, the Company may implement new lines of business or offer new products and services within existing lines of business. There are substantial risks and uncertainties associated with these efforts, particularly in instances where the markets are not fully developed. In developing and marketing new lines of business and/or products and services the Company may invest significant time and resources. External factors, such as compliance with regulations, competitive alternatives, and shifting market preferences, may also impact the successful implementation of a new line of business or a new product or service. If we are unable to successfully manage these risks in the development and implementation of new lines of business or new products or services, it could have a material adverse effect on the Company s business, financial condition and result of operations.

We are subject to environmental liability risk associated with lending activities.

A significant portion of our loan portfolio is secured by real property. During the ordinary course of business, we may foreclose on and take title to properties securing certain loans. In doing so, there is a risk that hazardous or toxic substances could be found on these properties. If hazardous or toxic substances are found, we may be liable for remediation costs, as well as for personal injury and property damage. Environmental laws may require us to incur substantial expenses and may materially reduce the affected property s value or limit our ability to use or sell the affected property. In addition, future laws or more stringent interpretations or enforcement policies with respect to existing laws may increase our exposure to environmental liability. Environmental reviews of real property before initiating foreclosure actions may not be sufficient to detect all potential environmental hazards. The remediation costs and any other financial liabilities associated with an environmental hazard could have a material adverse effect on our business, financial condition and results of operations.

We depend on the accuracy and completeness of information about customers and counterparties.

In deciding whether to extend credit or enter into other transactions, we must rely on information furnished by or on behalf of customers and counterparties, including financial statements, credit reports and other financial information. We also rely on representations of those customers, counterparties or other third parties, such as independent auditors, as to the accuracy and completeness of that information. Reliance on inaccurate or misleading financial statements, credit reports or other financial information could have a material adverse impact on our business, financial condition and results of operations.

We do business with other financial institutions that could experience financial difficulty.

We do business through the purchase and sale of Federal funds, check clearing and through the purchase and sale of loan participations with other financial institutions. Because these financial institutions have many risks, as do we, we could be adversely affected should one of these financial institutions experience significant financial difficulties or fail to comply with our agreements with them.

If we are unable to continue to originate residential real estate loans and sell them into the secondary market for a profit, our earnings could decrease.

We derive a portion of our noninterest income from the origination of residential real estate loans and the subsequent sale of such loans into the secondary market. If we are unable to continue to originate and sell residential real estate loans at historical or greater levels, our residential real estate loan volume would decrease, which could decrease our earnings. A rising interest rate environment, general economic conditions or other factors beyond our control could adversely affect our ability to originate residential real estate loans. We also are experiencing an increase in regulations and compliance requirements related to mortgage loan originations necessitating technology upgrades and other changes. If new regulations continue to increase and we are unable to make technology upgrades, our ability to originate mortgage loans will be reduced or eliminated. Additionally, we sell a large portion of our residential real estate loans to third party investors, and rising interest rates could negatively affect our ability to generate suitable profits on the sale of such loans. If interest rates increase after we originate the loans, our ability to market those loans is impaired as the profitability on the loans decreases. These fluctuations can have an adverse effect on the revenue we generate from residential real estate loans and in certain instances, could result in a loss on the sale of the loans.

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Further, for the mortgage loans we sell in the secondary market, the mortgage loan sales contracts contain indemnification clauses should the loans default, generally in the first sixty to ninety days, or if documentation is determined not to be in compliance with regulations. While the Company s historic losses as a result of these indemnities have been insignificant, we could be required to repurchase the mortgage loans or reimburse the purchaser of our loans for losses incurred. Both of these situations could have an adverse effect on the profitability of our mortgage loan activities and negatively impact our net income.

Difficult or changes in market conditions could adversely affect the financial services industry.

The financial markets have experienced volatility over the past several years. In some cases, the financial markets have produced downward pressure on stock prices and credit availability for certain companies without regard to those companies underlying financial strength. If financial market volatility worsens, or there are disruptions in these financial markets, including disruptions to the United States banking systems, there can be no assurance that we will not experience an adverse effect on our ability to access capital and our business, financial condition and result of operations could be adversely impacted.

We may need to raise additional capital and such funds may not be available when needed.

We may need to raise additional capital in the future to provide us with sufficient capital resources to meet our commitments and business needs, particularly if our asset quality or earnings were to deteriorate significantly. Our ability to raise additional capital, if needed, will depend on, among other things, conditions in the capital and financial markets at that time, which are outside of our control, and our financial performance. Economic conditions and the loss of confidence in financial institutions may increase our cost of funding and limit access to certain customary sources of capital, other financial institution borrowings and borrowings from the discount window of the Federal Reserve. Any occurrence that may limit our access to the capital markets, such as a decline in the confidence of other financial institutions, or counterparties participating in the capital markets, may adversely affect our costs and our ability to raise capital. An inability to raise additional capital on acceptable terms when needed could have a materially adverse effect on our financial condition and results of operations.

We may be subject to more stringent capital and liquidity requirements which would adversely affect our net income and future growth.

On July 2, 2013, the Federal Reserve Board, and on July 9, 2013, the FDIC and OCC, adopted a final rule that implements the Basel III changes to the international regulatory capital framework and revises the U.S. risk-based and leverage capital requirements for U.S. banking organizations to strengthen identified areas of weakness in capital rules and to address relevant provisions of the Dodd-Frank Act.

The final rule established a stricter regulatory capital framework that requires banking organizations to hold more and higher-quality capital to act as a financial cushion to absorb losses and help banking organizations better withstand periods of financial stress. The final rule increased capital ratios for all banking organizations and introduced a capital conservation buffer which is in addition to each capital ratio. If a banking organization dips into its capital conservation buffer, it may be restricted in its ability to pay dividends and discretionary bonus payments to its executive officers. The final rule assigned a higher risk weight (150%) to exposures that are more than 90 days past due or are on nonaccrual status and to certain commercial real estate facilities that finance the acquisition, development or construction of real property. The final rule also required unrealized gains and losses on certain available-for-sale securities holdings to be included for purposes of calculating regulatory capital requirements unless a one-time opt-out is exercised. We exercised this opt-out right in our March 31, 2015 quarterly financial filing. The final rule also included changes in what constitutes regulatory capital, some of which are subject to a two-year transition period. These changes included the phasing-out of certain instruments as qualifying capital. In addition, Tier 2 capital is no longer limited to the amount of Tier 1 capital included in total capital. Mortgage servicing rights, certain deferred tax assets and investments in unconsolidated subsidiaries over designated percentages of common stock are required to be deducted from capital, subject to a two-year transition period.

The final rule became effective for us on January 1, 2015. As of December 31, 2018, we met all of these new requirements, including the full capital conservation buffer.

Although we currently cannot predict the specific impact and long-term effects that Basel III will have on our Company and the banking industry more generally, the Company will be required to maintain higher regulatory capital levels which could impact our operations, net income and ability to grow. Furthermore, the Company s failure to comply with the minimum capital requirements could result in our regulators taking formal or informal actions against us which could restrict our future growth or operations.

The trust wealth management fees we receive may decrease as a result of poor investment performance, in either relative or absolute terms, which could decrease our revenues and net earnings.

Our trust company subsidiary derives its revenues primarily from investment management fees based on assets under management. Our ability to maintain or increase assets under management is subject to a number of factors, including investors perception of our past performance, in either relative or absolute terms, market and economic conditions, including changes in oil and gas prices, and competition from investment management companies. Financial markets are affected by many factors, all of which are beyond our control, including general economic conditions, including changes in oil and gas prices; securities market conditions; the level and volatility of interest rates and equity prices; competitive conditions; liquidity of global markets; international and regional political conditions; regulatory and legislative developments; monetary and fiscal policy; investor sentiment; availability and cost of capital; technological changes and events; outcome of legal proceedings; changes in currency values; inflation; credit ratings; and the size, volume and timing of transactions. A decline in the fair value of the assets under management, caused by a decline in general economic conditions, would decrease our wealth management fee income.

Investment performance is one of the most important factors in retaining existing clients and competing for new wealth management clients. Poor investment performance could reduce our revenues and impair our growth in the following ways:

- existing clients may withdraw funds from our wealth management business in favor of better performing products;

- asset-based management fees could decline from a decrease in assets under management;

- our ability to attract funds from existing and new clients might diminish; and

- our wealth managers and investment advisors may depart, to join a competitor or otherwise.

Even when market conditions are generally favorable, our investment performance may be adversely affected by the investment style of our wealth management and investment advisors and the particular investments that they make. To the extent our future investment performance is perceived to be poor in either relative or absolute terms, the revenues and profitability of our wealth management business will likely be reduced and our ability to attract new clients will likely be impaired. As such, fluctuations in the equity and debt markets can have a direct impact upon our net earnings. In addition, as approximately 17% of trust fees comes from management of oil and gas properties, a decline in the prices of oil and gas could lead to a loss of material amounts of our trust income.

Certain of our investment advisory and wealth management contracts are subject to termination on short notice, and termination of a significant number of investment advisory contracts could have a material adverse impact on our revenue.

Certain of our investment advisory and wealth management clients can terminate, with little or no notice, their relationships with us, reduce their aggregate assets under management, or shift their funds to other types of accounts with different rate structures for any number of reasons, including investment performance, changes in prevailing interest rates, inflation, changes in investment preferences of clients, changes in our reputation in the marketplace, change in management or control of clients, loss of key investment management personnel and financial market performance. We cannot be certain that our trust company subsidiary will be able to retain all of its clients. If its clients terminate their investment advisory and wealth management contracts, our trust company subsidiary, and consequently we, could lose a substantial portion of our revenues.

We are subject to possible claims and litigation pertaining to fiduciary responsibility.

From time to time, customers could make claims and take legal action pertaining to our performance of our fiduciary responsibilities. Whether customer claims and legal action related to our performance of our fiduciary responsibilities are founded or unfounded, if such claims and legal actions are not resolved in a manner favorable to us, they may result in significant financial liability and/or adversely affect our market perception of our products and services as well as impact customer demand for those products and services. Any financial liability or reputation damage could have a material adverse effect on our business, which, in turn, could have a material adverse effect on our financial condition and results of operations.

Our business is subject to significant government regulation.

We operate in a highly-regulated environment and are subject to supervision and regulation by a number of governmental regulatory agencies, including the Texas Department of Banking, the Federal Reserve Board, the OCC, and the FDIC. Regulations adopted by these agencies, which are generally intended to provide protection for depositors and customers rather than for the benefit of shareholders, govern a comprehensive range of matters relating to ownership and control of our shares, our acquisition of other companies and businesses, permissible activities for us to engage in, maintenance of adequate capital levels and other aspects of our operations. The bank regulatory agencies possess broad authority to prevent or remedy unsafe or unsound practices or violations of law.

The Dodd-Frank Act, enacted in July 2010, instituted major changes to the banking and financial institutions regulatory regimes in light of the recent performance of and government intervention in the financial services sector. Other changes to statues, regulations or regulatory policies, including changes in interpretation or implementation of statutes, regulations or policies, could affect the Company in substantial and unpredictable ways. Such changes could subject the Company to reduced revenues, additional costs, limit the types of financial services and products the Company may offer and/or increase the ability of non-banks to offer competing financial services and products, among other things. Failure to comply with laws, regulations or policies could result in sanctions by regulatory agencies, civil money penalties and/or reputation damage, which could have a material adverse effect on the Company s business, financial condition and results of operations. Additionally, the banking regulations could prohibit and significantly delay the Company s acquisition of other financial institutions.

Included in the Dodd-Frank Act are, for example, changes related to interchange fees and overdraft services. While the changes for interchange fees that can be charged for electronic debit transactions by payment card issuers relate only to banks with assets greater than $10 billion, concern exists that the regulations will also impact our Company. Beginning in the third quarter of 2010, we were prohibited from charging customers fees for paying overdrafts on automated teller machine and debit card transactions, unless the consumer opts in. We continue to monitor the impact of these new regulations and other developments on our service charge revenue.

Federal income tax reform could have unforeseen effects on our financial condition and results of operations.

On December 22, 2017, the President of the United States signed into law H.R. 1, originally known as the Tax Cuts and Jobs Act. The Tax Cuts and Jobs Act included a number of provisions, including the lowering of the U.S. corporate tax rate from 35 percent to 21 percent, effective January 1, 2018. There are also provisions that may partially offset the benefit of such rate reduction. Financial statement impacts include adjustments for, among other things, the re-measurement of deferred tax assets and liabilities. The intended and unintended consequences of Tax Cuts and Jobs Act on our business and on holders of our common shares is uncertain and could be adverse. The Company anticipates that the impact of Tax Cuts and Jobs Act may be material to our business, financial condition and results of operations. Changes in the political makeup of the Senate and House of Representatives in the U.S.

Congress could result also in the reversal of some or all of the effects of the Tax Cuts and Jobs Act.

A new accounting standard will result in a significant change in how we recognize credit losses and may have a material impact on our financial condition or results of operations.

In June 2016, the Financial Accounting Standards Board (FASB) issued an accounting standard update, Financial Instruments-Credit Losses (Topic 326), Measurement of Credit Losses on Financial Instruments, which replaces the current incurred loss model for recognizing credit losses with an expected loss model referred to as the Current Expected Credit Loss (CECL) model. Under the CECL model, we will be required to present certain financial assets carried at amortized cost, such as loans held for investment and held-to-maturity debt securities, at the net amount expected to be collected. The measurement of expected credit losses is to be based on information about past events, including historical experience, current conditions, and reasonable and supportable forecasts that affect the collectability of the reported amount. This measurement will take place at the time the financial asset is first added to the balance sheet and periodically thereafter. This differs significantly from the incurred loss model required under current generally accepted accounting principles (GAAP), which delays recognition until it is probable a loss has been incurred. Accordingly, we expect that the adoption of the CECL model will materially affect how we determine our allowance for loan losses and could require us to significantly increase our allowance. Moreover, the CECL model may create more volatility in the level of our allowance for loan losses. If we are required to materially increase our level of allowance for loan losses for any reason, such increase could adversely affect our business, financial condition and results of operations.

The new CECL standard will become effective for us on January 1, 2020 and for interim periods within that year. We are currently evaluating the impact the CECL model will have on our accounting, but we expect to recognize a one-time cumulative-effect adjustment to our allowance for loan losses as of the beginning of the first reporting period in which the new standard is effective, consistent with regulatory expectations set forth in interagency guidance issued at the end of 2016. We cannot yet determine the magnitude of any such one-time cumulative adjustment or of the overall impact of the new standard on our business, financial condition and results of operations.

Our FDIC insurance assessments could increase substantially resulting in higher operating costs.

We have historically paid the lowest premium rate available due to our sound financial position. Should the number of bank failures increase, FDIC premiums could increase or additional special assessments could be imposed. These increased premiums would have an adverse effect on our net income and results of operations.

We compete with many larger financial institutions which have substantially greater financial resources than we have.

Competition among financial institutions in Texas is intense. We compete with other bank holding companies, state and national commercial banks, savings and loan associations, consumer financial companies, credit unions, securities brokers, insurance companies, mortgage banking companies, money market mutual funds, asset-based non-bank lenders and other financial institutions. Many of these competitors have substantially greater financial resources, larger lending limits, larger branch networks, enhanced technology and less regulatory oversight than we do, and are able to offer a broader range of products and services than we can. Failure to compete effectively for deposit, loan and other banking customers in our markets could cause us to lose market share, slow our growth rate and may have an adverse effect on our financial condition, results of operations and liquidity.

We are subject to interest rate risk.

Our profitability is dependent to a large extent on our net interest income, which is the difference between interest income we earn as a result of interest paid to us on loans and investments and interest we pay to third parties such as our depositors and those from whom we borrow funds. Like most financial institutions, we are highly sensitive to many factors that are beyond our control, including general economic conditions and policies of various governmental and regulatory agencies and, in particular, the Federal Reserve Board. Changes in monetary policy, including changes in interest rates, could influence not only the interest we receive on loans and securities and the amount of interest we pay on deposits and borrowings, but such changes could also affect (i) our ability to originate loans and obtain deposits, (ii) the fair value of our financial assets and liabilities, and (iii) the average duration of our securities portfolio. If the interest rates paid on deposits and other borrowings increase at a faster rate than the interest rates received on loans and investments, our net interest income, and earnings, could be adversely affected. Earnings could also be adversely affected if the interest rates received on loans and investments fall more quickly than the interest rates paid on deposits and other borrowings.

The Federal Reserve began raising interest rates in late 2015 and have continued to increase through 2018. However, there is substantial uncertainty regarding the extent to which interest rates may increase in future periods and what the future effects of any such increases will be. There is no assurance that recent expectations of increasing interest rates in future periods will be realized. Increases in interest rates can have negative impacts on our business, including reducing our customers desire to borrow money from us or adversely affecting their ability to repay their outstanding loans by increasing their debt obligations through the periodic reset of adjustable interest rate loans. If our borrowers ability to pay their loans is impaired by increasing interest payment obligations, our level of non-performing assets would increase, producing an adverse effect on operating results. Asset values, especially commercial real estate as collateral, securities or other fixed rate earning assets, can decline significantly with relatively minor changes in interest rates. Although we have implemented strategies which we believe reduce the potential effects of adverse changes in interest rates on our results of operations, these strategies may not always be successful. Any of these events could adversely affect our results of operations, financial condition and liquidity.

We are subject to liquidity risk.

The Company requires liquidity to meet our deposit and other obligations as they come due. The Company s access to funding sources in amounts adequate to finance its activities or on terms that are acceptable to it could be impaired by factors that affect it specifically or the financial services industry or the general economy. Factors that could reduce its access to liquidity sources include a downturn in the Texas market, difficult credit markets or adverse regulatory actions against the Company. The Company s access to deposits may also be affected by the liquidity needs of its depositors. In particular, a substantial majority of the Company s liabilities are demand, savings, interest checking and money market deposits, which are payable on demand or upon several days notice, while by comparison, a substantial portion of its assets are loans, which cannot be called or sold in the same time frame. The Company may not be able to replace maturing deposits and advances as necessary in the future, especially if a large number of its depositors sought to withdraw their accounts, regardless of the reason. A failure to maintain adequate liquidity could have a material adverse effect on the Company s business, financial condition and result of operations.

The value of certain securities in our investment portfolio may be negatively affected by changes or disruptions in the market for these securities.

Our investment portfolio securities include obligations of, and mortgage-backed securities guaranteed by, government sponsored enterprises such as the Federal National Mortgage Association, referred to as Fannie Mae, the Government National Mortgage Association, referred to as Ginnie Mae, the Federal Home Loan Mortgage Corporation, referred to as Freddie Mac, and the Federal Home Loan Bank or otherwise backed by Federal Housing Administration or Veteran s Administration guaranteed loans; however, volatility or illiquidity in financial markets may cause investment securities held within our investment portfolio to fall in value or become less liquid. The FRB s actions to increase interest rates may cause a decline in the value of securities held by the Company. Uncertainty surrounding the credit risk associated with mortgage collateral or guarantors may cause material discrepancies in valuation estimates obtained from third parties. Volatile market conditions may reduce valuations due to the perception of heightened credit and liquidity risks in addition to interest rate risk typically associated with these securities. There can be no assurance that declines in market value associated with these disruptions will not result in impairments of these assets, which would lead to accounting charges that could have a material adverse effect on our results of operations, equity and capital ratios.

First Financial Bankshares, Inc. relies on dividends from its subsidiaries for most of its revenue.

First Financial Bankshares, Inc. is a separate and distinct legal entity from its subsidiaries. It receives substantially all of its revenue from dividends paid by its subsidiaries. These dividends are the principal source of funds to pay dividends on the Company s common stock and interest and principal on First Financial Bankshares, Inc. debt (if we had balances outstanding). Various federal and/or state laws and regulations limit the amount of dividends that our bank and trust subsidiaries may pay to First Financial Bankshares, Inc. In the event our subsidiaries are unable to pay dividends to First Financial Bankshares, Inc., First Financial Bankshares, Inc. may not be able to service debt, if any, or pay dividends on the Company s common stock. The inability to receive dividends from our subsidiaries could have a material adverse effect on the Company s business, financial condition, results of operations and liquidity.

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To continue our growth, we are affected by our ability to identify and acquire other financial institutions.

We intend to continue our current growth strategy. This strategy includes opening new branches and acquiring other banks that serve customers or markets we find desirable. The market for acquisitions remains highly competitive, and we may be unable to find satisfactory acquisition candidates in the future that fit our acquisition and growth strategy. To the extent that we are unable to find suitable acquisition candidates, an important component of our growth strategy may be lost. Additionally, our completed acquisitions, or any future acquisitions, may not produce the revenue, earnings or synergies that we anticipated.

We may not be able to complete future acquisitions, may not be successful in realizing the benefits of any acquisitions that are completed, or may choose not to pursue acquisition opportunities we might find beneficial.

A substantial part of our historical growth has been a result of acquisitions of other financial institutions, and we may, from time to time, evaluate and engage in the acquisition of other financial institutions. We must generally satisfy a number of conditions prior to completing any such transaction, including certain bank regulatory approvals. Bank regulators consider a number of factors with regard to all institutions involved in the transaction when determining whether to approve a proposed transaction, including, among others, the ratings and compliance history, anti-money laundering and Bank Secrecy Act compliance history, CRA examination results and the effect of the proposed transaction on the financial stability of the institutions involved and the market as a whole.

The process for obtaining required regulatory approvals has become substantially more difficult, time-consuming and unpredictable as a result of the financial crisis. We may fail to pursue, evaluate or complete strategic and competitively significant business opportunities as a result of our inability, or our perceived inability, to obtain required regulatory approvals in a timely manner or at all.

Assuming we are able to successfully complete one or more transactions, we may not be able to successfully integrate and realize the expected synergies from any completed transaction in a timely manner or at all. In particular, we may be charged by federal and state regulators with regulatory and compliance failures at an acquired business prior to the date of the acquisition, and these failures by the acquired company may have negative consequences for us, including the imposition of formal or informal enforcement actions. Completion and integration of any transaction may also divert management s attention from other matters, result in additional costs and expenses, or adversely affect our relationships with our customers and employees, any of which may adversely affect our business or results of operations. As a result, our financial condition may be affected, and we may become more susceptible to general economic conditions and competitive pressures.

Use of our common stock for future acquisitions or to raise capital may be dilutive to existing stockholders.

When we determine that appropriate strategic opportunities exist, we may acquire other financial institutions and related businesses, subject to applicable regulatory requirements. We may use our common stock for such acquisitions. We may also seek to raise capital through selling additional common stock, although we have not historically done so. It is possible that the issuance of additional common stock in such acquisition or capital transactions may be dilutive to the interests of our existing shareholders.

