SOUTHSIDE BANCSHARES INC
Form 10-Q
October 27, 2017
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q
(Mark One)
x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended September 30, 2017
OR
o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from ____________ to ____________

Commission file number: 0-12247
SOUTHSIDE BANCSHARES, INC.
(Exact name of registrant as specified in its charter)

TEXAS	75-1848732
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

1201 S. Beckham Avenue, Tyler, Texas	75701
(Address of principal executive offices)	(Zip Code)

903-531-7111
(Registrant's telephone number, including area code)

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

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

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

Large accelerated filer x	Accelerated filer o
Non-accelerated filer o	(Do not check if a smaller reporting company)
	Smaller reporting company o
	Emerging growth company o

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).
Yes o No x
The number of shares of the issuer’s common stock, par value $1.25, outstanding as of October 23, 2017 was 29,433,437 shares.

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

	September 30, 2017	December 31, 2016
ASSETS		
Cash and due from banks	$ 57,947	$ 59,363
Interest earning deposits	120,996	102,251
Federal funds sold	5,570	8,040
Total cash and cash equivalents	184,513	169,654
Securities available for sale, at estimated fair value	1,292,072	1,479,600
Securities held to maturity, at carrying value (estimated fair value of $928,507 and $944,282, respectively)	909,844	937,487
FHLB stock, at cost	61,845	61,084
Other investments	5,439	5,508
Loans held for sale	2,177	7,641
Loans:		
Loans	2,682,766	2,556,537
Less: Allowance for loan losses	(19,871)	(17,911)
Net Loans	2,662,895	2,538,626
Premises and equipment, net	107,099	106,003
Goodwill	91,520	91,520
Other intangible assets, net	3,379	4,608
Interest receivable	18,792	25,183
Deferred tax asset, net	21,842	28,891
Unsettled trades to sell securities	11,843	—
Bank owned life insurance	99,616	97,775
Other assets	11,554	10,187
Total assets	$ 5,484,430	$ 5,563,767
LIABILITIES AND SHAREHOLDERS’ EQUITY		
Deposits:		
Noninterest bearing	$ 781,701	$ 704,013
Interest bearing	2,782,474	2,829,063
Total deposits	3,564,175	3,533,076
Short-term obligations:		
Federal funds purchased and repurchase agreements	9,083	7,097
FHLB advances	990,500	866,518
Total short-term obligations	999,583	873,615
Long-term obligations:		
FHLB advances	152,056	443,128
Subordinated notes, net of unamortized debt issuance costs	98,209	98,100
Long-term debt, net of unamortized debt issuance costs	60,240	60,236
Total long-term obligations	310,505	601,464
Unsettled trades to purchase securities	16,673	160
Other liabilities	37,471	37,178

Total liabilities	4,928,407	5,045,493
Off-balance-sheet arrangements, commitments and contingencies (Note 13)		
Shareholders' equity:		
Common stock ($1.25 par value, 40,000,000 shares authorized, 32,256,777 shares issued at September 30, 2017 and 31,455,951 shares issued at December 31, 2016)	40,321	39,320
Paid-in capital	563,553	535,240
Retained earnings	25,677	30,098
Treasury stock, at cost (2,823,340 shares at September 30, 2017 and 2,913,064 shares at December 31, 2016)	(47,291)	(47,891)
Accumulated other comprehensive loss	(26,237)	(38,493)
Total shareholders' equity	556,023	518,274
Total liabilities and shareholders' equity	$ 5,484,430	$ 5,563,767

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

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SOUTHSIDE BANCSHARES, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF INCOME
(UNAUDITED)
(in thousands, except per share data)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2017	2016	2017	2016
Interest income				
Loans	$29,322	$25,740	$84,666	$79,738
Investment securities – taxable	58	251	702	572
Investment securities – tax-exempt	5,670	5,467	18,381	15,959
Mortgage-backed securities	10,567	9,399	31,430	28,156
FHLB stock and other investments	329	186	926	588
Other interest earning assets	527	89	1,265	220
Total interest income	46,473	41,132	137,370	125,233
Interest expense				
Deposits	5,420	3,604	14,839	10,375
Short-term obligations	3,382	1,122	7,927	2,724
Long-term obligations	2,711	2,476	8,940	7,210
Total interest expense	11,513	7,202	31,706	20,309
Net interest income	34,960	33,930	105,664	104,924
Provision for loan losses	960	1,631	3,404	7,715
Net interest income after provision for loan losses	34,000	32,299	102,260	97,209
Noninterest income				
Deposit services	5,476	5,335	15,845	15,519
Net gain on sale of securities available for sale	627	2,343	874	5,512
Gain on sale of loans	347	818	1,553	2,334
Trust income	873	867	2,662	2,591
Bank owned life insurance income	636	656	1,905	1,977
Brokerage services	561	551	1,790	1,661
Other	888	1,162	3,745	3,104
Total noninterest income	9,408	11,732	28,374	32,698
Noninterest expense				
Salaries and employee benefits	14,395	15,203	45,229	47,784
Occupancy expense	2,981	4,569	8,741	10,897
Advertising, travel & entertainment	487	588	1,618	1,995
ATM and debit card expense	1,024	868	2,840	2,316
Professional fees	996	1,148	2,985	3,964
Software and data processing expense	732	736	2,145	2,224
Telephone and communications	459	407	1,461	1,359
FDIC insurance	441	643	1,327	1,926
Other	3,492	4,263	10,056	11,180
Total noninterest expense	25,007	28,425	76,402	83,645
Income before income tax expense	18,401	15,606	54,232	46,262
Income tax expense	3,890	2,741	10,251	8,486
Net income	$14,511	$12,865	$43,981	$37,776

Earnings per common share – basic	$0.49	$0.48	$1.50	$1.40
Earnings per common share – diluted	$0.49	$0.48	$1.49	$1.39
Dividends paid per common share	$0.28	$0.24	$0.81	$0.71

