

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

FORM 10-K

(Mark One)

- ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For The Fiscal Year Ended December 31, 2017
- OR
- TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the transition period from _____ to _____
Commission File Number 001-35388

PROSPERITY BANCSHARES, INC.[®]
(Exact name of registrant as specified in its charter)

Texas
(State or other jurisdiction of
incorporation or organization)

74-2331986
(I.R.S. Employer
Identification No.)

Prosperity Bank Plaza
4295 San Felipe
Houston, Texas
(Address of principal executive offices)

77027
(Zip Code)

Registrant's Telephone Number, Including Area Code: (281) 269-7199

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

Common Stock, par value
\$1.00 per share
(Title of each class)

New York Stock Exchange, Inc.
(Name of each exchange on which registered)

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 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 during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark 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 of 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 filer," "smaller reporting company" and "emerging growth company" in Rule 12b-2 of the Exchange Act.

Large Accelerated Filer	<input checked="" type="checkbox"/>	Accelerated Filer	<input type="checkbox"/>
Non-accelerated Filer	<input type="checkbox"/>	Smaller Reporting Company	<input type="checkbox"/>
		Emerging Growth Company	<input type="checkbox"/>

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

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

The aggregate market value of the shares of common stock held by non-affiliates as of June 30, 2017, based on the closing price of the common stock on the New York Stock Exchange on June 30, 2017 was approximately \$4.24 billion.

As of February 26, 2018, the number of outstanding shares of common stock was 69,831,710.

Documents Incorporated by Reference:

Portions of the Company's Proxy Statement relating to the 2018 Annual Meeting of Shareholders, which will be filed within 120 days after December 31, 2017, are incorporated by reference into Part III, Items 10-14 of this Annual Report on Form 10-K.

PROSPERITY BANCSHARES, INC.®
2017 ANNUAL REPORT ON FORM 10-K

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PART I

ITEM 1. BUSINESS

General

Prosperity Bancshares, Inc.[®], a Texas corporation (the “Company”), was formed in 1983 as a vehicle to acquire the former Allied Bank in Edna, Texas, which was chartered in 1949 as The First National Bank of Edna and is now known as Prosperity Bank. The Company is a registered financial holding company that derives substantially all of its revenues and income from the operation of its bank subsidiary, Prosperity Bank[®] (“Prosperity Bank[®]” or the “Bank”). The Bank provides a wide array of financial products and services to small and medium-sized businesses and consumers. As of December 31, 2017, the Bank operated 242 full service banking locations; 65 in the Houston area, including The Woodlands; 29 in the South Texas area, including Corpus Christi and Victoria; 33 in the Dallas/Fort Worth area; 22 in the East Texas area; 29 in the Central Texas area, including Austin and San Antonio; 34 in the West Texas area, including Lubbock, Midland-Odessa and Abilene; 16 in the Bryan/College Station area; 6 in the Central Oklahoma area; and 8 in the Tulsa, Oklahoma area. The Company’s principal executive office is located at Prosperity Bank Plaza, 4295 San Felipe in Houston, Texas and its telephone number is (281) 269-7199. The Company’s website address is www.prosperitybankusa.com.

The Company’s market consists of the communities served by its banking centers. The diverse nature of the economies in each local market served by the Company provides the Company with a varied customer base and allows the Company to spread its lending risk throughout a number of different industries including professional service firms and their principals, manufacturing, tourism, recreation, petrochemicals, farming and ranching. The Company’s market areas outside of Houston, Dallas, Corpus Christi, San Antonio, Lubbock, Austin, Tulsa and Oklahoma City are dominated by either small community banks or branches of larger regional banks. Management believes that the Company, through its responsive customer service and community banking philosophy, combined with the sophistication of a larger regional bank holding company, has a competitive advantage in its market areas and excellent growth opportunities through acquisitions, new banking center locations and additional business development.

Operating under a community banking philosophy, the Company seeks to develop broad customer relationships based on service and convenience while maintaining its prudent approach to lending and sound asset quality. The Company has grown through a combination of internal growth, the acquisition of community banks and branches of banks and the opening of new banking centers. As a result of its stable customer relationships, the Company is able to maintain a low cost of funds. Utilizing that and employing stringent cost controls, the Company has been profitable in every year of its existence, including the periods of adverse economic conditions in Texas and Oklahoma.

In addition to internal growth, the Company completed the following acquisitions within the last ten years (through December 31, 2017):

Acquired Entity	Acquired Bank	Completion Date	Number of Banking Centers Acquired ⁽¹⁾
Texas United Bancshares, Inc.	State Bank, GNB Financial, n.a., Gateway National Bank and Northwest Bank	2007	34
The Bank of Navasota	The Bank of Navasota	2007	1
Banco Popular, NA (6 branches)	N/A	2008	5
1st Choice Bancorp	1st Choice Bank	2008	1
Franklin Bank (from FDIC, as receiver) ⁽²⁾	N/A	2008	33
U.S. Bank (3 branches)	N/A	2010	3
First Bank (19 branches)	N/A	2010	15
Texas Bankers, Inc.	Bank of Texas	2012	2
The Bank Arlington	The Bank Arlington	2012	1
American State Financial Corporation	American State Bank	2012	37
Community National Bank	Community National Bank	2012	1
East Texas Financial Services, Inc.	Firstbank	2013	4
Coppermark Bancshares, Inc.	Coppermark Bank	2013	6
FVNB Corp.	First Victoria National Bank	2013	20
F&M Bancorporation Inc.	The F&M Bank & Trust Company	2014	11
Tradition Bancshares, Inc.	Tradition Bank	2016	7

(1) The number of banking centers added does not include any locations of the acquired entity that were closed and consolidated with existing banking centers of the Company upon consummation of the transaction or closed after consummation of the transaction.

(2) The Company assumed approximately \$3.6 billion of deposits and acquired certain assets, including 33 banking centers, from the Federal Deposit Insurance Corporation (“FDIC”), acting in its capacity as receiver for Franklin Bank.

Acquisition

Acquisition of Tradition Bancshares, Inc.—On January 1, 2016, the Company completed the acquisition of Tradition Bancshares, Inc. (“Tradition”) and its wholly-owned subsidiary Tradition Bank headquartered in Houston, Texas. Tradition Bank operated 7 banking offices in the Houston, Texas area, including its main office in Bellaire, 3 banking centers in Katy and 1 banking center in The Woodlands.

As of December 31, 2015, Tradition, on a consolidated basis, reported total assets of \$548.0 million, total loans of \$253.3 million, total deposits of \$488.9 million and shareholders’ equity of \$43.1 million. Under the terms of the definitive agreement, the Company issued 679,528 shares of Company common stock plus \$39.0 million in cash for all outstanding shares of Tradition capital stock, for a total merger consideration of \$71.5 million, based on the Company’s closing stock price of \$47.86 on December 31, 2015. As of December 31, 2017, the Company recognized goodwill of \$32.0 million, which is calculated as the excess of both the consideration exchanged and liabilities assumed compared with the fair value of the assets acquired. Additionally, the Company recognized \$5.6 million of core deposit intangibles.

Available Information

The Company’s website address is www.prosperitybankusa.com. The Company makes available free of charge on or through its website its Annual Report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and all amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended (“Exchange Act”), as soon as reasonably practicable after such material is electronically filed with or furnished to the Securities and Exchange Commission. Information contained on the Company’s website is not incorporated by reference into this Annual Report on Form 10-K and is not part of this or any other report.

Officers and Associates

The Company's directors and officers are important to the Company's success and play a key role in the Company's business development efforts by actively participating in civic and public service activities in the communities served by the Company.

The Company has invested heavily in its officers and associates by recruiting talented officers in its market areas and providing them with economic incentives. The senior management team has substantial experience in the Houston, Dallas, Austin, Bryan/College Station, East Texas, South Texas, West Texas, Oklahoma City and Tulsa markets and the surrounding communities in which the Company has a presence. Each banking center location is overseen by a local president or manager with knowledge of the community and lending expertise in the specific industries found in the community. The Company entrusts its banking center presidents and managers with authority and flexibility within general parameters with respect to product pricing and decision making in order to minimize the bureaucratic structure of larger banks. The Company operates each banking center as a separate profit center, maintaining separate data with respect to each banking center's net interest income, efficiency ratio, deposit growth, loan growth and overall profitability. Banking center presidents and managers are accountable for performance in these areas and compensated accordingly.

As of December 31, 2017, the Company and the Bank had 3,017 full-time equivalent associates, 790 of whom were officers of the Bank. The Company provides medical and hospitalization insurance to its full-time associates. The Company considers its relations with associates to be good. Neither the Company nor the Bank is a party to any collective bargaining agreement.

Banking Activities

The Company, through the Bank, offers a variety of traditional loan and deposit products to its customers, which consist primarily of consumers and small and medium-sized businesses. The Bank tailors its products to the specific needs of customers in a given market. At December 31, 2017, the Bank maintained approximately 595,500 separate deposit accounts including certificates of deposit and 53,200 separate loan accounts. At December 31, 2017, noninterest-bearing demand deposits were 31.6% of the Bank's total deposits. For the year ended December 31, 2017, the Company's average cost of funds was 0.33% and the Company's average cost of deposits (excluding all borrowings) was 0.27%.

The Company has been an active real estate lender, with commercial real estate (including multifamily residential) and 1-4 family residential loans comprising 33.1% and 24.5%, respectively, of the Company's total loans as of December 31, 2017. The Company also offers commercial loans, loans for automobiles and other consumer durables, home equity loans, debit and credit cards, internet banking and other cash management services, mobile banking, trust and wealth management, retail brokerage services, mortgage banking services and automated telephone banking. The Company offers businesses a broad array of loan products including term loans, lines of credit and loans for working capital, business expansion and the purchase of equipment and machinery; land development and interim construction loans for builders; and owner-occupied and non-owner occupied commercial real estate loans.

By offering certificates of deposit, interest checking accounts, savings accounts and overdraft protection at competitive rates, the Company gives its depositors a full range of traditional deposit products.

As of December 31, 2017, the Company maintains a trust department with total assets of \$2.15 billion, including managed assets of \$1.75 billion. The trust department provides trust services in the Company's various market areas.

Business Strategies

The Company's main objective is to increase deposits and loans through internal growth, as well as through acquisition opportunities, while maintaining efficiency, individualized customer service and maximizing profitability. To achieve this objective, the Company has employed the following strategic goals:

Continue Community Banking Emphasis. Although the Company has significantly grown in the last several years, it intends to continue operating as a community banking organization focused on meeting the specific needs of consumers and small and medium-sized businesses in its market areas. The Company provides a high degree of responsiveness combined with a wide variety of banking products and services. The Company staffs its banking centers with experienced bankers who possess lending expertise in the specific industries found in the given community, and gives them authority within general parameters to make certain pricing and credit decisions, avoiding the bureaucratic structure of larger banks. Each banking center has its own listed local business telephone number. Customers are served by a local banker with decision making authority.

Expand Market Share Through Internal Growth and a Disciplined Acquisition Strategy. The Company intends to continue seeking opportunities, both inside and outside its existing markets, to expand either by acquiring existing banks or branches of banks or by establishing new banking centers. All of the Company's acquisitions have been accretive to earnings within 12 months after acquisition date and generally have supplied the Company with relatively low-cost deposits which have been used to fund the Company's lending and investing activities. However, future acquisitions, if any, may not be accretive to earnings within any particular time period. Factors used by the Company to evaluate expansion opportunities include (1) the similarity in management and operating philosophies, (2) whether the acquisition will be accretive to earnings and enhance shareholder value, (3) whether the acquisition will strategically expand the Company's geographic footprint and (4) the opportunity to enhance the Company's market presence in existing market areas.

Increase Loan Volume and Diversify Loan Portfolio. While maintaining its prudent approach to lending, the Company has emphasized both new and existing loan products, focusing on increasing its commercial real estate and commercial loan portfolios. During 2017, the Company's total loans increased from \$9.62 billion to \$10.02 billion or 4.1%. Construction, land development and other land loans increased 19.4%, and represented 15.1% of the total loan portfolio as of December 31, 2017. Commercial real estate loans (including multifamily residential) increased 4.9%, and represented 33.1% of the total portfolio, as of December 31, 2017.

Maintain Sound Asset Quality. The Company continues to maintain the sound asset quality that has been representative of its historical loan portfolio. As the Company continues to diversify and increase its lending activities and acquire loans in acquisitions, it may face higher risks of nonpayment and increased risks in the event of prolonged economic downturns. The Company intends to continue to employ the strict underwriting guidelines and comprehensive loan review process that have contributed to its low incidence of nonperforming assets and its minimal charge-offs in relation to its size.

Continue Focus on Efficiency. The Company plans to maintain its stringent cost control practices and policies. The Company has invested significantly in the infrastructure required to centralize many of its critical operations, such as data processing and loan processing. For its banking centers, which the Company operates as independent profit centers, the Company supplies complete support in the areas of loan review, loan processing, internal audit, compliance and training. Management believes that this centralized infrastructure can accommodate additional growth while enabling the Company to minimize operational costs through economies of scale.

Enhance Cross-Selling. The Company uses incentives and friendly competition to encourage cross-selling efforts and increase cross-selling results among its associates. Officers and associates have access to each customer's existing and related account relationships and are better able to inform customers of additional products when customers visit or call the various banking centers or use their drive-in facilities. In addition, the Company includes product information in monthly statements and other mailings.

Competition

The banking business is highly competitive, and the profitability of the Company depends principally on its ability to compete in its market areas. The Company competes with other commercial banks, savings banks, savings and loan associations, credit unions, finance companies, mutual funds, insurance companies, brokerage and investment banking firms, asset-based nonbank lenders and certain other nonfinancial entities, including retail stores that may maintain their own credit programs and certain governmental organizations that may offer more favorable financing than the Company. The Company believes it has been able to compete effectively with other financial institutions by emphasizing customer service, technology and responsive decision-making with respect to loans, by

establishing long-term customer relationships and building customer loyalty and by providing products and services designed to address the specific needs of its customers.

Supervision and Regulation

The supervision and regulation of bank holding companies and their subsidiaries is intended primarily for the protection of depositors, the Deposit Insurance Fund (“DIF”) of the FDIC and the banking system as a whole, and not for the protection of the bank holding company’s shareholders or creditors. The banking agencies have broad enforcement power over bank holding companies and banks including the power to impose substantial fines and other penalties for violations of laws and regulations.

The following description summarizes some of the laws to which the Company and the Bank are subject. References in this Annual Report on Form 10-K to applicable statutes and regulations are brief summaries thereof, do not purport to be complete, and are qualified in their entirety by reference to such statutes and regulations.

The Company

The Company is a financial holding company pursuant to the Gramm-Leach-Bliley Act and a bank holding company registered under the Bank Holding Company Act of 1956, as amended (“BHCA”). Accordingly, the Company is subject to supervision, regulation and examination by the Board of Governors of the Federal Reserve System (“Federal Reserve Board”). The Gramm-Leach-Bliley Act, the BHCA and other federal laws subject financial and bank holding companies to particular restrictions on the types of activities in which they may engage, and to a range of supervisory requirements and activities, including regulatory enforcement actions for violations of laws and regulations. Further, since the Company has securities registered with the Securities and Exchange Commission and traded on the New York Stock Exchange, it is also subject to the supervision and regulation of these organizations.

Regulatory Restrictions on Dividends. The Company is regarded as a legal entity separate and distinct from the Bank. The principal source of the Company’s revenues is dividends received from the Bank. As described in more detail below, federal and state law places limitations on the amount that banks may pay in dividends, which the Bank must adhere to when paying dividends to the Company. It is the policy of the Federal Reserve Board that bank holding companies should pay cash dividends on common stock only out of income available over the past year and only if the prospective rate of earnings retention is consistent with the organization’s expected capital needs and financial condition. 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. The Federal Reserve Board is authorized to limit or prohibit the payment of dividends if, in the Federal Reserve Board’s opinion, the payment of dividends would constitute an unsafe or unsound practice in light of a bank holding company’s financial condition. 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.

Stress Testing. In accordance with rules adopted by the Federal Reserve Board pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”), institutions with average total consolidated assets greater than \$10 billion, such as the Company and the Bank, are required to conduct an annual company-run stress test of capital and consolidated earnings and losses under one base and at least two stress scenarios provided by bank regulatory agencies. Public disclosure of summary stress test results under the severely adverse scenario will occur between October 15 and October 31. The Company’s capital ratios reflected in the stress test calculations are an important factor considered by the Federal Reserve Board in evaluating the capital adequacy of the Company and the Bank and determining whether proposed payments of dividends or stock repurchases may be an unsafe or unsound practice.

Source of Strength. Under Federal Reserve Board policy, a bank holding company has historically been required to act as a source of financial strength to each of its banking subsidiaries. The Dodd-Frank Act codified this policy as a statutory requirement. Under this requirement, the Company is expected to commit resources to support the Bank, including support at times when the Company may not be in a financial position to provide such resources. Any capital loans by a bank holding company to any of its subsidiary banks are subordinate in right of

payment to deposits and to certain other indebtedness of such subsidiary banks. As discussed below, a bank holding company, in certain circumstances, could be required to guarantee the capital plan of an undercapitalized banking subsidiary.

In the event of a bank holding company's bankruptcy under Chapter 11 of the U.S. Bankruptcy Code, the trustee will be deemed to have assumed and is required to cure immediately any deficit under any commitment by the debtor holding company to any of the federal banking agencies to maintain the capital of an insured depository institution. Any claim for breach of such obligation will generally have priority over most other unsecured claims.

Scope of Permissible Activities. Under the BHCA, bank holding companies generally may not acquire a direct or indirect interest in or control of more than 5% of the voting shares of any company that is not a bank or bank holding company and may not engage in activities other than those of banking, managing or controlling banks or furnishing services to or performing services for its subsidiaries, except that it may engage in, directly or indirectly, certain activities that the Federal Reserve Board has determined to be so closely related to banking or managing and controlling banks as to be a proper incident thereto. In approving acquisitions or the addition of activities, the Federal Reserve Board considers, among other things, whether the acquisition or the additional activities can reasonably be expected to produce benefits to the public, such as greater convenience, increased competition, or gains in efficiency, that outweigh such possible adverse effects as undue concentration of resources, decreased or unfair competition, conflicts of interest or unsound banking practices.

Notwithstanding the foregoing, the Gramm-Leach-Bliley Act eliminated the barriers to affiliations among banks, securities firms, insurance companies and other financial service providers and permits bank holding companies to become financial holding companies and thereby affiliate with securities firms and insurance companies and engage in other activities that are financial in nature. The Gramm-Leach-Bliley Act defines "financial in nature" to include securities underwriting, dealing and market making; sponsoring mutual funds and investment companies; insurance underwriting and agency; merchant banking activities; and activities that the Federal Reserve Board has determined to be closely related to banking. Generally, no regulatory approval will be required for a financial holding company, such as the Company, to acquire a company, other than a bank or savings association, engaged in activities that are financial in nature or incidental to activities that are financial in nature as determined by the Federal Reserve Board.

The Company's financial holding company status depends upon it maintaining its status as "well capitalized" and "well managed" under applicable Federal Reserve Board regulations. If a financial holding company ceases to meet these requirements, the Federal Reserve Board may impose corrective capital and/or managerial requirements on the financial holding company and place limitations on its ability to conduct the broader financial activities permissible for financial holding companies. Until the financial holding company returns to compliance, it may not acquire a company engaged in such financial activities without prior approval of the Federal Reserve Board. In addition, the Federal Reserve Board may require divestiture of the holding company's depository institutions and/or its non-bank subsidiaries if the deficiencies persist.

While the Federal Reserve Board is the "umbrella" regulator for financial holding companies and has the power to examine banking organizations engaged in new activities, regulation and supervision of activities which are financial in nature or determined to be incidental to such financial activities will be handled along functional lines. Accordingly, activities of subsidiaries of a financial holding company will be regulated by the agency or authorities with the most experience regulating that activity as it is conducted in a financial holding company.

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 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.

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 in excess of \$1.0 million for each day the activity continues.

Anti-Tying Restrictions. Bank holding companies and their affiliates are prohibited from tying the provision of certain services, such as extensions of credit, to other services offered by a holding company or its affiliates.

Basel III Capital Adequacy Requirements. In July 2013, the Federal Reserve Board and the FDIC published the Basel III Capital Rules establishing a new comprehensive capital framework for U.S. banking organizations. The rules implemented the Basel Committee's December 2010 framework known as "Basel III" for strengthening international capital standards as well as certain provisions of the Dodd-Frank Act. The Basel III Capital Rules define the components of capital and address other issues affecting the numerator in banking institutions' regulatory capital ratio calculations and also address risk weights and other issues affecting the denominator. The Basel III Capital Rules became effective for the Company and the Bank on January 1, 2015, subject to a phase-in period for certain provisions.

The Basel III Capital Rules, among other things, include a capital measure called "Common Equity Tier 1" ("CET1") and specify that Tier 1 capital consists of CET1 and "Additional Tier 1 capital" instruments meeting specified requirements. The Basel III Capital Rules also provide for a number of deductions from and adjustments to CET1. These include, for example, the requirement that certain deferred tax assets and significant investments in non-consolidated financial entities be deducted from CET1 to the extent that any one such category exceeds 10% of CET1 or all such items, in the aggregate, exceed 15% of CET1. Implementation of the deductions and other adjustments to CET1 began on January 1, 2015 and are being phased-in over a four-year transition period (beginning at 40% on January 1, 2015 and increasing by an additional 20% per year thereafter). In October 2017, however, the banking agencies proposed rules to modify the thresholds for deductions from CET1 and in connection with that rule proposal, in November 2017, extended the transition period for financial institutions with assets less than \$50 billion, like the Company and the Bank. Under the Basel III Capital Rules, trust preferred securities no longer included in Tier 1 capital of bank holding companies may be included as Tier 2 capital on a permanent basis.

The Basel III Capital Rules also require a capital conservation buffer, composed entirely of CET1 that is designed to absorb losses during periods of economic stress and has the effect of increasing the minimum required risk-weighted capital ratios, but has no effect on the leverage ratio. The implementation of the capital conservation buffer began on January 1, 2016 at the 0.625% level and is being phased in over a four-year period (increasing by that amount on each subsequent January 1, until it reaches 2.5% on January 1, 2019). The required phase-in buffer during 2017 was 1.25%. The Basel III Capital Rules also provide for a "countercyclical capital buffer" that is applicable to only certain covered institutions and does not have any current applicability to the Company or the Bank. Banking institutions with a ratio of CET1 to risk-weighted assets below the effective minimum (4.5% plus the capital conservation buffer and, if applicable, the countercyclical capital buffer) face constraints on dividends, equity repurchases and compensation based on the amount of the shortfall.

The minimum capital ratios under the Basel III Capital Rule, including the capital conservation buffer, that were effective as of January 1, 2017 are (1) 5.75% CET1 to risk-weighted assets, (2) 7.25% Tier 1 capital to risk-weighted assets, (3) 9.25% total capital (that is, Tier 1 plus Tier 2) to risk-weighted assets and (4) 4.0% Tier 1 capital to average quarterly assets as reported on consolidated financial statements (known as the "leverage ratio"). As of December 31, 2017, the Company's ratio of CET1 to risk-weighted assets was 15.08%, Tier 1 capital to risk-weighted assets was 15.08%, total capital to risk-weighted assets was 15.74% and Tier 1 capital to average quarterly assets was 9.31%.

When fully phased in on January 1, 2019, the Basel III Capital Rules will require the Company to maintain an additional capital conservation buffer of 2.5% CET1, effectively resulting in minimum ratios of (1) CET1 to risk-weighted assets of 7.0%, (2) Tier 1 capital to risk-weighted assets of 8.5%, (3) total capital to risk-weighted assets of 10.5% and (4) a leverage ratio of 4.0%.

With respect to the Bank, the Basel III Capital Rules also revise the “prompt corrective action” regulations as discussed below under “The Bank—Corrective Measures for Capital Deficiencies.”

The Basel III Capital Rules prescribe a standardized approach for risk weightings that expands the risk-weighting categories from the general risk-based capital rules to a 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.

The federal banking agencies’ risk-based and leverage capital ratios are minimum supervisory ratios generally applicable to banking organizations that meet certain specified criteria. Banking organizations not meeting these criteria are expected to operate with capital positions well above the minimum ratios. The federal bank regulatory agencies may set capital requirements for a particular banking organization that are higher than the minimum ratios when circumstances warrant. Federal Reserve Board guidelines also provide that banking organizations experiencing internal growth or making acquisitions will be expected to maintain strong capital positions substantially above the minimum supervisory levels, without significant reliance on intangible assets.

Liquidity Requirements. Historically, regulation and monitoring of bank and bank holding company liquidity has been addressed as a supervisory matter, without required formulaic measures. The Basel III liquidity framework requires banks and bank holding companies to measure their liquidity against specific liquidity tests that, although similar in some respects to liquidity measures historically applied by banks and regulators for management and supervisory purposes, are now required by regulation.

One test, referred to as the liquidity coverage ratio (“LCR”), is designed to ensure that a banking entity maintains an adequate level of unencumbered high-quality liquid assets equal to the entity’s expected net cash outflow for a 30-day time horizon (or, if greater, 25% of its expected total cash outflow) under an acute liquidity stress scenario. The other test, referred to as the net stable funding ratio (“NSFR”), is designed to promote more medium- and long-term funding of the assets and activities of banking entities over a one-year time horizon. Neither the LCR rule nor the proposed NSFR rule apply to U.S. banking organizations with less than \$50 billion in total consolidated assets such as the Company and the Bank.

Imposition of Liability for Undercapitalized Subsidiaries. Bank regulators are required to take “prompt corrective action” to resolve problems associated with insured depository institutions whose capital declines below certain levels. In the event an institution becomes “undercapitalized,” it must submit a capital restoration plan. The capital restoration plan will not be accepted by the regulators unless each company having control of the undercapitalized institution guarantees the subsidiary’s compliance with the capital restoration plan up to a certain specified amount. Any such guarantee from a depository institution’s holding company is entitled to a priority of payment in bankruptcy.

The aggregate liability of the holding company of an undercapitalized bank is limited to the lesser of 5% of the institution’s assets at the time it became undercapitalized or the amount necessary to cause the institution to be “adequately capitalized.” The bank regulators have greater power in situations where an institution becomes “significantly” or “critically” undercapitalized or fails to submit a capital restoration plan. For example, a bank holding company controlling such an institution can be required to obtain prior Federal Reserve Board approval of proposed dividends, or might be required to consent to a consolidation or to divest the troubled institution or other affiliates.

Acquisitions by Bank Holding Companies. The BHCA requires every bank holding company to obtain the prior approval of the Federal Reserve Board before it may acquire all or substantially all of the assets of any bank, or ownership or control of any voting shares of any bank, if after such acquisition it would own or control, directly or indirectly, 5% or more of the voting shares of such bank. In approving bank acquisitions by bank holding companies, the Federal Reserve Board is required to consider, among other things, the financial and managerial resources and future prospects of the bank holding company and the banks concerned, the convenience and needs of the communities to be served and various competitive factors.

Control Acquisitions. The Change in Bank Control Act (“CBCA”) prohibits a person or group of persons from acquiring “control” of a bank holding company unless the Federal Reserve Board has been notified and has not objected to the transaction. Under a rebuttable presumption established by the Federal Reserve Board, the acquisition of 10% or more of a class of voting stock of a bank holding company with a class of securities registered under Section 12 of the Exchange Act, such as the Company, would, under the circumstances set forth in the presumption, constitute acquisition of control of the Company.

In addition, a person may not acquire 25% (5% in the case of an acquiror that is a bank holding company) or more of a bank holding company’s or bank’s voting securities, or otherwise obtain control or a controlling influence over a bank holding company or bank without the approval of the Federal Reserve Board. In 2008, the Federal Reserve Board issued a policy statement on equity investments in bank holding companies and banks, which allows the Federal Reserve Board to generally be able to conclude that an entity’s investment is not “controlling” if the entity does not own in excess of 15% of the voting power and 33% of the total equity of the bank holding company or bank. Depending on the nature of the overall investment and the capital structure of the banking organization, the Federal Reserve Board will permit, based on the policy statement, noncontrolling investments in the form of voting and nonvoting shares that represent in the aggregate (1) less than one-third of the total equity of the banking organization (and less than one-third of any class of voting securities, assuming conversion of all convertible nonvoting securities held by the entity) and (2) less than 15% of any class of voting securities of the banking organization.

The Volcker Rule. The Volcker Rule under the Dodd-Frank Act prohibits banks and their affiliates from engaging in proprietary trading and investing in and sponsoring certain hedge funds and private equity funds. Since neither the Company nor the Bank engages in the types of trading or investing covered by the Volcker Rule, the Volcker Rule does not currently have any effect on the operations of the Company or the Bank.

The Bank

The Bank is a Texas-chartered banking association, the deposits of which are insured by the DIF of the FDIC. The Bank is not a member of the Federal Reserve System, therefore the Bank is subject to supervision and regulation by the FDIC and the Texas Department of Banking. Such supervision and regulation subject the Bank to special restrictions, requirements, potential enforcement actions and periodic examination by the FDIC and the Texas Department of Banking. Because the Federal Reserve Board regulates the Company, the Federal Reserve Board also has supervisory authority which affects the Bank. Further, because the Bank has total assets of over \$10 billion, the Bank is also subject to supervision and regulation by the Consumer Financial Protection Bureau (“CFPB”). The CFPB regulates the offering and provision of consumer financial products and services under the federal consumer financial laws.