If we are unable to continue our historical levels of growth, we may not be able to maintain our historical earnings trends.

To achieve our past levels of growth, we have focused on both internal growth and acquisitions. We may not be able to sustain our historical rate of growth or may not be able to grow at all. Additionally, we may not be able to obtain the financing necessary to fund additional growth and may not be able to find suitable acquisition candidates. Various factors, such as economic conditions, competition and heightened regulatory scrutiny, may impede or prohibit the opening of new banking centers and the completion of acquisitions. Further, we may be unable to attract and retain experienced bankers, which could adversely affect our internal growth. If we are not able to continue our historical levels of growth, we may not be able to maintain our historical earnings trends.

Our accounting estimates and risk management processes rely on analytical and forecasting models.

The processes we use to estimate our allowance for loan losses and to measure the fair value of financial instruments, as well as the processes used to estimate the effects of changing interest rates depends upon the use of analytical and forecasting models. In addition, these models are used to calculate fair value of our assets and liabilities when we acquire other financial institutions. These models reflect assumptions that may not be accurate, particularly in times of market stress or other unforeseen circumstances. Even if these assumptions are adequate, the models may prove to be inadequate or inaccurate because of other flaws in their design or their implementation. If the models we use for interest rate risk and asset-liability management are inadequate, we may incur increased or unexpected losses upon changes in market interest rates or other market measures. If the models we use for determining our probable loan losses are inadequate, the allowance for loan losses may not be sufficient to support future charge-offs. If the models we use to measure the fair value financial instruments is inadequate, the fair value of such financial instruments may fluctuate unexpectedly or may not accurately reflect what we could realize upon sale or settlement of such financial instruments. Such failure in our analytical or forecasting models could have a material adverse effect on our business, financial condition and results of operations.

The value of our goodwill and other intangible assets may decline in the future.

As of December 31, 2018, we had $174.68 million of goodwill and other intangible assets. A significant decline in our financial condition, a significant adverse change in the business climate, slower growth rates or a significant and sustained decline in the price of our common stock may necessitate taking charges in the future related to the impairment of our goodwill and other intangible assets. If we were to conclude that a future write-down of goodwill and other intangible assets is necessary, we would record the appropriate charge, which could have a material adverse effect on our financial condition and results of operations.

We rely heavily on our management team, and the unexpected loss of key management or inability to recruit qualified personnel in the future may adversely affect our operations.

Our success to date has been strongly influenced by our ability to attract and to retain senior management experienced in banking in the markets we serve. Our ability to retain executive officers and the current management teams will continue to be important to the successful implementation of our strategies. We do not have employment agreements with these key employees other than executive agreements in the event of a change of control and a confidential information, non-solicitation and non-competition agreements related to our stock options. The unexpected loss of services of any key management personnel, or the inability to recruit and retain qualified personnel in the future, could have an adverse effect on our business and financial results. In addition, the scope and content of U.S. banking regulators policies on incentive compensation, as well as changes to these policies, could adversely affect our ability to hire, retain and motivate our key employees.

The Company s stock price can be volatile.

Stock price volatility may make it more difficult for our shareholders to resell their common stock when they want and at prices they find attractive. The Company s stock price can fluctuate significantly in response to a variety of factors including, among other things:

- actual or anticipated variations in quarterly results of operations;

recommendations by securities analysts;

operating and stock price performance of other companies that investors deem comparable to the Company;

new reports relating to trends, concerns and other issues in the financial services industry or Texas economy, including oil and gas and cattle prices;

perceptions in the marketplace regarding the Company and/or its competitors;

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new technology used, or services offered, by competitors;

significant acquisitions or business combinations involving the Company or its competitors; and

changes in government regulations, including tax laws.

General market fluctuations, industry factors and general economic and political conditions and events, such as economic slowdowns or recessions, interest rate changes or credit loss trends could also cause the Company s stock price to decrease regardless of operational results.

We may not continue to pay dividends on our common stock in the future.

Holders of our common stock are only entitled to receive such dividends as our board of directors may declare out of funds legally available for such payments. Although we have historically declared cash dividends on our common stock, we are not required to do so and may reduce or eliminate our common stock dividends in the future. This could adversely affect the market price of our common stock. Also, we are a bank holding company, and our ability to declare and pay dividends is dependent on certain federal regulatory considerations, including the guidelines of the Federal Reserve Board regarding capital adequacy and dividends.

Certain banking laws may have an anti-takeover effect.

Provisions of federal banking laws, including regulatory approval requirements, could make it more difficult for a third party to acquire us, even if doing so would be perceived to be beneficial to our shareholders. These provisions effectively inhibit a non-negotiated merger or other business combination, which, in turn, could adversely affect the market price of our common stock.

The trading volume in our common stock is less than other larger financial institutions.

Although the Company s common stock is listed for trading on the Nasdaq Global Select Market, the trading volume in our common stock is less than that of other, larger financial services companies although such volume has increased in recent years. A public trading market having the desired characteristics of depth, liquidity and orderliness depends on the presence in the marketplace of willing buyers and sellers of the Company s common stock at any given time. This presence depends on the individual decisions of investors and general economic and market conditions over which the Company has no control. Given the lower trading volume of the Company s common stock, significant sales of the Company s common stock, or the expectation of these sales, could cause the Company s stock price to fall.

Our stock ownership has shifted to larger institutional shareholders.

Our ownership base has shifted over the past several years whereby the ownership in larger investors and indexed funds is a much larger percentage of our stock ownership base as compared to shareholders located in our footprint. These larger shareholders could decide to sell their holdings in our common stock and as such could result in lower market prices of our stock.

Breakdowns in our internal controls and procedures could have an adverse effect on us.

We believe our internal control system as currently documented and functioning is adequate to provide reasonable assurance over our internal controls. Nevertheless, because of the inherent limitation in administering a cost effective control system, misstatements due to error or fraud may occur and not be detected. Breakdowns in our internal controls and procedures could occur in the future, and any such breakdowns could have an adverse effect on us. See Item 9A Controls and Procedures for additional information.

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Our operations rely on certain external vendors.

We rely on certain external vendors to provide products and services necessary to maintain our day-to-day operations. Accordingly, our operations are exposed to risk that these vendors will not perform in accordance with the contracted agreements under service level agreements. The failure of an external vendor to perform in accordance with the contracted arrangements under service level agreements, because of changes in the vendor s organizational structure, financial condition, support for existing products or services or strategic focus or for any other reason, could be disruptive to our operations, which could have a material adverse effect on our business and, in turn, our financial condition and results of operations.

We compete in an industry that continually experiences technological change, and we may have fewer resources than many of our competitors to continue to invest in technological improvements.

The financial services industry is undergoing rapid technological changes, with frequent introductions of new technology-driven products and services and new fintech companies. In addition to improving the ability to serve customers, the effective use of technology increases efficiency and enables financial institutions to reduce costs. Our future success will depend, in part, upon our ability to address the needs of our customers by using technology to provide products and services that will satisfy customer demands for conveniences, as well as to create additional efficiencies in our operations. Many of our larger competitors have substantially greater resources to invest in technological improvements. We may not be able to effectively implement new technology-driven products and services or be successful in marketing these products and services to our customers.

System failure or cybersecurity breaches of our network security could subject us to increased operating costs as well as litigation and other potential losses.

The computer systems and network infrastructure we use could be vulnerable to unforeseen hardware and cybersecurity issues, including hacking and identity theft. Our operations are dependent upon our ability to protect our computer equipment against damage from fire, power loss, telecommunications failure or a similar catastrophic event. Any damage or failure that causes an interruption in our operations could have an adverse effect on our financial condition and results of operations. In addition, our operations are dependent upon our ability to protect the computer systems and network infrastructure utilized by us, including our Internet banking activities, against damage from physical break-ins, cybersecurity breaches and other disruptive problems caused by the Internet or other users. Such computer break-ins and other disruptions would jeopardize the security of information stored in and transmitted through our computer systems and network infrastructure, which may result in significant liability to us, damage our reputation and inhibit current and potential customers from our Internet banking services. Each year, we add additional security measures to our computer systems and network infrastructure to mitigate the possibility of cybersecurity breaches including firewalls and penetration testing. We continue to investigate cost effective measures as well as insurance protection.

Furthermore, our customers could incorrectly blame the Company and terminate their accounts with the Company for a cyber-incident which occurred on their own system or with that of an unrelated third party. In addition, a security breach could also subject us to additional regulatory scrutiny and expose us to civil litigation and possible financial liability.

Our business may be adversely affected by security breaches at third parties.

Our customers interact with their own and other third party systems, which pose operational risks to us. We may be adversely affected by data breaches at retailers and other third parties who maintain data relating to our customers that involve the theft of customers data, including the theft of customers debit card, merchant credit card, wire transfer and other identifying and/or access information used to make purchases or payments at such retailers and to other third parties.

In the event of a data breach at one or more retailers of considerable magnitude, the Company s business, financial condition and results of operations may be adversely affected.

Our reputation and business could be damaged from negative publicity.

Reputation risk, or the risk to our earnings and capital from negative public opinion, is inherent in our business. Negative public opinion could adversely affect our ability to keep and attract customers and expose us to adverse legal and regulatory consequences. Negative public opinion could result from our actual or alleged conduct in any number of activities, including lending practices, corporate governance, regulatory compliance, mergers and acquisitions, sharing or inadequate protection of customer information, and from actions taken by government regulators and community organizations in response to that conduct. Negative public opinion could also result from adverse news or publicity that impairs the reputation of the financial services industry.

We are subject to claims and litigation pertaining to intellectual property.

We rely on technology companies to provide information technology products and services necessary to support our day-to-day operations. Technology companies frequently enter into litigation based on allegations of patent infringement or other violations of intellectual property rights. In addition, patent holding companies seek to monetize patents they have purchased or otherwise obtained. Competitors of our vendors, or other individuals or companies, have from time to time claimed to hold intellectual property sold to us by its vendors. Such claims may increase in the future as the financial services sector becomes more reliant on information technology vendors. The plaintiffs in these actions frequently seek injunctions and substantial damages.

Regardless of the scope or validity of such patents or other intellectual property rights, or the merits of any claims by potential or actual litigants, we may have to engage in litigation that could be expensive, time-consuming, disruptive to our operations, and distracting to management. If we are found to infringe one or more patents or other intellectual property rights, we may be required to pay substantial damages or royalties to a third-party. In certain cases, we may consider entering into licensing agreements for disputed intellectual property, although no assurance can be given that such licenses can be obtained on acceptable terms or that litigation will not occur. These licenses may also significantly increase our operating expenses. If legal matters related to intellectual property claims were resolved against us or settled, we could be required to make payments in amounts that could have a material adverse effect on our business, financial condition and results of operations.

An investment in our common stock is not an insured deposit.

Our common stock is not a bank deposit and, therefore, is not insured against loss by the FDIC, any other deposit insurance fund, or by any other public or private entity. Investment in our common stock is inherently risky for the reasons described in this Risk Factors section and elsewhere in this Report. As a result, if you acquire our common stock, you may lose some or all of your investment.

ITEM 1B. UNRESOLVED STAFF COMMENTS

None.

ITEM 2. PROPERTIES

Our principal office is located in the First Financial Bank Building at 400 Pine Street in downtown Abilene, Texas. We lease four spaces in buildings owned by First Financial Bank, National Association, Abilene totaling approximately 9,000 square feet. As of December 31, 2018, our subsidiaries collectively own 72 banking facilities, some of which are detached drive-ins, and also lease 13 banking facilities and 15 ATM locations. Our management considers all our existing locations to be well-suited for conducting the business of banking. We believe our existing facilities are adequate to meet our requirements and our subsidiaries requirements for the foreseeable future.

ITEM 3. LEGAL PROCEEDINGS

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

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ITEM 4. MINE SAFETY DISCLOSURES

Not applicable.

PART II

ITEM 5. MARKET FOR REGISTRANT S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

Market Information

Our common stock, par value $0.01 per share, is traded on the Nasdaq Global Select Market under the trading symbol FFIN. See Item 8 Financial Statements and Supplementary Data Quarterly Financial Data for the high, low and closing sales prices as reported by the Nasdaq Global Select Market for our common stock for the periods indicated.

Record Holders

As of February 1, 2019, we had 1,025 registered shareholders of record with our stock transfer agent.

Dividends

See Item 8 Financial Statements and Supplementary Data Quarterly Results of Operations for the frequency and amount of cash dividends paid by us. Also, see Item 1 Business Supervision and Regulation Payment of Dividends and Item 7 Management s Discussion and Analysis of the Financial Condition and Results of Operations Liquidity Dividends for restrictions on our present or future ability to pay dividends, particularly those restrictions arising under federal and state banking laws.

Equity Compensation Plans

See Item 12 Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters .

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PERFORMANCE GRAPH

The following performance graph compares cumulative total shareholder returns for our common stock, the Russell 3000 Index, and the SNL Bank Index, which is a banking index prepared by SNL Financial LC and is comprised of banks with $5 billion to $10 billion in total assets, for a five-year period (December 31, 2013 to December 31, 2018). The performance graph assumes $100 invested in our common stock at its closing price on December 31, 2013, and in each of the Russell 3000 Index and the SNL Bank Index on the same date. The performance graph also assumes the reinvestment of all dividends. The dates on the performance graph represent the last trading day of each year indicated. The amounts noted on the performance graph have been adjusted to give effect to all stock splits and stock dividends.

First Financial Bankshares, Inc.

	Period Ending					
Index	**12/31/13**	**12/31/14**	**12/31/15**	**12/31/16**	**12/31/17**	**12/31/18**
First Financial Bankshares, Inc.	100.00	92.04	94.84	144.96	147.06	191.13
Russell 3000	100.00	112.56	113.10	127.50	154.44	146.34
SNL Bank $5B-$10B Index	100.00	103.01	117.34	168.11	167.48	151.57

Source : SNL Financial, an offering of S&P Global Market Intelligence

www.snl.com

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ITEM 6. SELECTED FINANCIAL DATA

The selected financial data presented below as of and for the years ended December 31, 2018, 2017, 2016, 2015, and 2014, have been derived from our audited consolidated financial statements. The selected financial data should be read in conjunction with Item 7 Management s Discussion and Analysis of Financial Condition and Results of Operations and our consolidated financial statements and accompanying notes presented elsewhere in this Form 10-K. The results of operations presented below are not necessarily indicative of the results of operations that may be achieved in the future. Management s Discussion and Analysis of Financial Condition and Results of Operations incorporates information required to be disclosed by the SEC s Industry Guide 3, Statistical Disclosure by Bank Holding Companies.

	Year Ended December 31,				
	2018	**2017**	**2016**	**2015**	**2014**
	(dollars in thousands, except per share data)				
Summary Income Statement Information:					
Interest income	$ 291,690	$ 245,975	$ 232,288	$ 221,623	$ 198,539
Interest expense	18,930	9,288	5,451	4,088	4,181
Net interest income	272,760	236,687	226,837	217,535	194,358
Provision for loan losses	5,665	6,530	10,212	9,685	4,465
Noninterest income	101,764	91,017	85,132	73,432	66,624
Noninterest expense	190,684	173,986	165,830	149,464	137,925
Earnings before income taxes	178,175	147,188	135,927	131,818	118,592
Income tax expense	27,537	26,817	31,153	31,437	29,033
Net earnings	$ 150,638	$ 120,371	$ 104,774	$ 100,381	$ 89,559
Per Share Data:					
Earnings per share, basic	$ 2.23	$ 1.82	$ 1.59	$ 1.55	$ 1.40
Earnings per share, assuming dilution	2.22	1.81	1.59	1.54	1.39
Cash dividends declared	0.82	0.75	0.70	0.62	0.55
Book value at period-end	15.55	13.93	12.68	12.20	10.63
Earnings performance ratios:					
Return on average assets	1.98%	1.72%	1.59%	1.61%	1.65%
Return on average equity	15.37	13.63	12.36	13.60	14.00
Summary Balance Sheet Data (Period-end):					
Securities	$ 3,158,777	$ 3,087,473	$ 2,860,958	$ 2,734,177	$ 2,416,297
Loans	3,975,308	3,500,699	3,384,205	3,350,593	2,937,991
Total assets	7,731,854	7,254,715	6,809,931	6,665,070	5,848,202
Deposits	6,180,389	5,962,961	5,478,539	5,190,169	4,750,255
Total liabilities	6,678,559	6,331,947	5,972,046	5,860,084	5,166,665
Total shareholders equity	1,053,295	922,768	837,885	804,986	681,537
Asset quality ratios:					

Allowance for loan losses/period-end loans	1.29%	1.38%	1.35%	1.25%	1.25%
Nonperforming assets/period-end loans plus foreclosed assets	0.75	0.57	0.86	0.89	0.74
Net charge offs/average loans	0.07	0.12	0.19	0.15	0.06
Capital ratios:					
Average shareholders equity/average assets	12.89%	12.65%	12.85%	11.86%	11.78%
Leverage ratio (1)	11.85	11.09	10.71	9.96	9.89
Tier 1 risk-based capital (2)	19.47	18.66	17.30	15.90	16.05
Common equity tier 1 capital (3)	19.47	18.66	17.30	15.90	N/A
Total risk-based capital (4)	20.61	19.85	18.45	16.97	17.16
Dividend payout ratio	36.84	41.24	44.14	40.20	39.34

(1) Calculated by dividing at period-end, shareholders equity (before accumulated other comprehensive earnings/loss) less intangible assets by fourth quarter average assets less intangible assets.

(2) Calculated by dividing at period-end, shareholders equity (before accumulated other comprehensive earnings/loss) less intangible assets by risk-adjusted assets.

(3) Calculated by dividing at period-end, shareholders equity (before accumulated other comprehensive earnings/loss) less intangible assets by risk-adjusted assets.

(4) Calculated by dividing at period-end, shareholders equity (before accumulated other comprehensive earnings/loss) less intangible assets plus allowance for loan losses to the extent allowed under regulatory guidelines by risk-adjusted assets.

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ITEM 7. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion contains forward-looking statements that are subject to risks and uncertainties. Actual results may differ materially from those contemplated by the forward-looking statements as a result of certain factors, including but not limited to those listed in Item 1A Risk Factors and in the Cautionary Statement Regarding Forward-Looking Statements notice on page 1.

Introduction

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

The following discussion and analysis of the major elements of our consolidated balance sheets as of December 31, 2018 and 2017, and consolidated statements of earnings for the years 2016 through 2018 should be read in conjunction with our consolidated financial statements, accompanying notes, and selected financial data presented elsewhere in this Form 10-K.

Critical Accounting Policies

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

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

We deem our most critical accounting policies to be (1) our allowance for loan losses and our provision for loan losses and (2) our valuation of securities. We have other significant accounting policies and continue to evaluate the materiality of their impact on our consolidated financial statements, but we believe these other policies either do not generally require us to make estimates and judgments that are difficult or subjective, or it is less likely they would have a material impact on our reported results for a given period. A discussion of (1) our allowance for loan losses and our provision for loan losses and (2) our valuation of securities is included in Note 1 to our Consolidated Financial Statements beginning on page F-8.

Hurricane Harvey

Houston and the surrounding Gulf Coast region were significantly affected by Hurricane Harvey beginning in late August 2017 and continuing into the fourth quarter of 2017. Our Company has locations (i) north of Houston in Conroe, Willis, Tomball, Huntsville, Montgomery, Magnolia, New Waverly and Cut and Shoot and (ii) in Southeast Texas in Orange, Beaumont, Vidor, Newton, Mauriceville and Port Arthur. We continue to evaluate the effect of the hurricane on our branch facilities and our loan and investment portfolios. Our assessment of our physical buildings and equipment indicated damage primarily at our Mauriceville branch and amounts not covered by insurance were not significant. At December 31, 2018, we had loans totaling $474.42 million in our Conroe region and $405.79 million in the Southeast Texas/Orange region. We continue to evaluate these loans and the related collateral and business operations underlying such loans as we learn more information about the damage caused by the hurricane and the impact of such damage on our customers ability to repay loans in accordance with their contractual terms. Our tax exempt municipal bonds in the counties of Texas affected by the hurricane have also been evaluated, including insurance on the bonds. At December 31, 2018, our municipal bonds in these counties totaled $422.86 million, but only $109.36 million do not have bond insurance. Based on analysis of these bonds and the related municipality, at December 31, 2018, we do not believe we have any credit related losses other than temporary impairment.

Acquisition

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

Results of Operations

Performance Summary. Net earnings for 2018 were $150.64 million, an increase of $30.27 million, or 25.14%, over net earnings for 2017 of $120.37 million. Net earnings for 2016 were $104.77 million. The increases in net earnings for 2018 over 2017 were primarily attributable to the change in income tax rates and 2017 over 2016 were primarily attributable to growth in net interest income and noninterest income.

On a basic net earnings per share basis, net earnings were $2.23 for 2018, as compared to $1.82 for 2017 and $1.59 for 2016. The return on average assets was 1.98% for 2018, as compared to 1.72% for 2017 and 1.59% for 2016. The return on average equity was 15.37% for 2018, as compared to 13.63% for 2017 and 12.36% for 2016.

Net Interest Income. Net interest income is the difference between interest income on earning assets and interest expense on liabilities incurred to fund those assets. Our earning assets consist primarily of loans and investment securities. Our liabilities to fund those assets consist primarily of noninterest-bearing and interest-bearing deposits. Tax-equivalent net interest income was $281.75 million in 2018, as compared to $262.18 million in 2017 and $251.78 million in 2016. The increases in 2018 compared to 2017 were largely attributable to increases in the volume of earning assets offset by rate increases on our interest-bearing liabilities. Average earning assets were $7.12 billion in 2018, as compared to $6.54 billion in 2017 and $6.17 billion in 2016. Average earning assets increased $570.96 million in 2018, when compared to 2017, due primarily from increases in loans and taxable securities. Average earning assets increased $373.50 million in 2017, when compared to 2016, due primarily from increases in loans and taxable securities. Average interest bearing liabilities were $4.47 billion in 2018, as compared to $4.21 billion in 2017 and $4.02 billion in 2016. The yield on earning assets increased eight basis points in 2018, although this yield was negatively impacted from the change in income tax rate from 35% to 21% and the related effect on the tax-exempt investment securities. The rate paid on interest-bearing liabilities increased twenty basis points when compared to 2017. The yield on earning assets decreased two basis points in 2017, whereas the rate paid on interest-bearing liabilities increased eight basis points when compared to 2016.