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

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2017	2016	2017	2016
Net income	$14,511	$12,865	$43,981	$37,776
Other comprehensive income:				
Securities available for sale and transferred securities:				
Change in net unrealized holding gains (losses) on available for sale securities during the period	344	(10,960)	18,450	33,031
Reclassification adjustment for amortization of unrealized losses on securities transferred to held to maturity	490	16	1,191	160
Reclassification adjustment for net gain on sale of available for sale securities, included in net income	(627)	(2,343)	(874)	(5,512)
Derivatives:				
Change in net unrealized (loss) gain on effective cash flow hedge interest rate swap derivatives	(236)	1,070	(2,084)	(5,125)
Change in net unrealized gains on interest rate swap derivatives terminated during the period	—	—	273	—
Reclassification adjustment for net loss on interest rate swap derivatives, included in net income	122	521	746	1,338
Reclassification adjustment for amortization of unrealized gains on terminated interest rate swap derivatives	(21)	—	(52)	—
Pension plans:				
Amortization of net actuarial loss, included in net periodic benefit cost	403	458	1,210	1,371
Amortization of prior service credit, included in net periodic benefit cost	(1)	(10)	(5)	(6)
Other comprehensive income (loss), before tax	474	(11,248)	18,855	25,257
Income tax (expense) benefit related to items of other comprehensive income	(166)	3,937	(6,599)	(8,840)
Other comprehensive income (loss), net of tax	308	(7,311)	12,256	16,417
Comprehensive income	$14,819	$5,554	$56,237	$54,193

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

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SOUTHSIDE BANCSHARES, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY
(UNAUDITED)
(in thousands, except share and per share data)

	Common Stock	Paid In Capital	Retained Earnings	Treasury Stock	Accumulated Other Comprehensive Income (Loss)	Total Shareholders' Equity
Balance at December 31, 2015	$34,832	$424,078	$41,527	$(37,692)	$ (18,683)	$444,062
Net income	—	—	37,776	—	—	37,776
Other comprehensive income	—	—	—	—	16,417	16,417
Issuance of common stock for dividend reinvestment plan (33,622 shares)	42	950	—	—	—	992
Purchase of common stock (443,426 shares)	—	—	—	(10,199)	—	(10,199)
Stock compensation expense	—	1,156	—	—	—	1,156
Tax benefits related to stock awards	—	79	—	—	—	79
Net issuance of common stock under employee stock plans (39,468 shares)	50	345	(49)	—	—	346
Cash dividends paid on common stock ($0.71 per share)	—	—	(18,069)	—	—	(18,069)
Stock dividend declared (1,252,353 shares)	1,565	33,200	(34,765)	—	—	—
Balance at September 30, 2016	$36,489	$459,808	$26,420	$(47,891)	$ (2,266)	$472,560
Balance at December 31, 2016	$39,320	$535,240	$30,098	$(47,891)	$ (38,493)	$518,274
Net income	—	—	43,981	—	—	43,981
Other comprehensive income	—	—	—	—	12,256	12,256
Issuance of common stock for dividend reinvestment plan (33,000 shares)	41	1,057	—	—	—	1,098
Stock compensation expense	—	1,393	—	—	—	1,393
Net issuance of common stock under employee stock plans (138,035 shares)	61	1,802	(73)	600	—	2,390
Cash dividends paid on common stock ($0.81 per share)	—	—	(23,369)	—	—	(23,369)
Stock dividend declared (719,515 shares)	899	24,061	(24,960)	—	—	—
Balance at September 30, 2017	$40,321	$563,553	$25,677	$(47,291)	$ (26,237)	$556,023

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

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

	Nine Months Ended September 30,	
	2017	2016
OPERATING ACTIVITIES:		
Net income	$43,981	$37,776
Adjustments to reconcile net income to net cash provided by operations:		
Depreciation and net amortization	7,251	6,612
Securities premium amortization (discount accretion), net	13,502	14,245
Loan (discount accretion) premium amortization, net	(818)	(2,113)
Provision for loan losses	3,404	7,715
Stock compensation expense	1,393	1,156
Deferred tax expense	453	1,916
Net tax benefit related to stock awards	—	(79)
Net gain on sale of securities available for sale	(874)	(5,512)
Net loss on premises and equipment	77	235
Gross proceeds from sales of loans held for sale	50,689	67,144
Gross originations of loans held for sale	(45,225)	(68,634)
Net (gain) loss on other real estate owned	(1)	224
Net gain on sale of customer receivables	—	(144)
Net change in:		
Interest receivable	6,391	5,242
Other assets	2,696	(2,094)
Interest payable	(923)	726
Other liabilities	(4,639)	2,182
Net cash provided by operating activities	77,357	66,597
INVESTING ACTIVITIES:		
Securities available for sale:		
Purchases	(371,555)	(761,900)
Sales	486,460	495,011
Maturities, calls and principal repayments	87,096	160,676
Securities held to maturity:		
Purchases	(1,521)	(29,725)
Maturities, calls and principal repayments	25,455	22,029
Proceeds from redemption of FHLB stock and other investments	114	3,644
Purchases of FHLB stock and other investments	(761)	(4,433)
Net loan originations	(127,240)	(66,633)
Proceeds from sales of customer receivables	—	3,314
Purchases of premises and equipment	(7,090)	(5,189)
Proceeds from sales of premises and equipment	8	120
Proceeds from sales of other real estate owned	134	1,918
Proceeds from sales of repossessed assets	341	767
Net cash provided by (used in) investing activities	91,441	(180,401)

(continued)