Equivalence to National Bank Powers. The Texas Constitution, as amended in 1986, provides that a Texas-chartered bank has the same rights and privileges that are or may be granted to national banks domiciled in Texas. To the extent that the Texas laws and regulations may have allowed state-chartered banks to engage in a broader range of activities than national banks, the Federal Deposit Insurance Corporation Improvement Act (“FDICIA”) has operated to limit this authority. FDICIA provides that no state bank or subsidiary thereof may engage as principal in any activity not permitted for national banks, unless the institution complies with applicable capital requirements and the FDIC determines that the activity poses no significant risk to the DIF. In general, statutory restrictions on the activities of banks are aimed at protecting the safety and soundness of depository institutions.

Financial Modernization. Under the Gramm-Leach-Bliley Act, a national bank may establish a financial subsidiary and engage, subject to limitations on investment, in activities that are financial in nature, other than insurance underwriting as principal, insurance company portfolio investment, real estate development, real estate investment, annuity issuance and merchant banking activities. To do so, a bank must be well capitalized, well managed and have a CRA rating of satisfactory or better. Subsidiary banks of a financial holding company or national banks with financial subsidiaries must remain well capitalized and well managed in order to continue to engage in activities that are financial in nature without regulatory actions or restrictions, which could include divestiture of the financial-in-nature subsidiary or subsidiaries. In addition, a financial holding company or a bank may not acquire a company that is engaged in activities that are financial in nature unless each of the subsidiary banks of the financial holding company or the bank has a CRA rating of satisfactory or better.

Although the powers of state chartered banks are not specifically addressed in the Gramm-Leach-Bliley Act, Texas-chartered banks such as the Bank, will have the same if not greater powers as national banks through the parity provision contained in the Texas Constitution.

Branching. Pursuant to the Dodd-Frank Act, banks are permitted to engage in de novo interstate branching if the laws of the state where the new branch is to be established would permit the establishment of the branch if it were chartered by such state, subject to applicable regulatory review and approval requirements. The Dodd-Frank Act also modified certain regulatory requirements for interstate mergers and acquisitions, including that the acquiring bank must be well capitalized and well managed. Texas law provides that a Texas-chartered bank can establish a branch anywhere in Texas or any other state, subject to federal law requirements, provided that the branch is approved in advance by the Texas Department of Banking. The branch must also be approved by the FDIC, which considers a number of factors, including financial history, capital adequacy, earnings prospects, character of management, needs of the community and consistency with corporate powers.

Restrictions on Transactions with Affiliates and Insiders. Transactions between the Bank and its nonbanking affiliates, including the Company, are subject to Section 23A and Section 23B of the Federal Reserve Act. In general, Section 23A imposes limits on the amount of such transactions to 10% of the Bank's capital stock and surplus and requires that such transactions be secured by designated amounts of specified collateral. It also limits the amount of advances to third parties which are collateralized by the securities or obligations of the Company or its subsidiaries. Section 23B generally requires that certain transactions between the Bank and its affiliates be on terms substantially the same, or at least as favorable to the Bank, as those prevailing at the time for comparable transactions with or involving other nonaffiliated persons.

Loans to directors, executive officers, principal shareholders and their related interests (collectively referred to herein as "insiders") are subject to restrictions contained in the Federal Reserve Act and Regulation O, which apply to all insured institutions and their subsidiaries and holding companies. Insiders are subject to enforcement actions for knowingly accepting loans in violation of applicable restrictions.

Restrictions on Distribution of Subsidiary Bank Dividends and Assets. Dividends paid by the Bank have provided a substantial part of the Company's operating funds and for the foreseeable future it is anticipated that dividends paid by the Bank to the Company will continue to be the Company's principal source of operating funds. Capital adequacy requirements serve to limit the amount of dividends that may be paid by the Bank. Under federal law, the Bank cannot pay a dividend if, after paying the dividend, the Bank will be "undercapitalized." The FDIC may declare a dividend payment to be unsafe and unsound even though the Bank would continue to meet its capital requirements after the dividend. The Bank is also subject to limitations on the payment of dividends under Texas law. Because the Company is a legal entity separate and distinct from its subsidiaries, its right to participate in the distribution of assets of any subsidiary upon the subsidiary's liquidation or reorganization will be subject to the prior claims of the subsidiary's creditors. In the event of a liquidation or other resolution of an insured depository institution, the claims of depositors and other general or subordinated creditors are entitled to a priority of payment over the claims of holders of any obligation of the institution to its shareholders, including any depository institution holding company (such as the Company) or any shareholder or creditor thereof.

Consumer Financial Protection. The Bank is subject to a number of federal and state consumer protection laws that extensively govern its relationship with its customers. These laws include the Equal Credit Opportunity Act, the Fair Credit Reporting Act, the Truth in Lending Act, the Truth in Savings Act, the Electronic Fund Transfer Act, the Expedited Funds Availability Act, the Home Mortgage Disclosure Act, the Fair Housing Act, the Real Estate Settlement Procedures Act, the Fair Debt Collection Practices Act, the Service Members Civil Relief Act and these laws' respective state-law counterparts, as well as state usury laws and laws regarding unfair and deceptive acts and practices. These and other federal laws, among other things, require disclosures of the cost of credit and terms of deposit accounts, provide substantive consumer rights, prohibit discrimination in credit transactions, regulate the use of credit report information, provide financial privacy protections, prohibit unfair, deceptive and abusive practices, restrict the Bank's ability to raise interest rates and subject the Bank to substantial regulatory oversight. Violations of applicable consumer protection laws can result in significant potential liability from litigation brought by customers, including actual damages, restitution and attorneys' fees. Federal bank regulators, state attorneys general and state and local consumer protection agencies may also seek to enforce consumer protection requirements and obtain these and other remedies, including regulatory sanctions, customer rescission rights and civil money penalties in each jurisdiction in which the Bank operates. Failure to comply with consumer

protection requirements may also result in the Bank's failure to obtain any required regulatory approval for merger or other acquisition transactions the Bank may wish to pursue or its prohibition from engaging in such transactions even if approval is not required.

The Dodd-Frank Act established the CFPB, which has supervisory, examination and enforcement authority over depository institutions with total assets of \$10 billion or greater and other providers of consumer financial products or services. The CFPB has broad rulemaking authority for a wide range of federal consumer financial laws, including, among other things, the authority to prohibit "unfair, deceptive or abusive" acts and practices. The CFPB can issue cease-and-desist orders against banks and other entities that violate federal consumer financial laws and may also institute a civil action against an entity in violation of federal consumer financial law in order to impose a civil penalty or injunction.

Customer Information Security. The federal banking agencies have adopted guidelines for safeguarding confidential, personal, nonpublic customer information. These guidelines require each financial institution, under the supervision and ongoing oversight of its board of directors or an appropriate committee thereof, to create, implement and maintain a comprehensive written information security program designed to ensure the security and confidentiality of customer information, protect against any anticipated threats or hazard to the security or integrity of such information and protect against unauthorized access to or use of such information that could result in substantial harm or inconvenience to any customer. The Bank has adopted a customer information security program to comply with these requirements.

Examinations. The FDIC periodically examines and evaluates state non-member banks, like the Bank. The Texas Department of Banking also conducts examinations of Texas-chartered banks, but may accept the results of a federal examination in lieu of conducting an independent examination. Additionally, the FDIC and Texas Department of Banking may elect to conduct a joint examination. Because the Bank has total assets of over \$10 billion, the CFPB also has examination authority with respect to the Bank's compliance with federal consumer protection laws.

Capital Adequacy Requirements. The FDIC has adopted regulations establishing minimum requirements for the capital adequacy of insured institutions. The FDIC may establish higher minimum requirements if, for example, a bank has previously received special attention or has a high susceptibility to interest rate risk.

The FDIC's risk-based capital guidelines generally require state banks to have minimum ratios of CET1 to risk-weighted assets of 4.5%, Tier 1 capital to total risk-weighted assets of 6.0% and total capital to total risk-weighted assets of 8.0%. The capital categories have the same definitions for the Bank as for the Company. As of December 31, 2017, the Bank's ratio of CET1 to risk-weighted assets was 14.98%, Tier 1 capital to total risk-weighted assets was 14.98% and its ratio of total capital to total risk-weighted assets was 15.65%.

The FDIC's leverage guidelines require state banks to maintain Tier 1 capital of no less than 4.0% of average total assets. As of December 31, 2017, the Bank's ratio of Tier 1 capital to average quarterly assets (leverage ratio) was 9.25%.

Corrective Measures for Capital Deficiencies. The federal banking regulators are required to take "prompt corrective action" with respect to capital-deficient institutions. Agency regulations define, for each capital category, the levels at which institutions are "well-capitalized," "adequately capitalized," "undercapitalized," "significantly undercapitalized" and "critically undercapitalized."

- A bank is "well capitalized" if it has a total risk-based capital ratio of 10.0% or higher; a CET1 capital ratio of 6.5% or higher; a Tier 1 risk-based capital ratio of 8.0% or higher; a leverage ratio of 5.0% or higher; and is not subject to any written agreement, order or directive requiring it to maintain a specific capital level for any capital measure.
- A bank is "adequately capitalized" if it has a total risk-based capital ratio of 8.0% or higher; a CET1 capital ratio of 4.5% or higher; a Tier 1 risk-based capital ratio of 6.0% or higher; a leverage ratio of 4.0% or higher; and does not meet the criteria for a well capitalized bank.

- A bank is “undercapitalized” if it has a total risk-based capital ratio of less than 8.0%; a CET1 capital ratio less than 4.5%; a Tier 1 risk-based capital ratio of less than 6.0% or a leverage ratio of less than 4.0%.
- A bank is “significantly undercapitalized” if it has a total risk-based capital ratio of less than 6.0%; a CET1 capital ratio less than 3.0%; a Tier 1 risk-based capital ratio of less than 4.0% or a leverage ratio of less than 3.0%.
- A bank is “critically undercapitalized” if it has a tangible equity ratio to total assets that is equal to or less than 2.0%.

At December 31, 2017, the Bank was classified as “well-capitalized” for purposes of the FDIC’s prompt corrective action regulations in effect as of such date.

In addition to requiring undercapitalized institutions to submit a capital restoration plan, agency regulations contain broad restrictions on certain activities of undercapitalized institutions including asset growth, acquisitions, branch establishment and expansion into new lines of business. With certain exceptions, an insured depository institution is prohibited from making capital distributions, including dividends, and is prohibited from paying management fees to control persons if the institution would be undercapitalized after any such distribution or payment.

As an institution’s capital decreases, the FDIC’s enforcement powers become more severe. A significantly undercapitalized institution is subject to mandated capital raising activities, restrictions on interest rates paid and transactions with affiliates, removal of management and other restrictions. The FDIC has only very limited discretion in dealing with a critically undercapitalized institution and is virtually required to appoint a receiver or conservator.

Banks with risk-based capital and leverage ratios below the required minimums may also be subject to certain administrative actions, including the termination of deposit insurance upon notice and hearing, or a temporary suspension of insurance without a hearing in the event the institution has no tangible capital.

Deposit Insurance Assessments. The deposits of the Bank are insured up to applicable limits by the DIF, and the Bank must pay deposit insurance assessments to the FDIC for such deposit insurance protection. A depository institution’s DIF assessment is calculated by multiplying its assessment rate by the assessment base, which is defined as the average consolidated total assets less the average tangible equity of the depository institution. The initial base assessment rate is based on its capital level and CAMELS ratings, certain financial measures to assess an institution’s ability to withstand asset related stress and funding related stress and, in some cases, additional discretionary adjustments by the FDIC to reflect additional risk factors.

The FDIC’s current DIF restoration plan is designed to ensure that the fund reserve ratio reaches 1.35% by September 30, 2020, as required by the Dodd-Frank Act. At least semi-annually, the FDIC updates its loss and income projections for the fund and, if needed, increases or decreases assessment rates, following notice-and-comment rulemaking, if required.

In August 2016, the FDIC announced that the DIF reserve ratio had surpassed 1.15% as of June 30, 2016. As a result, beginning in the third quarter of 2016, the initial assessment ranges for all institutions were adjusted downward such that the initial base deposit insurance assessment rate ranges from three to 30 basis points on an annualized basis (basis points representing cents per \$100 of assessable assets). After the effect of potential base-rate adjustments, the total base assessment rate could range from 1.5 to 40 basis points on an annualized basis.

Interchange Fees. Under the Durbin Amendment to the Dodd-Frank Act, the Federal Reserve Board adopted rules establishing standards for assessing whether the interchange fees that may be charged with respect to certain electronic debit transactions are “reasonable and proportional” to the costs incurred by issuers for processing such transactions. Interchange fees, or “swipe” fees, are charges that merchants pay to the Bank and other card-issuing banks for processing electronic payment transactions. Federal Reserve Board rules applicable to financial institutions that have assets of \$10 billion or more provide that the maximum permissible interchange fee for an

electronic debit transaction is the sum of 21 cents per transaction and 5 basis points multiplied by the value of the transaction. An upward adjustment of no more than 1 cent to an issuer's debit card interchange fee is allowed if the card issuer develops and implements policies and procedures reasonably designed to achieve certain fraud-prevention standards. The Federal Reserve Board also has rules governing routing and exclusivity that require issuers to offer at least two unaffiliated networks for routing transactions on each debit or prepaid product.

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 (1) total reported loans for construction, land development and other land represent 100% or more of total capital or (2) 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.

Community Reinvestment Act. The Community Reinvestment Act of 1977 ("CRA") and the regulations issued thereunder are intended to encourage banks to help meet the credit needs of their communities, including low and moderate income neighborhoods, consistent with the safe and sound operations of the banks. These regulations also provide for regulatory assessment of a bank's CRA record when considering applications to establish branches, merger applications and applications to acquire the assets and assume the liabilities of another bank. The Financial Institutions Reform, Recovery, and Enforcement Act ("FIRREA") requires federal banking agencies to make public a rating of a bank's performance under the CRA. In the case of a financial holding company or a bank holding company, the CRA performance records of the banks involved in the transaction are reviewed in connection with the filing of an application to acquire ownership or control of shares or assets of a bank or to merge with any other bank holding company. An unsatisfactory record can substantially delay or block the transaction.

Anti-Money Laundering and Anti-Terrorism Legislation. A major focus of governmental policy on financial institutions in recent years has been aimed at combating money laundering and terrorist financing. The USA PATRIOT Act of 2001 (the "USA Patriot Act") substantially broadened the scope of United States anti-money laundering laws and regulations by imposing significant new compliance and due diligence obligations, creating new crimes and penalties and expanding the extra-territorial jurisdiction of the United States. The United States Treasury Department has issued and, in some cases, proposed a number of regulations that apply various requirements of the USA Patriot Act to financial institutions. These regulations impose obligations on financial institutions to maintain appropriate policies, procedures and controls to detect, prevent and report money laundering and terrorist financing and to verify the identity of their customers. The regulations also impose specific due diligence requirements on financial institutions that maintain correspondent or private banking relationships with non-U.S. financial institutions or persons. Failure of a financial institution to maintain and implement adequate programs to combat money laundering and terrorist financing, or to comply with all of the relevant laws or regulations, could have serious legal and reputational consequences for the institution and could block or substantially delay a merger or other acquisition transaction.

Office of Foreign Assets Control Regulation. The United States has imposed economic sanctions that affect transactions with designated foreign countries, nationals and others. These are typically known as the "OFAC" rules based on their administration by the U.S. Treasury Department Office of Foreign Assets Control ("OFAC"). The OFAC-administered sanctions targeting countries take many different forms. Generally, however, they contain one or more of the following elements: (1) restrictions on trade with or investment in a sanctioned country, including prohibitions against direct or indirect imports from and exports to a sanctioned country and prohibitions on "U.S. persons" engaging in financial transactions relating to making investments in, or providing investment-related advice or assistance to, a sanctioned country; and (2) a blocking of assets in which the government or specially designated nationals of the sanctioned country have an interest, by prohibiting transfers of property subject to U.S. jurisdiction (including property in the possession or control of U.S. persons). Blocked assets (e.g., property and bank deposits) cannot be paid out, withdrawn, set off or transferred in any manner without a license from OFAC.

Failure to comply with these sanctions could have serious legal and reputational consequences, including substantial delay or blocking of a merger or other acquisition transaction.

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 (1) provide incentives that do not encourage risk-taking beyond the organization's ability to effectively identify and manage risks, (2) be compatible with effective internal controls and risk management and (3) be supported by strong corporate governance, including active and effective oversight by the organization's Board of Directors.

These three principles are incorporated into the proposed revised rules on incentive-based payment arrangements at specified covered institutions released in May 2016 by a number of federal agencies, including the Federal Reserve Board, FDIC and SEC. The proposed revised rules would establish general qualitative requirements applicable to all covered institutions, including the Company and the Bank, that have at least \$1 billion in total assets, which would include (1) prohibiting incentive arrangements that encourage inappropriate risks by providing excessive compensation; (2) prohibiting incentive arrangements that encourage inappropriate risks that could lead to a material financial loss; (3) establishing requirements for performance measures to appropriately balance risk and reward; (4) requiring Board of Director oversight of incentive arrangements; and (5) mandating appropriate record-keeping. Under the proposed rule, larger financial institutions with total consolidated assets of at least \$50 billion would also be subject to additional requirements.

The Federal Reserve Board and FDIC 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 are 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 this supervisory initiative 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.

Legislative and Regulatory Initiatives

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 the Bank could have a material effect on the Company's business, financial condition and results of operations. In addition, the recent change in federal administration in the United States, has added additional uncertainty to the implementation, scope and timing of regulatory reforms.

Effect on Economic Environment

The policies of regulatory authorities, including the monetary policy of the Federal Reserve Board, have a significant effect on the operating results of bank holding companies and their subsidiaries. Among the means available to the Federal Reserve Board to affect the money supply are open market operations in U.S. government securities, changes in the discount rate on member bank borrowings and changes in reserve requirements against member bank deposits. These means are used in varying combinations to influence overall growth and distribution of bank loans, investments and deposits; and their use may affect interest rates charged on loans or paid for deposits.

Federal Reserve Board monetary policies have materially affected the operating results of commercial banks in the past and are expected to continue to do so in the future. The nature of future monetary policies and the effect of such policies on the business and earnings of the Company and its subsidiaries cannot be predicted.

ITEM 1A. RISK FACTORS

An investment in the Company's common stock involves risks. The following is a description of the material risks and uncertainties that the Company believes affect its business and an investment in the common stock. Additional risks and uncertainties that the Company is unaware of, or that it currently deems immaterial, also may become important factors that affect the Company and its business. If any of the risks described in this Annual Report on Form 10-K were to occur, the Company's financial condition, results of operations and cash flows could be materially and adversely affected. If this were to happen, the value of the common stock could decline significantly and all or part of an investment could be lost.

Risks Associated with the Company's Business

The Company's business is subject to interest rate risk, and fluctuations in interest rates may adversely affect its financial condition and results of operations.

The majority of the Company's assets are monetary in nature, and, as a result, the Company is subject to significant risk from changes in interest rates. Changes in interest rates can impact the Company's net interest income as well as the valuation of its assets and liabilities. The Company's earnings are significantly dependent on its net interest income. Net interest income is the difference between the interest income earned on loans, investments and other interest-earning assets and the interest expense paid on deposits, borrowings and other interest-bearing liabilities.

Changes in monetary policy, including changes in interest rates, could influence the interest the Company receives on loans and securities and the amount of interest it pays on deposits and borrowings, and could also affect (1) the Company's ability to originate loans and obtain deposits, (2) the fair value of the Company's financial assets and liabilities and (3) the average duration of the Company's mortgage-backed 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 other investments, the Company's net interest income, and therefore earnings, could be adversely affected. Earnings also could be adversely affected if the interest rates received on loans and other investments decrease more quickly than the interest rates paid on deposits and other borrowings. Further, the Company's assets and liabilities may react differently to changes in overall market rates or conditions because there may be mismatches between the repricing or maturity characteristics of the assets and liabilities. Any substantial, unexpected, prolonged change in market interest rates could have a material adverse effect on the Company's business, financial condition and results of operations.

The Company's business depends on its ability to successfully manage credit risk.

Our business depends on our ability to successfully measure and manage credit risk. As a lender, we are exposed to the risk that the principal of, or interest on, a loan will not be repaid timely or at all or that the value of any collateral supporting a loan will be insufficient to cover our outstanding exposure. In addition, we are exposed to risks with respect to the period of time over which the loan may be repaid, risks relating to proper loan underwriting, risks resulting from changes in economic and industry conditions, and risks inherent in dealing with

individual loans and borrowers. The creditworthiness of a borrower is affected by many factors including local market conditions and general economic conditions. If the overall economic climate in the United States, generally, or our market areas, specifically, experiences material disruption, our borrowers may experience difficulties in repaying their loans, the collateral we hold may decrease in value or become illiquid, and the level of nonperforming loans, charge-offs and delinquencies could rise and require significant additional provisions for credit losses. Additional factors related to the credit quality of commercial loans include the quality of the management of the business and the borrower's ability both to properly evaluate changes in the supply and demand characteristics affecting their market for products and services and to effectively respond to those changes. Additional factors related to the credit quality of commercial real estate loans include tenant vacancy rates and the quality of management of the property.

Our risk management practices, such as monitoring the concentration of our loans within specific industries and our credit approval, review and administrative practices, may not adequately reduce credit risk, and our credit administration personnel, policies and procedures may not adequately adapt to changes in economic or any other conditions affecting customers and the quality of the loan portfolio. Many of our loans are made to small and medium-sized businesses that are less able to withstand competitive, economic and financial pressures than larger borrowers. Consequently, we may have significant exposure if any of these borrowers becomes unable to pay their loan obligations as a result of economic or market conditions, or personal circumstances, such as divorce or death. A failure to effectively measure and limit the credit risk associated with our loan portfolio may result in loan defaults, foreclosures and additional charge-offs, and may necessitate that we significantly increase our allowance for credit losses, each of which could adversely affect our net income. As a result, our inability to successfully manage credit risk could have a material adverse effect on our business, financial condition and results of operations.

The Company's allowance for credit losses may not be sufficient to cover actual credit losses, which could adversely affect its earnings.

As a lender, the Company is exposed to the risk that its 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 the Company for the outstanding balance of the loan plus the costs to dispose of the collateral. The Company maintains an allowance for credit losses in an attempt to cover estimated losses inherent in its loan portfolio. Additional credit losses will likely occur in the future and may occur at a rate greater than the Company has experienced to date. The determination of the appropriate level of the allowance inherently involves a high degree of subjectivity and requires the Company to make significant estimates of current credit risks, future trends and general economic conditions, all of which may undergo material changes. If the Company's assumptions prove to be incorrect or if it experiences significant credit losses in future periods, its current allowance may not be sufficient to cover actual credit losses and adjustments may be necessary to allow for different economic conditions or adverse developments in its loan portfolio. A material addition to the allowance could cause net income, and possibly capital, to decrease.

In addition, federal and state regulators periodically review the Company's allowance for credit losses and may require the Company to increase its provision for credit losses or recognize further charge-offs, based on judgments different than those of the Company's management. An increase in the Company's allowance for credit losses or charge-offs as required by these regulatory agencies could have a material adverse effect on the Company's operating results and financial condition.

In addition, in June 2016, the Financial Accounting Standards Board issued a new accounting standard that will replace the current approach under GAAP for establishing allowances for credit losses, which generally considers only past event and current conditions, with a forward-looking methodology that reflects the expected credit losses over the lives of financial assets, starting when such assets are first acquired. Under the revised methodology, credit losses will be measured based on past events, current conditions and reasonable and supportable forecasts that affect the collectability of financial assets. The standard is expected to result in increases to allowance levels generally and will require the application of the revised methodology to existing financial assets through a one-time adjustment to retained earnings upon initial effectiveness. The standard will be effective for us beginning in 2020. See "Notes to Consolidated Financial Statements—Note 1—Summary of Accounting Policies—Pending Accounting Pronouncements" for additional information about the standard.

The Company's profitability depends significantly on local economic conditions.

The Company's success depends primarily on the general economic conditions of the primary markets in Texas and Oklahoma in which it operates and where its loans are concentrated. The local economic conditions in Texas and Oklahoma have a significant impact on the Company's commercial, real estate and construction, land development and other land loans; the ability of its borrowers to repay their loans; and the value of the collateral securing these loans. Accordingly, if the population or income growth in the Company's market areas is slower than projected, income levels, deposits and housing starts could be adversely affected and could result in a reduction of the Company's expansion, growth and profitability. In addition, due to the large number of oil and gas companies in the Company's market areas, the volatility in oil prices may negatively impact economic conditions in these areas. If the Company's market areas experience a downturn or a recession for a prolonged period of time, the Company could experience significant increases in nonperforming loans, which could lead to operating losses, impaired liquidity and eroding capital. A significant decline in general economic conditions, caused by inflation, a decline in commodity prices, recession, weather extremes, acts of terrorism, outbreaks of hostilities or other international or domestic calamities, unemployment or other factors could impact these local economic conditions and could negatively affect the Company's financial condition, results of operations and cash flows.

If the Company is not able to continue its historical levels of growth, it may not be able to maintain its historical earnings trends.

To achieve its past levels of growth, the Company has focused on both internal growth and acquisitions. The Company may not be able to sustain its historical rate of growth or may not be able to grow at all. More specifically, the Company 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, the Company may be unable to attract and retain experienced bankers, which could adversely affect its internal growth. If the Company is not able to continue its historical levels of growth, it may not be able to maintain its historical earnings trends.

If the Company is unable to manage its growth effectively, its operations and profitability could be negatively affected.

The Company faces a variety of risks and difficulties pursuing its growth strategy, including:

- finding suitable markets for expansion;
- finding suitable candidates for acquisition;
- attracting funding to support additional growth;
- maintaining asset quality;
- attracting and retaining qualified management;
- managing execution risks;
- maintaining adequate regulatory capital; and
- scaling technology platforms.

In addition, in order to manage its growth and maintain adequate information and reporting systems within its organization, the Company must identify, hire and retain additional qualified associates, particularly in the accounting and operational areas of its business.

If the Company does not manage its growth effectively, its business, financial condition, results of operations and future prospects could be negatively affected, and the Company may not be able to continue to implement its business strategy and successfully conduct its operations.

If the Company is unable to identify and acquire other financial institutions and successfully integrate its acquired businesses, its business and earnings may be negatively affected.

The market for acquisitions remains highly competitive, and the Company may be unable to find acquisition candidates in the future that fit its acquisition and growth strategy. To the extent that the Company is unable to find suitable acquisition candidates, an important component of its growth strategy may be lost.

Acquisitions of financial institutions involve operational risks and uncertainties and acquired companies may have unforeseen liabilities, exposure to asset quality problems, key employee and customer retention problems and other problems that could negatively affect the Company's organization. The Company may not be able to complete future acquisitions; and, if completed, the Company may not be able to successfully integrate the operations, management, products and services of the entities that it acquires and eliminate redundancies. The integration process could result in the loss of key employees or disruption of the combined entity's ongoing business or inconsistencies in standards, controls, procedures and policies that adversely affect the Company's ability to maintain relationships with customers and employees or achieve the anticipated benefits of the transaction. The integration process may also require significant time and attention from the Company's management that they would otherwise direct at servicing existing business and developing new business. The Company's inability to find suitable acquisition candidates or failure to successfully integrate the entities it acquires into its existing operations may increase its operating costs significantly and adversely affect its business and earnings.

The Company's dependence on loans secured by real estate subjects it to risks relating to fluctuations in the real estate market that could adversely affect its financial condition, results of operations and cash flows.

Approximately 80.5% of the Company's total loans as of December 31, 2017 consisted of loans included in the real estate loan portfolio, with 38.1% in commercial real estate (including farmland and multifamily residential), 27.3% in residential real estate (including home equity) and 15.1% in construction, land development and other land loans. The real estate collateral in each case provides an alternate source of repayment in the event of default by the borrower and may deteriorate in value during the time the credit is extended. A weakening of the real estate market in the Company's primary market areas could have an adverse effect on the demand for new loans, the ability of borrowers to repay outstanding loans, the value of real estate and other collateral securing the loans and the value of real estate owned by the Company. If real estate values decline, it is also more likely that the Company would be required to increase its allowance for credit losses, which could adversely affect its financial condition, results of operations and cash flows.

The Company's commercial real estate and commercial loans expose it to increased credit risks, and these risks will increase if the Company succeeds in increasing these types of loans.

The Company, while maintaining its conservative approach to lending, has emphasized both new and existing loan products, focusing on managing its commercial real estate (including farmland and multifamily residential) and commercial loan portfolios, and intends to continue to increase its lending activities and acquire loans in possible future acquisitions. As a result, commercial real estate and commercial loans as a proportion of its portfolio could increase. As of December 31, 2017, commercial real estate (including farmland and multifamily residential) and commercial loans totaled \$5.30 billion. In general, commercial real estate loans and commercial loans yield higher returns and often generate a deposit relationship, but also pose greater credit risks than do owner-occupied residential real estate loans. These types of loans are also typically larger than residential real estate loans. Accordingly, the deterioration of one or several of these loans could cause a significant increase in nonperforming loans, which could result in a loss of earnings from these loans and an increase in the provision for credit losses and net charge-offs.