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

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

	2018 Compared to 2017			2017 Compared to 2016		
	Change Attributable to		Total	Change Attributable to		Total
	Volume	Rate	Change	Volume	Rate	Change
Short-term investments	$ (636)	$ 583	$ (53)	$ 443	$ 899	$ 1,342
Taxable investment securities	10,082	7,145	17,227	3,464	1,735	5,199
Tax-exempt investment securities (1)	(10,184)	(10,433)	(20,617)	1,173	677	1,850
Loans (1) (2)	19,293	13,362	32,655	4,998	851	5,849
Interest income	18,555	10,657	29,212	10,078	4,162	14,240
Interest-bearing deposits	583	8,149	8,732	409	3,300	3,709
Short-term borrowings	(8)	917	909	(223)	351	128
Interest expense	575	9,066	9,641	186	3,651	3,837
Net interest income	$ 17,980	$ 1,591	$ 19,571	$ 9,892	$ 511	$ 10,403

(1) Computed on tax-equivalent basis assuming marginal tax rate of 21% for 2018 and 35% for 2017 and 2016.
(2) Non-accrual loans are included in loans.

The net interest margin in 2018 was 3.96%, a decrease of five basis points from 2017 which also decreased an additional seven basis points from 2016. The decrease in our net interest margin in 2018 from 2017 was primarily due to (i) the change in the income tax rate from 35% to 21% from the Tax Cuts and Jobs Act and its effect on our tax free municipal bonds and tax free loans and (ii) the result of the extended period of historically low levels of short-term interest rates, although rates have begun to increase in the past 24 months. We have been able to somewhat mitigate the impact of lower short-term interest rates by establishing minimum interest rates on certain of our loans, improving the pricing for loan risk, and minimizing rates paid on interest bearing liabilities. As rates have begun to increase, we are adjusting loan rates, upon maturities, and converting to variable rates when we are able. We have also begun increasing rates paid on our interest-bearing deposits. The Federal Reserve increased rates 100 basis points in 2018, 75 basis points in 2017 and 25 basis points in 2016 and continues to issue forward guidance plans to increase rates further.

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The net interest margin, which measures tax-equivalent net interest income as a percentage of average earning assets, is illustrated in Table 2 for the years 2016 through 2018.

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

	2018			2017			2016		
	Average Balance	Income/ Expense	Yield/ Rate	Average Balance	Income/ Expense	Yield/ Rate	Average Balance	Income/ Expense	Yield/ Rate
Assets									
Short-term investments (1)	$ 90,374	$ 1,631	1.80%	$ 144,464	$ 1,684	1.17%	$ 63,882	$ 342	0.54%
Taxable investment securities (2)	1,934,160	50,052	2.59	1,479,698	32,825	2.22	1,314,820	27,626	2.10
Tax-exempt investment securities (2)(3)	1,262,947	47,501	3.76	1,484,952	68,118	4.59	1,459,121	66,268	4.54
Loans (3)(4)	3,828,040	201,498	5.26	3,435,447	168,843	4.91	3,333,241	162,994	4.89
Total earning assets	7,115,521	$ 300,682	4.23%	6,544,561	$ 271,470	4.15%	6,171,064	$ 257,230	4.17%
Cash and due from banks	176,799			162,255			152,648		
Bank premises and equipment, net	129,715			123,595			120,538		
Other assets	62,595			56,007			55,694		
Goodwill and other intangible assets, net	172,425			142,473			143,986		
Allowance for loan losses	(50,323)			(47,380)			(44,811)		
Total assets	$ 7,606,732			$ 6,981,511			$ 6,599,119		
Liabilities and Shareholders Equity									
Interest-bearing deposits	$ 4,052,614	$ 16,945	0.42%	$ 3,783,960	$ 8,213	0.22%	$ 3,469,005	$ 4,504	0.13%
Short-term borrowings	418,977	1,984	0.47	422,285	1,075	0.25	552,041	947	0.17
Total interest-bearing liabilities	4,471,591	$ 18,929	0.42%	4,206,245	$ 9,288	0.22%	4,021,046	$ 5,451	0.14%
Noninterest-bearing deposits	2,124,004			1,843,973			1,666,598		
Other liabilities	30,931			48,480			63,609		

Total liabilities	6,626,526	6,098,698	5,751,253
Shareholders equity	980,206	882,813	847,866
Total liabilities and shareholders equity	$ 7,606,732	$ 6,981,511	$ 6,599,119
Net interest income	$ 281,753	$ 262,182	$ 251,779
Rate Analysis:			
Interest income/earning assets	4.23%	4.15%	4.17%
Interest expense/earning assets	0.27	0.14	0.09
Net yield on earning assets	3.96%	4.01%	4.08%

(1) Short-term investments are comprised of Fed Funds sold, interest bearing deposits in banks and interest bearing time deposits in banks.
(2) Average balances include unrealized gains and losses on available-for-sale securities.
(3) Computed on a tax-equivalent basis assuming a marginal tax rate of 21% for 2018 and 35% for 2017 and 2016.
(4) Nonaccrual loans are included in loans.

Noninterest Income. Noninterest income for 2018 was $101.76 million, an increase of $10.75 million, or 11.81%, as compared to 2017. Increases in certain categories of noninterest income included (1) trust fees of $4.49 million (2) ATM, interchange and credit card fees of $2.85 million and (3) service charges on deposit accounts of $2.25 million when compared to 2017. The increase in trust fees resulted from an increase in assets under management over the prior year and an increase in oil and gas production for the majority of 2018 that increased related to trust fees by $2.61 million over 2017. The fair value of our trust assets managed, which are not reflected in our consolidated balance sheets, totaled $5.60 billion at December 31, 2018, as compared to $5.13 billion at December 31, 2017. The increases in ATM, interchange and credit card fees increased due to continued growth in debit cards and the Kingwood acquisition. Service charges on deposit accounts increased primarily due to continued growth in net new accounts, product and pricing changes made to better align the Company s account offerings and the Kingwood acquisition. Offsetting these increases were decreases in interest on net recoveries of $190 thousand and gains on sale of available-for-sale securities of $474 thousand.

Noninterest income for 2017 was $91.02 million, an increase of $5.89 million, or 6.91%, as compared to 2016. Increases in certain categories of noninterest income included (1) trust fees of $4.06 million (2) ATM, interchange and credit card fees of $1.78 million and (3) service charges on deposit accounts of $1.03 million when compared to 2016. The increase in trust fees resulted from an increase in assets under management over the prior year and an increase in oil and gas production that increased related trust fees by $364 thousand over 2016. The fair value of our trust assets managed, which are not reflected in our consolidated balance sheets, totaled $5.13 billion at December 31, 2017, as compared to $4.37 billion at December 31, 2016. The increases in ATM, interchange and credit card fees and service charges on deposit accounts were primarily the result of increases in the number of net new accounts and debit cards. Offsetting these increases were decreases in net recoveries of $984 thousand and real estate mortgage fees of $977 thousand.

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

Table 3 Noninterest Income (in thousands):

	2018	Increase (Decrease)	2017	Increase (Decrease)	2016
Trust fees	$ 28,181	$ 4,487	$ 23,694	$ 4,058	$ 19,636
Service charges on deposit accounts	21,663	2,247	19,416	1,030	18,386
ATM, interchange and credit card fees	28,532	2,846	25,686	1,776	23,910
Real estate mortgage operations	15,157	48	15,109	(977)	16,086
Net gain on sale of available-for-sale securities	1,354	(474)	1,828	558	1,270
Net gain (loss) on sale of foreclosed assets	116	166	(50)	(506)	456
Net gain (loss) on sale of assets	(147)	249	(396)	(564)	168
Interest on loan recoveries	938	(190)	1,128	(984)	2,112
Other:					
Check printing fees	216	43	173	(17)	190
Safe deposit rental fees	544	15	529	(2)	531
Credit life and debt protection fees	741	124	617	(2)	619
Brokerage commissions	1,707	417	1,290	717	573
Miscellaneous income	2,762	769	1,993	798	1,195
Total other	5,970	1,368	4,602	1,494	3,108
Total Noninterest Income	$ 101,764	$ 10,747	$ 91,017	$ 5,885	$ 85,132

Noninterest Expense. Total noninterest expense for 2018 was $190.68 million, an increase of $16.70 million, or 9.60%, as compared to 2017. Noninterest expense for 2017 amounted to $173.99 million, an increase of $8.16 million, or 4.92%, as compared to 2016. An important measure in determining whether a financial institution effectively manages noninterest expenses is the efficiency ratio, which is calculated by dividing noninterest expense by the sum of net interest income on a tax-equivalent basis and noninterest income. Lower ratios indicate better efficiency since more income is generated with a lower noninterest expense total. Our efficiency ratio for 2018 was 49.72%, as compared to 49.26% for 2017 and 49.22% for 2016.

Salaries and employee benefits for 2018 totaled $105.19 million, an increase of $9.90 million, or 10.39%, as compared to 2017. The increase was primarily driven by (i) annual merit pay increases that were effective March 1, 2018, (ii) an increase in our profit sharing expenses, and (iii) increases in all categories from the Kingwood acquisition.

All other categories of noninterest expense for 2018 totaled $85.50 million, an increase of $6.80 million, or 8.64%, as compared to 2017. Included in noninterest expense in 2018 was $1.55 million, before income tax, resulting from the

Company s partial settlement of its frozen defined benefit pension plan. Other notable increases in noninterest expense include a $1.83 million increase in ATM, interchange and credit card expenses and a $652 thousand increase in net occupancy expense. In addition, included in other miscellaneous expense for 2018 were technology contract termination and conversion related costs totaling $1,747,000 related to the Kingwood acquisition.

Salaries and employee benefits for 2017 totaled $95.29 million, an increase of $4.55 million, or 5.01%, as compared to 2016. The increase was primarily driven by (i) annual merit pay increases that were effective March 1, 2017, (ii) an increase in our profit sharing expenses and (iii) an increase in stock option and stock grant expense due to the stock option grant in June 2017 and restricted stock grant in October 2017.

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All other categories of noninterest expense for 2017 totaled $78.70 million, an increase of $3.61 million, or 4.80%, as compared to 2016. The increase in noninterest expense was largely attributable to increases in software amortization and expense of $1.29 million from the write-off of internally developed software, operational and other losses of $1.02 million due to fraud and weather related losses and professional and service fees of $1.19 million. Offsetting these increases in 2017 were a decrease of $463 thousand in FDIC insurance due to the lower rate charged by the FDIC beginning in the third quarter of 2016.

Table 4 Noninterest Expense (in thousands):

	2018	Increase (Decrease)	2017	Increase (Decrease)	2016
Salaries	$ 79,474	$ 7,342	$ 72,132	$ 2,135	$ 69,997
Medical	8,699	114	8,585	(174)	8,759
Profit sharing	7,049	2,314	4,735	1,514	3,221
Pension	(178)	(305)	127	(232)	359
401(k) match expense	2,588	196	2,392	61	2,331
Payroll taxes	5,369	360	5,009	200	4,809
Stock option expense	1,508	(237)	1,745	863	882
Restricted stock expense	680	118	562	181	381
Total salaries and employee benefits	105,189	9,902	95,287	4,548	90,739
Loss from partial settlement of pension plan	1,546	1,546		(267)	267
Net occupancy expense	11,173	652	10,521	101	10,420
Equipment expense	13,841	76	13,765	286	13,479
FDIC insurance premiums	2,333	116	2,217	(463)	2,680
ATM, interchange and credit card expenses	9,282	1,830	7,452	221	7,231
Professional and service fees	8,894	831	8,063	1,186	6,877
Printing, stationery and supplies	1,997	8	1,989	(104)	2,093
Amortization of intangible assets	1,272	659	613	(125)	738
Other:					
Data processing fees	1,462	343	1,119	656	463
Postage	1,749	86	1,663	(1)	1,664
Advertising	3,603	88	3,515	(21)	3,536
Correspondent bank service charges	772	(96)	868	(96)	964
Telephone	3,562	454	3,108	(145)	3,253
Public relations and business development	3,061	242	2,819	71	2,748
Directors fees	1,745	192	1,553	233	1,320
Audit and accounting fees	1,625	(4)	1,629	(83)	1,712
Legal fees	1,148	(632)	1,780	(316)	2,096
Regulatory exam fees	1,275	98	1,177	46	1,131
Travel	1,465	255	1,210	(32)	1,242
Courier expense	830	(49)	879	31	848
Operational and other losses	2,188	(1,004)	3,192	1,022	2,170
Other real estate	129	(59)	188	6	182
Software amortization and expense	2,297	(998)	3,295	1,289	2,006
Other miscellaneous expense	8,246	2,162	6,084	113	5,971

Total other	35,157	1,078	34,079	2,773	31,306
Total Noninterest Expense	$ 190,684	$ 16,698	$ 173,986	$ 8,156	$ 165,830

Income Taxes. Income tax expense was $27.54 million for 2018, as compared to $26.82 million for 2017 and $31.15 million for 2016. Our effective tax rates on pretax income were 15.46%, 18.22% and 22.92%, respectively, for the years 2018, 2017 and 2016. The effective tax rates differ from the statutory federal tax rate of 21.0% in 2018 and 2017 and 35.0% in 2016 largely due to tax exempt interest income earned on certain investment securities and loans, the deductibility of dividends paid to our employee stock ownership plan and income tax deductions from the partial donation of two of our branch buildings to municipalities.

On December 22, 2017, the Tax Cuts and Jobs Act was signed into law with sweeping modifications to the Internal Revenue Service Code. The primary change for the Company was to lower the corporate income tax rate to 21% from 35%. The Company s deferred tax assets and liabilities were re-measured based on the income tax rates at which they are expected to reverse in the future, which is generally 21%. The provisional amount recorded related to the re-measurement of the Company s deferred tax balance was $7.65 million, a reduction of income tax expense for the year ended December 31, 2017. In 2018, the Company continued to analyze certain aspects of the Tax Cuts and Jobs Act resulting in refinement of the calculation and recorded an additional reduction in its deferred tax balance of $664 thousand, which represents a reduction of income tax expense for year ended December 31, 2018.

Balance Sheet Review

Loans. Our portfolio is comprised of loans made to businesses, professionals, individuals, and farm and ranch operations located in the primary trade areas served by our subsidiary bank. Real estate loans represent loans primarily for 1-4 family residences and commercial real estate, which are primarily owner-occupied. The structure of loans in the real estate mortgage area generally provides re-pricing intervals to minimize the interest rate risk inherent in long-term fixed rate loans. As of December 31, 2018, total loans held for investment were $3.95 billion, an increase of $468.07 million, as compared to December 31, 2017. As compared to year-end 2017, real estate loans increased $336.35 million, commercial loans increased $160.85 million, agricultural loans increased $2.13 million and consumer loans decreased $31.27 million. Loans averaged $3.83 billion during 2018, an increase of $392.59 million over the 2017 average balances.

Table 5 Composition of Loans (in thousands):

	December 31,				
	2018	2017	2016	2015	2014
Commercial	$ 844,953	$ 684,099	$ 674,410	$ 696,163	$ 639,954
Agricultural	96,677	94,543	84,021	102,351	105,694
Real estate	2,639,346	2,302,998	2,189,844	2,136,233	1,822,854
Consumer	372,660	403,929	409,032	382,303	360,686
Total loans held-for-investment	$ 3,953,636	$ 3,485,569	$ 3,357,307	$ 3,317,050	$ 2,929,188

As of December 31, 2018, our real estate loans represent approximately 66.76% of our loan portfolio and are comprised of (i) commercial real estate loans of 29.11%, generally owner occupied, (ii) 1-4 family residence loans of 42.32%, (iii) residential development and construction loans of 9.47%, which includes our custom and speculation home construction loans, (iv) commercial development and construction loans of 4.98% and (v) other loans, which includes ranches, hospitals and universities of 14.12%.

Loans held-for-sale, consisting of secondary market mortgage loans, totaled $21.67 million and $15.13 million at December 31, 2018 and 2017, respectively. At December 31, 2018, $2.49 million is valued at the lower of cost or fair value, and the remaining amount is valued under the fair value option. All amounts at December 31, 2017 were valued at the lower of cost or fair value.

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

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

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

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

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

Table 6 Maturity Distribution and Interest Sensitivity of Loans at December 31, 2018 (in thousands):

The following tables summarize maturity and repricing information for the commercial and agricultural and the real estate-construction portion of our loan portfolio as of December 31, 2018:

	One Year or less	After One Year Through Five Years	After Five Years	Total
Commercial and agricultural	$ 378,169	$ 296,735	$ 266,726	$ 941,630
Real estate - construction	201,081	70,327	205,271	476,679

	Maturities After One Year
Loans with fixed interest rates	$ 446,838
Loans with floating or adjustable interest rates	392,221

Asset Quality. Our loan portfolio is subject to periodic reviews by our centralized independent loan review group as well as periodic examinations by bank regulatory agencies. Loans are placed on nonaccrual status when, in the judgment of management, the collectability of principal or interest under the original terms becomes doubtful. Nonaccrual, past due 90 days or more and still accruing, and restructured loans plus foreclosed assets were $29.63 million at December 31, 2018, as compared to $20.12 million at December 31, 2017 and $29.00 million at December 31, 2016. As a percent of loans and foreclosed assets, these assets were 0.75% at December 31, 2018, as compared to 0.57% at December 31, 2017 and 0.86% at December 31, 2016. As a percent of total assets, these assets were 0.38% at December 31, 2018, as compared to 0.28% at December 31, 2017 and 0.43% at December 31, 2016.

We believe the level of these assets to be manageable and are not aware of any material classified credits not properly disclosed as nonperforming at December 31, 2018.

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Supplemental Oil and Gas Information. At December 31, 2018, the Company s exposure to the oil and gas industry was 2.86% of gross loans, or $113.54 million, compared to 1.72% of gross loans, or $60.16 million at December 31, 2017. The increase in 2018 was primarily a result of the Kingwood acquisition. These oil and gas loans consisted (based on collateral supporting the loan) of (i) development and production loans of 0.34%, (ii) oil and gas field servicing loans of 8.52%, (iii) real estate loans of 40.78%, (iv) accounts receivable and inventory of 2.50%, (v) automobile of 39.64% and (vi) other of 8.22%. These loans have experienced increased stress due to lower oil and gas prices although such prices improved in 2018. The Company instituted additional monitoring procedures for these loans and has classified, downgraded and charged-off loans as appropriate. The following oil and gas information is as of and for the years ended December 31, 2018 and 2017:

	December 31,	
	2018	**2017**
Oil and gas related loans	$ 113,536	$ 60,164
Oil and gas related loans as a % of total loans	2.86%	1.72%
Classified oil and gas related loans	$ 3,894	$ 20,346
Nonaccrual oil and gas related loans	1,048	1,414
Net charge-offs for oil and gas related loans		50
Allowance for oil and gas related loans as a % of oil and gas loans	3.23%	7.90%

Table 7 Nonaccrual, Past Due 90 Days or More and Still Accruing, Restructured Loans and Foreclosed Assets (in thousands, except percentages):

	At December 31,				
	2018	**2017**	**2016**	**2015**	**2014**
Nonaccrual loans*	$ 27,534	$ 17,670	$ 27,371	$ 28,601	$ 20,194
Loans still accruing and past due 90 days or more	1,008	288	284	341	261
Troubled debt restructured loans**	513	627	701	199	226
Nonperforming loans	29,055	18,585	28,356	29,141	20,681
Foreclosed assets	577	1,532	644	627	1,035
Total nonperforming assets	$ 29,632	$ 20,117	$ 29,000	$ 29,768	$ 21,716
As a % of loans and foreclosed assets	0.75%	0.57%	0.86%	0.89%	0.74%
As a % of total assets	0.38	0.28	0.43	0.45	0.37

* Includes $827 thousand, $618 thousand, $1.26 million, $2.18 million and $2.15 million, respectively, of purchased credit impaired loans as of December 31, 2018, 2017, 2016, 2015 and 2014.

** Troubled debt restructured loans of $3.84 million, $4.63 million, $6.86 million, $6.11 million and $9.07 million, respectively, whose interest collection, after considering economic and business conditions and collection efforts, is doubtful are included in non-accrual loans as of December 31, 2018, 2017, 2016, 2015 and 2014.

We record interest payments received on non-accrual loans as reductions of principal. Prior to the loans being placed on non-accrual, we recognized interest income on impaired loans as of December 31, 2018 of approximately $395 thousand during the year ended December 31, 2018. If interest on these impaired loans had been recognized on a full accrual basis during the year ended December 31, 2018, such income would have approximated $2.57 million.

See Note 3 to the Consolidated Financial Statements beginning on page F-18 for more information on these assets.

Provision and Allowance for Loan Losses. The allowance for loan losses is the amount we determine as of a specific date to be appropriate to absorb probable losses on existing loans in which full collectability is unlikely based on our review and evaluation of the loan portfolio. For a discussion of our methodology, see our accounting policies in Note 1 to the Consolidated Financial Statements beginning on page F-8. The provision for loan losses was $5.67 million in 2018, as compared to $6.53 million in 2017 and $10.21 million in 2016. The continued provision for loan losses in 2018 reflects the continued growth in the loan portfolio and the continued levels of gross charge-offs. As a percent of average loans, net loan charge-offs were 0.07% during 2018, 0.12% during 2017 and 0.19% during 2016. The allowance for loan losses as a percent of loans was 1.29% as of December 31, 2018, as compared to 1.38% as of December 31, 2017 and 1.35% as of December 31, 2016. Included in Tables 8 and 9 are further analysis of our allowance for loan losses.

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Although we believe we use the best information available to make loan loss allowance determinations, future adjustments could be necessary if circumstances or economic conditions differ substantially from the assumptions used in making our initial determinations. A downturn in the economy or lower employment could result in increased levels of nonaccrual, past due 90 days or more and still accruing, restructured loans, foreclosed assets, charge-offs, increased loan loss provisions and reductions in income. Additionally, as an integral part of their examination process, bank regulatory agencies periodically review the adequacy of our allowance for loan losses. The banking agencies could require additions to the loan loss allowance based on their judgment of information available to them at the time of their examinations of our bank subsidiary.