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

	Nine Months Ended September 30, 2017	2016
FINANCING ACTIVITIES:		
Net change in deposits	$31,031	$126,748
Net increase in federal funds purchased and repurchase agreements	1,986	9,087
Proceeds from FHLB advances	2,366,476	6,548,551
Repayment of FHLB advances	(2,533,551)	(6,523,701)
Net proceeds from issuance of subordinated long-term debt	—	98,083
Tax benefit related to stock awards	—	79
Proceeds from stock option exercises	2,527	418
Cash paid to tax authority from stock option exercises	(137)	(72)
Purchase of common stock	—	(10,199)
Proceeds from the issuance of common stock for dividend reinvestment plan	1,098	992
Cash dividends paid	(23,369)	(18,069)
Net cash (used in) provided by financing activities	(153,939)	231,917
Net increase in cash and cash equivalents	14,859	118,113
Cash and cash equivalents at beginning of period	169,654	80,975
Cash and cash equivalents at end of period	$184,513	$199,088
SUPPLEMENTAL DISCLOSURES FOR CASH FLOW INFORMATION:		
Interest paid	$32,629	$19,583
Income taxes paid	$8,300	$5,700
SUPPLEMENTAL DISCLOSURES OF NONCASH INVESTING AND FINANCING ACTIVITIES:		
Loans transferred to other repossessed assets and real estate through foreclosure	$407	$5,434
Adjustment to pension liability	$(1,205)	$(1,365)
Stock dividend (2.5% and 5%, respectively)	$24,960	$34,765
Unsettled trades to purchase securities	$(16,673)	$(30,214)
Unsettled trades to sell securities	$11,843	$—

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

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

1. Summary of Significant Accounting and Reporting Policies

Basis of Presentation

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

The accompanying unaudited consolidated financial statements have been prepared in accordance with United States (“U.S.”) generally accepted accounting principles (“GAAP”) for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, not all information required by GAAP for complete financial statements is included in these interim statements. In the opinion of management, all adjustments necessary for a fair presentation of such financial statements have been included. Such adjustments consisted only of normal recurring items. The preparation of these consolidated financial statements in accordance with GAAP requires the use of management’s estimates. These estimates are subjective in nature and involve matters of judgment. Actual amounts could differ from these estimates.

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

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

Accounting Changes and Reclassifications

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

We adopted ASU 2016-09 “Compensation - Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting,” on January 1, 2017 which requires all income tax effects related to settlements of share-based payment awards be reported in earnings as an increase (or decrease) to income tax expense. Previously, income tax benefits at settlement of an award were reported as an increase (or decrease) to additional paid-in capital to the extent that those benefits were greater than (or less than) the income tax benefits recognized in earnings during the vesting period or exercise of the award. The requirement to report those income tax effects in earnings has been applied to settlements occurring on or after January 1, 2017, and the impact of applying that guidance reduced reported income tax expense by $213,000, or less than $0.01 on our diluted earnings per common share for the three months ended September 30, 2017, and $423,000, or $0.01 on our diluted earnings per common share for the nine months ended September 30, 2017. ASU 2016-09 also requires that all income tax-related cash flows resulting from share-based payments be reported as operating activities in the statement of cash flows. Previously, income tax benefits at settlement of an award were reported as a reduction to operating cash flows and an increase to financing cash flows to the extent that those benefits exceeded the income tax benefits reported in earnings during the vesting period or exercise of the award. We have elected to apply that change in cash flow on a prospective basis and therefore, prior periods have not been adjusted. ASU 2016-09 also requires the classification of employee taxes paid when an employer withholds shares for tax withholding purposes be classified as a financing activity in the statement of cash flow and be applied retrospectively. The requirement to report the employee taxes paid is reflected in prior period presentation in our consolidated statement of cash flows. In connection with the adoption of ASU 2016-09, we have also elected to recognize forfeitures as they occur.

Terminated Derivative Financial Instruments

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

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

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

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

Accounting Pronouncements

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

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

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

In January 2017, the FASB issued ASU 2017-04, “Intangibles - Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment.” ASU 2017-04 is intended to simplify goodwill impairment testing by eliminating the second step of the analysis which requires the calculation of the implied fair value of goodwill to measure a goodwill impairment charge. The update requires entities to compare the fair value of a reporting unit with its carrying amount and recognize an impairment charge for any amount by which the carrying amount exceeds the reporting unit’s fair value, to the extent that the loss recognized does not exceed the amount of goodwill allocated to that reporting unit. ASU 2017-04 is effective for annual and interim goodwill impairment tests performed in periods beginning after December 15, 2019. Early adoption is permitted for annual and interim goodwill impairment testing dates after January 1, 2017. The guidance requires companies to apply the requirements prospectively in the year of adoption. ASU 2017-04 is not expected to have a significant impact on our consolidated financial statements.

In March 2017, the FASB issued ASU 2017-07, “Compensation - Retirement Benefits (Topic 715): Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost.” ASU 2017-07 requires employers to present the service cost component of net periodic postretirement benefit cost in the same income statement line item as other employee compensation costs arising from services rendered during the period. Only the service cost component will be eligible for

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capitalization in assets. Employers are required to present the other components of the net periodic benefit cost separately from the line item that includes the service cost and outside of any subtotal of operating income, if one is presented. ASU 2017-07 is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2017. Early adoption is permitted as of the beginning of an annual period for which financial statements (interim or annual) have not been issued or made available for issuance. We did not early adopt ASU 2017-07. The guidance requires companies to apply the requirements retrospectively to all prior periods presented. ASU 2017-07 is not expected to have a significant impact on our consolidated financial statements.
In March 2017, the FASB issued ASU 2017-08, "Receivables - Nonrefundable Fees and Other Costs (Subtopic 310-20): Premium Amortization on Purchased Callable Debt Securities." Under current GAAP, premiums on callable debt securities are generally amortized over the contractual life of the security. ASU 2017-08 requires the premium on callable debt securities to be amortized to the earliest call date. If the debt security is not called at the earliest call date, the holder of the debt security would be required to reset the effective yield on the debt security based on the payment terms required by the debt security. ASU 2017-08 is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. Early adoption is permitted. The guidance requires companies to apply the requirements on a modified retrospective basis through a cumulative adjustment directly to retained earnings as of the beginning of the period of adoption. We are currently evaluating the potential impact of the pending adoption of ASU 2017-08 on our consolidated financial statements.