The Company makes both secured and some unsecured commercial loans. Unsecured loans generally involve a higher degree of risk of loss than do secured loans because, without collateral, repayment is wholly dependent upon the success of the borrowers' businesses. Secured commercial loans are generally collateralized by accounts receivable, inventory, equipment or other assets owned by the borrower and include a personal guaranty of the business owner. Compared to real estate, that type of collateral is more difficult to monitor, its value is harder to ascertain, it may depreciate more rapidly and it may not be as readily saleable if repossessed. Further, commercial loans generally will be serviced primarily from the operation of the business, which may not be successful, while

commercial real estate loans generally will be serviced from income on the properties securing the loans. As the Company's various commercial loan portfolios increase, the corresponding risks and potential for losses from these loans will also increase.

Failure to compete effectively for customers could adversely affect the Company's growth and profitability, which could have a material adverse effect on the Company's business, financial condition and results of operations.

The Company faces substantial competition in all areas of its operations from a variety of different competitors, many of which are larger and may have more financial resources. These competitors primarily include national, regional, and community banks within the various markets where the Company operates. The Company also faces competition from many other types of financial institutions, including savings and loans, credit unions, finance companies, brokerage firms, insurance companies and other financial intermediaries. The financial services industry could become even more competitive as a result of legislative, regulatory and technological changes and continued consolidation. Also, technology and other changes have lowered barriers to entry and made it possible for non-banks to offer products and services functionally equivalent to those provided by banks. The process of eliminating banks as intermediaries, known as "disintermediation," could result in the loss of fee income, as well as the loss of customer deposits and the related income generated from those deposits. Further, many of the Company's competitors have fewer regulatory constraints and may have lower cost structures. Additionally, due to their size, many competitors may be able to achieve economies of scale and, as a result, may offer a broader range of products and services as well as better pricing for those products and services than the Company can. Failure to compete effectively for deposit, loan and other banking customers in the Company's market areas could adversely affect the Company's growth and profitability, which, in turn, could have a material adverse effect on the Company's business, financial condition and results of operations.

Liquidity risk could impair the Company's ability to fund operations and jeopardize its financial condition.

Liquidity is essential to the Company's business. An inability to raise funds through deposits, borrowings, the sale of loans and other sources could have a substantial negative effect on its liquidity. The Company's access to funding sources in amounts adequate to finance its activities or on terms which are acceptable to it could be impaired by factors that affect the Company specifically or the financial services industry or economy in general. Factors that could detrimentally impact the Company's access to liquidity sources include a decrease in the level of its business activity as a result of a downturn in the markets in which its loans are concentrated or adverse regulatory action against it. The Company's ability to borrow could also be impaired by factors that are not specific to it, such as a disruption in the financial markets or negative views and expectations about the prospects for the financial services industry in light of the recent turmoil faced by banking organizations and the continued deterioration in credit markets.

We rely on customer deposits as a significant source of funding, and our deposits may decrease in the future.

We rely on customer deposits as a significant source of funding. Competition among U.S. banks for customer deposits is intense, and may increase the cost of deposits or prevent new deposits, and may otherwise negatively affect our ability to grow our deposit base. Our deposit accounts may decrease in the future, and any such decrease could have an adverse impact on our sources of funding, which impact could be material. Any changes we make to the rates offered on our deposit products to remain competitive with other financial institutions may adversely affect our profitability and liquidity. The demand for the deposit products we offer may also be reduced due to a variety of factors such as demographic patterns, changes in customer preferences, reductions in consumers' disposable income, regulatory actions that decrease customer access to particular products or the availability of competing products.

If the goodwill that the Company recorded in connection with a business acquisition becomes impaired, it could require charges to earnings.

Goodwill represents the amount by which the acquisition cost exceeds the fair value of net assets the Company acquired in the purchase of another financial institution. The Company reviews goodwill for impairment at least annually, or more frequently if events or changes in circumstances indicate the carrying value of the asset might be impaired.

The Company determines impairment by comparing the implied fair value of the reporting unit goodwill with the carrying amount of that goodwill. If the carrying amount of the reporting unit goodwill exceeds the implied fair value of that goodwill, an impairment loss is recognized in an amount equal to that excess. Any such adjustments are reflected in the Company's results of operations in the periods in which they become known. At December 31, 2017, the Company's goodwill totaled \$1.90 billion. Although the Company has not recorded any such impairment charges since it initially recorded the goodwill, the Company's future evaluations of goodwill could result in findings of impairment and related write-downs, which may have a material adverse effect on its financial condition and results of operations.

The Company's accounting estimates and risk management processes rely on analytical and forecasting models and tools that may prove to be inaccurate.

The processes the Company uses to estimate its probable credit losses and to measure the fair value of financial instruments, as well as the processes used to estimate the effects of changing interest rates and other market measures on the Company's financial condition and results of operations, depend upon the use of analytical and forecasting models and tools. These models and tools reflect assumptions that may not be accurate, particularly in times of market stress or other unforeseen circumstances. Even if these assumptions are accurate, the models and tools may prove to be inadequate or inaccurate because of other flaws in their design or their implementation. Any such failure in the Company's analytical or forecasting models and tools could have a material adverse effect on the Company's business, financial condition and results of operations.

The Company may be adversely affected by the soundness of other financial institutions.

Financial services institutions are interrelated as a result of trading, clearing, counterparty or other relationships. The Company has exposure to many different industries and counterparties, and routinely executes transactions with counterparties in the financial services industry, including commercial banks, brokers and dealers, investment banks and other institutional clients. Many of these transactions expose the Company to credit risk in the event of a default by a counterparty or client. In addition, the Company's credit risk may be exacerbated when the collateral held by the Company cannot be realized upon or is liquidated at prices not sufficient to recover the full amount of the credit or derivative exposure due to the Company. Any such losses could have a material adverse effect on the Company's financial condition, results of operations and cash flows.

The Company may need to raise additional capital in the future and such capital may not be available when needed on acceptable terms or at all.

The Company may need to raise additional capital in the future to provide it with sufficient capital resources and liquidity to meet regulatory capital requirements or its commitments and business needs. In addition, the Company may elect to raise additional capital to support its business or to finance acquisitions, if any. If needed, the Company's ability to raise additional capital will depend on many things, including conditions in the capital markets at that time, which are outside its control, and its financial performance.

Such capital may not be available to the Company on acceptable terms or at all. Any occurrence that may limit the Company's access to the capital markets, such as a decline in the confidence of investors, depositors of Prosperity Bank or counterparties participating in the capital markets, may adversely affect the Company's capital costs and its ability to raise capital and, in turn, its liquidity. Moreover, if the Company needs to raise capital in the future, it may have to do so when many other financial institutions are also seeking to raise capital and would have to compete with those institutions for investors. An inability to raise additional capital on acceptable terms when needed could have a material adverse effect on the Company's business, financial condition and results of operations.

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

From time to time, the Company may implement or acquire 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 new products and services, the Company may invest significant time and resources. Initial timetables for the introduction and development of new lines of business and/or new products or services may not be achieved and price and profitability targets may not prove feasible. 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. Furthermore, any new line of business and/or new product or service could have a significant impact on the effectiveness of the Company's system of internal controls. Failure to successfully manage these risks in the development and implementation of new lines of business or new products or services could have a material adverse effect on the Company's business, financial condition and results of operations.

An interruption in or breach in security of the Company's information systems may result in a loss of customer business and have an adverse effect on the Company's results of operations, financial condition and cash flows.

The Company relies heavily on communications and information systems to conduct its business. Any failure, interruption or breach in security of these systems, whether caused by physical damage, hackers, viruses or other malware, could jeopardize the security of information stored in and transmitted through the Company's computer systems and network infrastructure as well as result in failures or disruptions in the Company's customer relationship management, general ledger, deposits, servicing or loan origination systems. While the Company maintains specific "cyber" insurance coverage, which the Company expects would apply in the event of various breach scenarios, the amount of coverage may not be adequate in any particular case. In addition, cyber threat scenarios are inherently difficult to predict and can take many forms, some of which may not be covered under the Company's cyber insurance coverage. Although the Company, with the help of third-party service providers, has and intends to continue to implement security technology and operational procedures to prevent such damage, these security measures may not entirely mitigate these risks. In addition, advances in computer capabilities, new discoveries in the field of cryptography or other developments could result in a compromise or breach of the algorithms the Company and its third-party service providers use to protect client transaction data. The occurrence of any such failures, interruptions or security breaches could damage the Company's reputation, result in a loss of customer business, subject the Company to additional regulatory scrutiny or expose the Company to civil litigation and possible financial liability, any of which could have a material adverse effect on the Company's results of operations, financial condition and cash flows.

The Company is subject to certain risks in connection with its use of technology.

The financial services industry is undergoing rapid technological changes with frequent introductions of new technology-driven products and services. The Company's future success depends in part upon its ability to address the needs of its customers by using technology to provide products and services that will satisfy customer demands for convenience as well as create additional efficiencies in its operations. Many of the Company's competitors have substantially greater resources to invest in technological improvements. The Company may not be able to effectively implement new technology-driven products and services or be successful in marketing these products and services to its customers, which may negatively affect the Company's results of operations, financial condition and cash flows. Further, as technology advances, the ability to initiate transactions and access data has become more widely distributed among mobile devices, personal computers, automated teller machines, remote deposit capture sites and similar access points. These technological advances increase cybersecurity risk. While the Company maintains programs intended to prevent or limit the effects of cybersecurity risk, there is no assurance that unauthorized transactions or unauthorized access to customer information will not occur. The financial, reputational and regulatory impact of unauthorized transactions or unauthorized access to customer information could be significant.

The Company's operations rely on external vendors, which may fail to provide adequate services.

The Company relies on certain external vendors to provide products and services necessary to maintain its day-to-day operations. These third parties provide key components of the Company's business operations such as data processing, recording and monitoring transactions, online banking interfaces and services, Internet connections and network access. While the Company has selected these third-party vendors carefully, it does not control their actions. Any complications caused by these third parties, including those resulting from disruptions in communication services provided by a vendor, failure of a vendor to handle current or higher volumes, cyber-attacks and security breaches at a vendor, failure of a vendor to provide services for any reason or poor performance of services, could adversely affect the Company's ability to deliver products and services to its customers and otherwise conduct its business. Financial or operational difficulties of a third-party vendor could also hurt the Company's operations if those difficulties interfere with the vendor's ability to provide services. Furthermore, the Company's vendors could also be sources of operational and information security risk, including from breakdowns or failures of their own systems or capacity constraints, and reputational risk. Replacing these third-party vendors could also create significant delay and expense. Problems caused by external vendors could be disruptive to the Company's operations, which could have a material adverse impact on the Company's business and, in turn, the Company's financial condition and results of operations.

The Company's business may be adversely affected by security breaches at third parties.

The Company's customers interact with their own and other third-party systems, which pose operational risks to the Company. The Company may be adversely affected by data breaches at retailers and other third parties who maintain data relating to the Company's customers that involve the theft of customer data, including the theft of customers' debit card, 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. Despite third-party security risks that are beyond the Company's control, the Company offers its customers protection against fraud and attendant losses for unauthorized use of debit and credit cards in order to stay competitive in the marketplace. Offering such protection to customers exposes the Company to significant expenses and potential losses related to reimbursing the Company's customers for fraud losses, reissuing the compromised cards and increased monitoring for suspicious activity. 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.

The Company is subject to claims and litigation pertaining to intellectual property.

Banking and other financial services companies, such as the Company, rely on technology companies to provide information technology products and services necessary to support their 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 the Company's vendors, or other individuals or companies, have from time to time claimed to hold intellectual property sold to the Company 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, the Company may have to engage in protracted litigation. Such litigation is often expensive, time-consuming, disruptive to the Company's operations and distracting to management. If the Company were to be found to have infringed one or more patents or other intellectual property rights, it may be required to pay substantial damages or royalties to a third-party. In certain cases, the Company 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 the Company's operating expenses. If legal matters related to intellectual property claims were resolved against the Company or settled, the Company could be required to make payments in amounts that could have a material adverse effect on its business, financial condition and results of operations.

The Company is subject to claims and litigation pertaining to fiduciary responsibility.

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

The Company operates in a highly regulated environment and, as a result, is subject to extensive regulation and supervision.

The Company and the Bank are subject to extensive federal and state regulation and supervision. Banking regulations are primarily intended to protect depositors' funds, federal deposit insurance funds and the banking system as a whole, not the Company's shareholders. These regulations affect the Company's lending practices, capital structure, investment practices, dividend policy and growth, among other things. Congress and federal regulatory agencies continually review banking laws, regulations and policies for possible changes. Any change in applicable regulations or federal or state legislation could have a substantial impact on the Company, the Bank and their respective operations.

The Dodd-Frank Act, enacted in July 2010, instituted major changes to the banking and financial institutions regulatory regimes in light of the performance of and government intervention in the financial services sector during the several years prior to the implementation of such Act. Additional legislation and regulations or regulatory policies, including changes in interpretation or implementation of statutes, regulations or policies, could significantly affect the Company's powers, authority and operations, or the powers, authority and operations of the Bank in substantial and unpredictable ways. Further, regulators have significant discretion and power to prevent or remedy unsafe or unsound practices or violations of laws by banks and bank holding companies in the performance of their supervisory and enforcement duties. The exercise of this regulatory discretion and power could have a negative impact on the Company. 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.

The Company's risk management framework may not be effective in identifying, managing or mitigating risks and/or losses to it.

The Company has implemented a risk management framework to identify and manage its risk exposure, which is reviewed and overseen by the Company's Risk Committee. This framework consists of various processes, systems and strategies, and is designed to manage the types of risk to which the Company is subject, including, among others, credit, market, liquidity, operational, financial, interest rate, legal and regulatory, compliance, strategic, reputation, fiduciary and general economic risks. The Company's framework also includes financial or other modeling methodologies, which involves management assumptions and judgment. In addition, under this framework, the Company has developed a risk appetite statement to detail its risk tolerance levels at an enterprise-wide level. This risk management framework may not be effective under all circumstances, and it may not adequately identify, manage or mitigate all or any risk or loss to the Company. If this framework is not effective, the Company may be subject to potentially adverse regulatory consequences and could suffer unexpected losses and its financial condition or results of operations could be materially adversely affected.

The Company is subject to losses resulting from fraudulent and negligent acts on the part of loan applicants, correspondents or other third parties.

The Company relies heavily upon information supplied by third parties, including the information contained in credit applications, property appraisals, title information, equipment pricing and valuation and employment and income documentation, in deciding which loans the Company will originate, as well as the terms of those loans. If any of the information upon which the Company relies is misrepresented, either fraudulently or inadvertently, and the misrepresentation is not detected prior to asset funding, the value of the asset may be significantly lower than

expected, or the Company may fund a loan that it would not have funded or on terms it would not have extended. Whether a misrepresentation is made by the applicant or another third party, the Company generally bears the risk of loss associated with the misrepresentation. A loan subject to a material misrepresentation is typically unsellable or subject to repurchase if it is sold prior to detection of the misrepresentation. The sources of the misrepresentations are often difficult to locate, and it is often difficult to recover any of the monetary losses the Company may suffer.

The Company is subject to environmental liability risk associated with lending activities.

A significant portion of the Company's loan portfolio is secured by real property. During the ordinary course of business, the Company may foreclose on and take title to properties securing certain loans, and there is a risk that hazardous or toxic substances could be found on these properties. If hazardous or toxic substances are found, the Company may be liable for remediation costs, as well as for personal injury and property damage. Environmental laws may require the Company to incur substantial expenses and may materially reduce the affected property's value or limit the Company's 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 the Company's exposure to environmental liability. Although the Company has policies and procedures to perform an environmental review before initiating any foreclosure action on real property, these reviews 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 the Company's financial condition and results of operations.

Risks Associated with the Company's Common Stock

The Company's corporate organizational documents and the provisions of Texas law to which it is subject may delay or prevent a change in control of the Company that a shareholder may favor.

The Company's amended and restated articles of incorporation and amended and restated bylaws contain various provisions which may delay, discourage or prevent an attempted acquisition or change of control of the Company. These provisions include:

- a Board of Directors classified into three classes of directors with the directors of each class having staggered three-year terms;
- a provision that any special meeting of the Company's shareholders may be called only by the chairman of the board and chief executive officer, the president, a majority of the Board of Directors or the holders of at least 50% of the Company's shares entitled to vote at the meeting; and
- a provision establishing certain advance notice procedures for nomination of candidates for election as directors and for shareholder proposals to be considered at an annual or special meeting of shareholders.

The Company's articles of incorporation provide for noncumulative voting for directors and authorize the Board of Directors to issue shares of its preferred stock without shareholder approval and upon such terms as the Board of Directors may determine. The issuance of the Company's preferred stock could have the effect of making it more difficult for a third party to acquire, or of discouraging a third party from acquiring, a controlling interest in the Company. In addition, certain provisions of Texas law, including a provision which restricts certain business combinations between a Texas corporation and certain affiliated shareholders, may delay, discourage or prevent an attempted acquisition or change in control of the Company.

There are restrictions on the Company's ability to pay dividends.

Holders of the Company's common stock are only entitled to receive such dividends as the Company's Board of Directors may declare out of funds legally available for such payments. Although the Company has historically declared cash dividends on its common stock, it is not required to do so and there can be no assurance that the Company will pay dividends in the future. Any declaration and payment of dividends on common stock will depend upon the Company's earnings and financial condition, liquidity and capital requirements, the general economic and regulatory climate, the Company's ability to service any equity or debt obligations senior to the common stock and other factors deemed relevant by the Board of Directors.

The Company's principal source of funds to pay dividends on the shares of common stock is cash dividends that the Company receives from the Bank. Various banking laws applicable to the Bank limit the payment of dividends and other distributions by the Bank to the Company, and may therefore limit the Company's ability to pay dividends on its common stock.

There may be extreme fluctuations in the Company's stock price.

The trading price for the Company's common stock may fluctuate significantly in response to a variety of factors outside our control, including, among other things:

- actual or anticipated variations in quarterly results of operations;
- recommendations by securities analysts;
- failure to meet analysts' revenue or earnings estimates;
- operating and stock price performance of other companies that investors deem comparable to us;
- news reports relating to trends, concerns and other issues in the financial services industry;
- perceptions in the marketplace regarding us and/or our competitors;
- new technology used, or services offered, by competitors;
- cybersecurity breaches;
- actions by institutional shareholders;
- significant acquisitions or business combinations, strategic partnerships, joint ventures or capital commitments by or involving us or our competitors;
- failure to integrate acquisitions or realize anticipated benefits from acquisitions;
- changes in government regulations;
- geopolitical conditions such as acts or threats of terrorism or military conflicts;
- general market conditions, including real or anticipated changes in the strength of the Texas and Oklahoma economies; and
- industry factors and general economic and political conditions and events, such as economic slowdowns or recessions, interest rate changes, oil price volatility or credit loss.

ITEM 1B. UNRESOLVED STAFF COMMENTS

None.

ITEM 2. PROPERTIES

As of December 31, 2017, the Company conducted business at 242 full-service banking centers. The Company's principal executive office is located at Prosperity Bank Plaza, 4295 San Felipe, in the Galleria area in Houston, Texas. The Company also owns or leases other facilities in which its banking centers are located as listed below by geographical market area. The expiration dates of the leases range from 2018 to 2032 and do not include renewal periods which may be available at the Company's option.

The following table sets forth specific information regarding the banking centers located in each of the Company's geographical market areas at December 31, 2017:

<u>Geographical Area</u>	<u>Number of Banking Centers</u>	<u>Number of Leased Banking Centers</u>	<u>Deposits at December 31, 2017</u> (dollars in thousands)
Bryan/College Station area	16	—	\$ 1,158,880
Houston area	65	13	6,238,693
Central Texas area	29	3	1,452,985
Dallas/Fort Worth area	33	6	1,628,023
East Texas area	22	—	747,995
West Texas area	34	6	2,362,031
South Texas area	29	3	2,609,484
Central Oklahoma area	6	1	664,195
Tulsa Oklahoma area	8	2	959,174
	<u>242</u>	<u>34</u>	<u>\$ 17,821,460</u>

ITEM 3. LEGAL PROCEEDINGS

The Company and the Bank are defendants, from time to time, in legal actions arising from transactions conducted in the ordinary course of business. The Company and the Bank believe, after consultations with legal counsel, that the ultimate liability, if any, arising from such actions will not have a material adverse effect on their financial statements.

ITEM 4. MINE SAFETY DISCLOSURES

Not applicable.

PART II.

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

Common Stock Market Prices

The Company's common stock is listed on the New York Stock Exchange under the symbol "PB." As of February 26, 2018, there were 69,831,710 shares outstanding and 3,161 shareholders of record. The number of beneficial owners is unknown to the Company at this time.

The following table presents the high and low intra-day sales prices for the common stock as reported by the New York Stock Exchange:

2017	High	Low
Fourth Quarter	\$ 73.00	\$ 61.95
Third Quarter	66.75	55.84
Second Quarter	71.97	61.29
First Quarter	77.87	65.34
2016	High	Low
Fourth Quarter	\$ 73.68	\$ 52.81
Third Quarter	56.27	45.94
Second Quarter	54.57	43.28
First Quarter	47.50	33.57

Dividends

Holders of common stock are entitled to receive dividends when, as and if declared by the Company's Board of Directors out of funds legally available therefor. Although the Company has declared dividends on its common stock since 1994, and paid quarterly dividends aggregating \$1.38 per share for 2017 and \$1.24 per share for 2016, the Company could discontinue payment of dividends in the future. Future dividends on the common stock will depend upon the Company's earnings and financial condition, liquidity and capital requirements, the general economic and regulatory climate, the Company's ability to service any equity or debt obligations senior to the common stock and other factors deemed relevant by the Board of Directors of the Company.

As a holding company, the Company is ultimately dependent upon its subsidiaries to provide funding for its operating expenses, debt service and dividends. Various banking laws applicable to the Bank limit the payment of dividends and other distributions by the Bank to the Company, and may therefore limit the Company's ability to pay dividends on its common stock. Regulatory authorities could impose administratively stricter limitations on the ability of the Bank to pay dividends to the Company if such limits were deemed appropriate to preserve certain capital adequacy requirements.

In addition, the Federal Reserve Board has indicated that bank holding companies should carefully review their dividend policy in relation to the organization's overall asset quality, level of current and prospective earnings and level, composition and quality of capital. The guidance provides that the Company should inform and consult with the Federal Reserve Board prior to declaring and paying a dividend that exceeds earnings for the period for which the dividend is being paid or that could result in an adverse change to the Company's capital structure.

The cash dividends declared per share by quarter (and paid on the first business day of the subsequent quarter) for the Company's last two fiscal years were as follows:

	<u>2017</u>	<u>2016</u>
Fourth Quarter	\$ 0.36	\$ 0.34
Third Quarter	0.34	0.30
Second Quarter	0.34	0.30
First Quarter	0.34	0.30

Recent Sales of Unregistered Securities

None.

Securities Authorized for Issuance under Equity Compensation Plans

As of December 31, 2017, the Company had restricted stock issued under its 2004 and 2012 stock incentive plans, both of which were approved by the Company's shareholders. The following table provides information as of December 31, 2017 regarding the Company's equity compensation plans under which the Company's equity securities are authorized for issuance:

<u>Plan Category</u>	<u>Number of securities to be issued upon exercise of outstanding options, warrants and rights (a)</u>	<u>Weighted-average exercise price of outstanding options, warrants and rights (b)</u>	<u>Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a)) (c)</u>
Equity compensation plans approved by security holders	—	\$ —	890,867 ⁽¹⁾
Equity compensation plans not approved by security holders	—	—	—
	<u>—</u>	<u>\$ —</u>	<u>890,867</u>

- (1) All of these awards are available under the Company's 2012 Stock Incentive Plan. The Company's other stock award plans have expired, and no new awards may be issued thereunder.

Purchases of Equity Securities by the Issuer and Affiliated Purchasers

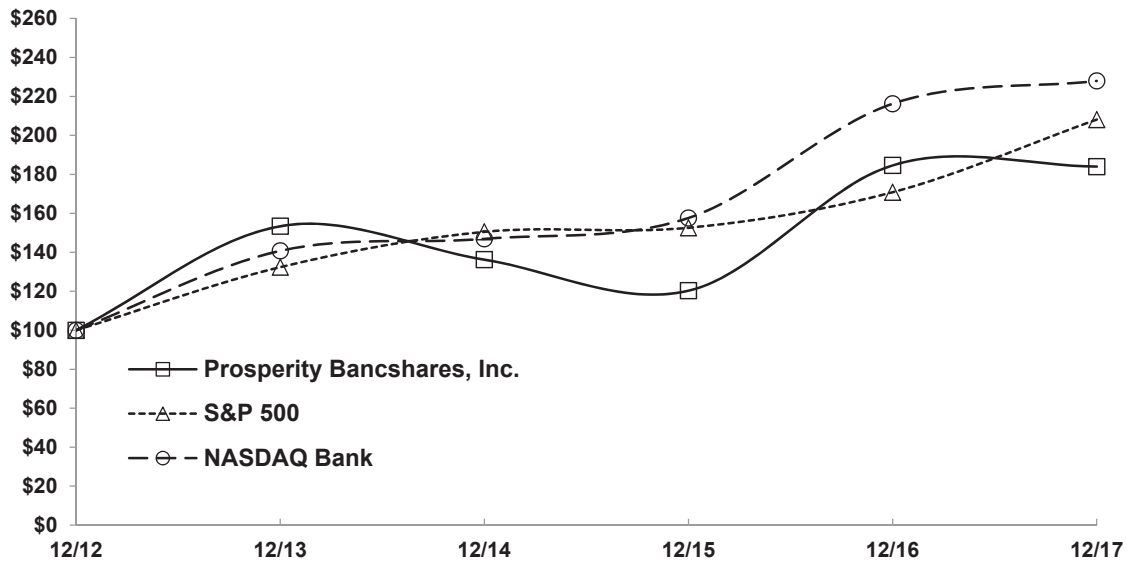
None.

Performance Graph

The following Performance Graph compares the cumulative total shareholder return on the Company's common stock for the period beginning at the close of trading on December 31, 2012 to December 31, 2017, with the cumulative total return of the S&P 500 Total Return Index and the Nasdaq Bank Index for the same period. Dividend reinvestment has been assumed. The Performance Graph assumes \$100 invested on December 31, 2012 in the Company's common stock, the S&P 500 Total Return Index and the Nasdaq Bank Index. The historical stock price performance for the Company's common stock shown on the graph below is not necessarily indicative of future stock performance.

COMPARISON OF 5 YEAR CUMULATIVE TOTAL RETURN*

Among Prosperity Bancshares, Inc., the S&P 500 Index, and the NASDAQ Bank Index



* \$100 invested on 12/31/12 in stock or index, including reinvestment of dividends. Fiscal year ending December 31.

	12/12	12/13	12/14	12/15	12/16	12/17
Prosperity Bancshares, Inc.	\$ 100.00	\$ 153.42	\$ 136.22	\$ 120.29	\$ 184.66	\$ 184.00
S&P 500	100.00	132.39	150.51	152.59	170.84	208.14
NASDAQ Bank	100.00	140.76	146.90	157.63	216.24	227.94

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ITEM 6. SELECTED CONSOLIDATED FINANCIAL DATA

The following selected consolidated financial data of the Company for, and as of the end of, each of the years in the five-year period ended December 31, 2017, is derived from and should be read in conjunction with the Company's consolidated financial statements and the notes thereto appearing elsewhere in this Annual Report on Form 10-K.