Table 8 Loan Loss Experience and Allowance for Loan Losses (in thousands, except percentages):

	2018	2017	2016	2015	2014
Balance at January 1,	$ 48,156	$ 45,779	$ 41,877	$ 36,824	$ 33,900
Charge-offs:					
Commercial	1,418	3,018	6,990	3,734	583
Agricultural		71	219	164	2
Real estate	1,479	1,215	682	441	1,075
Consumer	1,550	1,517	1,925	1,700	1,222
Total charge-offs	4,447	5,821	9,816	6,039	2,882
Recoveries:					
Commercial	839	942	952	344	346
Agricultural	15	33	25	55	18
Real estate	462	192	2,021	558	505
Consumer	512	501	508	450	472
Total recoveries	1,828	1,668	3,506	1,407	1,341
Net charge-offs	2,619	4,153	6,310	4,632	1,541
Provision for loan losses	5,665	6,530	10,212	9,685	4,465
Balance at December 31,	$ 51,202	$ 48,156	$ 45,779	$ 41,877	$ 36,824
Loans at year-end	$ 3,975,308	$ 3,500,699	$ 3,384,205	$ 3,350,593	$ 2,937,991
Average loans	3,828,040	3,435,447	3,333,241	3,090,538	2,786,011
Net charge-offs/average loans	0.07%	0.12%	0.19%	0.15%	0.06%
Allowance for loan losses/year-end loans*	1.29	1.38	1.35	1.25	1.25
Allowance for loan losses/nonaccrual, past due 90 days still accruing and restructured loans	176.22	259.11	161.44	143.70	178.06

* Reflects the impact of loans acquired in the Conroe acquisition in 2015 and the Kingwood acquisition in 2018, which were initially recorded at fair value with no allocated allowance for loan losses.

Table 9 Allocation of Allowance for Loan Losses (in thousands):

	At December 31,				
	2018 Allocation Amount	2017 Allocation Amount	2016 Allocation Amount	2015 Allocation Amount	2014 Allocation Amount
Commercial	$ 11,948	$ 10,865	$ 11,707	$ 12,644	$ 7,990
Agricultural	1,446	1,305	1,101	1,191	527
Real estate	32,342	29,896	26,864	24,375	26,657
Consumer	5,466	6,090	6,107	3,667	1,650
Total	$ 51,202	$ 48,156	$ 45,779	$ 41,877	$ 36,824

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Percent of Loans in Each Category of Total Loans:

	2018	2017	2016	2015	2014
Commercial	23.34%	19.63%	20.09%	20.99%	21.84%
Agricultural	2.82	2.71	2.50	3.09	3.61
Real estate	63.17	66.07	65.23	64.40	62.23
Consumer	10.67	11.59	12.18	11.52	12.32

Included in our loan portfolio are certain other loans not included in Table 7 that are deemed to be potential problem loans. Potential problem loans are those loans that are currently performing, but for which known information about trends, uncertainties or possible credit problems of the borrowers causes management to have serious doubts as to the ability of such borrowers to comply with present repayment terms, possibly resulting in the transfer of such loans to nonperforming status. These potential problem loans totaled $3.04 million as of December 31, 2018.

Interest-Bearing Deposits in Banks. The Company had interest-bearing deposits in banks of $42.27 million at December 31, 2018 and $164.22 million at December 31, 2017, respectively. At December 31, 2018, our interest-bearing deposits in banks included $40.17 million maintained at the Federal Reserve Bank of Dallas, $1.46 million invested in FDIC-insured certificates of deposit and $645 thousand on deposit with the Federal Home Loan Bank of Dallas (FHLB). The average balance of interest-bearing deposits in banks was $87.03 million $141.37 million and $58.25 million in 2018, 2017 and 2016, respectively. The average yield on interest-bearing deposits in banks was 1.79%, 1.17% and 0.55% in 2018, 2017 and 2016, respectively.

Available-for-Sale and Held-to-Maturity Securities. At December 31, 2018, securities with a fair value of $3.16 billion were classified as securities available-for-sale. There were no securities classified as held-to-maturity at December 31, 2018. As compared to December 31, 2017, the available-for-sale portfolio at December 31, 2018, reflected (1) an increase of $9.96 million in U.S. Treasury securities; (2) a decrease of $60.03 million in obligations of U.S. government sponsored enterprises and agencies; (3) a decrease of $162.98 million in obligations of states and political subdivisions; (4) a decrease of $6.66 million in corporate bonds and other; and (5) an increase of $291.01 million in mortgage-backed securities. As compared to December 31, 2016, the available-for-sale portfolio at December 31, 2017, reflected (1) a decrease of $10.67 million in U.S. Treasury securities; (2) a decrease of $53.37 million in obligations of U.S. government sponsored enterprises and agencies; (3) an decrease of $143.43 million in obligations of states and political subdivisions; (4) a decrease of $40.93 million in corporate bonds and other; and (5) an increase of $475.04 million in mortgage-backed securities. Securities-available-for-sale included fair value adjustments of $5.21 million, $44.86 million and $33.07 million at December 31, 2018, 2017 and 2016, respectively. We did not hold any collateralized mortgage obligations or structured notes as of December 31, 2018 that we consider to be high risk. Our mortgage related securities are backed by GNMA, FNMA or FHLMC or are collateralized by securities backed by these agencies.

See Table 10 and Note 2 to the Consolidated Financial Statements for additional disclosures relating to the maturities and fair values of the investment portfolio at December 31, 2018 and 2017.

Table 10 Maturities and Yields of Available-for-Sale Held at December 31, 2018 (in thousands, except percentages):

Maturing

	One Year or Less		After One Year Through Five Years		After Five Years Through Ten Years		After Ten Years		Total	
ble-for-Sale:	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Y
Treasury securities	$	%	$ 9,962	2.52%	$	%	$	%	$ 9,962	2
tions of U.S. government ered enterprises and agencies	301	1.83							301	1
tions of states and political isions	184,033	5.00	553,499	4.22	518,317	3.97	2,022	5.65	1,257,871	4
rate bonds and other securities	4,580	2.21	218	2.65					4,798	2
age-backed securities	26,749	2.17	1,119,800	2.51	727,640	3.06	11,656	3.01	1,885,845	2
	$ 215,663	4.59%	$ 1,683,479	3.07%	$ 1,245,957	3.44%	$ 13,678	3.40%	$ 3,158,777	3

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

As of December 31, 2018, the investment portfolio had an overall tax equivalent yield of 3.32%, a weighted average life of 4.37 years and modified duration of 3.88 years.

Deposits. Deposits held by our subsidiary bank represent our primary source of funding. Total deposits were $6.18 billion as of December 31, 2018 as compared to $5.96 billion as of December 31, 2017 and $5.48 billion as of December 31, 2016. Table 11 provides a breakdown of average deposits and rates paid over the past three years and the remaining maturity of time deposits of $100,000 or more:

Table 11 Composition of Average Deposits and Remaining Maturity of Time Deposits of $100,000 or More (in thousands, except percentages):

	2018		2017		2016	
	Average Balance	**Average Rate**	**Average Balance**	**Average Rate**	**Average Balance**	**Average Rate**
Noninterest-bearing deposits	$ 2,124,004		$ 1,843,973		$ 1,666,598	
Interest-bearing deposits						
Interest-bearing checking	2,025,810	0.53%	1,902,699	0.27%	1,713,498	0.12%
Savings and money market accounts	1,558,889	0.28	1,401,804	0.13	1,195,671	0.09
Time deposits under $100,000	204,929	0.25	267,754	0.13	237,419	0.18
Time deposits of $100,000 or more	262,987	0.48	211,703	0.40	322,417	0.31
Total interest-bearing deposits	4,052,615	0.42%	3,783,960	0.22%	3,469,005	0.13%
Total average deposits	$ 6,176,619		$ 5,627,933		$ 5,135,603	

	As of December 31, 2018
Three months or less	$ 88,404
Over three through six months	55,969
Over six through twelve months	68,808
Over twelve months	34,990
Total time deposits of $100,000 or more	$ 248,171

Borrowings. Included in borrowings were federal funds purchased, securities sold under repurchase agreements and advances from the FHLB of $468.71 million, $331.00 million and $445.77 million at December 31, 2018, 2017 and 2016, respectively. Securities sold under repurchase agreements are generally with significant customers of the Company that require short-term liquidity for their funds for which we pledge certain securities that have a fair value equal to at least the amount of the short-term borrowing. The average balances of federal funds purchased, securities sold under repurchase agreements and advances from the FHLB were $418.98 million, $422.29 million and $552.04 million in 2018, 2017 and 2016, respectively. The average rates paid on federal funds purchased, securities sold under repurchase agreements and advances from the FHLB were 0.47%, 0.25% and 0.17% for the years ended December 31, 2018, 2017 and 2016, respectively. The weighted average interest rate on federal funds purchased, securities sold under repurchase agreements and advances from the FHLB was 0.78%, 0.10% and 0.12% at December 31, 2018, 2017 and 2016, respectively. The highest amount of federal funds purchased, securities sold under repurchase agreements and advances from the FHLB at any month end during 2018, 2017 and 2016 was $529.64 million, $611.30 million and $598.77 million, respectively.

Capital Resources

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

Total shareholders equity was $1.05 billion, or 13.62% of total assets at December 31, 2018, as compared to $922.77 million, or 12.72% of total assets at December 31, 2017. During 2018, total shareholders equity averaged $980.21 million, or 12.89% of average assets, as compared to $882.81 million, or 12.65% of average assets during 2017.

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

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

As of December 31, 2018 and 2017, we had a total risk-based capital ratio of 20.61% and 19.85%, a Tier 1 capital to risk-weighted assets ratio of 19.47% and 18.66%, a common equity Tier 1 capital to risk-weighted ratio of 19.47% and 18.66% and a Tier 1 leverage ratio of 11.85% and 11.09%, respectively. The regulatory capital ratios as of December 31, 2018 and 2017 were calculated under Basel III rules. There is no threshold for well-capitalized status for bank holding companies.

We performed an assessment and believe the Company and Bank meet the requirements upon full implementation of the Basel III rules that will be effective in 2019.

Our subsidiary bank made the election to continue to exclude most accumulated other comprehensive income from capital in connection with its March 31, 2015 quarterly financial filing and, in effect, to retain the accumulated other comprehensive income treatment under the prior capital rules.

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

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

As of December 31, 2018, the model simulations projected that 100 and 200 basis point increases in interest rates would result in variances in net interest income of positive 1.68% and positive 2.96%, respectively, relative to the current financial statement structure over the next twelve months, while a decrease in interest rates of 100 basis points would result in a variance in a net interest income of negative 5.78% relative to the current financial statement structure over the next twelve months**.** We consider the likelihood of a decrease in interest rates beyond 100 basis points after December 31, 2018 remote given current interest rate levels. These are good faith estimates and assume that the composition of our interest sensitive assets and liabilities existing at each year-end will remain constant over the relevant twelve month measurement period and that changes in market interest rates are instantaneous and sustained across the yield curve regardless of duration of pricing characteristics on specific assets or liabilities. Also, this analysis does not contemplate any actions that we might undertake in response to changes in market interest rates. We believe these estimates are not necessarily indicative of what actually could occur in the event of immediate interest rate increases or decreases of this magnitude. As interest-bearing assets and liabilities re-price in different time frames and proportions to market interest rate movements, various assumptions must be made based on historical relationships of these variables in reaching any conclusion. Since these correlations are based on competitive and market conditions, we anticipate that our future results will likely be different from the foregoing estimates, and such differences could be material.

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

Liquidity

Liquidity is our ability to meet cash demands as they arise. Such needs can develop from loan demand, deposit withdrawals or acquisition opportunities. Potential obligations resulting from the issuance of standby letters of credit and commitments to fund future borrowings to our loan customers are other factors affecting our liquidity needs. Many of these obligations and commitments are expected to expire without being drawn upon; therefore the total commitment amounts do not necessarily represent future cash requirements affecting our liquidity position. The potential need for liquidity arising from these types of financial instruments is represented by the contractual notional amount of the instrument, as detailed in Tables 12 and 13. Asset liquidity is provided by cash and assets which are readily marketable or which will mature in the near future. Liquid assets include cash, federal funds sold, and short-term investments in time deposits in banks. Liquidity is also provided by access to funding sources, which include core depositors and correspondent banks that maintain accounts with and sell federal funds to our subsidiary bank. Other sources of funds include our ability to borrow from short-term sources, such as purchasing federal funds from correspondent banks, sales of securities under agreements to repurchase and advances from the FHLB, which amounted to $468.71 million at December 31, 2018, and an unfunded $25.00 million revolving line of credit established with Frost Bank, a nonaffiliated bank, which matures on June 30, 2019 (see next paragraph). Our subsidiary bank also has federal funds purchased lines of credit with two non-affiliated banks totaling $130.00 million. At December 31, 2018, there were no amounts drawn on these lines of credit. Our subsidiary bank also has available a line of credit with the FHLB totaling $1.23 billion at December 31, 2018, secured by portions of our loan portfolio and certain investment securities. At December 31, 2018, the Company had $55.00 million in advances outstanding under this line of credit.

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

In addition, we anticipate that any future acquisition of financial institutions, expansion of branch locations or offering of new products could also place a demand on our cash resources. Available cash and cash equivalents at the Company, which totaled $101.26 million at December 31, 2018, investment securities which totaled $6.28 million at December 31, 2018 with maturities over 10 to 12 years, available dividends from our subsidiaries which totaled $233.96 million at December 31, 2018, utilization of available lines of credit, and future debt or equity offerings are expected to be the source of funding for these potential acquisitions or expansions.

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Given the strong core deposit base and relatively low loan to deposit ratios maintained at our subsidiary bank, we consider our current liquidity position to be adequate to meet our short-term and long-term liquidity needs.

Table 12 Contractual Obligations as of December 31, 2018 (in thousands):

	Payment Due by Period				
	Total Amounts	Less than 1 year	More than 1 year but less than 3 years	More than 3 years but less than 5 years	Over 5 years
Deposits with stated maturity dates	$ 442,161	$ 373,359	$ 54,207	$ 14,541	$ 54
Pension obligation	4,613	837	706	731	2,339
Operating leases	1,275	610	633	32	
Outsourcing service contracts	2,858	2,201	657		
Total Contractual Obligations	$ 450,907	$ 377,007	$ 56,203	$ 15,304	$ 2,393

Amounts above for deposits do not include related accrued interest.

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

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

Unfunded lines of credit and commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. These commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. We evaluate each customer s creditworthiness on a case-by-case basis. The amount of collateral obtained, as we deem necessary upon extension of credit, is based on our credit evaluation of the counterparty. Collateral held varies but may include accounts receivable, inventory, property, plant, and equipment and income-producing commercial properties.

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

Table 13 Commitments as of December 31, 2018 (in thousands):

	Total Notional Amounts Committed	Less than 1 year	More than 1 year but less than 3 years	More than 3 years but less than 5 years	Over 5 years
Unfunded lines of credit	$ 632,667	$ 568,882	$ 25,927	$ 31,033	$ 6,825
Unfunded commitments to extend credit	301,616	193,416	8,270	18,755	81,175
Standby letters of credit	26,641	21,882	4,660	99	
Total Commercial Commitments	$ 960,924	$ 784,180	$ 38,857	$ 49,887	$ 88,000

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

Parent Company Funding. Our ability to fund various operating expenses, dividends, and cash acquisitions is generally dependent on our own earnings (without giving effect to our subsidiaries), cash reserves and funds derived from our subsidiaries. These funds historically have been produced by intercompany dividends and management fees that are limited to reimbursement of actual expenses. We anticipate that our recurring cash sources will continue to include dividends and management fees from our subsidiaries. At December 31, 2018, approximately $233.96 million was available for the payment of intercompany dividends by our subsidiaries without the prior approval of regulatory agencies. Our subsidiaries paid aggregate dividends to us of $74.10 million in 2018 and $30.80 million in 2017.

Dividends. Our long-term dividend policy is to pay cash dividends to our shareholders of approximately 40% of annual net earnings while maintaining adequate capital to support growth. We are also restricted by a loan covenant within our line of credit agreement with Frost Bank to dividend no greater than 55% of net income, as defined in such loan agreement. The cash dividend payout ratios have amounted to 36.84%, 41.24% and 44.14% of net earnings, respectively, in 2018, 2017 and 2016. Given our current capital position, projected earnings and asset growth rates, we do not anticipate any significant change in our current dividend policy.

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

To pay dividends, we and our subsidiary bank must maintain adequate capital above regulatory guidelines. In addition, if the applicable regulatory authority believes that a bank under its jurisdiction is engaged in or is about to engage in an unsafe or unsound practice (which, depending on the financial condition of the bank, could include the payment of dividends), the authority may require, after notice and hearing, that such bank cease and desist from the unsafe practice. The Federal Reserve, the FDIC and the OCC have each indicated that paying dividends that deplete a bank s capital base to an inadequate level would be an unsafe and unsound banking practice. The Federal Reserve, the OCC and the FDIC have issued policy statements that recommend that bank holding companies and insured banks should generally only pay dividends out of current operating earnings.

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Management considers interest rate risk to be a significant market risk for the Company. See Item 7 Management s Discussion and Analysis of Financial Condition and Results of Operations Capital Resources Interest Rate Risk for disclosure regarding this market risk.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

Our consolidated financial statements and the report of our independent registered public accounting firm begin on page F-1.

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Quarterly Results of Operations (in thousands, except per share and common stock data):

The following tables set forth certain unaudited historical quarterly financial data for each of the eight consecutive quarters in the fiscal years of 2018 and 2017. This information is derived from unaudited consolidated financial statements that include, in our opinion, all adjustments (consisting of normal recurring adjustments) necessary for a fair presentation when read in conjunction with our consolidated financial statements and notes thereto included elsewhere in this Form 10-K.

	2018			
	4th	3rd	2nd	1st
	(dollars in thousands, except per share amounts)			
Summary Income Statement Information:				
Interest income	$ 76,481	$ 74,049	$ 72,078	$ 69,082
Interest expense	6,207	4,623	4,467	3,633
Net interest income	70,274	69,426	67,611	65,449
Provision for loan losses	1,800	1,450	1,105	1,310
Net interest income after provision for loan losses	68,474	67,976	66,506	64,139
Noninterest income	24,789	26,997	25,421	23,202
Net gain on securities transactions	8	58	67	1,221
Noninterest expense	48,235	47,506	47,144	47,798
Earnings before income taxes	45,036	47,525	44,850	40,764
Income tax expense	6,599	7,475	7,217	6,245
Net earnings	$ 38,437	$ 40,050	$ 37,633	$ 34,519
Per Share Data:				
Earnings per share, basic	$ 0.57	$ 0.59	$ 0.56	$ 0.51
Earnings per share, assuming dilution	0.56	0.59	0.55	0.51
Cash dividends declared	0.21	0.21	0.21	0.19
Book value at period-end	15.55	14.71	14.57	14.34
Common stock sales price:				
High	$ 66.83	$ 61.86	$ 56.35	$ 49.60
Low	53.45	50.55	45.05	44.05
Close	57.69	59.10	50.90	46.30

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	2017			
	4th	3rd	2nd	1st
	(dollars in thousands, except per share amounts)			
Summary Income Statement Information:				
Interest income	$ 63,456	$ 62,554	$ 61,182	$ 58,783
Interest expense	2,562	2,866	2,097	1,763
Net interest income	60,894	59,688	59,085	57,020
Provision for loan losses	1,440	1,415	1,725	1,950
Net interest income after provision for loan losses	59,454	58,273	57,360	55,070
Noninterest income	22,298	23,185	22,423	21,283
Net gain on securities transactions	3	1,075	747	3
Noninterest expense	44,095	43,964	43,775	42,152
Earnings before income taxes	37,660	38,569	36,755	34,204
Income tax expense	1,517	9,195	8,500	7,605
Net earnings	$ 36,143	$ 29,374	$ 28,255	$ 26,599
Per Share Data:				
Earnings per share, basic	$ 0.55	$ 0.44	$ 0.43	$ 0.40
Earnings per share, assuming dilution	0.54	0.44	0.43	0.40
Cash dividends declared	0.19	0.19	0.19	0.18
Book value at period-end	13.93	13.69	13.41	12.99
Common stock sales price:				
High	$ 48.85	$ 46.00	$ 44.80	$ 46.45
Low	43.05	37.31	36.85	37.55
Close	45.05	45.20	44.20	40.10

ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

None.

ITEM 9A. CONTROLS AND PROCEDURES

As of December 31, 2018, we carried out an evaluation, under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, of the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rule 13a-15(e) or 15d-15(e) of the Securities Exchange Act of 1934). Our management, which includes our principal executive officer and our principal financial officer, does not expect that our disclosure controls and procedures will prevent all errors and all fraud.

A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within the Company have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty and that breakdowns can occur because of simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the control. The design of any system of controls also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions; over time, controls may become inadequate because of changes in conditions or the degree of compliance with the policies or procedures may deteriorate. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected. Our principal executive officer and principal financial officer have concluded, based on our evaluation of our disclosure controls and procedures, that our disclosure controls and procedures were effective at the reasonable assurance level as of December 31, 2018.

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

MANAGEMENT S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

The management of First Financial Bankshares, Inc. and subsidiaries is responsible for establishing and maintaining adequate internal control over financial reporting. First Financial Bankshares, Inc. and subsidiaries internal control system was designed to provide reasonable assurance to the Company s management and board of directors regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles.

All internal control systems, no matter how well designed, have inherent limitations. Therefore, even those systems determined to be effective can provide only reasonable assurance with respect to financial statement preparation and presentation.

First Financial Bankshares, Inc. and subsidiaries management assessed the effectiveness of the Company s internal control over financial reporting as of December 31, 2018. In making this assessment, it used the criteria for effective internal control over financial reporting set forth by the Committee of Sponsoring Organizations of the Treadway

Commission (2013 Framework) (COSO) in *Internal Control Integrated Framework*. Based on our assessment we believe that, as of December 31, 2018, the Company s internal control over financial reporting, as such term is defined in Rule 13a-15(f) of the Securities Exchange Act of 1934, is effective based on those criteria.

First Financial Bankshares, Inc. and subsidiaries independent auditors have issued an audit report, dated February 19, 2019, on the effectiveness of the Company s internal control over financial reporting as of December 31, 2018.

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Shareholders and the Board of Directors of First Financial Bankshares, Inc. and Subsidiaries

Opinion on Internal Control over Financial Reporting

We have audited First Financial Bankshares, Inc. and subsidiaries internal control over financial reporting as of December 31, 2018, based on criteria established in Internal Control Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (2013 framework) (the COSO criteria). In our opinion, First Financial Bankshares, Inc. and subsidiaries (the Company) maintained, in all material respects, effective internal control over financial reporting as of December 31, 2018, based on the COSO criteria.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States) (PCAOB), the consolidated balance sheets as of December 31, 2018 and 2017, and the related consolidated statements of earnings, comprehensive earnings, shareholders equity, and cash flows for each of the three years in the period ended December 31, 2018 and related notes and our report dated February 19, 2019 expressed an unqualified opinion thereon.