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

In August 2017, the FASB issued ASU 2017-12, "Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities." ASU 2017-12 (i) expands hedge accounting for nonfinancial and financial risk components and amends measurement methodologies to more closely align hedge accounting with a company's risk management activities, (ii) decreases the complexity of preparing and understanding hedge results by eliminating the separate measurement and reporting of hedge ineffectiveness, (iii) enhances transparency, comparability, and understanding of hedge results through enhanced disclosures and changing the presentation of hedge results to align the effects of the hedging instrument and the hedged item, and (iv) reduces the cost and complexity of applying hedge accounting by simplifying the manner in which assessments of hedge effectiveness may be performed. ASU 2017-12 is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. Early adoption is permitted. The guidance requires companies to apply the requirements to existing hedging relationships on the date of adoption, and the effect of the adoption should be reflected as of the beginning of the fiscal year of adoption. We are currently evaluating the potential impact of the pending adoption of ASU 2017-12 on our consolidated financial statements.

2. Pending Acquisition

On June 12, 2017, the Company entered into an Agreement and Plan of Merger (the "Merger Agreement") with Diboll State Bancshares, Inc., a Texas corporation ("Diboll") and the holding company for First Bank & Trust East Texas, a Texas banking association based in Diboll, Texas. As of September 30, 2017, Diboll had $1.01 billion in assets and $908.7 million in deposits The Merger Agreement provides that, subject to the terms and conditions thereof, Diboll will merge with and into the Company, with the Company as the surviving corporation. On October 17, 2017, Diboll's shareholders approved the Merger Agreement and the merger at a special meeting of shareholders. The merger of Southside Bank and Diboll's subsidiary bank has previously received the approval of the Federal Deposit Insurance Corporation and the Texas Department of Banking. The merger is expected to close during the fourth quarter of 2017, subject to receipt of regulatory approval from the Federal Reserve Board and the satisfaction of other customary closing conditions.

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

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3. Earnings Per Share

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2017	2016	2017	2016
Basic and Diluted Earnings:				
Net income	$14,511	$12,865	$43,981	$37,776
Basic weighted-average shares outstanding	29,370	26,923	29,326	26,976
Add: Stock awards	200	157	205	115
Diluted weighted-average shares outstanding	29,570	27,080	29,531	27,091
Basic Earnings Per Share:				
Net Income	$0.49	$0.48	$1.50	$1.40
Diluted Earnings Per Share:				
Net Income	$0.49	$0.48	$1.49	$1.39

For the three- and nine-month periods ended September 30, 2017, there were approximately 45,000 and 49,000 anti-dilutive shares, respectively. For the three- and nine-month periods ended September 30, 2016, there were approximately 3,000 and 29,000 anti-dilutive shares, respectively.

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4. Accumulated Other Comprehensive Income (Loss)

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

	Three Months Ended September 30, 2017				
			Pension Plans		
	Unrealized Gains (Losses) on Securities	Unrealized Gains (Losses) on Derivatives	Net Prior Service (Cost) Credit	Net Gain (Loss)	Total
Beginning balance, net of tax	$(11,644)	$ 3,957	$(136)	$(18,722)	$(26,545)
Other comprehensive income (loss):					
Other comprehensive income (loss) before reclassifications	344	(236)	—	—	108
Reclassified from accumulated other comprehensive (loss) income	(137)	101	(1)	403	366
Income (expense) tax benefit	(72)	47	—	(141)	(166)
Net current-period other comprehensive income (loss), net of tax	135	(88)	(1)	262	308
Ending balance, net of tax	$(11,509)	$ 3,869	$(137)	$(18,460)	$(26,237)

	Nine Months Ended September 30, 2017				
			Pension Plans		
	Unrealized Gains (Losses) on Securities	Unrealized Gains (Losses) on Derivatives	Net Prior Service (Cost) Credit	Net Gain (Loss)	Total
Beginning balance, net of tax	$(23,708)	$ 4,595	$(133)	$(19,247)	$(38,493)
Other comprehensive income (loss):					
Other comprehensive income (loss) before reclassifications	18,450	(1,811)	—	—	16,639
Reclassified from accumulated other comprehensive income (loss)	317	694	(5)	1,210	2,216
Income tax (expense) benefit	(6,568)	391	1	(423)	(6,599)
Net current-period other comprehensive income (loss), net of tax	12,199	(726)	(4)	787	12,256
Ending balance, net of tax	$(11,509)	$ 3,869	$(137)	$(18,460)	$(26,237)

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	Three Months Ended September 30, 2016				
			Pension Plans		
	Unrealized Gains (Losses) on Securities	Unrealized Gains (Losses) on Derivatives	Net Prior Service (Cost) Credit	Net Gain (Loss)	Total
Beginning balance, net of tax	$26,389	$ (3,496)	$(42)	$(17,806)	$5,045
Other comprehensive income (loss):					
Other comprehensive (loss) income before reclassifications	(10,960)	1,070	—	—	(9,890)
Reclassified from accumulated other comprehensive (loss) income	(2,327)	521	(10)	458	(1,358)
Income tax benefit (expense)	4,650	(557)	4	(160)	3,937
Net current-period other comprehensive (loss) income, net of tax	(8,637)	1,034	(6)	298	(7,311)
Ending balance, net of tax	$17,752	$ (2,462)	$(48)	$(17,508)	$(2,266)