	As of and for the Years Ended December 31,				
	2017	2016 ⁽¹⁾	2015	2014 ⁽¹⁾	2013 ⁽¹⁾
	(In thousands, except per share data)				
Income Statement Data:					
Interest income	\$ 677,355	\$ 675,779	\$ 669,701	\$ 714,795	\$ 539,297
Interest expense	60,492	43,159	39,191	43,641	40,471
Net interest income	616,863	632,620	630,510	671,154	498,826
Provision for credit losses	14,325	24,000	7,560	18,275	17,240
Net interest income after provision for credit losses	602,538	608,620	622,950	652,879	481,586
Noninterest income	116,633	118,425	120,781	120,832	95,427
Noninterest expense	313,101	318,387	313,536	327,962	247,196
Income before taxes	406,070	408,658	430,195	445,749	329,817
Provision for income taxes	133,905	134,192	143,549	148,308	108,419
Net income	<u>\$ 272,165</u>	<u>\$ 274,466</u>	<u>\$ 286,646</u>	<u>\$ 297,441</u>	<u>\$ 221,398</u>
Per Share Data:					
Basic earnings per share	\$ 3.92	\$ 3.94	\$ 4.09	\$ 4.32	\$ 3.66
Diluted earnings per share	3.92	3.94	4.09	4.32	3.65
Book value per share	55.03	52.41	49.45	46.50	42.19
Cash dividends declared per share	1.3800	1.2400	1.1175	0.9925	0.8850
Dividend payout ratio	35.23%	31.42%	27.30%	22.99%	24.41%
Weighted average shares outstanding (basic)	69,484	69,674	70,033	68,855	60,421
Weighted average shares outstanding (diluted)	69,484	69,680	70,049	68,911	60,578
Shares outstanding at end of period	69,491	69,491	70,022	69,780	66,048
Balance Sheet Data (at period end):					
Total assets	\$22,587,292	\$22,331,072	\$22,037,216	\$21,507,733	\$18,642,028
Securities	9,672,116	9,726,086	9,502,427	9,045,776	8,224,448
Loans	10,020,773	9,622,060	9,438,589	9,244,183	7,775,221
Allowance for credit losses	84,041	85,326	81,384	80,762	67,282
Total goodwill and intangibles	1,939,687	1,946,629	1,918,244	1,933,138	1,713,569
Other real estate owned	11,152	15,463	2,963	3,237	7,299
Total deposits	17,821,460	17,307,302	17,681,119	17,693,158	15,291,271
Federal funds purchased and other borrowings	505,223	990,781	491,399	8,724	10,689
Junior subordinated debentures	—	—	—	167,531	124,231
Total shareholders' equity	3,824,154	3,642,311	3,462,910	3,244,826	2,786,818

(Table continued on the next page)

	As of and for the Years Ended December 31,				
	2017	2016 ⁽¹⁾	2015	2014 ⁽¹⁾	2013 ⁽¹⁾
	(In thousands, except per share data)				
Average Balance Sheet Data:					
Total assets	\$22,340,201	\$21,880,762	\$21,618,604	\$20,596,929	\$16,255,914
Securities	9,681,763	9,401,669	9,541,443	8,723,011	7,932,782
Loans	9,822,225	9,629,714	9,200,765	8,988,069	6,202,897
Allowance for credit losses	84,410	84,189	80,894	72,714	57,001
Total goodwill and intangibles	1,942,999	1,947,979	1,934,099	1,853,350	1,395,323
Total deposits	17,015,372	17,348,387	17,157,864	16,690,344	12,764,302
Junior subordinated debentures	—	2,081	29,443	154,902	91,584
Total shareholders' equity	3,750,727	3,566,931	3,368,788	3,080,324	2,378,234
Performance Ratios:					
Return on average assets	1.22%	1.25%	1.33%	1.44%	1.36%
Return on average common equity	7.26%	7.69%	8.51%	9.66%	9.31%
Net interest margin (tax equivalent)	3.19%	3.35%	3.38%	3.80%	3.58%
Efficiency ratio ⁽²⁾	42.76%	42.50%	41.87%	41.81%	41.60%
Asset Quality Ratios⁽³⁾:					
Nonperforming assets to total loans and other real estate	0.37%	0.50%	0.46%	0.40%	0.29%
Net charge-offs to average loans	0.16%	0.21%	0.08%	0.05%	0.04%
Allowance for credit losses to total loans	0.84%	0.89%	0.86%	0.87%	0.87%
Allowance for credit losses to nonperforming loans ⁽⁴⁾	319.9%	261.8%	201.8%	240.3%	443.3%
Capital Ratios⁽³⁾:					
Leverage ratio	9.31% ⁽⁶⁾	8.68% ⁽⁶⁾	7.97% ⁽⁶⁾	7.69%	7.42%
Average shareholders' equity to average total assets	16.79%	16.30%	15.58%	14.96%	14.63%
CET1 capital ratio ⁽⁵⁾	15.08% ⁽⁶⁾	14.48% ⁽⁶⁾	13.55% ⁽⁶⁾	N/A	N/A
Tier 1 risk-based capital ratio	15.08% ⁽⁶⁾	14.48% ⁽⁶⁾	13.55% ⁽⁶⁾	13.80%	13.27%
Total risk-based capital ratio	15.74% ⁽⁶⁾	15.20% ⁽⁶⁾	14.25% ⁽⁶⁾	14.56%	14.02%

- (1) The Company completed the acquisition of Tradition Bancshares, Inc. on January 1, 2016. The Company completed one acquisition during the twelve-month period ended December 31, 2014 and three acquisitions during the twelve-month period ended December 31, 2013.
- (2) Represents a non-GAAP financial measure. Calculated by dividing total noninterest expense, excluding credit loss provision, by net interest income plus noninterest income, excluding net gains and losses on the sale of securities and assets. Additionally, taxes are not part of this calculation. See "Management's Discussion and Analysis of Financial Consolidation and Results of Operations—Results of Operations—Efficiency Ratio" on page 41 for calculation methodology and details.
- (3) At period end, except for net charge-offs to average loans and average shareholders' equity to average total assets, which are for periods ended at such dates.
- (4) Nonperforming loans consist of nonaccrual loans, loans contractually past due 90 days or more and any other loan management deems to be nonperforming.
- (5) CET1 capital ratio is required under the Basel III Capital Rules effective January 1, 2015.
- (6) Calculated pursuant to the phase-in provisions of the Basel III Capital Rules.

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

SPECIAL CAUTIONARY NOTICE REGARDING FORWARD-LOOKING STATEMENTS

Statements and financial discussion and analysis contained in this Annual Report on Form 10-K that are not statements of historical fact constitute forward-looking statements made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. These forward-looking statements are based on assumptions and involve a number of risks and uncertainties, many of which are beyond the Company's control. Forward-looking statements can be identified by words such as "believes," "intends," "expects," "plans," "will" and similar references to future periods. Many possible events or factors could affect the future financial results and performance of the Company and could cause such results or performance to differ materially from those expressed in the forward-looking statements. These possible events or factors include, but are not limited to:

- changes in the strength of the United States economy in general and the strength of the local economies in which the Company conducts operations resulting in, among other things, a deterioration in credit quality or reduced demand for credit, including the result and effect on the Company's loan portfolio and allowance for credit losses;
- changes in interest rates and market prices, which could reduce the Company's net interest margins, asset valuations and expense expectations;
- changes in the levels of loan prepayments and the resulting effects on the value of the Company's loan portfolio;
- changes in local economic and business conditions, including commodity prices, which adversely affect the Company's customers and their ability to transact profitable business with the company, including the ability of the Company's borrowers to repay their loans according to their terms or a change in the value of the related collateral;
- increased competition for deposits and loans adversely affecting rates and terms;
- the timing, impact and other uncertainties of any future acquisitions, including the Company's ability to identify suitable future acquisition candidates, the success or failure in the integration of their operations, and the ability to enter new markets successfully and capitalize on growth opportunities;
- the possible impairment of goodwill associated with an acquisition and possible adverse short-term effects on the results of operations;
- increased credit risk in the Company's assets and increased operating risk caused by a material change in commercial, consumer and/or real estate loans as a percentage of the total loan portfolio;
- the concentration of the Company's loan portfolio in loans collateralized by real estate;
- the failure of assumptions underlying the establishment of and provisions made to the allowance for credit losses;
- changes in the availability of funds resulting in increased costs or reduced liquidity;
- a deterioration or downgrade in the credit quality and credit agency ratings of the securities in the Company's securities portfolio;
- increased asset levels and changes in the composition of assets and the resulting impact on the Company's capital levels and regulatory capital ratios;
- the Company's ability to acquire, operate and maintain cost effective and efficient systems without incurring unexpectedly difficult or expensive but necessary technological changes;
- the loss of senior management or operating personnel and the potential inability to hire qualified personnel at reasonable compensation levels;
- government intervention in the U.S. financial system;

- changes in statutes and government regulations or their interpretations applicable to financial holding companies and the Company's present and future banking and other subsidiaries, including changes in tax requirements and tax rates;
- poor performance by external vendors;
- the failure of analytical and forecasting models and tools used by the Company to estimate probable credit losses and to measure the fair value of financial instruments;
- additional risks from new lines of businesses or new products and services;
- claims or litigation related to intellectual property or fiduciary responsibilities;
- the failure of the Company's enterprise risk management framework to identify or address risks adequately;
- a failure in or breach of operational or security systems of the Company's infrastructure, or those of its third-party vendors and other service providers, including as a result of cyber attacks;
- potential risk of environmental liability associated with lending activities;
- acts of terrorism, an outbreak of hostilities or other international or domestic calamities, weather or other acts of God and other matters beyond the Company's control; and
- other risks and uncertainties described in this Annual Report on Form 10-K or in the Company's other reports and documents filed with the Securities and Exchange Commission.

A forward-looking statement may include a statement of the assumptions or bases underlying the forward-looking statement. The Company believes it has chosen these assumptions or bases in good faith and that they are reasonable. However, the Company cautions that assumptions or bases almost always vary from actual results, and the differences between assumptions or bases and actual results can be material. Therefore, the Company cautions against placing undue reliance on its forward-looking statements. The forward-looking statements speak only as of the date the statements are made. The Company undertakes no obligation to publicly update or otherwise revise any forward-looking statements, whether as a result of new information, future events or otherwise.

Management's Discussion and Analysis of Financial Condition and Results of Operations analyzes the major elements of the Company's balance sheets and statements of income. This section should be read in conjunction with the Company's consolidated financial statements and accompanying notes and other detailed information appearing elsewhere in this Annual Report on Form 10-K.

Overview

The Company generates the majority of its revenues from interest income on loans, service charges and fees on customer accounts and income from investment in securities. The Company also earns revenues from various additional products and services it provides, including trust services, mortgage lending, brokerage, credit card and independent sales organization sponsorship operations. The Company's revenues are partially offset by interest expense paid on deposits and other borrowings and noninterest expenses such as administrative and occupancy expenses. Net interest income is the difference between interest income on earning assets such as loans and securities and interest expense on liabilities such as deposits and borrowings which are used to fund those assets. Net interest income is the Company's largest source of revenue. The level of interest rates and the volume and mix of earning assets and interest-bearing liabilities impact net interest income and margin.

Three principal components of the Company's growth strategy are internal growth, efficient operations and acquisitions, including strategic merger transactions. The Company focuses on continual internal growth. Each banking center is operated as a separate profit center, maintaining separate data with respect to its net interest income, efficiency ratio, deposit growth, loan growth and overall profitability. Banking center presidents and managers are accountable for performance in these areas and compensated accordingly. The Company also focuses on maintaining efficiency and stringent cost control practices and policies. The Company has centralized many of its critical operations, such as data processing and loan processing. Management believes that this centralized

infrastructure can accommodate substantial additional growth while enabling the Company to minimize operational costs through certain economies of scale. The Company also intends to continue to seek expansion opportunities. During 2016, the Company completed the acquisition of Tradition Bancshares, Inc., which added 7 banking centers after consolidation.

Net income was \$272.2 million, \$274.5 million and \$286.6 million for the years ended December 31, 2017, 2016 and 2015, respectively, and diluted earnings per share were \$3.92, \$3.94 and \$4.09, respectively, for these same periods. The change in net income during 2017 was principally due to an increase in interest expense and a decrease in loan discount accretion. The change in net income during 2016 was principally due to an increase in the provision for credit losses and the Tradition acquisition. The Company posted returns on average assets of 1.22%, 1.25% and 1.33% and returns on average common equity of 7.26%, 7.69% and 8.51% for the years ended December 31, 2017, 2016 and 2015, respectively. The Company's efficiency ratio was 42.76% in 2017, 42.50% in 2016 and 41.87% in 2015. The efficiency ratio is calculated by dividing total noninterest expense (excluding credit loss provisions) by the sum of net interest income and noninterest income. Because the ratio is a measure of revenues and expenses resulting from our lending activities and fee-based banking services, net gains and losses on the sale of assets and securities are not included. Additionally, taxes are not part of this calculation.

Total assets at December 31, 2017 and 2016 were \$22.59 billion and \$22.33 billion, respectively. Total deposits were \$17.82 billion at December 31, 2017, an increase of \$514.2 million or 3.0% compared with \$17.31 billion at December 31, 2016. Total loans were \$10.02 billion at December 31, 2017, an increase of \$398.7 million or 4.1% compared with \$9.62 billion at December 31, 2016. At December 31, 2017, the Company had \$26.3 million in nonperforming loans, and its allowance for credit losses was \$84.0 million compared with \$32.6 million in nonperforming loans and an allowance for credit losses of \$85.3 million at December 31, 2016. Shareholders' equity was \$3.82 billion and \$3.64 billion at December 31, 2017 and 2016, respectively.

Acquisition

Acquisition of Tradition Bancshares, Inc.—On January 1, 2016, the Company completed the acquisition of Tradition Bancshares, Inc. ("Tradition") and its wholly-owned subsidiary Tradition Bank headquartered in Houston, Texas. Tradition Bank operated 7 banking offices in the Houston, Texas area, including its main office in Bellaire, 3 banking centers in Katy and 1 banking center in The Woodlands.

As of December 31, 2015, Tradition, on a consolidated basis, reported total assets of \$548.0 million, total loans of \$253.3 million, total deposits of \$488.9 million and shareholders' equity of \$43.1 million. Under the terms of the definitive agreement, the Company issued 679,528 shares of its common stock plus \$39.0 million in cash for all outstanding shares of Tradition capital stock, for total merger consideration of \$71.5 million, based on the Company's closing stock price of \$47.86. As of December 31, 2017, the Company recognized goodwill of \$32.0 million, which is calculated as the excess of both the consideration exchanged and liabilities assumed compared with the fair value of the assets acquired. Additionally, the Company recognized \$5.6 million of core deposit intangibles during 2016.

On January 1, 2016, in connection with the acquisition of Tradition, the Company assumed \$7.2 million in junior subordinated debentures. During the second quarter of 2016, the Company redeemed all of the junior subordinated debentures. Accordingly, as of December 31, 2016 and 2017, the Company had no junior subordinated debentures outstanding.

Critical Accounting Policies

The Company's significant accounting policies are integral to understanding the results reported. The Company's accounting policies are described in detail in Note 1 to the consolidated financial statements, appearing elsewhere in this Annual Report on Form 10-K. The Company believes that of its significant accounting policies, the following may involve a higher degree of judgment and complexity:

Allowance for Credit Losses—The allowance for credit losses is established through charges to earnings in the form of a provision for credit losses. The Company's allowance for credit losses consists of two elements: (1) specific valuation allowances based on probable losses on impaired loans; and (2) a general valuation allowance based on historical loan loss experience, general economic conditions and other qualitative risk factors both internal and external to the Company. The allowance for acquired credit losses is calculated as described under the heading "Accounting for Acquired Loans and the Allowance for Acquired Credit Losses" below. Management has established an allowance for credit losses which it believes is adequate for estimated losses in the Company's loan portfolio. Based on an evaluation of the portfolio, management presents a quarterly review of the allowance for credit losses to the Bank's Board of Directors, indicating any change in the allowance since the last review and any recommendations as to adjustments in the allowance. In making its evaluation, management considers factors such as historical loan loss experience, the amount of nonperforming assets and related collateral, the volume, growth and composition of the portfolio, current economic conditions that may affect the borrower's ability to pay and the value of collateral, the evaluation of the portfolio through its internal loan review process and other relevant factors. Portions of the allowance may be allocated for specific credits; however, the entire allowance is available for any credit that, in management's judgment, should be charged off. Charge-offs occur when loans are deemed to be uncollectible. For further discussion of the methodology used in the determination of the allowance for credit losses, see "Financial Condition—Allowance for Credit Losses" below and Note 1 to the consolidated financial statements.

Accounting for Acquired Loans and the Allowance for Acquired Credit Losses—The Company accounts for its acquisitions using the acquisition method of accounting. Accordingly, the assets, including loans, and liabilities of the acquired entity were recorded at their fair values at the acquisition date. No allowance for credit losses related to the acquired loans is recorded on the acquisition date, as the fair value of the acquired loans incorporates assumptions regarding credit risk. These fair value estimates associated with acquired loans, and based on a discounted cash flow model, include estimates related to market interest rates and undiscounted projections of future cash flows that incorporate expectations of prepayments and the amount and timing of principal, interest and other cash flows, as well as any shortfalls thereof.

At period-end after acquisition, the fair-valued acquired loans from each acquisition are reassessed to determine whether an addition to the allowance for credit losses is appropriate due to further credit quality deterioration. For further discussion of the methodology used in the determination of the allowance for credit losses for acquired loans, see "Financial Condition—Allowance for Credit Losses" below. For further discussion of the Company's acquisition and loan accounting, see Note 1 to the consolidated financial statements.

Goodwill and Intangible Assets—Goodwill and intangible assets that have indefinite useful lives are subject to an impairment test at least annually, or more often, if events or circumstances indicate that it is more likely than not that the fair value of the Company's reporting unit is below the carrying value of its equity. Under Accounting Standards Codification ("ASC") topic 350-20, "Intangibles—Goodwill and Other—Goodwill," companies have the option to first assess qualitative factors to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount as a basis for determining the need to perform step one of the annual test for goodwill impairment. An entity has an unconditional option to bypass the qualitative assessment described in the preceding paragraph for any reporting unit in any period and proceed directly to performing the first step of the goodwill impairment test. An entity may resume performing the qualitative assessment in any subsequent period. The Company currently utilizes a qualitative assessment for its annual goodwill impairment analysis.

If the Company bypasses the qualitative assessment, a two-step goodwill impairment test is performed. The two-step process begins with an estimation of the fair value of the Company's reporting unit compared with its carrying value. If the carrying amount exceeds the fair value of the reporting unit, a second test is completed comparing the implied fair value of the reporting unit's goodwill to its carrying value to measure the amount of impairment.

The Company had no intangible assets with indefinite useful lives at December 31, 2017. Core deposit intangible assets that are subject to amortization are being amortized on a non-pro rata basis over the years expected to be benefited, which the Company believes is between ten and fifteen years. These core deposit intangible assets are reviewed for impairment if circumstances indicate their value may not be recoverable based on a comparison of fair value to carrying value. Based on the Company's annual goodwill impairment test as of September 30, 2017, management does not believe any of its goodwill is impaired as of December 31, 2017, because the fair value of the Company's equity exceeded its carrying value. While the Company believes no impairment existed at December 31, 2017, under accounting standards applicable at that date, different conditions or assumptions, or changes in cash flows or profitability, if significantly negative or unfavorable, could have a material adverse effect on the outcome of the Company's impairment evaluation and financial condition or future results of operations.

Stock-Based Compensation—The Company accounts for stock-based employee compensation plans using the fair value-based method of accounting. The Company's results of operations reflect compensation expense for all employee stock-based-compensation. The fair value of stock options granted is estimated at the date of grant using the Black-Scholes option-pricing model. This model requires the input of subjective assumptions including stock price volatility and employee turnover that are utilized to measure compensation expense.

Other-Than-Temporarily Impaired Securities—When the fair value of a security is below its amortized cost, and depending on the length of time the condition exists and the extent the fair market value is below amortized cost, additional analysis is performed to determine whether an other-than-temporary impairment exists. Available for sale and held to maturity securities are analyzed quarterly for possible other-than-temporary impairment. The analysis considers (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, (3) whether the market decline was affected by macroeconomic conditions and (4) whether the entity has the intent to sell the debt security or more likely than not will be required to sell the debt security before its anticipated recovery. Often, the information available to conduct these assessments is limited and rapidly changing, making estimates of fair value subject to judgment. If actual information or conditions are different than estimated, the extent of the impairment of the security may be different than previously estimated, which could have a material effect on the Company's results of operations and financial condition.

Fair Values of Financial Instruments—The Company determines the fair market values of financial instruments based on the fair value hierarchy established which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. There are three levels of inputs that may be used to measure fair value. Level 1 inputs include quoted market prices, where available. If such quoted market prices are not available, Level 2 inputs are used. These inputs are based upon internally developed analytical tools that primarily use observable, market-based parameters. Level 3 inputs are unobservable inputs which are typically based on an entity's own assumptions, as there is little, if any, related market activity. The Company's assessment of the significance of a particular input to the fair value measurement in its entirety requires judgment and considers factors specific to the asset or liability.

Hurricane Harvey

On August 25, 2017, Hurricane Harvey came ashore in Rockport, Texas impacting numerous communities along the Texas Gulf coast. Prosperity Bank operates 94 banking centers in the Houston and South Texas areas, which include Beaumont, Corpus Christi and Victoria. All of those banking centers are currently operational, including three currently using a temporary facility. As of December 31, 2017, the Company has not experienced any material financial impact related to Hurricane Harvey.

Tax Cuts and Jobs Act

The Tax Cuts and Jobs Act was enacted on December 22, 2017 and made widespread changes to the U.S. tax code effective January 1, 2018. Under ASC Topic 740 "Income Taxes," the Company was required to recalculate its deferred tax assets and liabilities to account for the future impact of lower corporate tax rates and lost deductions on these assets and liabilities. The recalculation resulted in a one-time non-cash charge of \$1.4 million recorded to income tax expense for the year ended December 31, 2017.

Results of Operations

Net Interest Income

The Company's operating results depend primarily on its net interest income, which is the difference between interest income on interest-earning assets, including securities and loans, and interest expense incurred on interest-bearing liabilities, including deposits and other borrowed funds. Interest rate fluctuations, as well as changes in the amount and type of earning assets and liabilities, combine to affect net interest income. The Company's net interest income is affected by changes in the amount and mix of interest-earning assets and interest-bearing liabilities, referred to as a "volume change." It is also affected by changes in yields earned on interest-earning assets and rates paid on interest-bearing deposits and other borrowed funds, referred to as a "rate change."

2017 versus 2016. Net interest income before the provision for credit losses for 2017 was \$616.9 million compared with \$632.6 million for 2016, a decrease of \$15.8 million or 2.5%. The decrease in net interest income was primarily due to a decrease in loan discount accretion of \$17.1 million and a 13-basis-point increase in the average rate on interest-bearing liabilities, partially offset by an increase in average interest-earning assets of \$474.1 million or 2.5%. Interest income was \$677.4 million in 2017, an increase of \$1.6 million or 0.2% compared with 2016. Interest income on loans was \$468.3 million for 2017, a decrease of \$6.7 million or 1.4% compared with 2016. This was primarily due to a decrease in loan discount accretion of \$17.1 million, partially offset by an increase in average loans of \$192.5 million or 2.0%. The Company had \$34.7 million of total outstanding discounts on purchased loans, of which \$28.7 million was accretable at December 31, 2017. Interest income on securities was \$208.2 million during 2017, an increase of \$7.8 million or 3.9% compared with 2016 due primarily to an increase in average securities of \$280.1 million or 3.0%. Average interest-bearing liabilities increased \$62.8 million or 0.5% during 2017 compared with 2016. The average rate on interest-bearing liabilities increased from 0.33% to 0.46% during the same time period, resulting in an increase in interest expense of \$17.3 million. The total cost of funds increased to 0.33% during 2017 from 0.24% during 2016.

Net interest margin, defined as net interest income divided by average interest-earning assets, on a tax equivalent basis, was 3.19% for 2017, a decrease of 16 basis points compared with 3.35% for 2016.

2016 versus 2015. Net interest income before the provision for credit losses for 2016 was \$632.6 million compared with \$630.5 million for 2015, an increase of \$2.1 million or 0.3%. The increase in net interest income was primarily due to an increase in average interest-earning assets of \$254.7 million or 1.4%, partially offset by a decrease in purchase accounting loan discount accretion of \$13.2 million and a 3-basis-point increase in the average rate paid on interest-bearing liabilities. Interest income was \$675.8 million in 2016, an increase of \$6.1 million or 0.9% compared with 2015. Interest income on loans was \$475.1 million for 2016, a decrease of \$368 thousand or 0.1% compared with 2015. This was primarily due to a decrease in purchase accounting loan discount accretion of \$13.2 million and a 24-basis-point decrease in the average yield earned on loans, partially offset by an increase in average loans outstanding of \$428.9 million. The Company had \$59.4 million of total outstanding discounts on purchased loans, of which \$45.2 million was accretable at December 31, 2016. Interest income on securities was \$200.4 million during 2016, an increase of \$6.4 million or 3.3% compared with 2015 due primarily to a 10-basis-point increase in the average yield on investment securities, partially offset by a decrease in average investment securities outstanding of \$139.8 million. Average interest-bearing liabilities decreased \$39.2 million or 0.3% for 2016 compared with 2015. The average rate paid increased from 0.30% to 0.33% for the same time period, resulting in an overall increase in interest expense of \$4.0 million. The increase in the average rate paid on interest-bearing liabilities contributed to an increase in total cost of funds to 0.24% during 2016 from 0.22% during 2015.

Net interest margin, on a tax equivalent basis, was 3.35% for 2016, a decrease of 3 basis points compared with 3.38% for 2015.

The following table presents, for the periods indicated, the total dollar amount of average balances, interest income from average interest-earning assets and the resultant yields, as well as the interest expense on average interest-bearing liabilities, expressed both in dollars and rates. Except as indicated in the footnotes, no tax-equivalent adjustments were made and all average balances are daily average balances. Any nonaccruing loans have been included in the table as loans carrying a zero yield.

	Years Ended December 31,								
	2017			2016			2015		
	Average Outstanding Balance	Interest Earned/ Paid	Average Yield/ Rate	Average Outstanding Balance	Interest Earned/ Paid	Average Yield/ Rate	Average Outstanding Balance	Interest Earned/ Paid	Average Yield/ Rate
	(Dollars in thousands)								
Assets									
Interest-Earning Assets:									
Loans	\$ 9,822,225	\$468,338	4.77%	\$ 9,629,714	\$475,059	4.93%	\$ 9,200,765	\$475,427	5.17%
Investment securities	9,681,763	208,189	2.15%	9,401,669	200,375	2.13%	9,541,443	194,003	2.03%
Federal funds sold and other earning assets	83,324	828	0.99%	81,804	345	0.42%	116,283	271	0.23%
Total interest-earning assets	<u>19,587,312</u>	<u>677,355</u>	3.46%	<u>19,113,187</u>	<u>675,779</u>	3.54%	<u>18,858,491</u>	<u>669,701</u>	3.55%
Allowance for credit losses	(84,410)			(84,189)			(80,894)		
Noninterest-earning assets	2,837,299			2,851,764			2,841,007		
Total assets	<u>\$22,340,201</u>			<u>\$21,880,762</u>			<u>\$21,618,604</u>		
Liabilities and Shareholders' Equity									
Interest-Bearing Liabilities:									
Interest-bearing demand deposits	\$ 3,816,996	\$ 11,703	0.31%	\$ 4,066,799	\$ 9,843	0.24%	\$ 3,873,495	\$ 8,776	0.23%
Savings and money market deposits	5,561,853	18,705	0.34%	5,658,441	15,016	0.27%	5,505,524	13,488	0.24%
Certificates and other time deposits	2,289,296	15,904	0.69%	2,505,526	14,266	0.57%	2,754,466	13,810	0.50%
Federal funds purchased and other borrowings	1,142,897	12,908	1.13%	524,492	3,065	0.58%	623,441	1,508	0.24%
Securities sold under repurchase agreements	328,652	1,272	0.39%	319,551	932	0.29%	329,745	818	0.25%
Junior subordinated debentures	—	—	—	2,081	37	1.78%	29,443	791	2.69%
Total interest-bearing liabilities	<u>13,139,694</u>	<u>60,492</u>	0.46%	<u>13,076,890</u>	<u>43,159</u>	0.33%	<u>13,116,114</u>	<u>39,191</u>	0.30%
Noninterest-Bearing Liabilities:									
Noninterest-bearing demand deposits	5,347,227			5,117,621			5,024,379		
Other liabilities	102,553			119,320			109,323		
Total liabilities	<u>18,589,474</u>			<u>18,313,831</u>			<u>18,249,816</u>		
Shareholders' equity	<u>3,750,727</u>			<u>3,566,931</u>			<u>3,368,788</u>		
Total liabilities and shareholders' equity	<u>\$22,340,201</u>			<u>\$21,880,762</u>			<u>\$21,618,604</u>		
Net interest rate spread			3.00%			3.21%			3.25%
Net interest income and margin ⁽¹⁾		<u>\$616,863</u>	3.15%		<u>\$632,620</u>	3.31%		<u>\$630,510</u>	3.34%
Net interest income and margin (tax equivalent) ⁽²⁾		<u>\$624,707</u>	3.19%		<u>\$640,285</u>	3.35%		<u>\$636,612</u>	3.38%

(1) The net interest margin is equal to net interest income divided by average interest-earning assets.

(2) In order to make pretax income and resultant yields on tax-exempt investments and loans comparable to those on taxable investments and loans, a tax equivalent adjustment has been computed using a federal income tax rate of 35% for the years ended December 31, 2017, 2016 and 2015 and other applicable effective tax rates.

The following table presents information regarding the dollar amount of changes in interest income and interest expense for the periods indicated for each major component of interest-earning assets and interest-bearing liabilities and distinguishes between the changes attributable to changes in volume and changes in interest rates. Changes in interest income and interest expense related to purchase accounting adjustments are allocated to rate. For purposes of this table, changes attributable to both rate and volume which cannot be segregated have been allocated to rate.

	Years Ended December 31,					
	2017 vs. 2016			2016 vs. 2015		
	Increase (Decrease) Due to Change in			Increase (Decrease) Due to Change in		
	Volume	Rate	Total	Volume	Rate	Total
	(Dollars in thousands)					
Interest-Earning assets:						
Loans	\$ 9,497	\$ (16,218)	\$ (6,721)	\$ 22,165	\$ (22,533)	\$ (368)
Securities	5,970	1,844	7,814	(2,842)	9,214	6,372
Federal funds sold and other temporary investments	6	477	483	(80)	154	74
Total increase (decrease) in interest income	<u>15,473</u>	<u>(13,897)</u>	<u>1,576</u>	<u>19,243</u>	<u>(13,165)</u>	<u>6,078</u>
Interest-Bearing liabilities:						
Interest-bearing demand deposits	(605)	2,465	1,860	438	629	1,067
Savings and money market accounts	(256)	3,945	3,689	375	1,153	1,528
Certificates of deposit	(1,231)	2,869	1,638	(1,248)	1,704	456
Other borrowings	3,613	6,230	9,843	(239)	1,796	1,557
Securities sold under repurchase agreements	27	313	340	(25)	139	114
Junior subordinated debentures	(37)	—	(37)	(735)	(19)	(754)
Total increase (decrease) in interest expense	<u>1,511</u>	<u>15,822</u>	<u>17,333</u>	<u>(1,434)</u>	<u>5,402</u>	<u>3,968</u>
Increase (decrease) in net interest income	<u>\$ 13,962</u>	<u>\$ (29,719)</u>	<u>\$ (15,757)</u>	<u>\$ 20,677</u>	<u>\$ (18,567)</u>	<u>\$ 2,110</u>

Provision for Credit Losses

The Company's provision for credit losses is established through charges to income in the form of the provision in order to bring the Company's allowance for credit losses to a level deemed appropriate by management based on the factors discussed under "Financial Condition—Allowance for Credit Losses." The allowance for credit losses at December 31, 2017 was \$84.0 million, representing 0.84% of total loans as of such date. Acquired loans were recorded at fair value based on a discounted cash flow valuation methodology that considers, among other things, interest rates, projected default rates, loss given defaults and recovery rates, with no carryover of any existing allowance for credit losses. The provision for credit losses for the year ended December 31, 2017 was \$14.3 million compared with \$24.0 million for the year ended December 31, 2016 and \$7.6 million for the year ended December 31, 2015. Net charge-offs for the years ended December 31, 2017, 2016 and 2015 were \$15.6 million, \$20.1 million and \$6.9 million, respectively.