Basis for Opinion

The Company s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting included in the accompanying Management s Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on the Company s internal control over financial reporting based on our audit. We are a public accounting firm registered with the PCAOB and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audit in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects.

Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

Definition and Limitations of Internal Control over Financial Reporting

A company s internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company s internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company s assets that could have a material effect on the financial statements.

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Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness of future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

/s/ Ernst & Young LLP

Dallas, Texas

February 19, 2019

ITEM 9B. OTHER INFORMATION

None.

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PART III

ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE

The information required by Item 10 is hereby incorporated by reference from our proxy statement for our 2019 annual meeting of shareholders which will be filed with the SEC not later than 120 days after December 31, 2018.

ITEM 11. EXECUTIVE COMPENSATION

The information required by Item 11 is hereby incorporated by reference from our proxy statement for our 2019 annual meeting of shareholders which will be filed with the SEC not later than 120 days after December 31, 2018.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

The information required by Item 12 related to security ownership of certain beneficial owners and management is hereby incorporated by reference from our proxy statement for our 2019 annual meeting of shareholders. The following chart gives aggregate information under our equity compensation plans as of December 31, 2018.

	Number of Securities To be Issued Upon Exercise of Outstanding Options, Warrants and Rights	Weighted Average Exercise Price of Outstanding Options, Warrants and Rights	Number of Securities Remaining Available For Future Issuance Under Equity Compensation Plans (Excluding Securities Reflected in Far Left Column)
Equity compensation plans approved by security holders	1,085,543	$ 34.54	2,295,448
Equity compensation plans not approved by security holders			
Total	1,085,543	$ 34.54	2,295,448

The remainder of the information required by Item 12 is incorporated by reference from our proxy statement for our 2019 annual meeting of shareholders.

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE

The information required by Item 13 is hereby incorporated by reference from our proxy statement for our 2019 annual meeting of shareholders which will be filed with the SEC not later than 120 days after December 31, 2018.

ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES

The information required by Item 14 is hereby incorporated by reference from our proxy statement for our 2019 annual meeting of shareholders which will be filed with the SEC not later than 120 days after December 31, 2018.

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PART IV

ITEM 15. EXHIBITS, FINANCIAL STATEMENT SCHEDULES

(a) The following documents are filed as part of this report:

(1) Financial Statements:
Report of Independent Registered Public Accounting Firm

Consolidated Balance Sheets as of December 31, 2018 and 2017

Consolidated Statements of Earnings for the years ended December 31, 2018, 2017 and 2016

Consolidated Statements of Comprehensive Earnings for the years ended December 31, 2018, 2017 and 2016

Consolidated Statements of Shareholders Equity for the years ended December 31, 2018, 2017 and 2016

Consolidated Statements of Cash Flows for the years ended December 31, 2018, 2017 and 2016

Notes to Consolidated Financial Statements

(2) Financial Statement Schedules:
These schedules have been omitted because they are not required, are not applicable or have been included in our consolidated financial statements.

(3) Exhibits:
The information required by this Item 15(a)(3) is set forth in the Exhibit Index immediately following our signature pages. The exhibits listed herein will be furnished upon written request to J. Bruce Hildebrand, Executive Vice President, First Financial Bankshares, Inc., 400 Pine Street, Abilene, Texas 79601, and payment of a reasonable fee that will be limited to our reasonable expense in furnishing such exhibits.

Exhibits Index

The following exhibits are filed as part of this report:

2.1	Agreement and Plan of Reorganization, dated October 12, 2017, by and among First Financial Bankshares, Inc., Kingwood Merger Sub, Inc., and Commercial Bancshares, Inc. (schedules have been omitted pursuant to Item 601(b)(2) of Regulation S-K) (incorporated by reference from Exhibit 2.1 to Registrant s Form 8-K filed October 12, 2017).
3.1	Amended and Restated Certificate of Formation (incorporated by reference from Exhibit 3.1 of the Registrant s Form 8-K filed April 28, 2015).
3.2	Amended and Restated Bylaws of the Registrant (incorporated by reference from Exhibit 99.1 of the Registrant s Form 8-K filed January 24, 2012).
4.1	Specimen certificate of First Financial Common Stock (incorporated by reference from Exhibit 3 of the Registrant s Amendment No. 1 to Form 8-A filed on Form 8-A/A No. 1 on January 7, 1994).
10.1	2002 Incentive Stock Option Plan (incorporated by reference from Exhibit 10.3 of the Registrant s Form 10-Q filed May 4, 2010).++
10.2	2012 Incentive Stock Option Plan (incorporated by reference from Appendix A of the Registrant s Definitive Proxy Statement Pursuant to Section 14(a) of the Securities Exchange Act of 1934 filed March 1, 2012).++
10.3	Loan Agreement, dated June 30, 2013, between First Financial Bankshares, Inc. and Frost Bank (incorporated by reference from Exhibit 10.1 of the Registrant s Form 8-K filed July 1, 2013).
10.4	First Amendment to Loan Agreement, dated June 30, 2015, between First Financial Bankshares, Inc. and Frost Bank (incorporated by reference from Exhibit 10.1 of the Registrant s Form 8-K filed June 30, 2015).
10.5	Second Amendment to Loan Agreement, dated June 30, 2017, between First Financial Bankhares, Inc. and Frost Bank (incorporated by reference from Exhibit 10.1 of the Registrant s Form 8-K filed June 30, 2017).
10.6	2015 Restricted Stock Plan (incorporated by reference from Appendix A of the Registrant s Definitive Proxy Statement Pursuant to Section 14(a) of the Securities Exchange Act of 1934 filed March 2, 2015).++
10.7	Form of Executive Recognition Agreement (incorporated by reference from Exhibit 10.1 of the Registrant s Form 8-K filed June 29, 2018).++
21.1	Subsidiaries of Registrant.*
23.1	Consent of Ernst & Young LLP.*
24.1	Power of Attorney (included on signature page of this Form 10-K).*
31.1	Rule 13a-14(a) / 15(d)-14(a) Certification of Chief Executive Officer of First Financial Bankshares, Inc.*
31.2	Rule 13a-14(a) / 15(d)-14(a) Certification of Chief Financial Officer of First Financial Bankshares, Inc.*
32.1	Section 1350 Certification of Chief Executive Officer of First Financial Bankshares, Inc.+

32.2	Section 1350 Certification of Chief Financial Officer of First Financial Bankshares, Inc.+
101.INS	XBRL Instance Document.*
101.SCH	XBRL Taxonomy Extension Schema Document.*
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document.*
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document.*
101.LAB	XBRL Taxonomy Extension Label Linkbase Document.*
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document.*

* Filed herewith.

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

++ Management contract or compensatory plan on arrangement.

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

FIRST FINANCIAL BANKSHARES, INC.

Date: February 19, 2019

By: /s/ F. SCOTT DUESER
F. SCOTT DUESER
Chairman of the Board, Director, President and Chief Executive Officer
(Principal Executive Officer)

The undersigned directors and officers of First Financial Bankshares, Inc. hereby constitute and appoint J. Bruce Hildebrand, with full power to act and with full power of substitution and resubstitution, our true and lawful attorney-in-fact with full power to execute in our name and behalf in the capacities indicated below any and all amendments to this report and to file the same, with all exhibits thereto and other documents in connection therewith with the Securities and Exchange Commission and hereby ratify and confirm all that such attorney-in-fact or his substitute shall lawfully do or cause to be done by virtue hereof.

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

Name	Title	Date
/s/ F. SCOTT DUESER F. Scott Dueser	Chairman of the Board, Director, President, and Chief Executive Officer (Principal Executive Officer)	February 19, 2019
/s/ J. BRUCE HILDEBRAND J. Bruce Hildebrand	Executive Vice President and Chief Financial Officer (Principal Financial Officer and Principal Accounting Officer)	February 19, 2019
/s/ APRIL K. ANTHONY April K. Anthony	Director	February 19, 2019
/s/ TUCKER S. BRIDWELL	Director	February 19, 2019

Tucker S. Bridwell		
/s/ DAVID COPELAND	Director	February 19, 2019
David Copeland		
/s/ MURRAY EDWARDS	Director	February 19, 2019
Murray Edwards		

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Name	Title	Date
/s/ RON GIDDIENS Ron Giddiens	Director	February 19, 2019
/s/ TIM LANCASTER Tim Lancaster	Director	February 19, 2019
/s/ KADE L. MATTHEWS Kade L. Matthews	Director	February 19, 2019
/s/ ROSS H. SMITH, JR. Ross H. Smith, Jr.	Director	February 19, 2019
/s/ JOHNNY TROTTER Johnny Trotter	Director	February 19, 2019

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Shareholders and the Board of Directors of First Financial Bankshares, Inc. and Subsidiaries

Opinion on the Financial Statements

We have audited the accompanying consolidated balance sheets of First Financial Bankshares, Inc. and subsidiaries (the Company) as of December 31, 2018 and 2017, and the related consolidated statements of earnings, comprehensive earnings, shareholders equity and cash flows for each of the three years in the period ended December 31, 2018 and the related notes (collectively referred to as the consolidated financial statements). In our opinion, the consolidated financial statements present fairly, in all material respects, the financial position of the Company at December 31, 2018 and 2017, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2018, in conformity with U.S. generally accepted accounting principles.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States) (PCAOB), the Company s internal control over financial reporting as of December 31, 2018, based on criteria established in Internal Control Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (2013 framework) and our report dated February 19, 2019 expressed an unqualified opinion thereon.

Basis for Opinion

These financial statements are the responsibility of the Company s management. Our responsibility is to express an opinion on the Company s financial statements based on our audits. We are a public accounting firm registered with the PCAOB and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud. Our audits included performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures included examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements. We believe that our audits provide a reasonable basis for our opinion.

/s/ Ernst & Young LLP

We have served as the Company s auditor since 2002.

Dallas, Texas

February 19, 2019

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FIRST FINANCIAL BANKSHARES, INC. AND SUBSIDIARIES

Consolidated Balance Sheets

December 31, 2018 and 2017

(Dollars in thousands, except share and per share amounts)

	2018	2017
ASSETS		
CASH AND DUE FROM BANKS	$ 207,835	$ 209,583
INTEREST-BEARING DEPOSITS IN BANKS	40,812	162,764
Total cash and cash equivalents	248,647	372,347
INTEREST-BEARING TIME DEPOSITS IN BANKS	1,458	1,458
SECURITIES AVAILABLE-FOR-SALE, at fair value	3,158,777	3,087,473
LOANS:		
Held-for-investment	3,953,636	3,485,569
Less allowance for loan losses	(51,202)	(48,156)
Net loans held for investment	3,902,434	3,437,413
Held-for-sale ($19,185 at fair value at December 31, 2018; none at December 31, 2017)	21,672	15,130
Net loans	3,924,106	3,452,543
BANK PREMISES AND EQUIPMENT, net	133,421	124,026
INTANGIBLE ASSETS	174,683	141,143
OTHER ASSETS	90,762	75,725
Total assets	$ 7,731,854	$ 7,254,715
LIABILITIES AND SHAREHOLDERS EQUITY		
NONINTEREST-BEARING DEPOSITS	$ 2,116,107	$ 2,041,650
INTEREST-BEARING DEPOSITS	4,064,282	3,921,311
Total deposits	6,180,389	5,962,961
DIVIDENDS PAYABLE	14,227	12,589
BORROWINGS	468,706	331,000
OTHER LIABILITIES	15,237	25,397
Total liabilities	6,678,559	6,331,947
COMMITMENTS AND CONTINGENCIES		
SHAREHOLDERS EQUITY:		
Common stock - $0.01 par value; authorized 120,000,000 shares; 67,753,133 and 66,260,444 shares issued at December 31, 2018 and 2017, respectively	678	663

Capital surplus	443,114	378,062
Retained earnings	606,658	517,257
Treasury stock (shares at cost: 467,811 and 495,964 at December 31, 2018 and 2017, respectively)	(7,507)	(7,148)
Deferred Compensation	7,507	7,148
Accumulated other comprehensive earnings	2,845	26,786
Total shareholders equity	1,053,295	922,768
Total liabilities and shareholders equity	$ 7,731,854	$ 7,254,715

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

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FIRST FINANCIAL BANKSHARES, INC. AND SUBSIDIARIES

Consolidated Statement of Earnings

December 31, 2018, 2017 and 2016

(Dollars in thousands, except share and per share amounts)

	2018	2017	2016
INTEREST INCOME:			
Interest and fees on loans	$ 200,347	$ 166,807	$ 161,018
Interest on investment securities:			
Taxable	50,052	32,825	27,626
Exempt from federal income tax	39,661	44,659	43,302
Interest on federal funds sold and interest-bearing deposits in banks	1,630	1,684	342
Total interest income	291,690	245,975	232,288
INTEREST EXPENSE:			
Interest on deposits	16,946	8,213	4,503
Other	1,984	1,075	948
Total interest expense	18,930	9,288	5,451
Net interest income	272,760	236,687	226,837
PROVISION FOR LOAN LOSSES	5,665	6,530	10,212
Net interest income after provision for loan losses	267,095	230,157	216,625
NONINTEREST INCOME:			
Trust fees	28,181	23,694	19,636
Service charges on deposit accounts	21,663	19,416	18,386
ATM, interchange and credit card fees	28,532	25,686	23,910
Real estate mortgage operations	15,157	15,109	16,086
Net gain on sale of available-for-sale securities (includes $1,354, $1,828 and $1,270 for the years ended December 31, 2018, 2017 and 2016, respectively, related to accumulated comprehensive earnings reclassifications)	1,354	1,828	1,270
Net gain (loss) on sale of foreclosed assets	116	(50)	456
Net gain (loss) on sale of assets	(147)	(396)	168
Interest on loan recoveries	938	1,128	2,112
Other	5,970	4,602	3,108
Total noninterest income	101,764	91,017	85,132
NONINTEREST EXPENSE:			
Salaries and employee benefits	105,189	95,287	90,739

Loss from partial settlement of pension plan	1,546		267
Net occupancy expense	11,173	10,521	10,420
Equipment expense	13,841	13,765	13,479
FDIC insurance premiums	2,333	2,217	2,680
ATM, interchange and credit card expenses	9,282	7,452	7,231
Professional and service fees	8,894	8,063	6,877
Printing, stationery and supplies	1,997	1,989	2,093
Operational and other losses	2,188	3,192	2,170
Amortization of intangible assets	1,272	613	738
Other	32,969	30,887	29,136
Total noninterest expense	190,684	173,986	165,830
EARNINGS BEFORE INCOME TAXES	178,175	147,188	135,927
INCOME TAX EXPENSE (includes $284, $640 and $445 for the years ended December 31, 2018, 2017 and 2016, respectively, related to income tax expense from reclassification items)	27,537	26,817	31,153
NET EARNINGS	$ 150,638	$ 120,371	$ 104,774
NET EARNINGS PER SHARE, BASIC	$ 2.23	$ 1.82	$ 1.59
NET EARNINGS PER SHARE, ASSUMING DILUTION	$ 2.22	$ 1.81	$ 1.59

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

FIRST FINANCIAL BANKSHARES, INC. AND SUBSIDIARIES

Consolidated Statements of Comprehensive Earnings

Years Ended December 31, 2018, 2017 and 2016

(Dollars in thousands)

	2018	2017	2016
NET EARNINGS	$ 150,638	$ 120,371	$ 104,774
OTHER ITEMS OF COMPREHENSIVE EARNINGS (LOSS):			
Change in unrealized gain (loss) on investment securities available-for-sale, before income tax	(38,185)	23,266	(44,679)
Reclassification adjustment for realized losses (gains) on investment securities included in net earnings, before income tax	(1,354)	(1,828)	(1,270)
Minimum liability pension adjustment, before income tax	1,970	257	1,410
Total other items of comprehensive earnings (losses)	(37,569)	21,695	(44,539)
Income tax benefit (expense) related to:			
Investment securities	8,303	(13,774)	16,082
Minimum liability pension adjustment	(414)	420	(493)
Total income tax benefit (expense)	7,889	(13,354)	15,589
COMPREHENSIVE EARNINGS	$ 120,958	$ 128,712	$ 75,824

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

FIRST FINANCIAL BANKSHARES, INC. AND SUBSIDIARIES

Consolidated Statements of Shareholders Equity

Years Ended December 31, 2018, 2017 and 2016

(Dollars in thousands)

	Common Stock		Capital	Retained	Treasury Stock		Deferred	Accumulated Other Comprehensive Earnings	Total Shareholders
	Shares	Amount	Surplus	Earnings	Shares	Amounts	Compensation	(Losses)	Equity
BALANCE, December 31, 2015	65,990,234	$ 660	$ 368,925	$ 388,006	(520,651)	$ (6,296)	$ 6,296	$ 47,395	$ 804,986
Net earnings				104,774					104,774
Stock option exercises	82,871	1	1,259						1,260
Restricted Stock grant	21,590		809						809
Cash dividends declared, $0.70 per share				(46,246)					(46,246)
Minimum liability pension adjustment, net of related income taxes								917	917
Change in unrealized gain (loss) in investment securities available-for-sale, net of related income taxes								(29,867)	(29,867)
Additional tax benefit related to directors deferred compensation plan			370						370
Shares purchased in connection with directors deferred					13,242	(375)	375		

compensation plan, net									
Stock option expense			882						882
BALANCE, December 31, 2016	66,094,695	$ 661	$ 372,245	$ 446,534	(507,409)	$ (6,671)	$ 6,671	$ 18,445	$ 837,885
Net earnings				120,371					120,371
Stock option exercises	140,250	2	2,933						2,935
Restricted Stock grant	25,499		1,139						1,139
Cash dividends declared, $0.75 per share				(49,648)					(49,648)
Minimum liability pension adjustment, net of related income taxes								677	677
Change in unrealized gain (loss) in investment securities available-for-sale, net of related income taxes								7,664	7,664
Shares purchased (redeemed) in connection with directors deferred compensation plan, net					11,445	(477)	477		
Stock option expense			1,745						1,745
BALANCE, December 31, 2017	66,260,444	$ 663	$ 378,062	$ 517,257	(495,964)	$ (7,148)	$ 7,148	$ 26,786	$ 922,768

(Continued)

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FIRST FINANCIAL BANKSHARES, INC. AND SUBSIDIARIES

Consolidated Statements of Shareholders Equity

Years Ended December 31, 2018, 2017 and 2016

(Dollars in thousands)

Net earnings				150,638					150,638
Stock option exercises	173,822	2	3,861						3,863
Restricted stock grant, net	29,496		1,609						1,609
Cash dividends declared, $0.82 per share				(55,499)					(55,499)
Stock issued in acquisition of Commercial Bancshares, Inc.	1,289,371	13	58,074						58,087
Minimum liability pension adjustment, net of related income taxes								1,556	1,556
Change in unrealized gain (loss) in investment securities available-for-sale, net of related income taxes								(31,235)	(31,235)
Shares purchased (redeemed) in connection with directors deferred compensation plan, net					28,153	(359)	359		
Stock option expense			1,508						1,508
Reclassification of certain income tax effects related to the change in the U.S. statutory				(5,759)				5,759	

federal income tax rate under the Tax Cuts and Jobs Acts to retained earnings									
Reclassification of unrealized gain in equity securities at December 31, 2017 from accumulated other comprehensive earnings to retained earnings				21				(21)	
BALANCE, December 31, 2018	67,753,133	$678	$ 443,114	$ 606,658	(467,811)	$ (7,507)	$ 7,507	$ 2,845	$ 1,053,295

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

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FIRST FINANCIAL BANKSHARES, INC. AND SUBSIDIARIES

Consolidated Statements of Cash Flows

Years Ended December 31, 2018, 2017 and 2016

(Dollars in thousands)

	2018	2017	2016
CASH FLOWS FROM OPERATING ACTIVITIES:			
Net earnings	$ 150,638	$ 120,371	$ 104,774
Adjustments to reconcile net earnings to net cash provided by operating activities:			
Depreciation and amortization	12,549	12,916	11,573
Provision for loan losses	5,665	6,530	10,212
Securities premium amortization, net	27,467	30,310	29,005
Gain on sale of assets, net	(1,216)	(1,167)	(1,894)
Deferred federal income tax expense (benefit)	(250)	(53)	673
Change in loans held for sale	(5,791)	11,769	6,645
Change in other assets	(1,697)	9,313	2,397
Change in other liabilities	1,621	285	(2,643)
Total adjustments	38,348	69,903	55,968
Net cash provided by operating activities	188,986	190,274	160,742
CASH FLOWS FROM INVESTING ACTIVITIES:			
Cash received in acquisition of Commercial Bancshares, Inc., net	18,653		
Net decrease in interest-bearing time deposits in banks		249	1,788
Activity in available-for-sale securities:			
Sales	220,259	120,576	40,510
Maturities	3,439,028	4,392,131	3,509,113
Purchases	(3,731,821)	(4,768,420)	(3,737,865)
Activity in held-to-maturity securities maturities		124	157
Net increase in loans	(205,238)	(134,627)	(48,836)
Purchases of bank premises and equipment and other assets	(17,646)	(14,162)	(20,399)
Proceeds from sale of bank premises and equipment and other assets	844	6,085	3,572
Net cash used in investing activities	(275,921)	(398,044)	(251,960)
CASH FLOWS FROM FINANCING ACTIVITIES:			
Net increase (decrease) in noninterest-bearing deposits	(87,583)	323,928	(28,230)
Net increase (decrease) in interest-bearing deposits	(36,891)	160,494	316,600
Net increase (decrease) in borrowings	137,706	(114,770)	(169,905)

Common stock transactions:			
Proceeds from stock issuances	3,864	2,934	1,260
Dividends paid	(53,861)	(48,955)	(44,907)
Net cash provided by (used in) financing activities	(36,765)	323,631	74,818
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	(123,700)	115,861	(16,400)
CASH AND CASH EQUIVALENTS, beginning of year	372,347	256,486	272,886
CASH AND CASH EQUIVALENTS, end of year	$ 248,647	$ 372,347	$ 256,486

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

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FIRST FINANCIAL BANKSHARES, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

December 31, 2018, 2017 and 2016

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES:

Nature of Operations

First Financial Bankshares, Inc. (a Texas corporation) (Bankshares , Company , we or us) is a financial holding company which owns all of the capital stock of one bank with 73 locations located in Texas as of December 31, 2018. The subsidiary bank is First Financial Bank, National Association, Abilene, Texas. The bank s primary source of revenue is providing loans and banking services to consumers and commercial customers in the market area in which the subsidiary is located. In addition, the Company also owns First Financial Trust & Asset Management Company, National Association, First Financial Insurance Agency, Inc., and First Technology Services, Inc.