	Nine Months Ended September 30, 2016				
			Pension Plans		
	Unrealized Gains (Losses) on Securities	Unrealized Gains (Losses) on Derivatives	Net Prior Service (Cost) Credit	Net Gain (Loss)	Total
Beginning balance, net of tax	$(239)	$ —	$(44)	$(18,400)	$(18,683)
Other comprehensive income (loss):					
Other comprehensive income (loss) before reclassifications	33,031	(5,125)	—	—	27,906
Reclassified from accumulated other comprehensive (loss) income	(5,352)	1,338	(6)	1,371	(2,649)
Income tax (expense) benefit	(9,688)	1,325	2	(479)	(8,840)
Net current-period other comprehensive income (loss), net of tax	17,991	(2,462)	(4)	892	16,417
Ending balance, net of tax	$17,752	$ (2,462)	$(48)	$(17,508)	$(2,266)

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2017	2016	2017	2016
Unrealized losses on securities transferred to held to maturity:				
Amortization of unrealized losses [1]	$(490)	$(16)	$(1,191)	$(160)
Tax benefit	172	6	417	56
Net of tax	$(318)	$(10)	$(774)	$(104)
Unrealized gains and losses on available for sale securities:				
Realized net gain on sale of securities [2]	$627	$2,343	$874	$5,512
Tax expense	(220)	(820)	(306)	(1,929)
Net of tax	$407	$1,523	$568	$3,583
Derivatives:				
Realized net loss on interest rate swap derivatives [3]	$(122)	$(521)	$(746)	$(1,338)
Tax benefit	43	182	261	468
Net of tax	$(79)	$(339)	$(485)	$(870)
Amortization of unrealized gains on terminated interest rate swap derivatives [3]	$21	$—	$52	$—
Tax expense	(7)	—	(18)	—
Net of tax	$14	$—	$34	$—
Amortization of pension plan:				
Net actuarial loss [4]	$(403)	$(458)	$(1,210)	$(1,371)
Prior service credit [4]	1	10	5	6
Total before tax	(402)	(448)	(1,205)	(1,365)
Tax benefit	141	156	422	477
Net of tax	(261)	(292)	(783)	(888)
Total reclassifications for the period, net of tax	$(237)	$882	$(1,440)	$1,721

(1) Included in interest income on the consolidated statements of income.
(2) Listed as net gain on sale of securities available for sale on the consolidated statements of income.
(3) Included in interest expense for long-term obligations on the consolidated statements of income.
(4) These accumulated other comprehensive income components are included in the computation of net periodic pension cost (income) presented in "Note 8 - Employee Benefit Plans."

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5. Securities

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

	September 30, 2017						
		Recognized in OCI			Not recognized in OCI		
	Amortized	Gross Unrealized	Gross Unrealized	Carrying	Gross Unrealized	Gross Unrealized	Estimated
AVAILABLE FOR SALE	Cost	Gains	Losses	Value	Gains	Losses	Fair Value
Investment Securities:							
State and Political Subdivisions	$340,790	$2,757	$ 6,387	$337,160	$—	$ —	$337,160
Other Stocks and Bonds	5,042	73	—	5,115	—	—	5,115
Other Equity Securities	6,031	—	71	5,960	—	—	5,960
Mortgage-backed Securities: (1)							
Residential	617,860	6,319	4,484	619,695	—	—	619,695
Commercial	322,577	2,320	755	324,142	—	—	324,142
Total	$1,292,300	$11,469	$ 11,697	$1,292,072	$—	$ —	$1,292,072
HELD TO MATURITY							
Investment Securities:							
State and Political Subdivisions	$424,729	$2,812	$ 12,299	$415,242	$13,019	$ 2,039	$426,222
Mortgage-backed Securities: (1)							
Residential	132,426	—	5,143	127,283	2,513	181	129,615
Commercial	370,167	941	3,789	367,319	5,925	574	372,670
Total	$927,322	$3,753	$ 21,231	$909,844	$21,457	$ 2,794	$928,507

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

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

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

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

	As of September 30, 2017					
	Less Than 12 Months		More Than 12 Months		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
AVAILABLE FOR SALE						
Investment Securities:						
State and Political Subdivisions	$67,886	$ 991	$153,073	$ 5,396	$220,959	$ 6,387
Other Equity Securities	5,960	71	—	—	5,960	71
Mortgage-backed Securities:						
Residential	161,949	710	110,503	3,774	272,452	4,484
Commercial	36,549	258	13,122	497	49,671	755
Total	$272,344	$ 2,030	$276,698	$ 9,667	$549,042	$ 11,697
HELD TO MATURITY						
Investment Securities:						
State and Political Subdivisions	$52,088	$ 643	$41,006	$ 1,396	$93,094	$ 2,039
Mortgage-backed Securities:						
Residential	3,795	57	2,922	124	6,717	181
Commercial	36,340	561	895	13	37,235	574
Total	$92,223	$ 1,261	$44,823	$ 1,533	$137,046	$ 2,794

	As of December 31, 2016					
	Less Than 12 Months		More Than 12 Months		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
AVAILABLE FOR SALE						
Investment Securities:						
U.S. Treasury	$70,069	$ 3,947	$—	$ —	$70,069	$ 3,947
State and Political Subdivisions	264,485	12,069	887	1	265,372	12,070
Other Equity Securities	5,920	119	—	—	5,920	119
Mortgage-backed Securities:						
Residential	369,903	9,491	6,199	38	376,102	9,529
Commercial	245,422	3,055	—	—	245,422	3,055
Total	$955,799	$ 28,681	$7,086	$ 39	$962,885	$ 28,720
HELD TO MATURITY						
Investment Securities:						
State and Political Subdivisions	$179,939	$ 2,190	$29,427	$ 1,303	$209,366	$ 3,493
Mortgage-backed Securities:						
Residential	107,024	950	—	—	107,024	950
Commercial	186,854	2,263	—	—	186,854	2,263
Total	$473,817	$ 5,403	$29,427	$ 1,303	$503,244	$ 6,706

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

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

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

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

	Three Months Ended September 30,	
	2017	2016
U.S. Treasury	$—	$182
State and Political Subdivisions	5,670	5,467
Other Stocks and Bonds	27	39
Other Equity Securities	31	30
Mortgage-backed Securities	10,567	9,399
Total interest income on securities	$16,295	$15,117

	Nine Months Ended September 30,	
	2017	2016
U.S. Treasury	$519	$330
State and Political Subdivisions	18,381	15,959
Other Stocks and Bonds	96	154
Other Equity Securities	87	88
Mortgage-backed Securities	31,430	28,156
Total interest income on securities	$50,513	$44,687

Of the approximately $874,000 in net securities gain from the AFS portfolio for the nine months ended September 30, 2017, there were $4.7 million in realized gain positions and $3.8 million in realized loss positions. Of the $5.5 million in net securities gain from the AFS portfolio for the nine months ended September 30, 2016, there were $6.2 million in realized gain positions and $663,000 in realized loss positions. There were no sales from the HTM portfolio during the nine months ended September 30, 2017 or 2016. We calculate realized gains and losses on sales of securities under the specific identification method.