Noninterest Income

The Company's primary sources of recurring noninterest income are nonsufficient funds ("NSF") fees, credit, debit and ATM card income, and service charges on deposit accounts. Additionally, the Company generates recurring noninterest income from its various additional products and services, including trust services, mortgage lending, brokerage and independent sales organization sponsorship operations. Noninterest income does not include loan origination fees which are recognized over the life of the related loan as an adjustment to yield using the interest method. For the year ended December 31, 2017, noninterest income totaled \$116.6 million, a decrease of \$1.8 million or 1.5% compared with 2016. The decrease was primarily due to the net loss on sale of assets and decreases in mortgage and brokerage income, partially offset by a gain on sale of securities and an increase in service charges on deposit accounts.

For the year ended December 31, 2016, noninterest income totaled \$118.4 million, a decrease of \$2.4 million or 2.0% compared with 2015. The decrease was primarily due to a decrease in other noninterest income, brokerage income and NSF fees, partially offset by an increase in service charges on deposit accounts and mortgage income.

The following table presents, for the periods indicated, the major categories of noninterest income:

	<u>Years Ended December 31,</u>		
	<u>2017</u>	<u>2016</u>	<u>2015</u>
	(Dollars in thousands)		
Nonsufficient funds fees	\$ 32,354	\$ 33,536	\$ 34,284
Credit card, debit card and ATM card income	24,425	23,561	23,534
Service charges on deposit accounts	21,327	18,832	17,095
Trust income	9,200	8,120	8,030
Mortgage income	4,053	7,076	5,720
Brokerage income	1,950	4,571	5,953
Bank owned life insurance income	5,430	5,663	5,548
Net (loss) gain on sale of assets	(1,921)	1,864	2,403
Gain on sale of securities	3,270	—	—
Other	16,545	15,202	18,214
Total noninterest income	<u>\$ 116,633</u>	<u>\$ 118,425</u>	<u>\$ 120,781</u>

Noninterest Expense

For the year ended December 31, 2017, noninterest expense totaled \$313.1 million, a decrease of \$5.3 million or 1.7% compared with 2016. This decrease was primarily due to decreases in salaries and benefits and amortization of core deposit intangibles, partially offset by the write-down of other real estate.

For the year ended December 31, 2016, noninterest expense totaled \$318.4 million, an increase of \$4.9 million or 1.5% compared with 2015. This increase was primarily due to the Tradition acquisition.

The following table presents, for the periods indicated, the major categories of noninterest expense:

	<u>Years Ended December 31,</u>		
	<u>2017</u>	<u>2016</u>	<u>2015</u>
	(Dollars in thousands)		
Salaries and employee benefits ⁽¹⁾	\$ 192,409	\$ 197,897	\$ 192,872
Non-staff expenses:			
Net occupancy and equipment	22,402	23,058	23,638
Credit and debit card, data processing and software amortization	17,230	17,050	15,782
Regulatory assessments and FDIC insurance	14,311	12,735	14,433
Core deposit intangibles amortization	6,942	9,200	9,530
Depreciation	12,215	13,094	12,959
Communications ⁽²⁾	10,592	11,561	11,121
Other real estate expense ⁽³⁾	3,271	514	625
Other	33,729	33,278	32,576
Total noninterest expense	<u>\$ 313,101</u>	<u>\$ 318,387</u>	<u>\$ 313,536</u>

(1) Total salaries and employee benefits include \$6.9 million, \$9.5 million and \$11.1 million in 2017, 2016 and 2015, respectively, in stock-based compensation expense.

(2) Communications expense includes telephone, data circuits, postage, and courier expenses.

(3) Other real estate expense is net of rental income and gains and losses on sales of real estate.

Salaries and Employee Benefits. Salaries and employee benefits were \$192.4 million for the year ended December 31, 2017, a decrease of \$5.5 million or 2.8% compared with 2016. This change was primarily due to a decrease in stock based compensation expense and commissions. Salaries and employee benefits were \$197.9 million for the year ended December 31, 2016, an increase of \$5.0 million or 2.6% compared with 2015. This change was primarily due to the Tradition acquisition and an increase in incentive compensation. The number of full-time equivalent associates employed by the Company were 3,017, 3,035 and 3,037 at December 31, 2017, 2016 and 2015, respectively. Total salaries and benefits for the year ended December 31, 2017 include \$6.9 million in stock-based compensation expense compared with \$9.5 million and \$11.1 million recorded for the years ended December 31, 2016 and 2015, respectively.

Credit and Debit Card, Data Processing and Software Amortization. Credit and Debit card, data processing and software amortization expenses were \$17.2 million for the year ended December 31, 2017, an increase of \$180 thousand or 1.1% compared with 2016. Credit and Debit card, data processing and software amortization expenses were \$17.1 million and \$15.8 million for the years ended December 31, 2016 and 2015, respectively.

Regulatory Assessments and FDIC Insurance. Regulatory assessments and FDIC insurance assessments were \$14.3 million for the year ended December 31, 2017, an increase of \$1.6 million or 12.4%, compared with \$12.7 million for the year ended December 31, 2016. Assessments for the year ended December 31, 2016 decreased \$1.7 million or 11.8% to \$12.7 million compared with \$14.4 million for the year ended December 31, 2015.

Core Deposit Intangibles Amortization. Core deposit intangibles (“CDI”) amortization was \$6.9 million for the year ended December 31, 2017, a decrease of \$2.3 million or 24.5% compared with \$9.2 million for the year ended December 31, 2016. This change was primarily due to certain intangible assets that fully amortized during 2017. CDI amortization decreased \$330 thousand or 3.5% to \$9.2 million at December 31, 2016, compared with \$9.5 million for the year ended December 31, 2015. This change was primarily due to a reduction in the annual amortization rate of certain previously recognized intangible assets. CDI are being amortized on a non-pro rata basis over an estimated life of 10 to 15 years.

Other Real Estate. Other real estate expense was \$3.3 million for the year ended December 31, 2017, an increase of \$2.8 million or 536.4%, compared with \$514 thousand for the year ended December 31, 2016. This change was primarily due to the write-down of other real estate. Other real estate expense decreased \$111 thousand or 17.8% to \$514 thousand for the year ended December 31, 2016, compared with \$625 thousand for the year ended December 31, 2015. This change was primarily due to a decrease in other real estate carrying cost.

Efficiency Ratio

The Company’s efficiency ratio is a supplemental financial measure utilized in management’s internal evaluation of the Company and is not calculated based on generally accepted accounting principles (“GAAP”). A GAAP-based efficiency ratio is calculated by dividing total noninterest expense, excluding credit loss provisions, by net interest income plus total noninterest income, as shown in the Consolidated Statements of Income. The Company’s efficiency ratio, as calculated and used by the Company, excludes from noninterest income the net gains and losses on the sale of securities and assets, which can vary widely from period to period. Taxes are not included in either calculation. An increase in the efficiency ratio indicates that more resources are being utilized to generate the same volume of income, while a decrease would indicate a more efficient allocation of resources. The Company’s efficiency ratio calculated pursuant to GAAP was 42.69% for the year ended December 31, 2017 compared with 42.39% for the year ended December 31, 2016 and 41.73% for the year ended December 31, 2015. The efficiency ratio, excluding net gains and losses on the sale of securities and assets, was 42.76% for the year ended December 31, 2017, compared with 42.50% for the year ended December 31, 2016 and 41.87% for the year ended December 31, 2015.

Income Taxes

The amount of federal and state income tax expense is influenced by the amount of pre-tax income, the amount of tax-exempt income and the amount of other nondeductible expenses. As a result of the Tax Cuts and Jobs Act enacted in December 2017, the Company recorded a one-time non-cash charge of \$1.4 million to income tax expense to account for the future impact of lower corporate tax rates and lost deductions on deferred tax assets and liabilities.

Income tax expense was \$133.9 million for the year ended December 31, 2017, a decrease of \$287 thousand or 0.2% compared with \$134.2 million for the year ended December 31, 2016. The decrease was primarily attributable to lower pre-tax net earnings, partially offset by the one-time non-cash charge related to the Tax Cuts and Jobs Act. Income tax expense decreased \$9.4 million or 6.5% for the year ended December 31, 2016, compared with \$143.5 million for the year ended December 31, 2015. The decrease was primarily attributable to lower pre-tax net earnings for the year ended December 31, 2016. The effective tax rate for the years ended December 31, 2017, 2016 and 2015 was 33.0%, 32.8% and 33.4%, respectively. The effective income tax rates differed from the U.S. statutory rate of 35% during the comparable periods primarily due to the effect of tax-exempt income from loans and securities.

Impact of Inflation

The Company's consolidated financial statements and related notes included in this Annual Report on Form 10-K have been prepared in accordance with GAAP. These require the measurement of financial position and operating results in terms of historical dollars, without considering changes in the relative value of money over time due to inflation or recession.

Unlike many industrial companies, substantially all of the Company's assets and liabilities are monetary in nature. As a result, interest rates have a more significant impact on the Company's performance than the effects of general levels of inflation. Interest rates may not necessarily move in the same direction or in the same magnitude as the prices of goods and services. However, noninterest expenses do reflect general levels of inflation.

Financial Condition

Loan Portfolio

At December 31, 2017, total loans were \$10.02 billion, an increase of \$398.7 million or 4.1%, compared with \$9.62 billion at December 31, 2016. Loans at December 31, 2017 included \$31.4 million of loans held for sale. At December 31, 2017, total loans were 56.2% of deposits and 44.4% of total assets. At December 31, 2016, total loans were \$9.62 billion, an increase of \$183.5 million or 1.9%, compared with \$9.44 billion at December 31, 2015. Loans at December 31, 2016 included \$27.0 million of loans held for sale.

The following table summarizes the Company's total loan portfolio by type of loan as of the dates indicated:

	December 31,									
	2017		2016		2015		2014		2013	
	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent
	(Dollars in thousands)									
Commercial and industrial	\$ 1,479,910	14.8%	\$ 1,539,439	16.0%	\$ 1,692,246	17.9%	\$ 1,806,267	19.5%	\$ 1,279,777	16.5%
Real estate:										
Construction, land development and other land loans	1,509,137	15.1%	1,263,923	13.1%	1,073,198	11.4%	1,026,475	11.1%	865,511	11.1%
1-4 family residential ⁽¹⁾	2,454,548	24.5%	2,439,348	25.3%	2,360,798	25.0%	2,250,251	24.3%	1,870,365	24.1%
Home equity	285,312	2.8%	278,483	2.9%	279,867	2.9%	271,930	3.0%	261,355	3.4%
Commercial real estate (including multifamily residential) ⁽²⁾	3,315,627	33.1%	3,162,109	32.9%	3,131,083	33.2%	3,030,340	32.8%	2,753,797	35.2%
Farmland	502,841	5.0%	484,588	5.0%	434,349	4.6%	361,943	3.9%	332,648	4.3%
Agriculture	187,277	1.9%	187,748	2.0%	214,469	2.3%	189,703	2.1%	198,610	2.6%
Consumer	116,393	1.1%	130,703	1.4%	142,363	1.5%	160,595	1.7%	146,942	1.9%
Other	169,728	1.7%	135,719	1.4%	110,216	1.2%	146,679	1.6%	66,216	0.9%
Total loans ⁽³⁾	<u>\$ 10,020,773</u>	<u>100.0%</u>	<u>\$ 9,622,060</u>	<u>100.0%</u>	<u>\$ 9,438,589</u>	<u>100.0%</u>	<u>\$ 9,244,183</u>	<u>100.0%</u>	<u>\$ 7,775,221</u>	<u>100.0%</u>

- (1) Includes loans held for sale of \$31.4 million, \$27.0 million, \$23.9 million, \$8.6 million and \$2.2 million at December 31, 2017, 2016, 2015, 2014 and 2013, respectively.
- (2) Commercial real estate loans include approximately \$1.52 billion, \$1.46 billion, \$1.42 billion, \$1.51 billion and \$1.49 billion of owner-occupied loans for the years ended December 31, 2017, 2016, 2015, 2014 and 2013, respectively.
- (3) Includes fair value discounts on acquired loans of \$34.7 million, \$59.4 million, \$94.7 million, \$161.4 million and \$133.3 million at December 31, 2017, 2016, 2015, 2014 and 2013, respectively.

The Company separates its loan portfolio into two general categories of loans: (1) loans originated by Prosperity Bank and made pursuant to the Company's loan policy and procedures in effect at the time the loan was made are referred to as "legacy loans" and (2) "acquired loans," which are loans acquired in a business combination. Those acquired loans that are renewed or substantially modified after the date of the business combination, thereby subjecting them to the Company's allowance for credit losses methodology, are referred to as "acquired legacy loans." If a renewal or substantial modification of an acquired loan is underwritten by the Company with a new credit analysis, the loan will no longer be categorized as an acquired loan. For example, acquired loans to one borrower may be combined into a new loan with a new loan number and categorized as a legacy loan. Acquired loans with a fair value discount or premium at the date of the business combination that remained at the reporting date are referred to as "fair-valued acquired loans." All fair-valued acquired loans are further categorized into "Non-PCI loans" and "PCI loans" (purchased credit impaired loans). Acquired loans with evidence of credit quality deterioration at acquisition for which it is probable that the Company would not be able to collect all contractual amounts due are PCI loans.

The following tables summarize the Company's legacy and acquired loan portfolios broken out into legacy loans, acquired legacy loans, Non-PCI loans and PCI loans as of the dates indicated.

	December 31, 2017				
	Acquired Loans				
	Legacy Loans	Acquired Legacy Loans	Non-PCI Loans	PCI Loans	Total Loans
	(dollars in thousands)				
Residential mortgage loans held for sale	\$ 31,389	\$ —	\$ —	\$ —	\$ 31,389
Commercial and industrial	1,196,539	226,972	53,347	3,052	1,479,910
Real estate:					
Construction, land development and other land loans	1,443,925	23,890	40,453	869	1,509,137
1-4 family residential (including home equity)	2,412,531	74,362	217,014	4,564	2,708,471
Commercial real estate (including multi-family residential)	2,650,333	317,905	334,271	13,118	3,315,627
Farmland	429,298	14,772	58,390	381	502,841
Agriculture	134,847	51,712	718	—	187,277
Consumer and other	244,044	28,097	13,980	—	286,121
Total loans held for investment	<u>8,511,517</u>	<u>737,710</u>	<u>718,173</u>	<u>21,984</u>	<u>9,989,384</u>
Total	<u>\$8,542,906</u>	<u>\$ 737,710</u>	<u>\$ 718,173</u>	<u>\$ 21,984</u>	<u>\$10,020,773</u>

	December 31, 2016				
	Acquired Loans				
	Legacy Loans	Acquired Legacy Loans	Non-PCI Loans	PCI Loans	Total Loans
	(dollars in thousands)				
Residential mortgage loans held for sale	\$ 26,975	\$ —	\$ —	\$ —	\$ 26,975
Commercial and industrial	1,135,846	284,898	115,011	3,684	1,539,439
Real estate:					
Construction, land development and other land loans	1,152,873	42,990	66,629	1,431	1,263,923
1-4 family residential (including home equity)	2,289,107	83,785	312,254	5,710	2,690,856
Commercial real estate (including multi-family residential)	2,352,094	300,773	492,822	16,420	3,162,109
Farmland	396,353	19,363	68,484	388	484,588
Agriculture	135,835	49,795	2,118	—	187,748
Consumer and other	214,905	29,175	22,342	—	266,422
Total loans held for investment	<u>7,677,013</u>	<u>810,779</u>	<u>1,079,660</u>	<u>27,633</u>	<u>9,595,085</u>
Total	<u>\$7,703,988</u>	<u>\$ 810,779</u>	<u>\$1,079,660</u>	<u>\$ 27,633</u>	<u>\$9,622,060</u>

The Company offers a broad range of short to medium-term commercial loans, primarily collateralized, to businesses for working capital (including inventory and receivables), business expansion (including acquisitions of real estate and improvements) and the purchase of equipment and machinery. Historically, the Company has originated loans for its own account, including all loans in the 1-4 family residential category, and has not securitized its loans. However, the Company does originate longer-term residential mortgage loans for sale into the secondary market. The purpose of a particular loan generally determines its structure.

Loans to borrowers with aggregate debt relationships over \$1.0 million and below \$3.5 million are evaluated and acted upon on a daily basis by two of the company-wide loan concurrence officers. Loans to borrowers with aggregate debt relationships above \$3.5 million are evaluated and acted upon by an officers' loan committee that meets weekly. In addition to the officers' loan committee evaluation, loans to borrowers with aggregate debt relationships from \$25.0 million to \$50.0 million are evaluated and acted upon by the directors' loan committee which consists of three directors of the Bank and meets as necessary. Loans to borrowers with aggregate debt relationships over \$50.0 million are evaluated and acted upon by the Bank's Board of Directors either at a regularly scheduled monthly board meeting or by teleconference or written consent.

Commercial and Industrial Loans. In nearly all cases, the Company's commercial loans are made in the Company's market areas and are underwritten on the basis of the borrower's ability to service the debt from income. As a general practice, the Company takes as collateral a lien on any available real estate, equipment or other assets owned by the borrower and obtains a personal guaranty of the borrower or principal. Working capital loans are primarily collateralized by short-term assets whereas term loans are primarily collateralized by long-term assets. In general, commercial loans involve more credit risk than residential mortgage loans and commercial mortgage loans and, therefore, usually yield a higher return. The increased risk in commercial loans is due to the type of collateral securing these loans as well as the expectation that commercial loans generally will be serviced principally from the operations of the business, and those operations may not be successful. Historical trends have shown these types of loans to have higher delinquencies than mortgage loans. As a result of these additional complexities, variables and risks, commercial loans require more thorough underwriting and servicing than other types of loans.

Included in commercial loans are (1) commitments to oil and gas producers secured by proven, developed and producing reserves and (2) commitments to service, equipment and midstream companies secured mainly by accounts receivable, inventory and equipment. Mineral reserve values supporting commitments to producers are normally re-determined semi-annually using reserve studies prepared by a third-party or the Company's oil and gas engineer. Accounts receivable and inventory borrowing bases for service companies are typically re-determined monthly. Funding requests by both producers and service companies are monitored relative to the most recently determined borrowing base. As of December 31, 2017, the Company had \$112.2 million in funded commitments outstanding to oil and gas production companies and \$63.0 million in unfunded commitments, for a total of \$175.2 million. This compares with funded commitments to production companies of \$119.9 million as of December 31, 2016 and \$72.1 million in unfunded commitments, for a total of \$192.0 million. Total unfunded commitments to producers include letters of credit issued in lieu of oil well plugging bonds. As of December 31, 2017, the Company had outstanding \$188.3 million in funded commitments to service companies and \$90.6 million in unfunded commitments for a total of \$278.9 million. This compares with funded commitments to service companies of \$164.6 million as of December 31, 2016 and \$73.4 million in unfunded commitments, for a total of \$238.0 million.

Commercial Real Estate. The Company makes commercial real estate loans collateralized by owner-occupied and nonowner-occupied real estate to finance the purchase of real estate. The Company's commercial real estate loans are collateralized by first liens on real estate, typically have variable interest rates (or five year or less fixed rates) and amortize over a 15- to 20-year period. Payments on loans secured by nonowner-occupied properties are often dependent on the successful operation or management of the properties. Accordingly, repayment of these loans may be subject to adverse conditions in the real estate market or the economy to a greater extent than other types of loans. The Company seeks to minimize these risks in a variety of ways, including giving careful consideration to the property's operating history, future operating projections, current and projected occupancy, location and physical condition, in connection with underwriting these loans. The underwriting analysis also includes credit verification, analysis of global cash flow, appraisals and a review of the financial condition of the borrower.

1-4 Family Residential Loans. The Company's lending activities also include the origination of 1-4 family residential mortgage loans (including home equity loans) collateralized by owner-occupied residential properties located in the Company's market areas. The Company offers a variety of mortgage loan portfolio products which generally are amortized over five to 25 years. Loans collateralized by 1-4 family residential real estate generally have been originated in amounts of no more than 89% of appraised value or have mortgage insurance. The Company requires mortgage title insurance and hazard insurance. The Company retains these portfolio loans for its own account rather than selling them into the secondary market. By doing so, the Company incurs interest rate risk as well as the risks associated with nonpayments on such loans. The Company's mortgage department also offers a variety of mortgage loan products which are generally amortized over 30 years, including FHA and VA loans. The Company sells these longer-term loans into the secondary market.

Construction, Land Development and Other Land Loans. The Company makes loans to finance the construction of residential and, to a lesser extent, nonresidential properties. Construction loans generally are collateralized by first liens on real estate and have floating interest rates. The Company conducts periodic inspections, either directly or through an agent, prior to approval of periodic draws on these loans. Underwriting guidelines similar to those described above are also used in the Company's construction lending activities. Construction loans involve additional risks attributable to the fact that loan funds are advanced upon the security of a project under construction, and the project is of uncertain value prior to its completion. Because of uncertainties inherent in estimating construction costs, the market value of the completed project and the effects of governmental regulation on real property, it can be difficult to accurately evaluate the total funds required to complete a project and the related loan to value ratio. As a result of these uncertainties, construction lending often involves the disbursement of substantial funds with repayment dependent, in part, on the success of the ultimate project rather than the ability of a borrower or guarantor to repay the loan. If the Company is forced to foreclose on a project prior to completion, the Company may not be able to recover all of the unpaid portion of the loan. In addition, the Company may be required to fund additional amounts to complete a project and may have to hold the property for an indeterminate period of time. Although the Company has underwriting procedures designed to identify what it believes to be acceptable levels of risks in construction lending, these procedures may not prevent losses from the risks described above.

Agriculture Loans. The Company provides agriculture loans for short-term crop production, including rice, cotton, milo and corn, farm equipment financing and agriculture real estate financing. The Company evaluates agriculture borrowers primarily based on their historical profitability, level of experience in their particular agriculture industry, overall financial capacity and the availability of secondary collateral to withstand economic and natural variations common to the industry. Because agriculture loans present a higher level of risk associated with events caused by nature, the Company routinely makes on-site visits and inspections in order to identify and monitor such risks.

Consumer Loans. Consumer loans made by the Company include direct "A"-credit automobile loans, recreational vehicle loans, boat loans, home improvement loans, personal loans (collateralized and uncollateralized) and deposit account collateralized loans. The terms of these loans typically range from 12 to 180 months and vary based upon the nature of collateral and size of loan. Generally, consumer loans entail greater risk than do real estate secured loans, particularly in the case of consumer loans that are unsecured or collateralized by rapidly depreciating assets such as automobiles. In such cases, any repossessed collateral for a defaulted consumer loan may not provide an adequate source of repayment for the outstanding loan balance. The remaining deficiency often does not warrant further substantial collection efforts against the borrower beyond obtaining a deficiency judgment. In addition, consumer loan collections are dependent on the borrower's continuing financial stability, and thus are more likely to be adversely affected by job loss, divorce, illness or personal bankruptcy. Furthermore, the application of various federal and state laws may limit the amount which can be recovered on such loans.

The contractual maturity ranges of the Company's loan portfolio by type of loan and the amount of such loans with predetermined interest rates and floating rates in each maturity range as of December 31, 2017 are summarized in the following table. Contractual maturities are based on contractual amounts outstanding and do not include loan purchase discounts of \$34.7 million or loans held for sale of \$31.4 million at December 31, 2017:

	<u>One Year or Less</u>	<u>After One Year Through Five Years</u>	<u>After Five Years</u>	<u>Total</u>
	(Dollars in thousands)			
Commercial and industrial	\$ 515,223	\$ 453,988	\$ 516,837	\$ 1,486,048
Real estate:				
Construction, land development and other land loans	401,352	267,000	843,226	1,511,578
1-4 family residential (includes home equity)	17,054	115,979	2,581,171	2,714,204
Commercial (includes multi-family residential)	72,072	285,509	2,974,839	3,332,420
Agriculture (includes farmland)	152,082	62,196	478,858	693,136
Consumer and other	78,385	103,458	104,903	286,746
Total	<u>\$1,236,168</u>	<u>\$ 1,288,130</u>	<u>\$7,499,834</u>	<u>\$10,024,132</u>
Loans with a predetermined interest rate	\$ 274,095	\$ 709,811	\$3,078,157	\$ 4,062,063
Loans with a floating interest rate	962,073	578,319	4,421,677	5,962,069
Total	<u>\$1,236,168</u>	<u>\$ 1,288,130</u>	<u>\$7,499,834</u>	<u>\$10,024,132</u>

Nonperforming Assets

Nonperforming assets include loans on nonaccrual status, accruing loans 90 days or more past due, repossessed assets and real estate which has been acquired through foreclosure and is awaiting disposition. Nonperforming assets do not include PCI loans unless the timing and amount of projected cash flows can no longer be reasonably estimated. PCI loans become subject to the Company's allowance for credit losses methodology when a deterioration in projected cash flows is identified.

The Company has several procedures in place to assist it in maintaining the overall quality of its loan portfolio. The Company has established underwriting guidelines to be followed by its officers, and the Company also monitors its delinquency levels for any negative or adverse trends. Nevertheless, the Company's loan portfolio could become subject to increasing pressures from deteriorating borrower credit due to general economic conditions.

As part of the on-going monitoring of the Company's loan portfolio and the methodology for calculating the allowance for credit losses, management grades each loan from 1 to 9. Depending on the grade, loans in the same grade are aggregated and a loss factor is applied to the total loans in the group to determine the allowance for credit losses. For certain loans in risk grades 7 to 9, a specific reserve may be required.

The Company generally places a loan on nonaccrual status and ceases accruing interest when the payment of principal or interest is delinquent for 90 days, or earlier in some cases, unless the loan is in the process of collection and the underlying collateral fully supports the carrying value of the loan.

The Company requires appraisals on loans collateralized by real estate. With respect to potential problem loans, an evaluation of the borrower's overall financial condition is made to determine the need, if any, for possible write-downs or appropriate additions to the allowance for credit losses.

The following table presents information regarding past due loans and nonperforming assets at the dates indicated:

	December 31,				
	2017	2016	2015	2014	2013
	(Dollars in thousands)				
Nonaccrual loans ⁽¹⁾	\$ 25,264	\$ 31,642	\$ 39,711	\$ 31,422	\$ 10,231
Accruing loans 90 or more days past due	1,004	956	614	2,193	4,947
Total nonperforming loans	26,268	32,598	40,325	33,615	15,178
Repossessed assets	35	241	171	67	27
Other real estate	11,152	15,463	2,963	3,237	7,299
Total nonperforming assets	<u>\$ 37,455</u>	<u>\$ 48,302</u>	<u>\$ 43,459</u>	<u>\$ 36,919</u>	<u>\$ 22,504</u>
Nonperforming assets to total loans and other real estate	0.37%	0.50%	0.46%	0.40%	0.29%

(1) Includes troubled debt restructurings of \$53 thousand, \$97 thousand, \$681 thousand, \$911 thousand and \$1.4 million for the years ended December 31, 2017, 2016, 2015, 2014 and 2013, respectively.

The following tables present information regarding past due loans and nonperforming assets differentiated among legacy loans, acquired legacy loans, Non-PCI loans and PCI loans at the dates indicated:

	December 31, 2017				
	Acquired Loans				Total Loans
	Legacy Loans	Acquired Legacy Loans	Non-PCI Loans	PCI Loans	
	(Dollars in thousands)				
Nonaccrual loans	\$ 8,040	\$ 12,373	\$ 3,341	\$ 1,510	\$ 25,264
Accruing loans 90 or more days past due	1,004	—	—	—	1,004
Total nonperforming loans	9,044	12,373	3,341	1,510	26,268
Repossessed assets	19	—	16	—	35
Other real estate	10,952	—	200	—	11,152
Total nonperforming assets	<u>\$ 20,015</u>	<u>\$ 12,373</u>	<u>\$ 3,557</u>	<u>\$ 1,510</u>	<u>\$ 37,455</u>
Nonperforming assets to total loans and other real estate by category	0.23%	1.68%	0.50%	6.87%	0.37%

	December 31, 2016				
	Acquired Loans				Total Loans
	Legacy Loans	Acquired Legacy Loans	Non-PCI Loans	PCI Loans	
	(Dollars in thousands)				
Nonaccrual loans	\$ 9,983	\$ 12,703	\$ 6,210	\$ 2,746	\$ 31,642
Accruing loans 90 or more days past due	903	—	53	—	956
Total nonperforming loans	10,886	12,703	6,263	2,746	32,598
Repossessed assets	—	225	16	—	241
Other real estate	13,442	1,178	70	773	15,463
Total nonperforming assets	<u>\$ 24,328</u>	<u>\$ 14,106</u>	<u>\$ 6,349</u>	<u>\$ 3,519</u>	<u>\$ 48,302</u>
Nonperforming assets to total loans and other real estate by category	0.32%	1.74%	0.59%	12.39%	0.50%

The Company had \$37.5 million in nonperforming assets at December 31, 2017 compared with \$48.3 million at December 31, 2016 and \$43.5 million at December 31, 2015. The nonperforming assets consisted of 99 separate credits or other real estate properties at December 31, 2017, compared with 158 at December 31, 2016 and 147 at December 31, 2015. If interest on nonaccrual loans had been accrued under the original loan terms, approximately \$2.7 million, \$3.2 million and \$3.9 million would have been recorded as income for the years ended December 31, 2017, 2016 and 2015, respectively.