A summary of significant accounting policies of Bankshares and its subsidiaries applied in the preparation of the accompanying consolidated financial statements follows. The accounting principles followed by the Company and the methods of applying them are in conformity with both U.S. GAAP and prevailing practices of the banking industry.

The Company evaluated subsequent events for potential recognition through the date the consolidated financial statements were issued.

Use of Estimates in Preparation of Financial Statements

The preparation of financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. The Company s significant estimates include its allowance for loan losses and its valuation of financial instruments.

Consolidation

The accompanying consolidated financial statements include the accounts of Bankshares and its subsidiaries, all of which are wholly-owned. All significant intercompany accounts and transactions have been eliminated.

Stock Repurchase

On June 25, 2017, the Company s Board of Directors authorized the repurchase of up to 2,000,000 common shares through September 30, 2020. Previously, the Board of Directors had authorized the repurchase of up to 1,500,000 common shares through September 30, 2017. The stock buyback plan authorizes management to repurchase the stock at such time as repurchases are considered beneficial to stockholders. Any repurchase of stock will be made through the open market, block trades or in privately negotiated transactions in accordance with applicable laws and regulations. Under the repurchase plan, there is no minimum number of shares that the Company is required to repurchase. For the years ended December 31, 2018, 2017 and 2016, no shares were repurchased under this or the prior authorization that expired September 30, 2017.

Acquisition

On January 1, 2018, the Company acquired 100% of the outstanding capital stock of Commercial Bancshares, Inc. through the merger of a wholly-owned subsidiary with and into Commercial Bancshares, Inc. Following such merger, Commercial Bancshares, Inc. and its wholly-owned subsidiary, Commercial State Bank, Kingwood, Texas were merged into the Company and First Financial Bank, National Association, respectively. The results of operations of Commercial Bancshares, Inc. subsequent to the acquisition date, are include in the consolidated earnings of the Company. See Note 20 for additional information.

FIRST FINANCIAL BANKSHARES, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

December 31, 2018, 2017 and 2016

Investment Securities

Management classifies debt and equity securities as held-to-maturity, available-for-sale, or trading based on its intent. Debt securities that management has the positive intent and ability to hold to maturity are classified as held-to-maturity and recorded at cost, adjusted for amortization of premiums and accretion of discounts, which are recognized as adjustments to interest income using the interest method. Debt securities not classified as held-to-maturity or trading are classified as available-for-sale and recorded at fair value, with all unrealized gains and unrealized losses judged to be temporary, net of deferred income taxes, excluded from earnings and reported in the consolidated statements of comprehensive earnings. Available-for-sale debt securities that have unrealized gains and losses are excluded from earnings and reported net of tax in accumulated other comprehensive income until realized. Declines in the fair value of available-for-sale debt securities below their cost that are deemed to be other-than-temporary are reflected in earnings as a realized loss if there is no ability or intent to hold to recovery. If the Company does not intend to sell and will not be required to sell prior to recovery of its amortized cost basis, only the credit component of the impairment is reflected in earnings as a realized loss with the noncredit portion recognized in other comprehensive income. In estimating other-than-temporary impairment losses, we consider (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, and (3) our intent and ability to retain our investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value.

Effective January 1, 2018, in accordance with ASU 2016-01 (see note 1), increases or decreases in the fair value of equity securities are recorded in earnings. Prior to January 1, 2018, such increases or decreases were recorded similar to increases or decreases in debt securities.

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

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

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

Loans Held-for-Investment and Allowance for Loan Losses

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

FIRST FINANCIAL BANKSHARES, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

December 31, 2018, 2017 and 2016

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

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

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

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

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

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

FIRST FINANCIAL BANKSHARES, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

December 31, 2018, 2017 and 2016

The Company originates certain mortgage loans for sale in the secondary market. Accordingly, these loans are classified as held-for-sale and are carried at the lower of cost or fair value on an aggregate basis. The mortgage loan sales contracts contain indemnification clauses should the loans default, generally in the first three to six months, or if documentation is determined not to be in compliance with regulations. The Company s historic losses as a result of these indemnities have been insignificant.

Loans acquired, including loans acquired in a business combination, are initially recorded at fair value with no valuation allowance. Acquired loans are segregated between those considered to be credit impaired and those deemed performing. To make this determination, management considers such factors as past due status, non-accrual status and credit risk ratings. The fair value of acquired performing loans is determined by discounting expected cash flows, both principal and interest, at prevailing market interest rates. The difference between the fair value and principal balances at acquisition date, the fair value discount, is accreted into interest income over the estimated life of the acquired portfolio.

Purchased credit impaired loans are those loans that showed evidence of deterioration of credit quality since origination and for which it is probable, at acquisition, that the Company will be unable to collect all amounts contractually owed. Their acquisition fair value, which includes a credit component at the acquisition date, was based on the estimate of cash flows, both principal and interest, expected to be collected or estimated collateral values if cash flows are not estimable, discounted at prevailing market rates of interest. The difference between the discounted cash flows expected at acquisition and the investment in the loan is recognized as interest income on a level-yield method over the life of the loan, unless management was unable to reasonably forecast cash flows in which case the loans were placed on nonaccrual. Subsequent to the acquisition date, increases in expected cash flows will generally result in a recovery of any previously recorded allowance for loan loss, to the extent applicable, and/or a reclassification from the nonaccretable difference to accretable yield, which will be recognized prospectively. Decreases in expected cash flows subsequent to acquisition are recognized as impairment. Valuation allowances on these impaired loans reflect only losses incurred after the acquisition. The carrying amount of purchased credit impaired loans at December 31, 2018 and 2017 were $827,000 and $618,000, respectively, compared to a contractual balance of $1,157,000 and $1,865,000, respectively. Other purchased credit impaired loan disclosures were omitted due to immateriality.

Other Real Estate

Other real estate owned is foreclosed property held pending disposition and is initially recorded at fair value, less estimated costs to sell. At foreclosure, if the fair value of the real estate, less estimated costs to sell, is less than the Company s recorded investment in the related loan, a write-down is recognized through a charge to the allowance for loan losses. Any subsequent reduction in value is recognized by a charge to income. Operating and holding expenses of such properties, net of related income, and gains and losses on their disposition are included in net gain (loss) on sale of foreclosed assets as incurred.

Bank Premises and Equipment

Bank premises and equipment are stated at cost less accumulated depreciation and amortization. Depreciation and amortization are computed principally on a straight-line basis over the estimated useful lives of the related assets. Leasehold improvements are amortized over the life of the respective lease or the estimated useful lives of the improvements, whichever is shorter.

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Business Combinations, Goodwill and Other Intangible Assets

The Company accounts for all business combinations under the purchase method of accounting. Tangible and intangible assets and liabilities of the acquired entity are recorded at fair value. Intangible assets with finite useful lives represent the future benefit associated with the acquisition of the core deposits and are amortized over seven years, utilizing a method that approximates the expected attrition of the deposits. Goodwill with an indefinite life is not amortized, but rather tested annually for impairment as of June 30 each year and totaled $171,565,000 and $139,971,000, respectively at December 31, 2018 and 2017. There was no impairment recorded for the years ended December 31, 2018, 2017 and 2016.

The carrying amount of goodwill arising from acquisitions that qualify as an asset purchase for federal income tax purposes was $22,526,000 and $26,618,000 at December 31, 2018 and 2017, respectively, and is deductible for federal income tax purposes.

For the year ended December 31, 2017, the Company sold its mortgage servicing rights totaling $1,795,000 to an unrelated third party resulting in a loss on sale of approximately $215,000.

Securities Sold Under Agreements To Repurchase

Securities sold under agreements to repurchase, which are classified as borrowings, generally mature within one to four days from the transaction date. Securities sold under agreements to repurchase are reflected at the amount of the cash received in connection with the transaction. The Company may be required to provide additional collateral based on the estimated fair value of the underlying securities.

Segment Reporting

The Company has determined that its banking regions meet the aggregation criteria of the current authoritative accounting guidance since each of its banking regions offer similar products and services, operate in a similar manner, have similar customers and report to the same regulatory authority, and therefore operate one line of business (community banking) located in a single geographic area (Texas).

Statements of Cash Flows

For purposes of reporting cash flows, cash and cash equivalents includes cash on hand, amounts due from banks, including interest-bearing deposits in banks with original maturity of 90 days or less, and federal funds sold.

Accumulated Other Comprehensive Income (Loss)

Unrealized net gains on the Company s available-for-sale securities (after applicable income tax expense) totaling $4,169,000 and $29,156,000 at December 31, 2018 and 2017, respectively, and the minimum pension liability (after applicable income tax benefit) totaling ($1,324,000) and ($2,370,000) at December 31, 2018 and 2017, respectively, are included in accumulated other comprehensive income.

Income Taxes

The Company s provision for income taxes is based on income before income taxes adjusted for permanent differences between financial reporting and taxable income. Deferred tax assets and liabilities are determined using the liability (or balance sheet) method. Under this method, the net deferred tax asset or liability is determined based on the tax effects of the temporary differences between the book and tax bases of the various balance sheet assets and liabilities and gives current recognition to changes in tax rates and laws.

Stock Based Compensation

The Company grants stock options for a fixed number of shares to employees with an exercise price equal to the fair value of the shares at the grant date. The Company recorded stock option expense totaling $1,508,000, $1,745,000, and $882,000, for the years ended December 31, 2018, 2017 and 2016, respectively.

The Company also grants restricted stock for a fixed number of shares. The Company recorded expenses associated with its director and officer restricted stock grants totaling $560,000 and $680,000, respectively, for the year ended December 31, 2018, $483,000 and $562,000, respectively, for the year ended December 31, 2017, and $278,000 and $381,000, respectively, for the year ended December 31, 2016.

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See Note 17 for further information.

Advertising Costs

Advertising costs are expensed as incurred.

Per Share Data

Net earnings per share (EPS) are computed by dividing net earnings by the weighted average number of common stock shares outstanding during the period. The Company calculates dilutive EPS assuming all outstanding stock options to purchase common stock have been exercised at the beginning of the year (or the time of issuance, if later.) The dilutive effect of the outstanding options and restricted stock is reflected by application of the treasury stock method, whereby the proceeds from the exercised options and restricted stock are assumed to be used to purchase common stock at the average market price during the respective year. There were no such anti-dilutive stock options for the years ended December 31, 2018, 2017 and 2016. The following table reconciles the computation of basic EPS to dilutive EPS:

	Net Earnings (in thousands)	Weighted Average Shares	Per Share Amount
For the year ended December 31, 2018:			
Net earnings per share, basic	$ 150,638	67,609,367	$ 2.23
Effect of stock options and stock grants		373,647	(0.01)
Net earnings per share, assuming dilution	$ 150,638	67,983,014	$ 2.22
For the year ended December 31, 2017:			
Net earnings per share, basic	$ 120,371	66,126,863	$ 1.82
Effect of stock options and stock grants		197,467	(0.01)
Net earnings per share, assuming dilution	$ 120,371	66,324,330	$ 1.81
For the year ended December 31, 2016:			
Net earnings per share, basic	$ 104,774	66,013,004	$ 1.59
Effect of stock options and stock grants		89,882	
Net earnings per share, assuming dilution	$ 104,774	66,102,886	$ 1.59

Recently Issued Authoritative Accounting Guidance

Accounting Standards Update (ASU) 2014-09, Revenue from Contracts with Customers. ASU 2014-09 implements a comprehensive new revenue recognition standard that supersedes substantially all existing revenue recognition guidance. The new standard s core principle is that a company will recognize revenue when it transfers promised goods or services to customers in an amount that reflects the consideration to which the company expects to be entitled in exchange for those goods or services. To achieve that core principle, an entity applies the following steps: (i) identify the contract(s) with a customer, (ii) identify the performance obligations in the contract, (iii) determine the transaction price, (iv) allocate the transaction price to the performance obligations in the contract and (v) recognize revenue when (or as) the entity satisfies a performance obligation. ASU 2015-04 Revenue from Contracts with Customers Deferral of the Effective Date deferred the effective date of ASU 2014-09 by one year and as a result, the new standard became effective in the first quarter of 2018. The Company s revenue is comprised of net interest income on financial assets and financial liabilities, which is explicitly excluded from the scope of ASU 2014-09, and non-interest income. The adoption of the new standard in the first quarter of 2018 did not have a significant impact on the Company s financial statements and no adjustment to opening retained earnings was recorded.

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ASU 2016-01, ASU 2016-01 Financial Instruments Overall: Recognition and Measurement of Financial Assets and Financial Liabilities. ASU 2016-01, among other things, (i) requires equity investments, with certain exceptions, to be measured at fair value with changes in fair value recognized in net income, (ii) simplifies the impairment assessment of equity investments without readily determinable fair values by requiring a qualitative assessment to identify impairment, (iii) eliminates the requirement for public business entities to disclose the methods and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured at amortized cost on the balance sheet, (iv) requires public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes, (v) requires an entity to present separately in other comprehensive income the portion of the total change in the fair value of a liability resulting from a change in the instrument-specific credit risk when the entity has elected to measure the liability at fair value in accordance with the fair value option for financial instruments, (vi) requires separate presentation of financial assets and financial liabilities by measurement category and form of financial asset on the balance sheet or the accompanying notes to the financial statements and (vii) clarifies that an entity should evaluate the need for a valuation allowance on a deferred tax asset related to available-for-sale securities. ASU 2016-1 became effective for the Company on January 1, 2018 and did not have a significant impact on the Company s financial statements.

ASU 2016-02, Leases. ASU 2016-02 will amend current lease accounting to require lessees to recognize (i) a lease liability, which is a lessee s obligation to make lease payments arising from a lease, measured on a discounted basis, and (ii) a right-of-use asset, which is an asset that represents the lessee s right to use, or control the use of, a specified asset for the lease term. ASU 2016-02 does not significantly change lease accounting requirements applicable to lessors; however, certain changes were made to align, where necessary, lessor accounting with the lessee accounting model. The amended guidance will be effective in the first quarter of 2019 and will require transition using a modified retrospective approach for leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements. The Company evaluated the provision of the new lease standard and, due to the small dollar amounts and number of lease agreements, all considered operating leases, the effect for the Company on January 1, 2019 was not significant.

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

ASU 2016-13, Financial Instruments Credit Losses. ASU 2016-13 implements a comprehensive change in estimating the allowances for loan losses from the current model of losses inherent in the loan portfolio to a current expected credit loss model that generally is expected to result in earlier recognition of allowances for losses.

Additionally, purchase accounting rules have been modified as well as credit losses on held-to-maturity debt securities. ASU 2016-13 will be effective in the first quarter of 2020. While the Company generally expects that the implementation of ASU 2016-13 will increase their allowance for loan losses balance, the Company is continuing to evaluate the potential impact on the Company s financial statements.

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

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

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

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

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

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

2. INTEREST-BEARING TIME DEPOSITS IN BANKS AND SECURITIES:

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

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A summary of the Company s available-for-sale securities as of December 31, 2018 and 2017 are as follows (dollars in thousands):

	December 31, 2018			
	Amortized Cost Basis	Gross Unrealized Holding Gains	Gross Unrealized Holding Losses	Estimated Fair Value
Securities available-for-sale:				
U.S. Treasury securities	$ 9,970	$	$ (8)	$ 9,962
Obligations of U.S. government sponsored enterprises and agencies	301			301
Obligations of state and political subdivisions	1,229,828	30,013	(1,970)	1,257,871
Corporate bonds and other	4,875		(77)	4,798
Residential mortgage-backed securities	1,472,228	3,928	(21,611)	1,454,545
Commercial mortgage-backed securities	436,366	670	(5,736)	431,300
Total securities available-for-sale	$ 3,153,568	$ 34,611	$ (29,402)	$ 3,158,777

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

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

The amortized cost and estimated fair value of available-for-sale securities at December 31, 2018, by contractual and expected maturity, are shown below (in thousands):

	Amortized Cost Basis	Estimated Fair Value
Due within one year	$ 187,600	$ 188,914
Due after one year through five years	547,868	563,679
Due after five years through ten years	507,792	518,317
Due after ten years	1,714	2,022
Mortgage-backed securities	1,908,594	1,885,845
Total	$ 3,153,568	$ 3,158,777

The following tables disclose, as of December 31, 2018 and 2017, the Company s investment securities that have been in a continuous unrealized-loss position for less than 12 months and for 12 or more months (in thousands):

	Less than 12 Months		12 Months or Longer		Total	
December 31, 2018	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
U.S. Treasury securities	$ 9,962	$ 8	$	$	$ 9,962	$ 8
Obligations of U.S. government sponsored enterprises and agencies			301		301	
Obligations of state and political subdivisions	27,489	107	114,461	1,863	141,950	1,970
Corporate bonds and other	4,348	68	450	9	4,798	77
Residential mortgage-backed securities	119,584	483	922,289	21,128	1,041,873	21,611
Commercial mortgage-backed securities	1,994	5	343,015	5,731	345,009	5,736

Total	$ 163,377	$ 671	$ 1,380,516	$ 28,731	$ 1,543,893	$ 29,402

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

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The number of investments in an unrealized loss position totaled 366 at December 31, 2018. We do not believe these unrealized losses are other-than-temporary . 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. Additionally management does not (i) have the intent to sell our securities prior to recovery and/or maturity and, (ii) it is more likely than not that we will not have to sell our securities prior to recovery and/or maturity and (iii) that the length of time and extent that fair value has been less than cost is not indicative of recoverability. The unrealized losses noted are interest rate related due to the level of interest rates at December 31, 2018 compared to the time of purchase. We have reviewed the ratings of the issuers and have not identified any issues related to the ultimate repayment of principal as a result of credit concerns on these securities. Our mortgage related securities are backed by GNMA, FNMA and FHLMC or are collateralized by securities backed by these agencies. At December 31, 2018, 84.70% of our available-for-sale securities that are obligations of states and political subdivisions were issued within the State of Texas, of which 32.65% are guaranteed by the Texas Permanent School Fund.

Securities, carried at approximately $1,988,579,000 and $2,018,420,000 at December 31, 2018 and 2017, respectively, were pledged as collateral for public or trust fund deposits, repurchase agreements and for other purposes required or permitted by law.

During 2018, 2017 and 2016, sales of investment securities that were classified as available-for-sale totaled $220,259,000, $120,576,000 and $40,510,000. Gross realized gains from 2018, 2017 and 2016, securities sales were $1,847,000, $2,643,000 and $1,579,000, respectively. Gross realized losses from 2018, 2017 and 2016 securities sales were $493,000, $815,000 and $309,000, respectively. The specific identification method was used to determine cost in order to compute the realized gains and losses.

3. LOANS HELD FOR INVESTMENT AND ALLOWANCE FOR LOAN LOSSES:

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

	December 31,	
	2018	2017
Commercial	$ 844,953	$ 684,099
Agricultural	96,677	94,543
Real estate	2,639,346	2,302,998
Consumer	372,660	403,929
Total loans held-for-investment	$ 3,953,636	$ 3,485,569

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

	December 31,	
	2018	2017
Non-accrual loans*	$ 27,534	$ 17,670
Loans still accruing and past due 90 days or more	1,008	288
Troubled debt restructured loans**	513	627
Total	$ 29,055	$ 18,585

* Includes $827,000 and $618,000, respectively, of purchased credit impaired loans as of December 31, 2018 and 2017.

** Our troubled debt restructured loans of $3,840,000 and $4,629,000, whose interest collection, after considering economic and business conditions and collection efforts, is doubtful are included in non-accrual loans as of December 31, 2018 and 2017, respectively.

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

December 31, 2018		December 31, 2017	
Recorded Investment	Valuation Allowance	Recorded Investment	Valuation Allowance
$ 27,534	$ 4,069	$ 17,670	$ 3,996

The Company had $29,632,000 and $20,117,000 in non-accrual, past due 90 days or more and still accruing, restructured loans and foreclosed assets at December 31, 2018 and 2017, respectively. Non-accrual loans totaled $27,534,000 and $17,670,000 at December 31, 2018 and 2017, respectively, and consisted of the following amounts by type (dollars in thousands):

	December 31,	
	2018	2017
Commercial	$ 9,334	$ 3,612
Agricultural	759	134
Real Estate	16,714	12,838
Consumer	727	1,086
Total	$ 27,534	$ 17,670

No significant additional funds are committed to be advanced in connection with impaired loans as of December 31, 2018.

The Company s impaired loans and related allowance as of December 31, 2018 and 2017 are summarized in the following tables by class of financing receivables (in thousands). No interest income was recognized on impaired loans subsequent to their classification as impaired.

December 31, 2018	Unpaid Contractual Principal Balance	Recorded Investment With No Allowance*	Recorded Investment With Allowance	Total Recorded Investment	Related Allowance	12 Month Average Recorded Investment

Commercial	$ 10,808	$ 6,728	$ 2,606	$ 9,334	$ 1,133	$ 7,986
Agricultural	799	213	546	759	170	842
Real Estate	24,072	6,699	10,015	16,714	2,409	16,042
Consumer	935	101	626	727	357	914
Total	$ 36,614	$ 13,741	$ 13,793	$ 27,534	$ 4,069	$ 25,784

* Includes $827,000 of purchased credit impaired loans.

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

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

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The Company recognized interest income on impaired loans prior to being recognized as impaired of approximately $948,000, $624,000 and $829,000 during the years ended December 31, 2018, 2017 and 2016, respectively.