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

	September 30, 2017	
	Amortized Cost	Fair Value
AVAILABLE FOR SALE		
Investment Securities:		
Due in one year or less	$9,844	$9,965
Due after one year through five years	15,651	16,066
Due after five years through ten years	34,121	34,655
Due after ten years	286,216	281,589
	345,832	342,275
Mortgage-backed Securities and Other Equity Securities:	946,468	949,797
Total	$1,292,300	$1,292,072

	September 30, 2017	
	Carrying Value	Fair Value
HELD TO MATURITY		
Investment Securities:		
Due in one year or less	$23,631	$23,372
Due after one year through five years	57,827	58,663
Due after five years through ten years	110,903	113,443
Due after ten years	222,881	230,744
	415,242	426,222
Mortgage-backed Securities:	494,602	502,285
Total	$909,844	$928,507

Investment securities and MBS with carrying values of $1.15 billion and $1.50 billion were pledged as of September 30, 2017 and December 31, 2016, respectively, to collateralize Federal Home Loan Bank of Dallas (“FHLB”) advances, repurchase agreements, and public funds or for other purposes as required by law.

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

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6. Loans and Allowance for Probable Loan Losses

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

	September 30, 2017	December 31, 2016
Real Estate Loans:		
Construction	$ 420,497	$ 380,175
1-4 Family Residential	609,159	637,239
Commercial	1,073,646	945,978
Commercial Loans	166,919	177,265
Municipal Loans	322,286	298,583
Loans to Individuals	90,259	117,297
Total Loans (1)	2,682,766	2,556,537
Less: Allowance for Loan Losses (2)	19,871	17,911
Net Loans	$ 2,662,895	$ 2,538,626

(1) Includes approximately $278.7 million and $372.4 million of loans acquired with the Omni acquisition as of September 30, 2017 and December 31, 2016, respectively.

(2) The allowance for loan loss recorded on purchase credit impaired (“PCI”) loans totaled $53,000 and $3,000 as of September 30, 2017 and December 31, 2016, respectively.

Real Estate Construction Loans

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

Real Estate 1-4 Family Residential Loans

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

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

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

Commercial Real Estate Loans

Commercial real estate loans as of September 30, 2017 consisted of $975.2 million of owner and non-owner occupied real estate, $95.5 million of loans secured by multi-family properties and $2.9 million of loans secured by farmland. Commercial real estate loans primarily include loans collateralized by retail, commercial office buildings, multi-family residential buildings, medical facilities and offices, senior living, assisted living and skilled nursing facilities, warehouse facilities, hotels and churches. In determining whether to originate commercial real estate loans, we generally consider such factors as the financial condition of the borrower and the debt service coverage of the property. Commercial real estate loans are made at both fixed and adjustable interest rates for terms generally up to 20 years.

Commercial Loans

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

Municipal Loans

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

Loans to Individuals

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

Allowance for Loan Losses

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

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

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

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

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

Credit Quality Indicators

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

- Pass (Rating 1 – 4) – This rating is assigned to all satisfactory loans. This category, by definition, consists of acceptable credit. Credit and collateral exceptions should not be present, although their presence would not necessarily prohibit a loan from being rated Pass, if deficiencies are in the process of correction. These loans are not included in the Watch List.
- Pass Watch (Rating 5) – These loans require some degree of special treatment, but not due to credit quality. This category does not include loans specially mentioned or adversely classified; however, particular attention is warranted to characteristics such as:

  A lack of, or abnormally extended payment program;
  A heavy degree of concentration of collateral without sufficient margin;
  A vulnerability to competition through lesser or extensive financial leverage; and
  A dependence on a single or few customers or sources of supply and materials without suitable substitutes or alternatives.
- Special Mention (Rating 6) – A Special Mention loan has potential weaknesses that deserve management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the loan or in our credit position at some future date. Special Mention loans are not adversely classified and do not expose us to sufficient risk to warrant adverse classification.
- Substandard (Rating 7) – Substandard loans are inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Loans so classified must have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the Bank will sustain some loss if the deficiencies are not corrected.
- Doubtful (Rating 8) – Loans classified as Doubtful have all the weaknesses inherent in those classified Substandard with the added characteristic that the weaknesses make collection or liquidation, in full, on the basis of currently known facts, conditions and values, highly questionable and improbable.