At December 31, 2017, of the total nonperforming assets, \$20.0 million resulted from legacy loans, \$12.4 million resulted from acquired legacy loans, \$3.6 million resulted from Non-PCI loans and \$1.5 million resulted from PCI loans. At December 31, 2016, of the total nonperforming assets, \$24.3 million resulted from legacy loans, \$14.1 million resulted from acquired legacy loans, \$6.3 million resulted from Non-PCI loans and \$3.5 million resulted from PCI loans. A PCI loan becomes impaired when there is a deterioration in projected cash flows after acquisition.

Nonperforming assets were 0.37% of total loans and other real estate at December 31, 2017 compared with 0.50% of total loans and other real estate at December 31, 2016. The allowance for credit losses as a percentage of total nonperforming loans was 319.9% at December 31, 2017 and 261.8% at December 31, 2016.

Allowance for Credit Losses

The following table presents, as of and for the periods indicated, an analysis of the allowance for credit losses and other related data:

	Years Ended December 31,				
	2017	2016	2015	2014	2013
	(Dollars in thousands)				
Average loans outstanding	<u>\$ 9,822,225</u>	<u>\$9,629,714</u>	<u>\$9,200,765</u>	<u>\$8,988,069</u>	<u>\$6,202,897</u>
Gross loans outstanding at end of period	<u>\$10,020,773</u>	<u>\$9,622,060</u>	<u>\$9,438,589</u>	<u>\$9,244,183</u>	<u>\$7,775,221</u>
Allowance for credit losses at beginning of period	\$ 85,326	\$ 81,384	\$ 80,762	\$ 67,282	\$ 52,564
Provision for credit losses	14,325	24,000	7,560	18,275	17,240
Charge-offs:					
Commercial and industrial	(14,836)	(14,371)	(7,696)	(818)	(672)
Real estate and agriculture	(446)	(7,796)	(1,150)	(3,458)	(1,423)
Consumer and other	(3,652)	(5,346)	(3,304)	(5,674)	(3,398)
Recoveries:					
Commercial and industrial	1,763	2,812	3,322	466	348
Real estate and agriculture	506	3,516	600	1,561	1,330
Consumer and other	1,055	1,127	1,290	3,128	1,293
Net charge-offs	<u>(15,610)</u>	<u>(20,058)</u>	<u>(6,938)</u>	<u>(4,795)</u>	<u>(2,522)</u>
Allowance for credit losses at end of period	<u>\$ 84,041</u>	<u>\$ 85,326</u>	<u>\$ 81,384</u>	<u>\$ 80,762</u>	<u>\$ 67,282</u>
Ratio of allowance to end of period loans	0.84%	0.89%	0.86%	0.87%	0.87%
Ratio of net charge-offs to average loans	0.16%	0.21%	0.08%	0.05%	0.04%
Ratio of allowance to end of period nonperforming loans	319.9%	261.8%	201.8%	240.3%	443.3%

The allowance for credit losses is a valuation established through charges to earnings in the form of a provision for credit losses. The amount of the allowance for credit losses is affected by the following: (1) charge-offs of loans that occur when loans are deemed uncollectible and decrease the allowance, (2) recoveries on loans previously charged off that increase the allowance and (3) provisions for credit losses charged to earnings that increase the allowance. Based on an evaluation of the loan portfolio and consideration of the factors listed below, management presents a quarterly review of the allowance for credit losses to the Bank's Board of Directors, indicating any change in the allowance since the last review and any recommendations as to adjustments in the allowance. Although management believes it uses the best information available to make determinations with respect to the allowance for credit losses, further adjustments may be necessary if economic conditions differ from the assumptions used in making the initial determinations.

The Company's allowance for credit losses consists of two components: a specific valuation allowance based on probable losses on specifically identified loans and a general valuation allowance based on historical loan loss experience, general economic conditions and other qualitative risk factors both internal and external to the Company.

In setting the specific valuation allowance, the Company follows a loan review program to evaluate the credit risk in the total loan portfolio and assigns risk grades to each loan. Through this loan review process, the Company maintains an internal list of impaired loans which, along with the delinquency list of loans, helps management assess the overall quality of the loan portfolio and the adequacy of the allowance for credit losses. All loans that have been identified as impaired are reviewed on a quarterly basis in order to determine whether a specific reserve is required. For certain impaired loans, the Company allocates a specific loan loss reserve primarily based on the value of the collateral securing the impaired loan. The specific reserves are determined on an individual loan basis. Loans for which specific reserves are provided are excluded from the general valuation allowance described below.

In connection with this review of the loan portfolio, the Company considers risk elements attributable to particular loan types or categories in assessing the quality of individual loans. Some of the risk elements include:

- for 1-4 family residential mortgage loans, the borrower's ability to repay the loan, including a consideration of the debt to income ratio and employment and income stability, the loan to value ratio, and the age, condition and marketability of collateral;
- for commercial mortgage loans and multifamily residential loans, the debt service coverage ratio (income from the property in excess of operating expenses compared to loan payment requirements), operating results of the owner in the case of owner-occupied properties, the loan to value ratio, the age and condition of the collateral and the volatility of income, property value and future operating results typical of properties of that type;
- for construction, land development and other land loans, the perceived feasibility of the project including the ability to sell developed lots or improvements constructed for resale or the ability to lease property constructed for lease, the quality and nature of contracts for presale or prelease, if any, experience and ability of the developer and loan to value ratio;
- for commercial and industrial loans, the operating results of the commercial, industrial or professional enterprise, the borrower's business, professional and financial ability and expertise, the specific risks and volatility of income and operating results typical for businesses in that category and the value, nature and marketability of collateral;
- for agriculture real estate loans, the experience and financial capability of the borrower, projected debt service coverage of the operations of the borrower and loan to value ratio; and
- for non-real estate agriculture loans, the operating results, experience and financial capability of the borrower, historical and expected market conditions and the value, nature and marketability of collateral.

In addition, for each category, the Company considers secondary sources of income and the financial strength and credit history of the borrower and any guarantors.

In determining the amount of the general valuation allowance, management considers factors such as historical loan loss experience, concentration risk of specific loan types, the volume, growth and composition of the Company's loan portfolio, current economic conditions that may affect the borrower's ability to pay and the value of collateral, the evaluation of the Company's loan portfolio through its internal loan review process, general economic conditions, other qualitative risk factors both internal and external to the Company and other relevant factors. Based on a review of these factors for each loan type, the Company applies an estimated percentage to the outstanding balance of each loan type, excluding any loan that has a specific reserve allocated to it. The Company uses this information to establish the amount of the general valuation allowance.

A change in the allowance for credit losses can be attributable to several factors, most notably (1) specific reserves identified for impaired loans, (2) historical credit loss information, (3) changes in environmental factors and (4) growth in the balance of legacy loans and the re-categorization of fair-valued acquired loans to acquired legacy loans, which subjects such loans to the allowance methodology.

Changes in the Company's asset quality are reflected in the allowance in several ways. Specific reserves that are calculated on a loan-by-loan basis and the qualitative assessment of all other loans reflect current changes in the credit quality of the loan portfolio. Historical credit losses, on the other hand, are based on a three-year look back period, which are then applied to estimate current credit losses inherent in the loan portfolio. A deterioration in the credit quality of the loan portfolio in the current period would increase the historical credit loss factor to be applied in future periods, just as an improvement in credit quality would decrease the historical credit loss factor.

The allowance for credit losses is further determined by the size of the loan portfolio subject to the allowance methodology and environmental factors that include Company-specific risk indicators and general economic conditions, both of which are constantly changing. The Company evaluates the economic and portfolio-specific factors on a quarterly basis to determine a qualitative component of the general valuation allowance. The factors include economic metrics, business conditions, delinquency trends, credit concentrations, nature and volume of the portfolio and other adjustments for items not covered by specific reserves and historical loss experience. Management's assessment of qualitative factors is a statistically based approach to determine the inherent probable loss associated with such factors. Based on the Company's actual historical loan loss experience relative to economic and loan portfolio-specific factors at the time the losses occurred, management is able to identify the probabilities of default and loss severity based on current economic conditions. The correlation of historical loss experience with current economic conditions provides an estimate of inherent and probable losses that has not been previously factored into the general valuation allowance by the determination of specific reserves and recent historical losses. Additionally, the Company considers qualitative factors not easily quantified and the possibility of model imprecision.

Utilizing the aggregation of specific reserves, historical loss experience and a qualitative component, management is able to determine the valuation allowance to reflect the full inherent probable loss.

In determining the allowance for credit losses, management also considers the type of loan (legacy or acquired) and the credit quality of the loan. The Company distinguishes between legacy loans and acquired legacy loans, which are accounted for under the contractual yield method, and fair-valued acquired loans consisting of Non-PCI loans and PCI loans, which are accounted for as purchased loans.

Loans acquired in business combinations are initially recorded at fair value, which includes an estimate of inherent credit losses expected to be realized over the remaining lives of the loans, and therefore no corresponding allowance for credit losses is recorded for these loans at acquisition. When a fair-valued acquired loan is renewed at its maturity date, the loan is re-categorized as an acquired legacy loan. When a fair-valued acquired loan is modified after acquisition, the loan is independently evaluated subsequent to the modification decision to determine whether the modification was substantial, and therefore requires that the loan be re-categorized as an acquired legacy loan. This determination is based on a discounted cash-flow analysis. Generally, when a change in discounted cash-flow of greater than 10% is identified, the fair-valued acquired loan becomes categorized as an acquired legacy loan. If and when a fair-valued acquired loan becomes an acquired legacy loan, the acquired legacy loan is evaluated at the time of renewal or modification in accordance with the Company's allowance for credit losses methodology described above.

Non-PCI loans that were not deemed impaired subsequent to the acquisition date are considered non-impaired and are evaluated as part of the general valuation allowance. Non-PCI loans that have not become impaired subsequent to acquisition are segregated into a pool for each acquisition for allowance calculation purposes. For each pool, the Company estimates a hypothetical allowance for credit losses also referred to as an "indicated reserve" that is calculated in accordance with GAAP requirements. The Company uses the acquired bank's past loss history adjusted for qualitative factors to establish the indicated reserve. The indicated reserve for each pool of Non-PCI loans is compared with the remaining discount for the respective pool to test for credit quality deterioration and the possible need for a loan loss provision. To the extent the remaining discount of the pool is greater than the indicated reserve, no additional allowance is necessary. If the remaining discount of the pool is less than the indicated reserve, the difference results in an increase to the allowance recorded through a provision for credit losses.

Non-PCI loans that have deteriorated to an impaired status subsequent to acquisition are evaluated for a specific reserve on a quarterly basis which, when identified, is added to the allowance for credit losses. The Company reviews impaired Non-PCI loans on a loan-by-loan basis and determines the specific reserve based on the difference between the recorded investment in the loan and one of three factors: expected future cash flows, observable market price or fair value of the collateral. Because essentially all of the Company's impaired Non-PCI loans have been collateral-dependent, the amount of the specific reserve historically has been determined by comparing the fair value of the collateral securing the Non-PCI loan with the recorded investment in such loan. In the future, the Company will continue to analyze impaired Non-PCI loans on a loan-by-loan basis and may use an alternative measurement method to determine the specific reserve, as appropriate and in accordance with applicable accounting standards.

PCI loans are individually monitored on a quarterly basis to assess for deterioration subsequent to acquisition and are only subject to the Company's allowance methodology when a deterioration in projected cash flows is identified. If a deterioration in cash flows is identified, an additional provision for credit losses is made. PCI loans were recorded at their acquisition date fair values, which were based on expected cash flows and included estimates of expected future credit losses. The Company's estimates of loan fair values at the acquisition date may be adjusted for a period of up to one year as the Company continues to evaluate its estimate of expected future cash flows at the acquisition date. If the Company determines that losses arose after the acquisition date, the additional losses will be reflected as a provision for credit losses. An allowance for credit losses is not calculated for PCI loans that have not experienced deterioration subsequent to the acquisition date. See "Critical Accounting Policies" above for more information.

As described in the section captioned "Critical Accounting Policies" above, the Company's determination of the allowance for credit losses involves a high degree of judgment and complexity. The Company's analysis of qualitative, or environmental, factors on pools of loans with common risk characteristics, in combination with the quantitative historical loss information and specific reserves, provides the Company with an estimate of inherent losses. The allowance must reflect changes in the balance of loans subject to the allowance methodology, as well as the estimated imminent losses associated with those loans. In the Company's case, the \$1.3 million decrease in the allowance for credit losses for the year ended December 31, 2017 was primarily attributable to improved environmental factors, partially offset by increases in historical loss rates, loan balances and specific reserves identified for loans with deteriorated credit quality.

The following table shows the allocation of the allowance for credit losses among various categories of loans and certain other information as of the dates indicated. The allocation is made for analytical purposes and is not necessarily indicative of the categories in which future losses may occur. The total allowance is available to absorb losses from any loan category.

	December 31,									
	2017		2016		2015		2014		2013	
	Percent of Loans to Total Amount	Loans	Percent of Loans to Total Amount	Loans	Percent of Loans to Total Amount	Loans	Percent of Loans to Total Amount	Loans	Percent of Loans to Total Amount	Loans
	(Dollars in thousands)									
Balance of allowance for credit losses applicable to:										
Commercial and industrial	\$38,810	14.8%	\$35,836	16.0%	\$33,409	17.9%	\$30,002	19.5%	\$ 8,167	16.5%
Real estate	39,933	75.5%	43,811	74.2%	42,769	72.5%	44,946	71.2%	56,234	73.9%
Agriculture and agriculture real estate	3,772	6.9%	4,073	7.0%	3,845	6.9%	3,722	6.0%	1,229	6.8%
Consumer and other	1,526	2.8%	1,606	2.8%	1,361	2.7%	2,092	3.3%	1,652	2.8%
Total allowance for credit losses	<u>\$84,041</u>	<u>100.0%</u>	<u>\$85,326</u>	<u>100.0%</u>	<u>\$81,384</u>	<u>100.0%</u>	<u>\$80,762</u>	<u>100.0%</u>	<u>\$67,282</u>	<u>100.0%</u>

The Company further disaggregates its allowance for credit losses to distinguish between the portion of the allowance attributed to legacy loans and the portion attributed to acquired loans.

The following tables present, as of and for the periods indicated, information regarding the allowance for credit losses differentiated between legacy loans and acquired loans, which includes acquired legacy loans, Non-PCI loans and PCI loans. The charge-offs and recoveries with respect to the acquired loans shown below are primarily from acquired legacy loans. Reported net charge-offs may include those from Non-PCI loans and PCI loans, but only if the total charge-off required is greater than the remaining discount.

	As of and for the Year Ended December 31, 2017		
	Legacy Loans	Acquired Loans	Total
	(Dollars in thousands)		
Average loans outstanding	\$ 8,153,733	\$ 1,668,492	\$ 9,822,225
Gross loans outstanding at end of period	\$ 8,542,906	\$ 1,477,867	\$ 10,020,773
Allowance for credit losses at beginning of period	\$ 73,846	\$ 11,480	\$ 85,326
Provision for credit losses	6,587	7,738	14,325
Charge-offs:			
Commercial and industrial	(5,503)	(9,333)	(14,836)
Real estate and agriculture	(228)	(218)	(446)
Consumer and other	(3,618)	(34)	(3,652)
Recoveries:			
Commercial and industrial	959	804	1,763
Real estate and agriculture	340	166	506
Consumer and other	1,024	31	1,055
Net charge-offs	(7,026)	(8,584)	(15,610)
Allowance for credit losses at end of period	\$ 73,407	\$ 10,634	\$ 84,041
Ratio of allowance to end of period loans	0.86%	0.72%	0.84%
Ratio of net charge-offs to average loans	0.09%	0.51%	0.16%
Ratio of allowance to end of period nonperforming loans	811.7%	61.7%	319.9%

	As of and for the Year Ended December 31, 2016		
	Legacy Loans	Acquired Loans	Total
	(Dollars in thousands)		
Average loans outstanding	\$ 7,403,995	\$ 2,225,719	\$ 9,629,714
Gross loans outstanding at end of period	\$ 7,703,988	\$ 1,918,072	\$ 9,622,060
Allowance for credit losses at beginning of period	\$ 64,909	\$ 16,475	\$ 81,384
Provision for credit losses	19,740	4,260	24,000
Charge-offs:			
Commercial and industrial	(4,019)	(10,352)	(14,371)
Real estate and agriculture	(7,675)	(121)	(7,796)
Consumer and other	(5,158)	(188)	(5,346)
Recoveries:			
Commercial and industrial	1,497	1,315	2,812
Real estate and agriculture	3,435	81	3,516
Consumer and other	1,117	10	1,127
Net charge-offs	(10,803)	(9,255)	(20,058)
Allowance for credit losses at end of period	\$ 73,846	\$ 11,480	\$ 85,326
Ratio of allowance to end of period loans	0.96%	0.60%	0.89%
Ratio of net charge-offs to average loans	0.15%	0.42%	0.21%
Ratio of allowance to end of period nonperforming loans	678.4%	52.9%	261.8%

At December 31, 2017, \$373 thousand of the allowance was attributable to Non-PCI loans compared with \$185 thousand of the allowance at December 31, 2016, an increase of \$188 thousand or 101.6%. This change was primarily attributable to an increase in specific reserves identified for loans with deteriorated credit quality.

At December 31, 2017, no part of the allowance was attributable to PCI loans compared with \$31 thousand of the allowance at December 31, 2016. This decrease was primarily attributable to the charge-off of one loan with specific reserves identified at December 31, 2016.

At December 31, 2017, the Company had \$34.7 million of total outstanding discounts on Non-PCI and PCI loans, of which \$28.7 million was accretable.

The Company believes that the allowance for credit losses at December 31, 2017 is adequate to cover estimated losses in the loan portfolio as of such date. Nevertheless, the Company could sustain losses in future periods that could be substantial in relation to the size of the allowance at December 31, 2017.

Securities

The Company uses its securities portfolio to manage interest rate risk and as a source of income and liquidity for cash requirements. At December 31, 2017, the carrying amount of investment securities totaled \$9.67 billion, a decrease of \$54.0 million or 0.6% compared with \$9.73 billion at December 31, 2016. At December 31, 2017, securities represented 42.8% of total assets compared with 43.6% of total assets at December 31, 2016.

At the date of purchase, the Company is required to classify debt and equity securities into one of three categories: held to maturity, trading or available for sale. At each reporting date, the appropriateness of the classification is reassessed. Investments in debt securities are classified as held to maturity and measured at amortized cost in the financial statements only if management has the positive intent and ability to hold those securities to maturity. Securities that are bought and held principally for the purpose of selling them in the near term are classified as trading and measured at fair value in the financial statements with unrealized gains and losses included in earnings. Investments not classified as either held to maturity or trading are classified as available for sale and measured at fair value in the financial statements with unrealized gains and losses reported, net of tax, in a separate component of shareholders' equity until realized.

The following table summarizes the carrying value by classification of securities as of the dates shown:

	December 31,					
	2017		2016		2015	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value	Amortized Cost	Fair Value
	(Dollars in thousands)					
Available for Sale						
States and political subdivisions	\$ 1,817	\$ 1,820	\$ 1,915	\$ 1,920	\$ 5,463	\$ 5,485
Collateralized mortgage obligations	99,996	100,061	120,478	120,599	25,991	25,916
Mortgage-backed securities	103,612	103,489	84,024	85,863	55,884	58,971
Other securities	12,588	12,500	12,588	12,794	12,588	12,692
Total	<u>\$ 218,013</u>	<u>\$ 217,870</u>	<u>\$ 219,005</u>	<u>\$ 221,176</u>	<u>\$ 99,926</u>	<u>\$ 103,064</u>
Held to Maturity						
U.S. Treasury securities and obligations of						
U.S. Government agencies	\$ 32,235	\$ 32,380	\$ 33,523	\$ 34,020	\$ 47,598	\$ 48,396
States and political subdivisions	328,666	332,122	384,015	386,621	363,505	370,043
Corporate debt securities	—	—	100	100	—	—
Collateralized mortgage obligations	653	650	850	851	2,107	2,122
Mortgage-backed securities	9,092,692	8,958,330	9,086,422	8,917,863	8,986,153	8,972,614
Total	<u>\$9,454,246</u>	<u>\$9,323,482</u>	<u>\$9,504,910</u>	<u>\$9,339,455</u>	<u>\$9,399,363</u>	<u>\$9,393,175</u>

Certain investment securities are valued at less than their historical cost. Management evaluates securities for other-than-temporary impairment (“OTTI”) at least on a quarterly basis, and more frequently when economic or market conditions warrant such an evaluation.

In determining OTTI, management considers many factors, including: (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, (3) whether the market decline was affected by macroeconomic conditions and (4) whether the entity has the intent to sell the debt security or more likely than not will be required to sell the debt security before its anticipated recovery. The assessment of whether an other-than-temporary decline exists involves a high degree of subjectivity and judgment and is based on the information available to management at the time of such determination.

Management has the ability and intent to hold the securities classified as held-to-maturity until they mature, at which time the Company will receive full value for the securities. Furthermore, as of December 31, 2017, management does not have the intent to sell any of the securities classified as available for sale before a recovery of cost. In addition, management believes it is more likely than not that the Company will not have to sell any of its investment securities before a recovery of cost. As of December 31, 2017, management believes any impairment in the Company’s securities is temporary and no impairment loss has been realized in the Company’s consolidated statement of income. The Company recorded no other-than-temporary impairment charges in 2017, 2016 or 2015.

The following table summarizes the contractual maturity of securities and their weighted average yields as of December 31, 2017. The contractual maturity of a mortgage-backed security is the date at which the last underlying mortgage matures. The weighted average life of the Company’s securities portfolio is 3.97 years, with a modified duration of 3.67 at December 31, 2017. Available for sale securities are shown at fair value and held to maturity securities are shown at amortized cost. For purposes of the table below, tax-exempt states and political subdivisions are calculated on a tax equivalent basis.

	December 31, 2017									
	Within One Year		After One Year but Within Five Years		After Five Years but Within Ten Years		After Ten Years		Total	
	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield	Total	Yield
	(Dollars in thousands)									
U.S. Treasury securities and obligations of U.S. government agencies	\$ 6,640	1.81%	\$ 25,595	2.23%	\$ —	—	\$ —	—	\$ 32,235	2.14%
States and political subdivisions	26,889	2.45%	158,646	2.89%	128,457	3.79%	16,494	4.16%	330,486	3.27%
Other Securities	12,500	2.23%	—	—	—	—	—	—	12,500	2.23%
Collateralized mortgage obligations	—	—	17	—	144	1.81%	100,553	1.74%	100,714	1.74%
Mortgage-backed securities	7,599	4.06%	250,835	3.21%	2,029,830	2.24%	6,907,917	2.16%	9,196,181	2.21%
Total	<u>\$53,628</u>	<u>2.54%</u>	<u>\$435,093</u>	<u>3.04%</u>	<u>\$2,158,431</u>	<u>2.33%</u>	<u>\$7,024,964</u>	<u>2.16%</u>	<u>\$9,672,116</u>	<u>2.24%</u>

The contractual maturity of mortgage-backed securities and collateralized mortgage obligations is not a reliable indicator of their expected life because borrowers have the right to prepay their obligations at any time. Mortgage-backed securities monthly pay downs cause the average lives of the securities to be much different than their stated lives. During a period of increasing interest rates, fixed rate mortgage-backed securities do not tend to experience heavy prepayments of principal, and consequently, the average life of this security will be lengthened. If interest rates begin to fall, prepayments may increase, thereby shortening the estimated life of this security.

At December 31, 2017 and 2016, the Company did not own securities of any one issuer (other than the U.S. government and its agencies) for which aggregate adjusted cost exceeded 10% of the consolidated shareholders’ equity at such respective dates.

The average tax equivalent yield of the securities portfolio was 2.24% as of December 31, 2017 compared with 2.24% as of December 31, 2016 and 2.28% as of December 31, 2015. The decrease in yields during 2016 was primarily due to the Company's reinvestment of funds at lower rates in 2016 compared with the rates in 2015. The average yield excluding the tax equivalent adjustment was 2.15% for the year ended December 31, 2017 compared with 2.13% for the year ended December 31, 2016 and 2.03% for the year ended December 31, 2015. The overall non-acquisition growth in the average securities portfolio over the comparable periods was primarily funded by average deposit growth and other borrowings.

Mortgage-backed securities are securities that have been developed by pooling a number of real estate mortgages and which are principally issued by federal agencies such as Government National Mortgage Association (Ginnie Mae), Fannie Mae and Freddie Mac. These securities are deemed to have high credit ratings, and minimum regular monthly cash flows of principal and interest are guaranteed by the issuing agencies.

Unlike U.S. Treasury and U.S. government agency securities, which have a lump sum payment at maturity, mortgage-backed securities provide cash flows from regular principal and interest payments and principal prepayments throughout the lives of the securities. Premiums and discounts on mortgage-backed securities are amortized over the expected life of the security and may be impacted by prepayments. As such, mortgage-backed securities which are purchased at a premium will generally suffer decreasing net yields as interest rates drop because home owners tend to refinance their mortgages resulting in prepayments and an acceleration of premium amortization. Securities purchased at a discount will obtain higher net yields in a decreasing interest rate environment as prepayments result in an acceleration of discount accretion. At December 31, 2017, 75.1% of the mortgage-backed securities held by the Company had contractual final maturities of more than ten years with a weighted average life of 4.38 years.

Collateralized mortgage obligations ("CMOs") are bonds that are backed by pools of mortgages. The pools can be Ginnie Mae, Fannie Mae or Freddie Mac pools or they can be private-label pools. CMOs are designed so that the mortgage collateral will generate a cash flow sufficient to provide for the timely repayment of the bonds. Provided that the collateral cash flow is adequate to meet scheduled bond payments, the mortgage collateral pool can be structured to accommodate various desired bond repayment schedules.

This is accomplished by dividing the bonds into classes to which payments on the underlying mortgage pools are allocated in different order. The bond's cash flow, for example, can be dedicated to one class of bondholders at a time, thereby increasing call protection to bondholders. In private-label CMOs, losses on underlying mortgages are directed to the most junior of all classes and then to the classes above in order of increasing seniority, which means that the senior classes have enough credit protection to be given the highest credit rating by the rating agencies.

Deposits

The Company's lending and investing activities are primarily funded by deposits. The Company offers a variety of deposit accounts having a wide range of interest rates and terms including demand, savings, money market and time accounts. The Company relies primarily on competitive pricing policies and customer service to attract and retain these deposits.

Total deposits at December 31, 2017 were \$17.82 billion, an increase of \$514.2 million or 3.0% compared with \$17.31 billion at December 31, 2016. Total deposits at December 31, 2016 were \$17.31 billion, a decrease of \$373.8 million or 2.1% compared with \$17.68 billion at December 31, 2015. Noninterest-bearing deposits at December 31, 2017 were \$5.62 billion compared with \$5.19 billion at December 31, 2016, an increase of \$432.3 million or 8.3%. Noninterest-bearing deposits at December 31, 2016 were \$5.19 billion compared with \$5.14 billion at December 31, 2015, an increase of \$54.4 million or 1.1%. Interest-bearing deposits at December 31, 2017 were \$12.20 billion, an increase of \$81.8 million or 0.7% compared with \$12.12 billion at December 31, 2016. Interest-bearing deposits at December 31, 2016 were \$12.12 billion, a decrease of \$428.2 million or 3.4% compared with \$12.54 billion at December 31, 2015.

The daily average balances and weighted average rates paid on deposits for each of the years ended December 31, 2017, 2016 and 2015 are presented below:

	Years Ended December 31,					
	2017		2016		2015	
	Average Balance	Average Rate	Average Balance	Average Rate	Average Balance	Average Rate
	(Dollars in thousands)					
Interest-bearing checking	\$ 3,816,996	0.31%	\$ 4,066,799	0.24%	\$ 3,873,495	0.23%
Regular savings	2,224,936	0.29	2,037,051	0.25	1,859,257	0.20
Money market savings	3,336,917	0.36	3,621,390	0.27	3,646,267	0.27
Time deposits	2,289,296	0.69	2,505,526	0.57	2,754,466	0.50
Total interest-bearing deposits	11,668,145	0.40	12,230,766	0.32	12,133,485	0.30
Noninterest-bearing deposits	5,347,227	—	5,117,621	—	5,024,379	—
Total deposits	<u>\$17,015,372</u>	<u>0.27%</u>	<u>\$17,348,387</u>	<u>0.23%</u>	<u>\$17,157,864</u>	<u>0.21%</u>

The Company's ratio of average noninterest-bearing deposits to average total deposits for the years ended December 31, 2017, 2016 and 2015 was 31.4%, 29.5% and 29.3%, respectively.