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

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

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

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

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

The following summarizes the Company s internal ratings of its loans held-for-investment by class of financing receivables and portfolio segments, which classes are the same, at December 31, 2018 and 2017 (in thousands):

December 31, 2018	Pass	Special Mention	Substandard	Doubtful	Total
Commercial	$ 804,584	$ 23,392	$ 16,977	$	$ 844,953
Agricultural	92,864	46	3,767		96,677

Real Estate	2,559,379	26,626	53,341		2,639,346
Consumer	370,510	315	1,835		372,660
Total	$ 3,827,337	$ 50,379	$ 75,920	$	$ 3,953,636

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

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At December 31, 2018 and 2017, the Company s past due loans are as follows (dollars in thousands):

December 31, 2018	15-59 Days Past Due*	60-89 Days Past Due	Greater Than 90 Days	Total Past Due	Total Current	Total Loans	Total 90 Days Past Due Still Accruing
Commercial	$ 3,546	$ 682	$ 677	$ 4,905	$ 840,048	$ 844,953	$
Agricultural	791	19	26	836	95,841	96,677	
Real Estate	13,185	881	2,020	16,086	2,623,260	2,639,346	960
Consumer	782	263	54	1,099	371,561	372,660	48
Total	$ 18,304	$ 1,845	$ 2,777	$ 22,926	$ 3,930,710	$ 3,953,636	$ 1,008

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

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

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

December 31, 2018	Commercial	Agricultural	Real Estate	Consumer	Total
Loans individually evaluated for impairment	$ 1,133	$ 170	$ 2,409	$ 357	$ 4,069
Loan collectively evaluated for impairment	10,815	1,276	29,933	5,109	47,133
Total	$ 11,948	$ 1,446	$ 32,342	$ 5,466	$ 51,202

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

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Changes in the allowance for loan losses for the years ended December 31, 2018 and 2017 are summarized as follows (in thousands):

December 31, 2018	Commercial	Agricultural	Real Estate	Consumer	Total
Beginning balance	$ 10,865	$ 1,305	$ 29,896	$ 6,090	$ 48,156
Provision for loan losses	1,662	126	3,463	414	5,665
Recoveries	839	15	462	512	1,828
Charge-offs	(1,418)		(1,479)	(1,550)	(4,447)
Ending balance	$ 11,948	$ 1,446	$ 32,342	$ 5,466	$ 51,202

December 31, 2017	Commercial	Agricultural	Real Estate	Consumer	Total
Beginning balance	$ 11,707	$ 1,101	$ 26,864	$ 6,107	$ 45,779
Provision for loan losses	1,233	243	4,055	999	6,530
Recoveries	943	32	192	501	1,668
Charge-offs	(3,018)	(71)	(1,215)	(1,517)	(5,821)
Ending balance	$ 10,865	$ 1,305	$ 29,896	$ 6,090	$ 48,156

The Company s recorded investment in loans as of December 31, 2018 and 2017 related to the balance in the allowance for loan losses on the basis of the Company s impairment methodology was as follows (in thousands). Purchased credit impaired loans of $827,000 and $618,000, respectively, at December 31, 2018 and 2017 are included in loans individually evaluated for impairment.

December 31, 2018	Commercial	Agricultural	Real Estate	Consumer	Total
Loans individually evaluated for impairment	$ 9,334	$ 759	$ 16,714	$ 727	$ 27,534
Loan collectively evaluated for impairment	835,619	95,918	2,622,632	371,933	3,926,102
Total	$ 844,953	$ 96,677	$ 2,639,346	$ 372,660	$ 3,953,636

December 31, 2017	Commercial	Agricultural	Real Estate	Consumer	Total
Loans individually evaluated for impairment	$ 3,612	$ 134	$ 12,838	$ 1,086	$ 17,670

Loan collectively evaluated for impairment	680,487	94,409	2,290,160	402,843	3,467,899
Total	$ 684,099	$ 94,543	$ 2,302,998	$ 403,929	$ 3,485,569

The Company s loans that were modified in the years ended December 31, 2018 and 2017, and considered troubled debt restructurings are as follows (dollars in thousands):

	Year Ended December 31, 2018			Year Ended December 31, 2017		
	Number	Pre-Modification Recorded Investment	Post-Modification Recorded Investment	Number	Pre-Modification Recorded Investment	Post-Modification Recorded Investment
Commercial	4	$ 864	$ 864	11	$ 895	$ 895
Agricultural	1	4	4			
Real Estate	5	643	643	5	625	625
Consumer	8	209	209	1	25	25
Total	18	$ 1,720	$ 1,720	17	$ 1,545	$ 1,545

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The balances below provide information as to how the loans were modified as troubled debt restructured loans during the years ended December 31, 2018 and 2017 (dollars in thousands):

	Year Ended December 31, 2018			Year Ended December 31, 2017		
	Adjusted Interest Rate	Extended Maturity	Combined Rate and Maturity	Adjusted Interest Rate	Extended Maturity	Combined Rate and Maturity
Commercial	$	$ 529	$ 335	$	$ 195	$ 700
Agricultural			4			
Real Estate		280	363		312	313
Consumer			209		25	
Total	$	$ 809	$ 911	$	$ 532	$ 1,013

During the years ended December 31, 2018 and 2017, certain loans were modified as a troubled debt restructured loans within the previous 12 months and for which there was a payment default. A default for purposes of this disclosure is a troubled debt restructured loan in which the borrower is 90 days past or more due or results in the foreclosure and repossession of the applicable collateral. The loans with payment default are as follows (dollars in thousands):

	Year Ended December 31, 2018		Year Ended December 31, 2017	
	Number	Balance	Number	Balance
Commercial	1	$ 491	2	$ 88
Agriculture				
Real Estate				
Consumer				
Total	1	$ 491	2	$ 88

As of December 31, 2018, the Company has no commitments to lend additional funds to loan customers whose terms have been modified in troubled debt restructurings.

An analysis of the changes in loans to officers, directors, principal shareholders, or associates of such persons for the year ended December 31, 2018 (determined as of each respective year-end) follows (dollars in thousands):

	Beginning Balance	Additional Loans	Payments	Ending Balance
Year ended December 31, 2018	$ 55,904	$ 55,678	$ 44,188	$ 67,394

In the opinion of management, those loans are on substantially the same terms, including interest rates and collateral requirements, as those prevailing at the time for comparable transactions with unaffiliated persons.

Our subsidiary bank has established a line of credit with the Federal Home Loan Bank of Dallas (FHLB) to provide liquidity and meet pledging requirements for those customers eligible to have securities pledged to secure certain uninsured deposits. At December 31, 2018, $2,495,150,000 in loans held by our bank subsidiary were subject to blanket liens as security for this line of credit. At December 31, 2018, there was $55,000,000 outstanding under this line of credit.

Note 4 Loans Held-for-Sale

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

Loans held for sale totaled $21,672,000 and $15,130,000 at December 31, 2018 and 2017, respectively. At December 31, 2018, $2,487,000 is valued at the lower of cost or fair value, and the remaining amount is valued under the fair value option. All of the amounts for December 31, 2017 were valued at the lower of cost or fair value. The change to the fair value option for loans held for sale was effective at June 30, 2018 and was done in conjunction with the Company s move to mandatory delivery in the secondary market and the purchase of forward mortgage-backed securities to manage the changes in fair value (see note 5 for additional information).

FIRST FINANCIAL BANKSHARES, INC. AND SUBSIDIARIES

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These loans, which are sold on a servicing released basis, are valued using a market approach by utilizing either: (i) the fair value of the securities backed by similar mortgage loans, adjusted for certain factors to approximate the fair value of a whole mortgage loan, including the value attributable to mortgage servicing and credit risk, (ii) current commitments to purchase loans or (iii) recent observable market trades for similar loans, adjusted for credit risk and other individual loan characteristics. As these prices are derived from market observable inputs, the Company classifies these valuations as Level 2 in the fair value disclosures (see note 10). Interest income on mortgage loans held for sale is recognized based on the contractual rates and reflected in interest income on loans in the consolidated statements of earnings. The Company has no continuing ownership in any of these residential mortgage loans sold.

Note 5 Derivative Financial Instruments

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

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

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

The fair values of IRLCs are based on current secondary market prices for underlying loans and estimated servicing value with similar coupons, maturity and credit quality, subject to the anticipated loan funding probability (pull-through rate). The fair value of IRLCs is subject to change primarily due to changes in interest rates and the estimated pull-through rate. These commitments are classified as Level 2 in the fair value disclosures (see note 10), as the valuations are based on observable market inputs.

Forward mortgage-backed securities contracts are exchange-traded or traded within highly active dealer markets. In order to determine the fair value of these instruments, the Company utilizes the exchange price or dealer market price for the particular derivative contract and these instruments are therefore classified as Level 2 in the fair value disclosures (see note 10). The estimated fair values are subject to change primarily due to changes in interest rates.

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

December 31, 2018:

	Outstanding Notional Balance	Asset Derivative Fair Value	Liability Derivative Fair Value
IRLCs	$ 37,088	$ 765	$
Forward mortgage-backed securities trades	45,500		403

December 31, 2017:	Outstanding Notional Balance	Asset Derivative Fair Value	Liability Derivative Fair Value
IRLCs	$ 37,589	$ 500	$

FIRST FINANCIAL BANKSHARES, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

December 31, 2018, 2017 and 2016

6. BANK PREMISES AND EQUIPMENT:

The following is a summary of bank premises and equipment (in thousands):

	Useful Life	December 31, 2018	December 31, 2017
Land		$ 31,190	$ 29,508
Buildings	20 to 40 years	135,335	119,728
Furniture and equipment	3 to 10 years	58,969	58,672
Leasehold improvements	Lesser of lease term or 5 to 15 years	3,557	4,118
		229,051	212,026
Less- accumulated depreciation and amortization		(95,630)	(88,000)
Total Bank Premises and Equipment		$ 133,421	$ 124,026

Depreciation expense for the years ended December 31, 2018, 2017 and 2016 amounted to $10,130,000, $9,810,000 and $9,390,000, respectively, and is included in the captions net occupancy expense and equipment expense in the accompanying consolidated statements of earnings.

The Company is lessor for portions of its banking premises. Total rental income for all leases included in net occupancy expense is approximately $2,682,000, $2,367,000 and $2,139,000, for the years ended December 31, 2018, 2017 and 2016, respectively.

During the years ended December 31, 2018, 2017 and 2016, the Company recorded gains (losses) on sale of the bank premises and equipment totaling ($147,000), ($396,000) and $168,000. In 2017, the Company sold its San Angelo main region branch building for $1,586,000 and recorded a gain of $210,000 and cancelled its San Angelo grocery store branch lease and recorded a write off of leasehold improvements of $360,000. In 2016, the Company sold its Weatherford and Orange main region branch building for $1,385,000 and $2,000,000 and recorded a gain of $560,000 and a loss of $31,000, respectively.

7. DEPOSITS AND BORROWINGS:

Time deposits of $250,000 or more totaled approximately $118,590,000 and $115,203,000 at December 31, 2018 and 2017, respectively.

At December 31, 2018, the scheduled maturities of time deposits (in thousands) were, as follows:

Year ending December 31,	
2019	$ 373,359
2020	42,801
2021	11,406
2022	8,066
2023	6,475
Thereafter	54
	$442,161

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Deposits received from related parties at December 31, 2018 and 2017 totaled $103,413,000 and $74,270,000, respectively.

Borrowings at December 31, 2018 and 2017 consisted of the following (dollars in thousands):

	December 31, 2018	December 31, 2017
Securities sold under agreements with customers to repurchase	$ 409,631	$ 320,450
Federal funds purchased	4,075	10,550
Advances from Federal Home Loan Bank of Dallas	55,000	
Total	$ 468,706	$ 331,000

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

At December 31, 2018, the Company had advances from the Federal Home Loan Bank of Dallas of $55,000,000 that will be repaid in 2019. The interest rate on this advance was 2.65% at December 31, 2018. There were no such advances outstanding at December 31, 2017.

8. LINE OF CREDIT:

The Company renewed its loan agreement, effective June 30, 2017, with Frost Bank. Under the loan agreement, as renewed and amended, we are permitted to draw up to $25,000,000 on a revolving line of credit. Prior to June 30, 2019, interest is paid quarterly at *The Wall Street Journal* Prime Rate and the line of credit matures June 30, 2019. If a balance exists at June 30, 2019, the principal balance converts to a term facility payable quarterly over five years and interest is paid quarterly at our election at *The Wall Street Journal* Prime Rate plus 50 basis points or LIBOR plus 250 basis points. The line of credit is unsecured. Among other provisions in the credit agreement, we must satisfy certain financial covenants during the term of the loan agreement, including, without limitation, covenants that require us to maintain certain capital, tangible net worth, loan loss reserve, non-performing asset and cash flow coverage ratios. In addition, the credit agreement contains certain operational covenants, which among others, restricts the payment of dividends above 55% of consolidated net income, limits the incurrence of debt (excluding any amounts acquired in an acquisition) and prohibits the disposal of assets except in the ordinary course of business. Since 1995, we have historically declared dividends as a percentage of our consolidated net income in a range of 37% (low) in 1995 to 53% (high) in 2003 and 2006. The Company was in compliance with the financial and operational covenants at December 31, 2018. There was no outstanding balance under the line of credit as of December 31, 2018 or 2017.

9. INCOME TAXES:

On December 22, 2017 the Tax Cuts and Jobs Act was signed into law with sweeping modifications to the Internal Revenue Code. The primary change for the Company was to lower the corporate income tax rate to 21% from 35%. The Company s deferred tax assets and liabilities were re-measured based on the income tax rates at which they are expected to reverse in the future, which is generally 21%. The provisional amount recorded related to the re-measurement of the Company s deferred tax balance was $7,650,000, a reduction of income tax expense for the year ended December 31, 2017. At December 31, 2018, final regulations for the Tax Cuts and Jobs Act are still pending; however, we made a reasonable estimate of the impact to our deferred tax balances based on the proposed regulations issued to date. During the year ended December 31, 2018, we filed our 2017 U.S. federal income tax return and updated our 2017 estimated tax benefit from $7,650,000 to $8,314,000. We will continue to assess our provision for income taxes as future guidance is issued, but do not currently anticipate significant revisions will be necessary.

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The Company files a consolidated federal income tax return. Income tax expense is comprised of the following (dollars in thousands):

	Year Ended December 31 ,		
	2018	2017	2016
Current federal income tax	$ 28,359	$ 34,421	$ 30,381
Current state income tax	92	99	99
Deferred federal income tax expense (benefit)	(250)	(53)	673
Restatement of net deferred tax liability due to change in income tax rate	(664)	(7,650)	
Income tax expense	$ 27,537	$ 26,817	$ 31,153

Income tax expense, as a percentage of pretax earnings, differs from the statutory federal income tax rate as follows:

	As a Percent of Pretax Earnings		
	2018	2017	2016
Statutory federal income tax rate	21.0%	35.0%	35.0%
Restatement of net deferred tax liability due to change in income tax rate	(0.4)	(5.3)	
Reductions in tax rate resulting from interest income exempt from federal income tax	(5.2)	(11.5)	(12.1)
Effect of state income tax	0.1	0.1	0.1
ESOP tax deduction	(0.1)	(0.2)	(0.2)
Other	0.1	0.1	0.1
Effective income tax rate	15.5%	18.2%	22.9%

The approximate effects of each type of difference that gave rise to the Company s deferred tax assets and liabilities at December 31, 2018 and 2017 are as follows (dollars in thousands):

	2018	2017
Deferred tax assets:		
Tax basis of loans in excess of financial statement basis	$ 12,010	$ 10,550

Minimum liability in defined benefit plan	352	766
Recognized for financial reporting purposes but not yet for tax purposes:		
Deferred compensation	2,056	1,818
Write-downs and adjustments to other real estate owned and repossessed assets	49	11
Other deferred tax assets	208	79
Total deferred tax assets	$ 14,675	$ 13,224
Deferred tax liabilities:		
Financial statement basis of fixed assets in excess of tax basis	$ 4,182	3,343
Intangible asset amortization deductible for tax purposes, but not for financial reporting purposes	11,263	9,926
Recognized for financial reporting purposes but not yet for tax purposes:		
Accretion on investment securities	745	1,039
Pension plan contributions	816	1,086
Net unrealized gain on investment securities available-for-sale	1,111	9,420
Other deferred tax liabilities	34	31
Total deferred tax liabilities	$ 18,151	$ 24,845
Net deferred tax asset (liability)	$ (3,476)	$ (11,621)

FIRST FINANCIAL BANKSHARES, INC. AND SUBSIDIARIES

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At December 31, 2018 and 2017, management believes that it is more likely than not that all of the deferred tax amounts shown above will be realized and therefore no valuation allowance was recorded.

Current authoritative accounting guidance prescribes a recognition threshold and a measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. Benefits from tax positions should be recognized in the financial statements only when it is more likely than not that the tax position will be sustained upon examination by the appropriate taxing authority that would have full knowledge of all relevant information. A tax position that meets the more-likely-than-not recognition threshold is measured at the largest amount of cumulative benefit that is greater than fifty percent likely of being realized upon ultimate settlement. Tax positions that previously failed to meet the more-likely-than-not recognition threshold should be recognized in the first subsequent financial reporting period in which that threshold is met. Previously recognized tax positions that no longer meet the more-likely-than-not recognition threshold should be derecognized in the first subsequent financial reporting period in which that threshold is no longer met. Current authoritative accounting guidance also provides guidance on the accounting for and disclosure of unrecognized tax benefits, interest and penalties. The Company concluded the tax benefits of positions taken and expected to be taken on its tax returns should be recognized in the financial statements under this guidance. The Company files income tax returns in the U.S. federal jurisdiction and state margin tax returns in the state of Texas. 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 2016. As of December 31, 2018 and 2017, the Company believes that there are no uncertain tax positions.

10. FAIR VALUE DISCLOSURES:

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

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

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Level 1 Inputs Unadjusted quoted prices in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date.

Level 2 Inputs Inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly or indirectly. These include quoted prices for similar assets or liabilities in active markets, quoted prices for identical or similar assets or liabilities in markets that are not active, inputs other than quoted prices that are observable for the asset or liability (for example, interest rates, volatilities, prepayment speeds, loss severities, credit risks and default rates) or inputs that are derived principally from or corroborated by observable market data by correlation or other means.

Level 3 Inputs Significant unobservable inputs that reflect an entity s own assumptions that market participants would use in pricing the assets or liabilities.

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

In general, fair value is based upon quoted market prices, where available. If such quoted market prices are not available, fair value is based upon internally developed models that primarily use, as inputs, observable market-based parameters. Valuation adjustments may be made to ensure that financial instruments are recorded at fair value. While management believes the Company s valuation methodologies are appropriate and consistent with other market participants, the use of different methodologies or assumptions to determine the fair value of certain financial instruments could result in a different estimate of fair value at the reporting date.

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

See notes 4 and 5 related to the determination of fair value for loans held-for-sale, IRLCs and forward mortgage-backed securities traded.

There were no transfers between Level 2 and Level 3 during the years ended December 31, 2018, 2017 and 2016.

The following table summarizes financial assets and financial liabilities measured at fair value on a recurring basis as of December 31, 2018 and 2017 segregated by the level of the valuation inputs within the fair value hierarchy utilized to measure fair value (in thousands):

December 31, 2018	Level 1 Inputs	Level 2 Inputs	Level 3 Inputs	Total Fair Value
Available-for-sale investment securities:				
U.S Treasury securities	$ 9,962	$	$	$ 9,962
Obligations of U. S. government sponsored enterprises and agencies		301		301
Obligations of state and political subdivisions		1,257,871		1,257,871
Corporate bonds		450		450
Residential mortgage-backed securities		1,454,545		1,454,545
Commercial mortgage-backed securities		431,300		431,300
Other securities	4,348			4,348
Total	$ 14,310	$ 3,144,467	$	$ 3,158,777
Loans held-for-sale	$	$ 19,185	$	$ 19,185
IRLCs	$	$ 765	$	$ 765
Forward mortgage-backed securities traded	$	$ 403	$	$ 403

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December 31, 2017	Level 1 Inputs	Level 2 Inputs	Level 3 Inputs	Total Fair Value
Available-for-sale investment securities:				
Obligations of U. S. government sponsored enterprises and agencies	$	$ 60,330	$	$ 60,330
Obligations of state and political subdivisions		1,420,850		1,420,850
Corporate bonds		7,031		7,031
Residential mortgage-backed securities		1,219,097		1,219,097
Commercial mortgage-backed securities		375,737		375,737
Other securities	4,428			4,428
Total	$ 4,428	$ 3,083,045	$	$ 3,087,473
IRLCs	$	$ 500	$	$ 500

Certain financial assets and financial liabilities are measured at fair value on a nonrecurring basis, that is, the instruments are not measured at fair value on an ongoing basis but are subject to fair value adjustments in certain circumstances (for example, when there is evidence of impairment). Financial assets and financial liabilities measured at fair value on a non-recurring basis include the following at December 31, 2018:

Impaired Loans   Impaired loans are reported at the fair value of the underlying collateral less selling costs if repayment is expected solely from the collateral. Collateral values are estimated using Level 2 inputs based on observable market data. At December 31, 2018, impaired loans with a carrying value of $13,793,000 were reduced by specific valuation reserves totaling $4,069,000 resulting in a net fair value of $9,724,000. The Company also had impaired loans of $13,741,000 with no specific valuation reserve at December 31, 2018, due to the loans carrying value generally being lower than the value of the collateral associated with the loan.

Loans Held-for-Sale   Loans held-for-sale are reported at the lower of cost or fair value. The Company originates conforming loans that are sold in the secondary market in which loan pricing is available. These loans are considered Level 2 of the fair value hierarchy. See note 4 related to the determination of fair value. At December 31, 2018, these loans were reported at $2,487,000 and had a fair value of $2,594,000.

Certain non-financial assets and non-financial liabilities measured at fair value on a non-recurring basis include other real estate owned, goodwill and other intangible assets and other non-financial long-lived assets. Non-financial assets measured at fair value on a non-recurring basis during the year ended December 31, 2018 and 2017 include other real estate owned which, subsequent to their initial transfer to other real estate owned from loans, were re-measured at fair value through a write-down included in gain (loss) on sale of foreclosed assets. During the reported periods, all fair value measurements for foreclosed assets utilized Level 2 inputs based on observable market data, generally third-party appraisals, or Level 3 inputs based on customized discounting criteria. These appraisals are evaluated individually and discounted as necessary due to the age of the appraisal, lack of comparable sales, expected holding periods of property or special use type of the property. Such discounts vary by appraisal based on the above factors but generally range from 5% to 25% of the appraised value. Reevaluation of other real estate owned is performed at least annually as required by regulatory guidelines or more often if particular circumstances arise. The following table presents other real estate owned that were re-measured subsequent to their initial transfer to other real estate owned (dollars in thousands):

	Year Ended December 31,	
	2018	2017
Carrying value of other real estate owned prior to re-measurement	$ 1,046	$ 1,067
Write-downs included in gain (loss) on sale of other real estate owned	(236)	(306)
Fair value	$ 810	$ 761

At December 31, 2018 and 2017, other real estate owned totaled $448,000 and $1,347,000, respectively.

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

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

In addition, reasonable comparability between financial institutions may not be likely due to the wide range of permitted valuation techniques and numerous estimates that must be made given the absence of active secondary markets for many of the financial instruments. This lack of uniform valuation methodologies also introduces a greater degree of subjectivity to these estimated fair values.

Cash and due from banks, federal funds sold, interest-bearing deposits and time deposits in banks and accrued interest receivable and payable are liquid in nature and considered Levels 1 or 2 of the fair value hierarchy.