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

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

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

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

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These factors are also considered for the non-PCI purchased Omni loan portfolio specifically in regards to changes in credit quality, past due, nonaccrual and charge-off trends.
The following tables detail activity in the allowance for loan losses by portfolio segment for the periods presented (in thousands):

	Three Months Ended September 30, 2017						
	Real Estate						
	Construction	1-4 Family Residential	Commercial	Commercial Loans	Municipal Loans	Loans to Individuals	Total
Balance at beginning of period	$3,573	$ 2,392	$ 9,970	$ 1,624	$ 765	$ 917	$19,241
Provision (reversal) for loan losses (1)	(20)	34	383	189	41	333	960
Loans charged off	—	(11)	—	(73)	—	(593)	(677)
Recoveries of loans charged off	—	10	2	89	—	246	347
Balance at end of period	$3,553	$ 2,425	$ 10,355	$ 1,829	$ 806	$ 903	$19,871

	Nine Months Ended September 30, 2017						
	Real Estate						
	Construction	1-4 Family Residential	Commercial	Commercial Loans	Municipal Loans	Loans to Individuals	Total
Balance at beginning of period	$4,147	$ 2,665	$ 7,204	$ 2,263	$ 750	$ 882	$17,911
Provision (reversal) for loan losses (1)	(560)	46	3,140	(84)	56	806	3,404
Loans charged off	(35)	(299)	—	(650)	—	(1,835)	(2,819)
Recoveries of loans charged off	1	13	11	300	—	1,050	1,375
Balance at end of period	$3,553	$ 2,425	$ 10,355	$ 1,829	$ 806	$ 903	$19,871

	Three Months Ended September 30, 2016						
	Real Estate						
	Construction	1-4 Family Residential	Commercial	Commercial Loans	Municipal Loans	Loans to Individuals	Total
Balance at beginning of period	$4,423	$ 1,686	$ 4,680	$ 2,474	$ 737	$ 908	$14,908
Provision (reversal) for loan losses (1)	734	574	556	(682)	1	448	1,631
Loans charged off	—	(24)	—	(452)	—	(781)	(1,257)
Recoveries of loans charged off	—	7	6	344	—	354	711
Balance at end of period	$5,157	$ 2,243	$ 5,242	$ 1,684	$ 738	$ 929	$15,993

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	Nine Months Ended September 30, 2016						
	Real Estate						
	Construction	1-4 Family Residential	Commercial	Commercial Loans [2]	Municipal Loans	Loans to Individuals	Total
Balance at beginning of period	$4,350	$ 2,595	$ 4,577	$ 6,596	$ 725	$ 893	$19,736
Provision (reversal) for loan losses [1]	538	(449)	648	6,032	(236)	1,182	7,715
Loans charged off	—	(43)	—	(11,375)	—	(2,283)	(13,701)
Recoveries of loans charged off	269	140	17	431	249	1,137	2,243
Balance at end of period	$5,157	$ 2,243	$ 5,242	$ 1,684	$ 738	$ 929	$15,993

(1) Of the $960,000 and $3.4 million recorded in provision for loan losses for the three and nine months ended September 30, 2017, $50,000 related to provision expense on PCI loans. Of the $1.6 million recorded in provision for loan losses for the three months ended September 30, 2016, none related to provision expense on PCI loans. Of the $7.7 million recorded in provision for loan losses for the nine months ended September 30, 2016, approximately $1.4 million related to provision expense on PCI loans.

(2) Of the $11.4 million in commercial charge-offs recorded for the nine months ended September 30, 2016, $10.9 million includes the partial charge-off of two large commercial borrowing relationships.

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

	As of September 30, 2017						
	Real Estate						
	Construction	1-4 Family Residential	Commercial	Commercial Loans	Municipal Loans	Loans to Individuals	Total
Ending balance – individually evaluated for impairment [1]	$7	$ 12	$ 15	$ 175	$ 10	$ 100	$319
Ending balance – collectively evaluated for impairment	3,546	2,413	10,340	1,654	796	803	19,552
Balance at end of period	$3,553	$ 2,425	$ 10,355	$ 1,829	$ 806	$ 903	$19,871

	As of December 31, 2016						
	Real Estate						
	Construction	1-4 Family Residential	Commercial	Commercial Loans	Municipal Loans	Loans to Individuals	Total
Ending balance – individually evaluated for impairment [1]	$13	$ 16	$ 17	$ 923	$ 11	$ 106	$1,086
Ending balance – collectively evaluated for impairment	4,134	2,649	7,187	1,340	739	776	16,825
Balance at end of period	$4,147	$ 2,665	$ 7,204	$ 2,263	$ 750	$ 882	$17,911

(1) There was approximately $53,000 and $3,000 of allowance for loan losses associated with PCI loans as of September 30, 2017 and December 31, 2016, respectively.

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

	September 30, 2017						
	Real Estate						
	Construction	1-4 Family Residential	Commercial	Commercial Loans	Municipal Loans	Loans to Individuals	Total
Loans individually evaluated for impairment	$90	$ 1,629	$ 1,078	$ 941	$ 502	$ 243	$ 4,483
Loans collectively evaluated for impairment	420,286	602,102	1,071,148	165,027	321,784	89,965	2,670,312
Purchased credit impaired loans	121	5,428	1,420	951	—	51	7,971
Total ending loan balance	$ 420,497	$ 609,159	$ 1,073,646	$ 166,919	$ 322,286	$ 90,259	$ 2,682,766

	December 31, 2016						
	Real Estate						
	Construction	1-4 Family Residential	Commercial	Commercial Loans	Municipal Loans	Loans to Individuals	Total
Loans individually evaluated for impairment	$ 480	$ 1,693	$ 1,184	$ 5,840	$ 571	$ 241	$ 10,009
Loans collectively evaluated for impairment	379,526	629,893	942,818	170,159	298,012	116,923	2,537,331
Purchased credit impaired loans	169	5,653	1,976	1,266	—	133	9,197
Total ending loan balance	$ 380,175	$ 637,239	$ 945,978	$ 177,265	$ 298,583	$ 117,297	$ 2,556,537

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

	September 30, 2017					
	Pass	Pass Watch (1)	Special Mention (1)	Substandard (1)	Doubtful (1)	Total
Real Estate Loans:						
Construction	$ 420,118	$ —	$ —	$ 365	$ 14	$ 420,497
1-4 Family Residential	603,761	35	—	4,996	367	609,159
Commercial	961,054	16,189	43,423	52,826	154	1,073,646
Commercial Loans	157,449	955	4,760	3,480	275	166,919
Municipal Loans	320,854	—	930	502	—	322,286
Loans to Individuals	89,419	—	31	466	343	90,259
Total	$ 2,552,655	$ 17,179	$ 49,144	$ 62,635	$ 1,153	$ 2,682,766