The following table sets forth the amount of the Company's certificates of deposit that are \$100,000 or greater by time remaining until maturity at December 31, 2017 (dollars in thousands):

Three months or less	\$ 360,625	27.7%
Over three through six months	291,117	22.4
Over six through 12 months	351,823	27.0
Over 12 months	298,476	22.9
Total	<u>\$1,302,041</u>	<u>100.00%</u>

Other Borrowings

The Company utilizes borrowings to supplement deposits to fund its lending and investment activities. Borrowings consist of funds from the Federal Home Loan Bank ("FHLB") and securities sold under repurchase agreements.

The following table presents the Company's borrowings at December 31, 2017 and 2016:

	FHLB Advances	FHLB Long- Term Notes Payable	Securities Sold Under Repurchase Agreements
	(Dollars in thousands)		
December 31, 2017			
Amount outstanding at year-end	\$ 500,000	\$ 5,223	\$ 324,154
Weighted average interest rate at year-end	1.21%	5.70%	0.39%
Maximum month-end balance during the year	\$ 1,539,000	\$ 5,735	\$ 363,753
Average balance outstanding during the year	\$ 1,137,378	\$ 5,519	\$ 328,652
Weighted average interest rate during the year	1.11%	5.69%	0.39%
December 31, 2016			
Amount outstanding at year-end	\$ 985,000	\$ 5,781	\$ 320,430
Weighted average interest rate at year-end	0.56%	5.66%	0.29%
Maximum month-end balance during the year	\$ 985,000	\$ 6,342	\$ 331,599
Average balance outstanding during the year	\$ 518,404	\$ 6,086	\$ 319,551
Weighted average interest rate during the year	0.52%	5.65%	0.29%

FHLB advances and long-term notes payable—The Company has an available line of credit with the FHLB of Dallas, which allows the Company to borrow on a collateralized basis. The Company’s FHLB advances are typically considered short-term borrowings used to manage liquidity as needed. Maturing advances are replaced by drawing on available cash, making additional borrowings or through increased customer deposits. At December 31, 2017, the Company had total funds of \$5.77 billion available under this line, of which a total amount of \$505.2 million was outstanding. FHLB advances were \$500.0 million at December 31, 2017 with a weighted average interest rate of 1.21%. Long-term notes payable were \$5.2 million at December 31, 2017, with an average interest rate of 5.70%. The maturity dates on the FHLB notes payable range from the years 2018 to 2027 and have interest rates ranging from 4.51% to 6.10%.

Securities sold under repurchase agreements with Company customers—At December 31, 2017, the Company had \$324.2 million in securities sold under repurchase agreements compared with \$320.4 million at December 31, 2016, with weighted average rates paid of 0.39% and 0.29% for the years ended December 31, 2017 and 2016, respectively. Repurchase agreements are generally settled on the following business day; however, approximately \$9.8 million of repurchase agreements outstanding at December 31, 2017 have maturity dates ranging from 6 to 24 months. All securities sold under agreements to repurchase are collateralized by certain pledged securities.

Junior Subordinated Debentures

On January 1, 2016, in connection with the acquisition of Tradition, the Company assumed \$7.2 million in junior subordinated debentures. During the second quarter of 2016, the Company redeemed all of its outstanding junior subordinated debentures. Accordingly, as of December 31, 2017 and 2016, the Company had no junior subordinated debentures outstanding.

Interest Rate Sensitivity and Market Risk

The Company’s asset liability and funds management policy provides management with the guidelines for effective funds management, and the Company has established a measurement system for monitoring its net interest rate sensitivity position. The Company manages its sensitivity position within established guidelines.

As a financial institution, the Company’s primary component of market risk is interest rate volatility. Fluctuations in interest rates will ultimately impact both the level of income and expense recorded on most of the Company’s assets and liabilities, and the market value of all interest-earning assets and interest-bearing liabilities, other than those which have a short term to maturity. Interest rate risk is the potential of economic losses due to future interest rate changes. These economic losses can be reflected as a loss of future net interest income and/or a loss of current fair market values. The objective is to measure the effect on net interest income and to adjust the balance sheet to minimize the inherent risk while at the same time maximizing income.

The Company manages its exposure to interest rates by structuring its balance sheet in the ordinary course of business. The Company does not enter into instruments such as leveraged derivatives, interest rate swaps, financial options, financial future contracts or forward delivery contracts for the purpose of reducing interest rate risk. Based upon the nature of the Company’s operations, with the exception of how commodity prices may impact the Company’s borrowers’ ability to repay loans, the Company is not subject to foreign exchange or commodity price risk. The Company does not own any trading assets.

The Company’s exposure to interest rate risk is managed by the Asset Liability Committee (“ALCO”), which is composed of senior officers of the Company, in accordance with policies approved by the Company’s Board of Directors. The ALCO formulates strategies based on appropriate levels of interest rate risk. In determining the appropriate level of interest rate risk, the ALCO considers the impact on earnings and capital of the current outlook on interest rates, potential changes in interest rates, regional economies, liquidity, business strategies and other factors. The ALCO meets regularly to review, among other things, the sensitivity of assets and liabilities to interest rate changes, the book and market values of assets and liabilities, unrealized gains and losses, purchase and sale activities, commitments to originate loans and the maturities of investments and borrowings. Additionally, the ALCO reviews liquidity, cash flow flexibility, maturities of deposits and consumer and commercial deposit activity. Management uses two methodologies to manage interest rate risk: (1) an analysis of relationships between interest-earning assets and interest-bearing liabilities; and (2) an interest rate shock simulation model. The Company has traditionally managed its business to reduce its overall exposure to changes in interest rates.

The Company uses an interest rate risk simulation model and shock analysis to test the interest rate sensitivity of net interest income and the balance sheet. Contractual maturities and repricing opportunities of loans are incorporated in the model as are prepayment assumptions, maturity data and call options within the investment portfolio. Assumptions based on past experience are incorporated into the model for nonmaturity deposit accounts. The assumptions used are inherently uncertain, and, as a result, the model cannot precisely measure future net interest income or precisely predict the impact of fluctuations in market interest rates on net interest income. Actual results will differ from the model’s simulated results due to timing, magnitude and frequency of interest rate changes as well as changes in market conditions and the application and timing of various management strategies.

The Company utilizes static balance sheet rate shocks to estimate the potential impact on net interest income of changes in interest rates under various rate scenarios. This analysis estimates a percentage of change in the metric from the stable rate base scenario versus alternative scenarios of rising and falling market interest rates by instantaneously shocking a static balance sheet.

The following table summarizes the simulated change in net interest income at the 12-month horizon, considering the balance sheet composition as of December 31, 2017:

Change in Interest Rates (Basis Points)	Percent Change in Net Interest Income
+200	1.5%
+100	1.4%
Base	0.0%
-100	(7.6)%

The results are significantly influenced by the behavior of demand, money market and savings deposits and the overall balance sheet composition during such rate fluctuations. The Company has found that, historically, interest rates on these deposits change more slowly than changes in the discount and federal funds rates. This assumption is incorporated into the simulation model and is generally not fully reflected in a gap analysis. The assumptions incorporated into the model are inherently uncertain and, as a result, the model cannot precisely measure future net interest income or precisely predict the impact of fluctuations in market interest rates on net interest income. Actual results will differ from the model’s simulated results due to timing, magnitude and frequency of interest rate changes as well as changes in market conditions and the application and timing of various strategies.

Liquidity

Liquidity involves the Company's ability to raise funds to support asset growth and acquisitions or reduce assets to meet deposit withdrawals and other payment obligations, to maintain reserve requirements and otherwise to operate the Company on an ongoing basis and manage unexpected events. During 2017 and 2016, the Company's liquidity needs have primarily been met by growth in core deposits, security and loan maturities, amortizing investment and loan portfolios and advances from the FHLB of Dallas. Although access to purchased funds from correspondent banks is available and has been utilized on occasion to take advantage of investment opportunities, the Company does not generally rely on this external funding source.

The following table illustrates, during the years presented, the mix of the Company's funding sources and the average assets in which those funds are invested as a percentage of the Company's average total assets for the periods indicated. Average assets totaled \$22.34 billion for 2017 compared with \$21.88 billion for 2016.

	<u>2017</u>	<u>2016</u>
Source of Funds:		
Deposits:		
Noninterest-bearing	23.93%	23.39%
Interest-bearing	52.23	55.90
Securities sold under repurchase agreements	1.47	1.46
Other borrowings	5.12	2.40
Other noninterest-bearing liabilities	0.46	0.55
Shareholders' equity	<u>16.79</u>	<u>16.30</u>
Total	<u>100.00%</u>	<u>100.00%</u>
Uses of Funds:		
Loans	43.97%	44.01%
Securities	43.34	42.97
Federal funds sold and other interest-earning assets	0.37	0.37
Other noninterest-earning assets	<u>12.32</u>	<u>12.65</u>
Total	<u>100.00%</u>	<u>100.00%</u>
Average noninterest-bearing deposits to average deposits	31.43%	29.50%
Average loans to average deposits	57.73%	55.51%

The Company's largest source of funds is deposits and its largest uses of funds are securities and loans. The Company does not expect a change in the source or use of its funds in the foreseeable future. The Company's average loans increased 2.0% for the year ended December 31, 2017 compared with the year ended December 31, 2016. The Company predominantly invests excess deposits in government-backed securities until the funds are needed to fund loan growth. The Company's securities portfolio has a weighted average life of 3.97 years and a modified duration of 3.67 at December 31, 2017.

As of December 31, 2017, the Company had outstanding \$2.38 billion in commitments to extend credit and \$72.4 million in commitments associated with outstanding standby letters of credit. Since commitments associated with letters of credit and commitments to extend credit may expire unused, the total outstanding may not necessarily reflect the actual future cash funding requirements.

As of December 31, 2017, the Company had no exposure to future cash requirements associated with known uncertainties or capital expenditures of a material nature.

As of December 31, 2017, the Company had cash and cash equivalents of \$392.3 million compared with \$437.4 million at December 31, 2016. The decrease was primarily due to the net repayments of other short-term borrowings of \$485.0 million and the net increase in loans held for investment of \$387.5 million, partially offset by the net increase in noninterest-bearing deposits of \$432.3 million and net income of \$272.2 million.

Contractual Obligations

The following table summarizes the Company's contractual obligations and other commitments to make future payments as of December 31, 2017 (other than deposit obligations and securities sold under repurchase agreements). The Company's future cash payments associated with its contractual obligations pursuant to its FHLB notes payable and operating leases as of December 31, 2017 are summarized below. The future interest payments were calculated using the current rate in effect at December 31, 2017. Payments for FHLB notes payable include interest of \$364 thousand that will be paid over the future periods. Payments related to leases are based on actual payments specified in underlying contracts.

	<u>1 year or less</u>	<u>More than 1 year but less than 3 years</u>	<u>3 years or more but less than 5 years</u>	<u>5 years or more</u>	<u>Total</u>
	(Dollars in thousands)				
Federal Home Loan Bank notes payable	\$ 504,330	\$ 980	\$ 125	\$ 152	\$ 505,587
Operating leases	5,019	7,781	4,106	6,256	23,162
Total	<u>\$ 509,349</u>	<u>\$ 8,761</u>	<u>\$ 4,231</u>	<u>\$ 6,408</u>	<u>\$ 528,749</u>

Off-Balance Sheet Items

In the normal course of business, the Company enters into various transactions that, in accordance with GAAP, are not included in its consolidated balance sheets. The Company enters into these transactions to meet the financing needs of its customers. These transactions include commitments to extend credit and standby letters of credit, which involve, to varying degrees, elements of credit risk and interest rate risk in excess of the amounts recognized in the consolidated balance sheets.

The Company's commitments associated with outstanding standby letters of credit and commitments to extend credit expiring by period as of December 31, 2017 are summarized below. Since commitments associated with letters of credit and commitments to extend credit may expire unused, the amounts shown do not necessarily reflect the actual future cash funding requirements.

	<u>1 year or less</u>	<u>More than 1 year but less than 3 years</u>	<u>3 years or more but less than 5 years</u>	<u>5 years or more</u>	<u>Total</u>
	(Dollars in thousands)				
Standby letters of credit	\$ 64,799	\$ 7,133	\$ 488	\$ —	\$ 72,420
Commitments to extend credit	908,606	394,752	211,191	864,275	2,378,824
Total	<u>\$ 973,405</u>	<u>\$ 401,885</u>	<u>\$ 211,679</u>	<u>\$ 864,275</u>	<u>\$ 2,451,244</u>

Standby Letters of Credit. Standby letters of credit are written conditional commitments issued by the Company to guarantee the payment by or performance of a customer to a third party. If the customer does not perform in accordance with the terms of the agreement with the third party, the Company would be required to fund the commitment. The maximum potential amount of future payments the Company could be required to make is represented by the contractual amount of the commitment. If the commitment is funded, the Company would be entitled to seek recovery from the customer. The Company's policies generally require that standby letter of credit arrangements contain security and debt covenants similar to those contained in loan agreements.

Commitments to Extend Credit. The Company enters into contractual commitments to extend credit, normally with fixed expiration dates or termination clauses, at specified rates and for specific purposes. Substantially all of the Company's commitments to extend credit are contingent upon customers maintaining specific credit standards at the time of loan funding. The Company minimizes its exposure to loss under these commitments by subjecting them to credit approval and monitoring procedures. Management assesses the credit risk associated with certain commitments to extend credit in determining the level of the allowance for credit losses.

Capital Resources

Capital management consists of providing equity to support the Company's current and future operations. The Company is subject to capital adequacy requirements imposed by the Federal Reserve Board, and the Bank is subject to capital adequacy requirements imposed by the FDIC. Both the Federal Reserve Board and the FDIC have adopted risk-based capital requirements for assessing bank holding company and bank capital adequacy. These standards define capital and establish minimum capital requirements in relation to assets and off-balance sheet exposure, adjusted for credit risk.

In July 2013, the Federal Reserve Board and the FDIC published the Basel III Capital Rules establishing a new comprehensive capital framework for U.S. banking organizations. The Basel III Capital Rules, among other things, (1) introduced a new capital measure called "Common Equity Tier 1" ("CET1"), (2) specified that Tier 1 capital consists of CET1 and "Additional Tier 1 capital" instruments meeting specified requirements, (3) defined CET1 narrowly by requiring that most deductions/ adjustments to regulatory capital measures be made to CET1 and not to the other components of capital and (4) expanded the scope of the deductions/ adjustments as compared to existing regulations.

The initial minimum capital ratios under the Basel III Capital Rules that became effective as of January 1, 2015 were (1) 4.5% CET1 to risk-weighted assets, (2) 6.0% Tier 1 capital to risk-weighted assets, (3) 8.0% Total capital to risk-weighted assets and (4) 4.0% Tier 1 capital to average quarterly assets as reported on consolidated financial statements (known as the "leverage ratio").

The Basel III Capital Rules require a "capital conservation buffer," composed entirely of CET1, in addition to the minimum risk-weighted asset capital ratios. The implementation of the capital conservation buffer began on January 1, 2016 at the 0.625% level and is being phased in over a four-year period (increasing by that amount on each subsequent January 1, until it reaches 2.5% on January 1, 2019). The required phase-in buffer during 2017 was 1.25%.

When fully phased in on January 1, 2019, the Basel III Capital Rules will require the Company to maintain an additional capital conservation buffer of 2.5% CET1, effectively resulting in minimum ratios of (1) CET1 to risk-weighted assets of 7.0%, (2) Tier 1 capital to risk-weighted assets of 8.5%, (3) Total capital (that is, Tier 1 plus Tier 2) to risk-weighted assets of 10.5% and (4) a leverage ratio of 4.0%. The Bank is subject to capital adequacy guidelines of the FDIC that are substantially similar to the Federal Reserve Board's guidelines. Also pursuant to FDICIA, the FDIC has promulgated regulations setting the levels at which an insured institution such as the Bank would be considered "well-capitalized," "adequately capitalized," "undercapitalized," "significantly undercapitalized" and "critically undercapitalized." Under the FDIC's regulations, the Bank is classified "well-capitalized" for purposes of prompt corrective action.

Total shareholders' equity increased to \$3.82 billion at December 31, 2017, compared with \$3.64 billion at December 31, 2016, an increase of \$181.8 million or 5.0%. This increase was primarily the result of net income of \$272.2 million, partially offset by dividends paid on common stock of \$95.9 million.

The following table provides a comparison of the Company's and the Bank's leverage and risk-weighted capital ratios as of December 31, 2017 to the minimum and well-capitalized regulatory standards:

	<u>Minimum Required For Capital Adequacy Purposes</u>	<u>Minimum Required Plus Capital Conservation Buffer for 2017</u>	<u>To Be Categorized As Well Capitalized Under Prompt Corrective Action Provisions</u>	<u>Actual Ratio at December 31, 2017</u>
The Company				
CET1 capital ratio	4.50%	5.750%	N/A	15.08%
Tier 1 risk-based capital ratio	6.00%	7.250%	N/A	15.08%
Total risk-based capital ratio	8.00%	9.250%	N/A	15.74%
Leverage ratio	4.00% ⁽¹⁾	4.000%	N/A	9.31%
The Bank				
CET1 capital ratio	4.50%	5.750%	6.50%	14.98%
Tier 1 risk-based capital ratio	6.00%	7.250%	8.00%	14.98%
Total risk-based capital ratio	8.00%	9.250%	10.00%	15.65%
Leverage ratio	4.00% ⁽²⁾	4.000%	5.00%	9.25%

(1) The Federal Reserve Board may require the Company to maintain a leverage ratio above the required minimum.

(2) The FDIC may require the Bank to maintain a leverage ratio above the required minimum.

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

For information regarding the market risk of the Company's financial instruments, see Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operation—Financial Condition—Interest Rate Sensitivity and Market Risk. The Company's principal market risk exposure is to changes in interest rates.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

The financial statements, the report thereon, the notes thereto and supplementary data commence at page 73 of this Annual Report on Form 10-K.

The following table presents certain unaudited consolidated quarterly financial information concerning the Company's results of operations for each of the two years indicated below. The information should be read in conjunction with the historical consolidated financial statements of the Company and the notes thereto appearing elsewhere in this Annual Report on Form 10-K.

CONSOLIDATED QUARTERLY FINANCIAL DATA OF THE COMPANY

	Quarter Ended 2017			
	December 31	September 30	June 30	March 31
	(Dollars in thousands, except per share data) (unaudited)			
Interest income	\$ 171,839	\$ 172,419	\$ 168,047	\$ 165,050
Interest expense	15,789	16,272	15,816	12,615
Net interest income	156,050	156,147	152,231	152,435
Provision for credit losses	2,000	6,900	2,750	2,675
Net interest income after provision	154,050	149,247	149,481	149,760
Noninterest income	29,220	28,809	27,780	30,824
Noninterest expense	81,088	77,509	76,442	78,062
Income before income taxes	102,182	100,547	100,819	102,522
Provision for income taxes	35,044	32,639	32,265	33,957
Net income	<u>\$ 67,138</u>	<u>\$ 67,908</u>	<u>\$ 68,554</u>	<u>\$ 68,565</u>
Earnings per share ⁽¹⁾ :				
Basic	<u>\$ 0.97</u>	<u>\$ 0.98</u>	<u>\$ 0.99</u>	<u>\$ 0.99</u>
Diluted	<u>\$ 0.97</u>	<u>\$ 0.98</u>	<u>\$ 0.99</u>	<u>\$ 0.99</u>

	Quarter Ended 2016			
	December 31	September 30	June 30	March 31
	(Dollars in thousands, except per share data) (unaudited)			
Interest income	\$ 164,669	\$ 164,460	\$ 169,459	\$ 177,191
Interest expense	10,837	10,396	10,992	10,934
Net interest income	153,832	154,064	158,467	166,257
Provision for credit losses	2,000	2,000	6,000	14,000
Net interest income after provision	151,832	152,064	152,467	152,257
Noninterest income	29,475	29,684	28,473	30,793
Noninterest expense	79,148	79,476	79,235	80,528
Income before income taxes	102,159	102,272	101,705	102,522
Provision for income taxes	33,366	33,621	33,634	33,571
Net income	<u>\$ 68,793</u>	<u>\$ 68,651</u>	<u>\$ 68,071</u>	<u>\$ 68,951</u>
Earnings per share ⁽¹⁾ :				
Basic	<u>\$ 0.99</u>	<u>\$ 0.99</u>	<u>\$ 0.98</u>	<u>\$ 0.98</u>
Diluted	<u>\$ 0.99</u>	<u>\$ 0.99</u>	<u>\$ 0.98</u>	<u>\$ 0.98</u>

(1) Earnings per share are computed independently for each of the quarters presented and therefore may not total earnings per share for the year.

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

None.

ITEM 9A. CONTROLS AND PROCEDURES

Evaluation of disclosure controls and procedures. As of the end of the period covered by this report, the Company carried out an evaluation, under the supervision and with the participation of its management, including its Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of its disclosure controls and procedures. In designing and evaluating the disclosure controls and procedures, management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and management was required to apply judgment in evaluating its controls and procedures. Based on this evaluation, the Company's Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act), were effective as of the end of the period covered by this report.

Changes in internal control over financial reporting. There were no changes in the Company's internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) that occurred during the quarter ended December 31, 2017, that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

MANAGEMENT'S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

The management of the Company is responsible for establishing and maintaining adequate internal control over financial reporting. The Company's internal control over financial reporting is a process designed under the supervision of the Company's Chief Executive Officer and Chief Financial Officer to provide reasonable assurance regarding the reliability of financial reporting and the preparation of the Company's financial statements for external purposes in accordance with generally accepted accounting principles.

As of December 31, 2017, management assessed the effectiveness of the Company's internal control over financial reporting based on the criteria for effective internal control over financial reporting established in "*Internal Control—Integrated Framework*," issued by the Committee of Sponsoring Organizations ("COSO") of the Treadway Commission ("2013 Framework"). This assessment included controls over the preparation of the schedules equivalent to the basic financial statements in accordance with the instructions for the Consolidated Financial Statements for Bank Holding Companies (Form FR Y-9C) to meet the reporting requirements of Section 112 of the Federal Deposit Insurance Corporation Improvement Act. Based on the assessment, management determined that the Company maintained effective internal control over financial reporting as of December 31, 2017.

Deloitte & Touche LLP the independent registered public accounting firm that audited the consolidated financial statements of the Company included in this Annual Report on Form 10-K, has issued an attestation report on the Company's internal control over financial reporting as of December 31, 2017. The report is included in this Item under the heading "Report of Independent Registered Public Accounting Firm."

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the shareholders and the Board of Directors of Prosperity Bancshares, Inc.

Opinion on Internal Control over Financial Reporting

We have audited the internal control over financial reporting of Prosperity Bancshares, Inc. and subsidiaries (the "Company") as of December 31, 2017, based on criteria established in *Internal Control — Integrated Framework (2013)* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Because management's assessment and our audit were conducted to meet the reporting requirements of Section 112 of the Federal Deposit Insurance Corporation Improvement Act (FDICIA), management's assessment and our audit of the Company's internal control over financial reporting included controls over the preparation of the schedules equivalent to the basic financial statements in accordance with the instructions for the Consolidated Financial Statements for Bank Holding Companies (Form FR Y-9C). In our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2017, based on criteria established in *Internal Control — Integrated Framework (2013)* issued by COSO.

We have not examined and, accordingly, we do not express an opinion or any other form of assurance on management's statement referring to compliance with laws and regulations.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States) (PCAOB), the consolidated financial statements as of and for the year ended December 31, 2017, of the Company and our report dated February 27, 2018, expressed an unqualified opinion on those financial statements.

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.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to 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/ Deloitte and Touche LLP

Houston, Texas
February 27, 2018

ITEM 9B. OTHER INFORMATION

None.

PART III.

ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE

The information required by this Item is incorporated herein by reference to the information under the captions “Election of Directors,” “Continuing Directors and Executive Officers,” “Section 16(a) Beneficial Ownership Reporting Compliance,” “Corporate Governance—Committees of the Board—Audit Committee,” “Corporate Governance—Director Nominations Process” and “Corporate Governance—Code of Ethics” in the Company’s definitive Proxy Statement for its 2018 Annual Meeting of Shareholders (the “2018 Proxy Statement”) to be filed with the Commission pursuant to Regulation 14A under the Exchange Act within 120 days of the Company’s fiscal year end.

ITEM 11. EXECUTIVE COMPENSATION

The information required by this Item is incorporated herein by reference to the information under the captions “Executive Compensation and Other Matters” and “Director Compensation” in the 2018 Proxy Statement.

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

Certain information required by this Item 12 is included under “Securities Authorized for Issuance under Equity Compensation Plans” in Part II, Item 5 of this Annual Report on Form 10-K. The other information required by this Item is incorporated herein by reference to the information under the caption “Beneficial Ownership of Common Stock by Management of the Company and Principal Shareholders” in the 2018 Proxy Statement.

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS AND DIRECTOR INDEPENDENCE

The information required by this Item is incorporated herein by reference to the information under the captions “Corporate Governance—Director Independence” and “Certain Relationships and Related Transactions” in the 2018 Proxy Statement.

ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES

The information required by this Item is incorporated herein by reference to the information under the caption “Fees and Services of Independent Registered Public Accounting Firm” in the 2018 Proxy Statement.

PART IV.

ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES

(a) The following documents are filed as part of this Annual Report on Form 10-K:

1. Consolidated Financial Statements. Reference is made to the Consolidated Financial Statements, the report thereon and the notes thereto commencing at page 73 of this Annual Report on Form 10-K. Set forth below is a list of such Consolidated Financial Statements:

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2. Financial Statement Schedules. All supplemental schedules are omitted as inapplicable or because the required information is included in the Consolidated Financial Statements or notes thereto.

3. The exhibits to this Annual Report on Form 10-K listed below have been included only with the copy of this report filed with the Securities and Exchange Commission. The Company will furnish a copy of any exhibit to shareholders upon written request to the Company and payment of a reasonable fee not to exceed the Company's reasonable expense.

Each exhibit marked with an asterisk is filed or furnished with this Annual Report on Form 10-K as noted below.

Exhibit Number (1)	Description
3.1	— Amended and Restated Articles of Incorporation of Prosperity Bancshares, Inc. (incorporated herein by reference to Exhibit 3.1 to the Company's Registration Statement on Form S-1 (Registration No. 333-63267))
3.2	— Articles of Amendment to Amended and Restated Articles of Incorporation of Prosperity Bancshares, Inc. (incorporated herein by reference to Exhibit 3.2 to the Company's Quarterly Report on Form 10-Q for the quarter ended March 31, 2006)
3.3	— Amended and Restated Bylaws of Prosperity Bancshares, Inc. (incorporated herein by reference to Exhibit 3.1 to the Company's Current Report on Form 8-K filed January 19, 2018)
4.1	— Form of certificate representing shares of Prosperity Bancshares, Inc. common stock (incorporated herein by reference to Exhibit 4 to the Company's Registration Statement on Form S-1 (Registration No. 333-63267))
10.1†	— Prosperity Bancshares, Inc. 2004 Stock Incentive Plan (incorporated herein by reference to Exhibit 10.3 to the Company's Registration Statement on Form S-4 (Registration No. 333-121767))
10.2†	— Prosperity Bancshares, Inc. 2012 Stock Incentive Plan (incorporated herein by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K filed on April 23, 2012)
10.3†	— Second Amended and Restated Employment Agreement effective January 1, 2009 by and among Prosperity Bancshares, Inc., Prosperity Bank and David Zalman (incorporated herein by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K filed January 7, 2009)
10.4†	— First Amendment to the Second Amended and Restated Employment Agreement effective February 22, 2012 by and among Prosperity Bancshares, Inc., Prosperity Bank and H. E. Timanus, Jr. (incorporated herein by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K filed February 24, 2012)
10.5†	— Second Amended and Restated Employment Agreement effective January 1, 2009 by and among Prosperity Bancshares, Inc., Prosperity Bank and H. E. Timanus, Jr. (incorporated herein by reference to Exhibit 10.4 to the Company's Current Report on Form 8-K filed January 7, 2009)

Exhibit Number (1)	Description
10.6†	— Amended and Restated Employment Agreement effective January 1, 2009 by and among Prosperity Bancshares, Inc., Prosperity Bank and David Holloway (incorporated herein by reference to Exhibit 10.2 to the Company's Current Report on Form 8-K filed on January 7, 2009)
10.7	— Agreement and Plan of Reorganization by and between Prosperity Bancshares, Inc. and American State Financial Corporation dated February 26, 2012 (incorporated herein by reference to Exhibit 2.1 to the Company's Current Report on Form 8-K filed on February 27, 2012)
10.8†	— Amended and Restated Employment Agreement dated October 20, 2014 by and between W.R. Collier and Prosperity Bank (incorporated herein by reference to Exhibit 10.1 to the Company's Quarterly Report on Form 10-Q for the quarter ended September 30, 2014)
10.09†	— Employment Agreement dated February 26, 2012 by and between Michael F. Epps and Prosperity Bank (incorporated herein by reference to Exhibit 10.10 to the Company's Annual Report on Form 10-K for the year ended December 31, 2014)
10.10†	— Management Security Plan Agreement of American State Bank, amended and restated effective as of January 1, 2005, as assumed by Prosperity Bank (incorporated herein by reference to Exhibit 10.11 to the Company's Annual Report on Form 10-K for the year ended December 31, 2014)
10.11†	— Employment Agreement, dated July 30, 2004, by and between Prosperity Bank and Edward Z. Safady (incorporated herein by reference to Exhibit 10.1 to the Company's Quarterly Report on Form 10-Q filed on August 7, 2015)
10.12†	— Amendment to Employment Agreement, dated December 24, 2008, by and between Prosperity Bank and Edward Safady (incorporated herein by reference to Exhibit 10.2 to the Company's Quarterly Report on Form 10-Q filed on August 7, 2015)
10.13†	— Non-Disclosure and Non-Solicitation Agreement, effective May 15, 2015, by and between Prosperity Bank and Edward Safady (incorporated herein by reference to Exhibit 10.3 to the Company's Quarterly Report on Form 10-Q filed on August 7, 2015)
10.14†	— Amended and Restated Prosperity Bancshares, Inc. 401(k) Profit Sharing Plan (incorporated herein by reference to Exhibit 10.1 to the Company's Quarterly Report on Form 10-Q filed on August 10, 2016)
21.1*	— Subsidiaries of Prosperity Bancshares, Inc.
23.1*	— Consent of Deloitte & Touche LLP
31.1*	— Certification of the Chief Executive Officer pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended
31.2*	— Certification of the Chief Financial Officer pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended
32.1**	— Certification of the Chief Executive Officer pursuant to 18 U.S.C. Section 1350, adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
32.2**	— Certification of the Chief Financial Officer pursuant to 18 U.S.C. Section 1350, adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
101*	— Interactive financial data

† Management contract or compensatory plan or arrangement.