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

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

The estimated fair values and carrying values of all financial instruments under current authoritative guidance at December 31, 2018 and 2017, were as follows (dollars in thousands):

	2018		2017		
	Carrying Value	Estimated Fair Value	Carrying Value	Estimated Fair Value	Fair Value Hierarchy
Cash and due from banks	$ 207,835	$ 207,835	$ 209,583	$ 209,583	Level 1
Interest-bearing deposits in banks	40,812	40,812	162,764	162,764	Level 1
Interest-bearing time deposits in banks	1,458	1,458	1,458	1,458	Level 2
Available-for-sale securities	3,158,777	3,158,777	3,087,473	3,087,473	Levels 1 and 2
Loans held-for-investment	3,902,434	3,947,391	3,437,413	3,455,003	Level 3
Loans held-for-sale	21,672	21,779	15,130	15,314	Level 2
Accrued interest receivable	36,765	36,765	36,081	36,081	Level 2
Deposits with stated maturities	442,161	441,727	451,255	452,000	Level 2
Deposits with no stated maturities	5,738,228	5,738,228	5,511,706	5,511,706	Level 1

Borrowings	468,706	468,706	331,000	331,000	Level 2
Accrued interest payable	408	408	197	197	Level 2
IRLCs	765	765	500	500	Level 2
Forward mortgage-backed securities traded	403	403			Level 2

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11. COMMITMENTS AND CONTINGENCIES:

The Company is engaged in legal actions arising from the normal course of business. In management s opinion, the Company has adequate legal defenses with respect to these actions, and as of December 31, 2018 the resolution of these matters is not expected to have material adverse effects upon the results of operations or financial condition of the Company.

The Company leases a portion of its bank premises and equipment under operating leases. At December 31, 2018, future minimum lease commitments were: 2019 $610,000, 2020 $409,000, 2021 $224,000, 2022 $27,000 and 2023 and thereafter $5,000.

12. FINANCIAL INSTRUMENTS WITH OFF-BALANCE-SHEET RISK:

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

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

	December 31, 2018 (in thousands)	
Financial instruments whose contract amounts represent credit risk:		
Unfunded lines of credit	$	632,667
Unfunded commitments to extend credit		301,616
Standby letters of credit		26,641
Total commercial commitments	$	960,924

Unfunded lines of credit and commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. These commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. We evaluate each customer s creditworthiness on a case-by-case basis. The amount of collateral obtained, as we deem necessary upon extension of credit, is based on our credit evaluation of the counterparty. Collateral held varies but may include accounts receivable, inventory, property, plant, and equipment and income-producing commercial properties.

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

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

13. CONCENTRATION OF CREDIT RISK:

The Company grants commercial, retail, agriculture and residential real estate loans to customers primarily in North Central, Southeastern and West Texas. Although the Company has a diversified loan portfolio, a substantial portion of its borrowers ability to honor their commitments is dependent upon each local economic sector. In addition, the Company holds mortgage related securities which are guaranteed by GNMA, FNMA or FHLMC or are collateralized by loans backed by these agencies.

14. PENSION AND PROFIT SHARING PLANS:

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

In December 2018, due to the rising interest rate environment, the Company determined it was in the best interest of its shareholders to settle its pension obligation to its retiree group in payout, approximately 53% of the pension benefit obligation on that date, and recorded a loss on settlement totaling $1,546,000 for the year ended December 31, 2018. In 2019, the Company began steps to terminate and settle the remaining obligation in its pension plan. Termination of the plan is expected to be in late 2019 but is subject to regulatory approval and changes in interest rates and, therefore there is no certainty that it will be consummated.

Using an actuarial measurement date of December 31, 2018 and 2017, benefit obligation activity and fair value of plan assets for the years ended December 31, 2018 and 2017, and a statement of the funded status as of December 31, 2018 and 2017, are as follows (dollars in thousands):

	2018	2017
Reconciliation of benefit obligations:		

Benefit obligation at January 1	$ 15,531	$ 15,453
Interest cost on projected benefit obligation	523	635
Actuarial (gain) loss	(811)	486
Benefits paid, including settlement of certain participant balances	(8,630)	(1,043)
Benefit obligation at December 31	$ 6,613	$ 15,531
Reconciliation of fair value of plan assets:		
Fair value of plan assets at January 1	$ 17,046	$ 15,787
Actual return on plan assets	365	2,302
Employer contributions		
Benefits paid, including settlement of certain participant balances	(8,630)	(1,043)
Fair value of plan assets at December 31	8,781	17,046
Funded status	$ 2,168	$ 1,515

Amounts recognized as a component of accumulated other comprehensive earnings as of year-end that have not been recognized as a component of the net period benefit cost of the Company s defined benefit pension plan are as follows (dollars in thousands):

	2018	2017
Net actuarial loss	$ (1,717)	$ (3,597)
Deferred tax benefit	393	1,227
Amounts included in accumulated other comprehensive earnings, net of tax	$ (1,324)	$ (2,370)

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Net periodic benefit cost for the years ended December 31, 2018, 2017 and 2016, are as follows (dollars in thousands):

	Year Ended December 31, 2018	2017	2016
Service cost benefits earned during the period	$	$	$
Interest cost on projected benefit obligation	523	635	665
Expected return on plan assets	(1,028)	(974)	(912)
Amortization of unrecognized net loss	186	249	375
Recognized loss on partial settlement of certain participant balances	1,546		267
Net periodic pension benefit expense (benefit)	$ 1,227	$ (90)	$ 395

The following table sets forth the rates used in the actuarial calculations of the present value of benefit obligations and net periodic pension cost and the rate of return on plan assets:

	2018	2017	2016
Weighted average discount rate	4.25%	3.50%	4.25%
Expected long-term rate of return on assets	6.25%	6.25%	6.25%

The weighted average discount rate is estimated based on setting a discount rate to establish an obligation for pension benefits equivalent to an amount that, if invested in high quality fixed income securities, would produce a return that matches the expected benefit payment stream. The expected long-term rate of return on plan assets is based on historical returns and expectations of future returns based on asset mix, after consultation with our investment advisors and actuaries.

The major type of plan assets in the pension plan and the targeted allocation percentage as of December 31, 2018 and 2017 is as follows:

	December 31, 2018 Allocation	December 31, 2017 Allocation	Targeted Allocation
Equity securities	72%	75%	75%
Debt securities	27%	24%	25%
Cash and equivalents	1%	1%	

The range and weighted average final maturities of debt securities held in the pension plan as of December 31, 2018 are 2.54 to 18.76 years and approximately 6.91 years, respectively. Assets held in the pension plan are considered either Level 1 consisting of the money market funds, publicly traded common stocks and publically traded mutual funds or Level 2 consisting of obligations of state and political subdivisions, corporate bonds and mortgage-backed securities. There were no Level 3 securities. See note 10 for a discussion of the fair value hierarchy. The breakdown by level is as follows (dollars in thousands):

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	Level 1 Inputs	Level 2 Inputs	Level 3 Inputs	Total Fair Value
Money market fund	$ 87	$	$	$ 87
Obligations of state and political subdivisions		208		208
Corporate bonds		449		449
Mortgage-backed securities		901		901
Corporate stocks and mutual funds	7,136			7,136
Total	$ 7,223	$ 1,558	$	$ 8,781

First Financial Trust & Asset Management Company, National Association, a wholly owned subsidiary of the Company, manages the pension plan assets as well as the profit sharing plan assets (see below). The investment strategy and targeted allocations are based on similar strategies First Financial Trust & Asset Management Company, National Association employs for most of its managed accounts whereby appropriate diversification is achieved. First Financial Trust & Asset Management Company, National Association is prohibited from holding investments deemed to be high risk by the Office of the Comptroller of the Currency.

An estimate of the undiscounted projected future payments to eligible participants for the next five years and the following five years in the aggregate is as follows (dollars in thousands):

Year Ending December 31,	
2019	$ 837
2020	$ 318
2021	$ 388
2022	$ 398
2023	$ 333
2024 forward	$ 2,339

As of December 31, 2018 and 2017, the pension plan s total assets included First Financial Bankshares, Inc. common stock valued at approximately $3,373,000 and $2,776,000, respectively.

The Company also provides a profit sharing plan, which covers substantially all full-time employees. The profit sharing plan is a defined contribution plan and allows employees to contribute a percentage of their base annual salary. Employees are fully vested to the extent of their contributions and become fully vested in the Company s contributions over a six-year vesting period. Costs related to the Company s defined contribution plan totaled approximately $7,049,000, $4,735,000 and $3,221,000 in 2018, 2017 and 2016, respectively, and are included in salaries and employee benefits in the accompanying consolidated statements of earnings. As of December 31, 2018 and 2017, the profit sharing plan s assets included First Financial Bankshares, Inc. common stock valued at approximately $68,855,000 and $55,796,000, respectively.

In 2004, after freezing our pension plan, we added a safe harbor match to the 401(k) plan. We match a maximum of 4% on employee deferrals of 5% of their employee compensation. Total expense for this matching in 2018, 2017 and 2016 was $2,588,000, $2,392,000 and $2,331,000, respectively, and is included in salaries and employee benefits in the statements of earnings.

The Company has a directors deferred compensation plan whereby the directors may elect to defer up to 100% of their directors fees. All deferred compensation is invested in the Company s common stock held in a rabbi trust. The stock is held in nominee name of the trustee, and the principal and earnings of the trust are held separate and apart from other funds of the Company, and are used exclusively for the uses and purposes of the deferred compensation agreement. The accounts of the trust have been consolidated in the financial statements of the Company.

15. DIVIDENDS FROM SUBSIDIARIES:

At December 31, 2018, approximately $233,956,000 was available for the declaration of dividends by the Company s subsidiaries without the prior approval of regulatory agencies.

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16. REGULATORY MATTERS:

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

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

As of December 31, 2018 and 2017, we had a total risk-based capital ratio of 20.61% and 19.85%, a Tier 1 capital to risk-weighted assets ratio of 19.47% and 18.66%; a common equity Tier 1 capital to risk-weighted assets ratio of 19.47% and 18.66%, and a Tier 1 leverage ratio of 11.85% and 11.09%, respectively. The regulatory capital ratios as of December 31, 2018 and 2017 were calculated under Basel III rules. There is no threshold for well-capitalized status for bank holding companies.

As of December 31, 2018 and 2017, the regulatory capital ratios of the Company and Bank under the Basel III regulatory capital framework are as follows:

	Actual		Minimum Capital Required Under Basel III Phase-In		Minimum Capital Required-Basel III Fully Phased-In		Required to be Considered Well-Capitalized	
As of December 31, 2018:	**Amount**	**Ratio**	**Amount**	**Ratio**	**Amount**	**Ratio**	**Amount**	**Ratio**
Total Capital to Risk-Weighted Assets:								
Consolidated	$ 940,026	20.61%	$ 450,459	9.875%	$ 478,969	10.50%		N/A
First Financial Bank, N.A	$ 824,428	18.12%	$ 449,350	9.875%	$ 477,790	10.50%	$ 455,038	10.00%
Tier 1 Capital to Risk-Weighted Assets:								

Consolidated	$ 888,015	19.47%	$ 359,226	7.875%	$ 387,737	8.50%		N/A
First Financial Bank, N.A	$ 772,417	16.97%	$ 358,342	7.875%	$ 386,782	8.50%	$ 364,030	8.00%
Common Equity Tier 1 Capital to Risk-Weighted Assets:								
Consolidated	$ 888,015	19.47%	$ 290,802	6.375%	$ 319,312	7.00%		N/A
First Financial Bank, N.A	$ 772,417	16.97%	$ 290,087	6.375%	$ 318,526	7.00%	$ 295,775	6.50%
Leverage Ratio:								
Consolidated	$ 888,015	11.85%	$ 299,682	4.00%	$ 299,682	4.00%		N/A
First Financial Bank, N.A	$ 772,417	10.35%	$ 298,576	4.00%	$ 298,576	4.00%	$ 373,220	5.00%

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As of December 31, 2017:	Actual Amount	Actual Ratio	Minimum Capital Required Under Basel III Phase-In Amount	Ratio	Minimum Capital Required-Basel III Fully Phased-In Amount	Ratio	Required to be Considered Well-Capitalized Amount	Ratio
Total Capital to Risk-Weighted Assets:								
Consolidated	$ 814,634	19.85%	$ 379,578	9.250%	$ 430,872	10.50%		N/A
First Financial Bank, N.A	$ 723,563	17.68%	$ 378,614	9.250%	$ 429,777	10.50%	$ 409,312	10.00%
Tier 1 Capital to Risk-Weighted Assets:								
Consolidated	$ 765,882	18.66%	$ 297,507	7.250%	$ 348,801	8.50%		N/A
First Financial Bank, N.A	$ 674,811	16.49%	$ 296,751	7.250%	$ 347,915	8.50%	$ 327,450	8.00%
Common Equity Tier 1 Capital to Risk-Weighted Assets:								
Consolidated	$ 765,882	18.66%	$ 235,954	5.750%	$ 287,248	7.00%		N/A
First Financial Bank, N.A	$ 674,811	16.49%	$ 235,354	5.750%	$ 286,518	7.00%	$ 266,053	6.50%
Leverage Ratio:								
Consolidated	$ 765,882	11.09%	$ 276,296	4.000%	$ 276,296	4.00%		N/A
First Financial Bank, N.A	$ 674,811	9.80%	$ 275,320	4.000%	$ 275,320	4.00%	$ 344,151	5.00%

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

In connection with the adoption of the Basel III regulatory capital framework, our subsidiary bank made the election to continue to exclude most accumulated other comprehensive income (AOCI) from capital in connection with its March 31, 2015 quarterly financial filing and, in effect, to retain the AOCI treatment under the prior capital rules.

In connection with the First Financial Trust & Asset Management Company, National Association s (the Trust Company) application to obtain our trust charter, the Trust Company is required to maintain tangible net assets of $2,000,000 at all times. As of December 31, 2018, our Trust Company had tangible net assets totaling $22,503,000.

Our subsidiary bank may be required at times to maintain reserve balances with the Federal Reserve Bank. At December 31, 2018 and 2017, the subsidiary bank s reserve balances were $11,372,000 and $11,504,000, respectively.

17. <u>STOCK OPTION PLAN AND RESTRICTED STOCK PLAN:</u>

The Company has an incentive stock plan to provide for the granting of options to employees of the Company at prices not less than market at the date of grant. At December 31, 2018, the Company had allocated 3,003,000 shares of stock for issuance under the plan. The plan provides that options granted are exercisable after two years from date of grant at a rate of 20% each year cumulatively during the 10-year term of the option. Shares are issued under the stock option plan from available authorized shares. An analysis of stock option activity for the year ended December 31, 2018 is presented in the table and narrative below:

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	Shares	Weighted-Average Ex. Price	Weighted-Average Remaining Contractual Term (Years)	Aggregate Intrinsic Value ($000)
Outstanding, beginning of year	1,325,965	$ 33.01		
Granted				
Exercised	(173,822)	22.23		
Cancelled	(66,600)	36.25		
Outstanding, end of year	1,085,543	34.54	6.55	$ 25,135
Exercisable at end of year	407,463	$ 27.41	4.65	$ 12,337

The options outstanding at December 31, 2018 had exercise prices ranging between $16.78 and $42.35. Stock options have been adjusted retroactively for the effects of stock dividends and splits.

The following table summarizes information concerning outstanding and vested stock options as of December 31, 2018:

Exercise Price	Number Outstanding	Remaining Contracted Life (Years)	Number Vested
$ 16.78	29,823	0.4	29,823
15.73	90,265	2.8	90,265
30.85	211,355	4.8	161,135
33.89	341,250	6.8	126,240
$ 42.35	412,850	8.5	

The fair value of the options granted during 2017 was estimated using the Black-Scholes options pricing model with the following weighted-average assumptions: risk-free interest rate of 1.89%; expected dividend yield of 1.79%; expected life of 6.24 years; and expected volatility of 26.51%.

The weighted-average grant-date fair value of options granted during 2017 was $9.90. There were no grants during 2018 and 2016. The total intrinsic value of options exercised during the years ended December 31, 2018, 2017 and 2016, was $5,476,000, $3,082,000 and $1,226,000, respectively.

As of December 31, 2018, there was $3,522,000 of total unrecognized compensation cost related to nonvested share-based compensation arrangements granted under the Plan. That cost is expected to be recognized over a weighted-average period of 1.89 years. The total fair value of shares vested during the years ended December 31, 2018, 2017 and 2016 was $888,000, $1,246,000 and $592,000.

The aggregate intrinsic value of vested stock options at December 31, 2018 totaled $11,170,000.

On April 28, 2015, shareholders of the Company approved a restricted stock plan for selected employees, officers, non-employee directors and consultants. At December 31, 2018, the Company had allocated 379,000 shares of stock for issuance under the plan.

On July 21, 2015, upon re-election of existing directors, 7,070 shares with a total value of $250,000 were granted to the ten non-employee directors and was expensed over the period from grant day to April 26, 2016, the Company s next shareholders meeting at which the directors term expired. On April 26, 2016, upon re-election of existing directors, 7,660 shares with a total value of $250,000 were granted to the ten non-employee directors and was expensed over the period from grant day to April 25, 2017, the next scheduled annual shareholders meeting at which the directors current term expired. On April 25, 2017, upon re-election of existing directors, 14,650 restricted shares with a total value of $600,000 were granted to the ten non-employee directors and was expensed over the period from grant day to April 24, 2018, the Company s next shareholders meeting at which the directors term expires. On April 24, 2018, upon re-election of nine of the existing directors, 10,710 restricted shares with a total value of $540,000 were granted to the nine non-employee directors and is being expensed over the period from grant day to April 23, 2019, the Company s next shareholders meeting at which the directors term expires. The Company recorded director expense related to these restricted stock grants of $560,000, $483,000 and $278,000 for the year ended December 31, 2018, 2017, and 2016, respectively.

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On October 27, 2015, the Company granted 31,273 shares with a total value of $1,060,000 to certain officers that is being expensed over the vesting period of three years. On October 25, 2016, the Company granted 15,405 shares with a total value of $560,000 to certain officers that is being expensed over the vesting period of three years. On October 24, 2017, the Company granted 14,191 restricted shares with a total value of $655,000 to certain officers that is being expensed over the vesting period of one to three years. On October 23, 2018, the Company granted 26,021 restricted shares with a total value of $1,440,000 to certain officers that will be expensed over a three year vesting period. The Company recorded restricted stock expense for officers of $680,000, $562,000 and $381,000, respectively, for the year ended December 31, 2018, 2017 and 2016.

18. CONDENSED FINANCIAL INFORMATION PARENT COMPANY:

Condensed Balance Sheets-December 31, 2018 and 2017

	2018	2017
ASSETS		
Cash in subsidiary bank	$ 16,981	$ 14,272
Cash in unaffiliated banks	2	2
Interest-bearing deposits in subsidiary bank	84,279	64,195
Total cash and cash equivalents	101,262	78,469
Securities available-for-sale, at fair value	6,276	8,515
Investment in and advances to subsidiaries, at equity	959,352	847,445
Intangible assets	723	723
Other assets	2,647	2,654
Total assets	$ 1,070,260	$ 937,806
LIABILITIES AND SHAREHOLDERS EQUITY		
Total liabilities	$ 16,965	$ 15,038
Shareholders equity:		
Common stock	678	663
Capital surplus	443,114	378,062
Retained earnings	606,658	517,257
Treasury stock	(7,507)	(7,148)
Deferred compensation	7,507	7,148
Accumulated other comprehensive earnings	2,845	26,786
Total shareholders equity	1,053,295	922,768

Total liabilities and shareholders equity	$ 1,070,260	$ 937,806

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Condensed Statements of Earnings-

For the Years Ended December 31, 2018, 2017 and 2016

	2018	2017	2016
Income:			
Cash dividends from subsidiaries	$ 74,100	$ 30,800	$ 48,800
Excess of earnings over dividends of subsidiaries	82,323	92,929	58,809
Other	7,269	6,590	4,184
Total income	163,692	130,319	111,793
Expenses:			
Salaries and employee benefits	9,966	8,606	5,655
Other operating expenses	4,781	3,871	3,531
Total expense	14,747	12,477	9,186
Earnings before income taxes	148,945	117,842	102,607
Income tax benefit	1,693	2,529	2,167
Net earnings	$ 150,638	$ 120,371	$ 104,774

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Condensed Statements of Cash Flows-

For the Years Ended December 31, 2018, 2017 and 2016

	2018	2017	2016
Cash flows from operating activities:			
Net earnings	$ 150,638	$ 120,371	$ 104,774
Adjustments to reconcile net earnings to net cash provided by operating activities:			
Excess of earnings over dividends of subsidiary bank	(82,323)	(92,929)	(58,809)
Depreciation and amortization, net	331	207	208
Decrease (increase) in other assets	560	438	1,702
Increase (decrease) in other liabilities	1,932	183	(1,374)
Other	(2)	2	8
Net cash provided by operating activities	71,136	28,272	46,509
Cash flows from investing activities:			
Cash received in connection with acquisition of banks			
Maturity of available-for-sale security	2,000	2,997	
Purchases of bank premises and equipment and software	(346)	(30)	(94)
Other			10
Net cash provided by (used in) investing activities	1,654	2,967	(84)
Cash flows from financing activities:			
Proceeds of stock issuances	3,864	2,934	1,260
Cash dividends paid	(53,861)	(48,955)	(44,907)
Net cash used in financing activities	(49,997)	(46,021)	(43,647)
Net increase (decrease) in cash and cash equivalents	22,793	(14,782)	2,778
Cash and cash equivalents, beginning of year	78,469	93,251	90,473
Cash and cash equivalents, end of year	$ 101,262	$ 78,469	$ 93,251

FIRST FINANCIAL BANKSHARES, INC. AND SUBSIDIARIES

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19. CASH FLOW INFORMATION:

Supplemental information on cash flows and noncash transactions is as follows (dollars in thousands):

	Year Ended December 31,		
	2018	2017	2016
Supplemental cash flow information:			
Interest paid	$ 18,709	$ 9,316	$ 5,465
Federal income taxes paid	26,578	29,695	28,348
Schedule of noncash investing and financing activities:			
Assets acquired through foreclosure	126	2,211	2,269
Investment securities purchased but not settled			12,381
Restricted stock grant to officers and directors	1,609	1,139	810

20. ACQUISITION

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

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

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The following table presents the amounts recorded on the consolidated balance sheet on the acquisition date (dollars in thousands):

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

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

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

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