	December 31, 2016					
	Pass	Pass Watch (1)	Special Mention (1)	Substandard (1)	Doubtful (1)	Total
Real Estate Loans:						
Construction	$ 374,443	$ 34	$ 571	$ 5,108	$ 19	$ 380,175
1-4 Family Residential	632,937	68	—	3,380	854	637,239
Commercial	885,049	17,739	10,587	32,603	—	945,978
Commercial Loans	158,943	1,187	8,086	9,012	37	177,265
Municipal Loans	297,014	—	998	571	—	298,583
Loans to Individuals	115,952	—	9	629	707	117,297

Total	$2,464,338	$19,028	$20,251	$ 51,303	$ 1,617	$2,556,537

(1) Includes PCI loans comprised of $6,000 pass watch, $482,000 special mention, $2.0 million substandard and $315,000 doubtful as of September 30, 2017. Includes PCI loans comprised of $5,000 pass watch, $511,000 special mention, $1.5 million substandard and $28,000 doubtful as of December 31, 2016.

Nonperforming Assets and Past Due Loans

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

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

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

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

	At September 30, 2017	At December 31, 2016
Nonaccrual loans (1)	$ 3,095	$ 8,280
Accruing loans past due more than 90 days (1)	—	6
Restructured loans (2)	5,725	6,431
Other real estate owned	298	339
Repossessed assets	1	49
Total Nonperforming Assets	$ 9,119	$ 15,105

(1) Excludes PCI loans measured at fair value at acquisition.
(2) Includes $3.0 million and $3.1 million in PCI loans restructured as of September 30, 2017 and December 31, 2016, respectively.

Foreclosed assets include other real estate owned and repossessed assets. For 1-4 family residential real estate properties, a loan is recognized as a foreclosed property once legal title to the real estate property has been received upon completion of foreclosure or the borrower has conveyed all interest in the residential property through a deed in lieu of foreclosure. As of September 30, 2017, there were $27,000 in loans secured by 1-4 family residential properties for which formal foreclosure proceedings were in process. As of December 31, 2016, there were $28,000 in loans secured by 1-4 family residential properties for which formal foreclosure proceedings were in process.

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

	Nonaccrual Loans	
	September 30, 2017	December 31, 2016
Real Estate Loans:		
Construction	$90	$ 105
1-4 Family Residential	1,127	1,067
Commercial	765	808
Commercial Loans	641	5,477
Loans to Individuals	472	823
Total	$3,095	$ 8,280

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

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

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

	September 30, 2017		
	Unpaid Contractual Principal Balance	Recorded Investment	Related Allowance for Loan Losses
Real Estate Loans:			
Construction	$94	$ 90	$ 7
1-4 Family Residential	4,351	4,149	12
Commercial	1,531	1,433	15
Commercial Loans	1,442	1,304	175
Municipal Loans	502	502	10
Loans to Individuals	276	243	100
Total (1)	$8,196	$ 7,721	$ 319

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

(1) Includes $3.2 million and $3.1 million of PCI loans that experienced deterioration in credit quality subsequent to the acquisition date as of September 30, 2017 and December 31, 2016, respectively.

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

	September 30, 2017					
	30-59 Days Past Due	60-89 Days Past Due	Greater than 90 Days Past Due	Total Past Due	Current (1)	Total
Real Estate Loans:						
Construction	$5,471	$—	$75	$5,546	$414,951	$420,497
1-4 Family Residential	98	340	817	1,255	607,904	609,159
Commercial	577	—	154	731	1,072,915	1,073,646
Commercial Loans	91	177	14	282	166,637	166,919
Municipal Loans	—	—	—	—	322,286	322,286
Loans to Individuals	411	157	192	760	89,499	90,259
Total	$6,648	$674	$1,252	$8,574	$2,674,192	$2,682,766

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

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

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

	Three Months Ended			
	September 30, 2017		September 30, 2016	
	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized
Real Estate Loans:				
Construction	$62	$ —	$564	$ 5
1-4 Family residential	4,170	26	4,559	42
Commercial	1,459	2	4,281	21
Commercial loans	1,148	28	7,457	13
Municipal loans	537	7	604	8
Loans to individuals	250	1	275	2
Total	$7,626	$ 64	$17,740	$ 91

	Nine Months Ended			
	September 30, 2017		September 30, 2016	
	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized
Real Estate Loans:				
Construction	$301	$ —	$519	$ 17
1-4 Family Residential	4,322	134	2,915	124
Commercial	1,368	27	4,952	64
Commercial Loans	3,320	118	15,990	30
Municipal Loans	558	23	624	26
Loans to Individuals	248	4	262	6
Total	$10,117	$ 306	$25,262	$ 267

Troubled Debt Restructurings

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

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

	Three Months Ended September 30, 2017				
	Extended Amortization Period	Interest Rate Reductions	Combination	Total Modifications	Number of Loans
Loans to Individuals	$—	$ —	$ 8	$ 8	1
Total	$—	$ —	$ 8	$ 8	1

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	Nine Months Ended September 30, 2017				
	Extend Amortization Period	Interest Rate Reductions	Combination	Total Modifications	Number of Loans
Commercial Loans	$810	$ —	$ —	$ 810	3
Loans to Individuals	27	—	56	83	6
Total	$837	$ —	$ 56	$ 893	9

	Three Months Ended September 30, 2016				
	Extend Amortization Period	Interest Rate Reductions	Combination	Total Modifications	Number of Loans
Real Estate Loans:					
1-4 Family Residential	$—	$ —	$ 30	$ 30	2
Total	$—	$ —	$ 30	$ 30	2

	Nine Months Ended September 30, 2016				
	Extend Amortization Period	Interest Rate Reductions	Combination	Total Modifications	Number of Loans
Real Estate Loans:					