* Filed with this Annual Report on Form 10-K.

** Furnished with this Annual Report on Form 10-K.

- (1) The Company has other long-term debt agreements that meet the exclusion set forth in Section 601(b)(4)(iii)(A) of Regulation S-K. The Company hereby agrees to furnish a copy of such agreements to the Commission upon request.
- (b) Exhibits. See the exhibit list included in Item 15(a)3 of this Annual Report on Form 10-K.
- (c) Financial Statement Schedules. See Item 15(a)2 of this Annual Report on Form 10-K.

ITEM 16. FORM 10-K SUMMARY

None.

SIGNATURES

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

Date: February 27, 2018

PROSPERITY BANCSHARES, INC.®
(Registrant)

BY: /S/ DAVID ZALMAN
David Zalman
Chairman of the Board and Chief
Executive Officer

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

Signature	Positions	Date
<u> /S/ DAVID ZALMAN </u> David Zalman	Chairman of the Board and Chief Executive Officer (principal executive officer); Director	February 27, 2018
<u> /S/ DAVID HOLLOWAY </u> David Hollaway	Chief Financial Officer (principal financial officer and principal accounting officer)	February 27, 2018
<u> /S/ JAMES A. BOULIGNY </u> James A. Bouligny	Director	February 27, 2018
<u> /S/ W. R. COLLIER </u> W. R. Collier	Director	February 27, 2018
<u> /S/ LEAH HENDERSON </u> Leah Henderson	Director	February 27, 2018
<u> /S/ NED S. HOLMES </u> Ned S. Holmes	Director	February 27, 2018
<u> /S/ JACK LORD </u> Jack Lord	Director	February 27, 2018
<u> /S/ WILLIAM T. LUEDKE IV </u> William T. Luedke IV	Director	February 27, 2018
<u> /S/ PERRY MUELLER, JR., D.D.S. </u> Perry Mueller, Jr., D.D.S.	Director	February 27, 2018
<u> /S/ HARRISON STAFFORD II </u> Harrison Stafford II	Director	February 27, 2018
<u> /S/ ROBERT STEELHAMMER </u> Robert Steelhammer	Director	February 27, 2018
<u> /S/ H.E. TIMANUS, JR. </u> H.E. Timanus, Jr.	Director	February 27, 2018

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the shareholders and the Board of Directors of Prosperity Bancshares, Inc.

Opinion on the Financial Statements

We have audited the accompanying consolidated balance sheets of Prosperity Bancshares, Inc. and subsidiaries (the “Company”) as of December 31, 2017 and 2016, the related consolidated statements of income, comprehensive income, changes in shareholders' equity, and cash flows, for each of the three years in the period ended December 31, 2017, and the related notes (collectively referred to as the “financial statements”). In our opinion, the financial statements present fairly, in all material respects, the financial position of the Company as of December 31, 2017 and 2016, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2017, in conformity with accounting principles generally accepted in the United States of America.

We have also 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, 2017, based on criteria established in *Internal Control — Integrated Framework (2013)* issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated February 27, 2018, expressed an unqualified opinion on the Company's internal control over financial reporting.

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/ Deloitte and Touche LLP

Houston, Texas
February 27, 2018

We have served as the Company's auditor since 1993.

PROSPERITY BANCSHARES, INC.[®] AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS

	December 31,	
	2017	2016
	(Dollars in thousands)	
ASSETS		
Cash and due from banks	\$ 391,616	\$ 436,203
Federal funds sold	697	1,178
Total cash and cash equivalents	392,313	437,381
Available for sale securities, at fair value	217,870	221,176
Held to maturity securities, at cost (fair value of \$9,323,482 and \$9,339,455 respectively)	9,454,246	9,504,910
Total securities	9,672,116	9,726,086
Loans held for sale	31,389	26,975
Loans held for investment	9,989,384	9,595,085
Total loans	10,020,773	9,622,060
Less: allowance for credit losses	(84,041)	(85,326)
Loans, net	9,936,732	9,536,734
Accrued interest receivable	56,368	53,310
Goodwill	1,900,845	1,900,845
Core deposit intangibles, net	38,842	45,784
Bank premises and equipment, net	257,065	262,083
Other real estate owned	11,152	15,463
Bank owned life insurance (BOLI)	255,132	247,116
Federal Home Loan Bank of Dallas stock	49,764	55,430
Other assets	16,963	50,840
TOTAL ASSETS	\$ 22,587,292	\$ 22,331,072
LIABILITIES AND SHAREHOLDERS' EQUITY		
LIABILITIES:		
Deposits:		
Noninterest-bearing	\$ 5,623,322	\$ 5,190,973
Interest-bearing	12,198,138	12,116,329
Total deposits	17,821,460	17,307,302
Fed funds purchased and other borrowings	505,223	990,781
Securities sold under repurchase agreements	324,154	320,430
Accrued interest payable	2,945	2,319
Other liabilities	109,356	67,929
Total liabilities	18,763,138	18,688,761
COMMITMENTS AND CONTINGENCIES	—	—
SHAREHOLDERS' EQUITY:		
Preferred stock, \$1 par value; 20,000,000 shares authorized; none issued or outstanding	—	—
Common stock, \$1 par value; 200,000,000 shares authorized; 69,490,910 shares issued and outstanding at December 31, 2017; 69,491,012 shares issued and outstanding at December 31, 2016	69,491	69,491
Capital surplus	2,035,219	2,028,129
Retained earnings	1,719,557	1,543,280
Accumulated other comprehensive (loss) income—net unrealized (loss) gain on available for sale securities, net of tax (benefit) expense of (\$30) and \$760, respectively	(113)	1,411
Total shareholders' equity	3,824,154	3,642,311
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	\$ 22,587,292	\$ 22,331,072

See notes to consolidated financial statements.

PROSPERITY BANCSHARES, INC.® AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF INCOME

	For the Years Ended December 31,		
	2017	2016	2015
	(Dollars in thousands, except per share data)		
INTEREST INCOME:			
Loans, including fees	\$ 468,338	\$ 475,059	\$ 475,427
Securities	208,189	200,375	194,003
Federal funds sold	828	345	271
Total interest income	677,355	675,779	669,701
INTEREST EXPENSE:			
Deposits	46,312	39,125	36,074
Other borrowings	12,908	3,065	1,508
Securities sold under repurchase agreements	1,272	932	818
Junior subordinated debentures	—	37	791
Total interest expense	60,492	43,159	39,191
NET INTEREST INCOME	616,863	632,620	630,510
PROVISION FOR CREDIT LOSSES	14,325	24,000	7,560
NET INTEREST INCOME AFTER PROVISION FOR CREDIT LOSSES	602,538	608,620	622,950
NONINTEREST INCOME:			
Nonsufficient funds (NSF) fees	32,354	33,536	34,284
Credit card, debit card and ATM card income	24,425	23,561	23,534
Service charges on deposit accounts	21,327	18,832	17,095
Trust income	9,200	8,120	8,030
Mortgage income	4,053	7,076	5,720
Brokerage income	1,950	4,571	5,953
Net (loss) gain on sale of assets	(1,921)	1,864	2,403
Gain on sale of securities	3,270	—	—
Other	21,975	20,865	23,762
Total noninterest income	116,633	118,425	120,781
NONINTEREST EXPENSE:			
Salaries and employee benefits	192,409	197,897	192,872
Net occupancy and equipment	22,402	23,058	23,638
Credit and debit card, data processing and software amortization	17,230	17,050	15,782
Regulatory assessments and FDIC insurance	14,311	12,735	14,433
Core deposit intangibles amortization	6,942	9,200	9,530
Depreciation	12,215	13,094	12,959
Communications	10,592	11,561	11,121
Other real estate expense	3,271	514	625
Other	33,729	33,278	32,576
Total noninterest expense	313,101	318,387	313,536
INCOME BEFORE INCOME TAXES	406,070	408,658	430,195
PROVISION FOR INCOME TAXES	133,905	134,192	143,549
NET INCOME	\$ 272,165	\$ 274,466	\$ 286,646
EARNINGS PER SHARE:			
Basic	\$ 3.92	\$ 3.94	\$ 4.09
Diluted	\$ 3.92	\$ 3.94	\$ 4.09

See notes to consolidated financial statements.

PROSPERITY BANCSHARES, INC. ® AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

	For the Years Ended December 31,		
	2017	2016	2015
	(Dollars in thousands)		
Net income	\$ 272,165	\$ 274,466	\$ 286,646
Other comprehensive loss, before tax:			
Securities available for sale:			
Change in unrealized gain during period	(2,314)	(967)	(2,599)
Total other comprehensive loss	(2,314)	(967)	(2,599)
Deferred tax benefit related to other comprehensive loss	790	338	910
Other comprehensive loss, net of tax	(1,524)	(629)	(1,689)
Comprehensive income	\$ 270,641	\$ 273,837	\$ 284,957

See notes to consolidated financial statements.

PROSPERITY BANCSHARES, INC.[®] AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

	<u>Common Stock</u>		<u>Capital Surplus</u>	<u>Retained Earnings</u>	<u>Accumulated Other Comprehensive</u>	<u>Treasury Stock</u>	<u>Total Shareholders' Equity</u>
	<u>Shares</u>	<u>Amount</u>			<u>Income (Loss)</u>		
	(In thousands, except share and per share data)						
BALANCE AT DECEMBER 31, 2014	69,816,653	\$69,817	\$2,025,235	\$1,146,652	\$ 3,729	\$ (607)	\$ 3,244,826
Net income				286,646			286,646
Other comprehensive loss					(1,689)		(1,689)
Common stock issued in connection with the exercise of stock options and restricted stock awards	242,108	242	48				290
Stock based compensation expense			11,095				11,095
Cash dividends declared, \$1.1175 per share				(78,258)			(78,258)
BALANCE AT DECEMBER 31, 2015	70,058,761	70,059	2,036,378	1,355,040	2,040	(607)	3,462,910
Net income				274,466			274,466
Other comprehensive loss					(629)		(629)
Common stock issued in connection with the exercise of stock options and restricted stock awards	34,701	35	743				778
Common stock issued in connection with the acquisition of Tradition Bancshares, Inc.	679,528	679	31,843				32,522
Treasury stock cancellation	(37,088)	(37)	(570)			607	—
Common stock repurchase	(1,244,890)	(1,245)	(49,812)				(51,057)
Stock based compensation expense			9,547				9,547
Cash dividends declared, \$1.24 per share				(86,226)			(86,226)
BALANCE AT DECEMBER 31, 2016	69,491,012	69,491	2,028,129	1,543,280	1,411	—	3,642,311
Net income				272,165			272,165
Other comprehensive loss					(1,524)		(1,524)
Common stock issued in connection with the exercise of stock options and restricted stock awards, net	(102)	—	148				148
Stock based compensation expense			6,942				6,942
Cash dividends declared, \$1.38 per share				(95,888)			(95,888)
BALANCE AT DECEMBER 31, 2017	<u>69,490,910</u>	<u>\$69,491</u>	<u>\$2,035,219</u>	<u>\$1,719,557</u>	<u>\$ (113)</u>	<u>\$ —</u>	<u>\$ 3,824,154</u>

See notes to consolidated financial statements.

PROSPERITY BANCSHARES, INC.[®] AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

	For the Years Ended December 31,		
	2017	2016	2015
	(Dollars in thousands)		
CASH FLOWS FROM OPERATING ACTIVITIES:			
Net income	\$ 272,165	\$ 274,466	\$ 286,646
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and core deposit intangibles amortization	19,157	22,294	22,489
Provision for credit losses	14,325	24,000	7,560
Deferred income tax expense	10,534	19,047	34,999
Net amortization of premium on investments	38,922	43,474	58,229
Loss (gain) on sale or write down of premises, equipment and other real estate	4,678	(1,578)	(2,437)
Gain on sale of investment securities	(3,270)	—	—
Net amortization of premium on deposits	(217)	(1,167)	(1,055)
Net accretion of discount on loans	(21,906)	(38,970)	(52,122)
Proceeds from sale of loans held for sale	190,816	272,873	233,535
Originations of loans held for sale	(197,538)	(278,259)	(248,866)
Stock based compensation expense	6,942	9,547	11,095
Decrease (increase) in accrued interest receivable and other assets	24,598	15,615	(44,756)
Increase (decrease) in accrued interest payable and other liabilities	31,519	(26,987)	5,497
Net cash provided by operating activities	<u>390,725</u>	<u>334,355</u>	<u>310,814</u>
CASH FLOWS FROM INVESTING ACTIVITIES:			
Proceeds from maturities, sales and principal paydowns of held to maturity securities	1,763,089	1,916,701	1,654,471
Purchase of held to maturity securities	(1,747,126)	(1,820,346)	(2,211,731)
Proceeds from maturities and principal paydowns of available for sale securities	7,253,433	8,133,829	7,974,775
Purchase of available for sale securities	(7,253,392)	(8,253,214)	(7,934,994)
Net (increase) decrease in loans held for investment	(387,499)	64,390	(136,829)
Purchase of bank premises and equipment	(11,229)	(5,007)	(9,357)
Proceeds from sale of bank premises, equipment and other real estate	10,130	13,617	13,037
Net cash used in the purchase of Traditions Bancshares, Inc.	—	(8,963)	—
Net cash (used in) provided by investing activities	<u>(372,594)</u>	<u>41,007</u>	<u>(650,628)</u>
CASH FLOWS FROM FINANCING ACTIVITIES:			
Net increase (decrease) in noninterest-bearing deposits	432,349	(67,958)	200,159
Net increase (decrease) in interest-bearing deposits	82,026	(794,822)	(211,143)
Net (repayments) proceeds from other short-term borrowings	(485,000)	500,000	485,000
Repayments of other long-term borrowings	(558)	(618)	(2,325)
Net increase (decrease) in securities sold under repurchase agreements	3,724	5,177	(270)
Redemption of junior subordinated debentures	—	(7,217)	(167,531)
Proceeds from stock option exercises	148	778	290
Repurchase of common stock	—	(51,057)	—
Payments of cash dividends	(95,888)	(86,226)	(78,258)
Net cash (used in) provided by financing activities	<u>(63,199)</u>	<u>(501,943)</u>	<u>225,922</u>
NET DECREASE IN CASH AND CASH EQUIVALENTS	(45,068)	(126,581)	(113,892)
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	437,381	563,962	677,854
CASH AND CASH EQUIVALENTS, END OF PERIOD	<u>\$ 392,313</u>	<u>\$ 437,381</u>	<u>\$ 563,962</u>
NONCASH ACTIVITIES:			
Stock issued in connection with the Tradition Bancshares, Inc. acquisition	\$ —	\$ 32,522	\$ —
Acquisition of real estate through foreclosure of collateral	1,644	14,816	2,591
SUPPLEMENTAL INFORMATION:			
Income taxes paid	\$ 64,152	\$ 122,418	\$ 103,116
Interest paid	59,866	42,736	44,277

See notes to consolidated financial statements.

PROSPERITY BANCSHARES, INC.® AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. NATURE OF OPERATIONS AND SUMMARY OF SIGNIFICANT ACCOUNTING AND REPORTING POLICIES

Nature of Operations—Prosperity Bancshares, Inc.® (“Bancshares”) and its subsidiary, Prosperity Bank® (the “Bank”, collectively referred to as the “Company”), provide retail and commercial banking services.

As of December 31, 2017, the Bank operated 242 full-service banking locations; with 65 in the Houston area, including The Woodlands; 29 in the South Texas area including Corpus Christi and Victoria; 33 in the Dallas/Fort Worth, Texas area; 22 in the East Texas area; 29 in the Central Texas area, including Austin and San Antonio; 34 in the West Texas area including Lubbock, Midland-Odessa and Abilene; 16 in the Bryan/College Station area; 6 in the Central Oklahoma area; and 8 in the Tulsa, Oklahoma area.

Summary of Significant Accounting and Reporting Policies—The accounting and reporting policies of the Company conform to generally accepted accounting principles (“GAAP”) and the prevailing practices within the financial services industry. A summary of significant accounting and reporting policies are as follows:

Basis of Presentation—The consolidated financial statements include the accounts of Bancshares and its subsidiaries. Intercompany transactions have been eliminated in consolidation. Operations are managed and financial performance is evaluated on a company-wide basis. Accordingly, all of the Company’s banking operations are considered by management to be aggregated in one reportable operating segment. Because the overall banking operations comprise the vast majority of the consolidated operations, no separate segment disclosures are presented.

Use of Estimates—The preparation of financial statements in conformity with 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 the reported amounts of revenues and expenses during the reporting period. Such estimates include, but are not limited to certain fair value measures including the calculation of stock-based compensation, the valuation of goodwill and available for sale and held to maturity securities and the calculation of allowance for credit losses. Actual results could differ from these estimates.

Securities —Securities held to maturity are carried at cost, adjusted for the amortization of premiums and the accretion of discounts. Management has the positive intent and the Company has the ability to hold these assets until their estimated maturities.

Securities available for sale are carried at fair value. Unrealized gains and losses are excluded from earnings and reported, net of tax, as a separate component of shareholders’ equity until realized. Securities within the available for sale portfolio may be used as part of the Company’s asset/liability strategy and may be sold in response to changes in interest rate risk, prepayment risk or other similar economic factors.

For debt securities, when other-than-temporary impairment (“OTTI”) occurs, the amount of the OTTI recognized in earnings depends on whether an entity intends to sell the security or more likely than not will be required to sell the security before recovery of its amortized cost basis less any current-period credit loss. If an entity intends to sell or more likely than not will be required to sell the security before recovery of its amortized cost basis less any current-period credit loss, the OTTI will be recognized in earnings equal to the entire difference between the investment’s amortized cost basis and its fair value at the balance sheet date. If an entity does not intend to sell the security and it is not more likely than not that the entity will be required to sell the security before recovery of its amortized cost basis less any current-period loss, the OTTI will be separated into the amount representing the credit-related portion of the impairment loss (“credit loss”) and the noncredit portion of the impairment loss (“noncredit portion”). The amount of the total OTTI related to the credit loss is determined based on the difference between the present value of cash flows expected to be collected and the amortized cost basis and such difference is recognized in earnings. The amount of the total OTTI related to the noncredit portion is recognized in other comprehensive

income, net of applicable taxes. The previous amortized cost basis less the OTTI recognized in earnings shall become the new amortized cost basis of the investment.

Premiums and discounts are amortized and accreted to operations using the level-yield method of accounting, adjusted for prepayments as applicable. The specific identification method of accounting is used to compute gains or losses on the sales of these assets. Interest earned on these assets is included in interest income.

Loans Held for Sale—Loans held for sale are carried at the lower of aggregate cost or market value. Premiums, discounts and loan fees (net of certain direct loan origination costs) on loans held for sale are deferred until the related loans are sold or repaid. Gains or losses on loan sales are recognized at the time of sale and determined using the specific identification method.

Loans Held for Investment—Loans originated and held for investment are stated at the principal amount outstanding, net of unearned fees. The related interest income for multipayment loans is recognized principally by the simple interest method; for single payment loans, such income is recognized using the straight-line method.

The Company has two general categories of loans in its portfolio. Loans originated by the Bank and made pursuant to the Company's loan policy and procedures in effect at the time the loan was made are referred to as "legacy loans" and loans acquired in a business combination are referred to as "acquired loans." Acquired loans are initially recorded at fair value based on a discounted cash flow valuation methodology that considers, among other things, interest rates, projected default rates, loss given default and recovery rates, with no carryover of any existing allowance for credit losses. Those acquired loans that are renewed or substantially modified after the date of the business combination, thereby subjecting them to the Company's allowance for credit losses methodology, are referred to as "acquired legacy loans." Modifications are reviewed for determination of troubled debt restructuring status independently of this process. In certain instances, acquired loans to one borrower may be combined or otherwise re-originated such that they are re-categorized as legacy loans. Acquired loans with a fair value discount or premium at the date of the business combination that remained at the reporting date are referred to as "fair-valued acquired loans." All fair-valued acquired loans are further categorized into "Non-PCI loans" and "PCI loans" (purchased credit impaired loans). Acquired loans with evidence of credit quality deterioration at acquisition are reviewed to determine if it is probable that the Company will not be able to collect all contractual amounts due, including both principal and interest. When both conditions exist, such loans are accounted for as PCI loans.

The Company estimates the total cash flows expected to be collected from the PCI loans, which include undiscounted expected principal and interest, using credit risk, interest rate and prepayment risk assessments that incorporate management's best estimate of current key assumptions such as default rates, loss severity and payment speeds. The excess of the undiscounted total cash flows expected to be collected over the fair value of the related PCI loans represents the accretable yield, which is recognized as interest income on a level-yield basis over the life of the related loan. The difference between the undiscounted contractual principal and interest and the undiscounted total cash flows expected to be collected is the nonaccretable difference, which reflects the impact of estimated credit losses and other factors. Subsequent increases in expected cash flows will result in a recovery of any previously recorded allowance for credit losses, to the extent applicable, and a reclassification from nonaccretable difference to accretable yield, which is recognized prospectively over the then remaining life of the loan. Subsequent decreases in expected cash flows will result in an impairment charge to the provision for credit losses, resulting in an addition to the allowance for credit losses, and a reclassification from accretable yield to nonaccretable difference.

A loan disposal, which may include a loan sale, receipt of payment in full from the borrower or foreclosure, results in removal of the loan from the balance sheet at its allocated carrying amount and accretion of any remaining fair value discount to income.

Nonrefundable Fees and Costs Associated with Lending Activities—Loan origination fees in excess of the associated costs are recognized over the life of the related loan as an adjustment to yield using the interest method.

Loan commitment fees and loan origination costs are deferred and recognized as an adjustment of yield by the interest method over the related loan life or, if the commitment expires unexercised, recognized in income upon expiration of the commitment.

Nonperforming and Past Due Loans—Included in the nonperforming loan category are loans which have been categorized by management as nonaccrual because collection of interest is doubtful and loans which have been restructured to provide a reduction in the interest rate or a deferral of interest or principal payments. When the payment of principal or interest on a loan is delinquent for 90 days, or earlier in some cases, the loan is placed on nonaccrual status unless the loan is in the process of collection and the underlying collateral fully supports the carrying value of the loan. If the decision is made to continue accruing interest on the loan, periodic reviews are made to confirm the accruing status of the loan. When a loan is placed on nonaccrual status, interest accrued but not yet collected prior to the determination of uncollectibility is charged to operations. Interest accrued during prior periods is charged to the allowance for credit losses. Any payments received on nonaccrual loans are applied first to outstanding principal of the loan amount, next to the recovery of charged-off loan amounts and finally, any excess is treated as recovery of lost interest.

Restructured loans are those loans on which concessions in terms have been granted because of a borrower's financial difficulty. Interest is generally not accrued on such loans in accordance with the new terms.

Allowance for Credit Losses—The allowance for credit losses is a valuation allowance available for losses incurred on loans. All losses are charged to the allowance when the loss actually occurs or when a determination is made that such a loss is probable and reasonably estimatable. Recoveries are credited to the allowance at the time of recovery.

Throughout the year, management estimates the probable level of losses to determine whether the allowance for credit losses is adequate to absorb losses inherent in the loan portfolio. Based on these estimates, an amount is charged to the provision for credit losses and credited to the allowance for credit losses in order to adjust the allowance to a level determined to be adequate to absorb losses.

In making its evaluation of the adequacy of the allowance for credit losses, management considers factors such as historical loan loss experience, the amount of nonperforming assets and related collateral, the volume, growth and composition of the Company's loan portfolio, current economic conditions that may affect the borrower's ability to pay and the value of collateral, the evaluation of the Company's loan portfolio through its internal loan review process and other relevant factors.

Estimates of credit losses involve an exercise of judgment. While it is possible that in the short term the Company may sustain losses which are substantial in relation to the allowance for credit losses, it is the judgment of management that the allowance for credit losses reflected in the consolidated balance sheets is adequate to absorb probable losses that exist in the loan portfolio as of December 31, 2017.

The Company's allowance for credit losses consists of two elements: (1) specific valuation allowances based on probable losses on impaired loans; and (2) a general valuation allowance based on historical loan loss experience, general economic conditions and other qualitative risk factors both internal and external to the Company. A loan is defined as impaired if, based on current information and events, it is probable that a creditor will be unable to collect all amounts due, both interest and principal, according to the contractual terms of the loan agreement. The allowance for credit losses related to impaired loans is determined based on the difference of carrying value of loans and the present value of expected cash flows discounted at the loan's effective interest rate or, as a practical expedient, the loan's observable market price or the fair value of the collateral if the loan is collateral dependent.

Loans acquired in business combinations are initially recorded at fair value, which includes an estimate of credit losses expected to be realized over the remaining lives of the loans, and therefore no corresponding allowance for credit losses is recorded for these loans at acquisition. These fair value estimates associated with acquired loans, based on a discounted cash flow model, include estimates related to market interest rates and undiscounted projections of future cash flows that incorporate expectations of prepayments and the amount and timing of principal, interest and other cash flows, as well as any shortfalls thereof. At period-end after acquisition, the fair-valued acquired loans from each acquisition are reassessed to determine whether an addition to the allowance for credit losses is appropriate due to further credit quality deterioration. Methods utilized to estimate any subsequently required allowance for acquired loans not deemed credit impaired at acquisition are similar to originated loans; however, the estimate of loss is based on the unpaid principal balance and then compared to any remaining

unaccreted purchase discount. To the extent that the calculated loss is greater than the remaining unaccreted purchase discount, an allowance is recorded for such difference.

Premises and Equipment—Premises and equipment are carried at cost less accumulated depreciation. Depreciation expense is computed principally using the straight-line method over the estimated useful lives of the assets which range from three to 39 years. Leasehold improvements are amortized using the straight-line method over the periods of the leases or the estimated useful lives, whichever is shorter.

Goodwill—Goodwill is annually assessed for impairment or when events or changes in circumstances indicate that the carrying amount of the asset may not be recoverable.

Under Accounting Standards Codification (“ASC”) topic 350-20, “*Intangibles—Goodwill and Other—Goodwill*” companies have the option to first assess qualitative factors to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount as a basis for determining the need to perform step one of the annual test for goodwill impairment. An entity has an unconditional option to bypass the qualitative assessment described in the preceding paragraph for any reporting unit in any period and proceed directly to performing the first step of the goodwill impairment test. An entity may resume performing the qualitative assessment in any subsequent period.

If the Company bypasses the qualitative assessment, a two-step goodwill impairment test would be performed. The first step of the goodwill impairment test compares the estimated fair value of the Company’s reporting unit to its carrying value. If the estimated fair value of the reporting unit exceeds its carrying value, goodwill of the reporting unit is not impaired. If the estimated fair value of the reporting unit is less than the carrying value, the second step must be performed to determine the implied fair value of the reporting unit’s goodwill and the amount of goodwill impairment, if any. The Company currently utilizes a qualitative assessment for its annual goodwill impairment analysis.

Amortization of Core Deposit Intangibles—Core deposit intangibles are being amortized on a non-pro rata basis over an estimated life of 10 to 15 years.

Income Taxes— The Company files a consolidated federal income tax return and a consolidated Oklahoma state income tax return. Since 2014, the Bank files an Arkansas state income tax return.

Deferred tax assets and liabilities are recognized for the estimated tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and are recorded in other assets or other liabilities on the Company’s consolidated balance sheets. The Company records uncertain tax positions in accordance with ASC topic 740 “*Income Taxes*” on the basis of a two-step process whereby (1) the Company determines whether it is more likely than not that the tax positions will be sustained on the basis of the technical merits of the position and (2) for those tax positions that meet the more-likely-than-not recognition threshold, the Company recognizes the largest amount of tax benefit that is more than 50 percent likely to be realized upon ultimate settlement with the related tax authority.

Realization of net deferred tax assets is based upon the level of historical income and on estimates of future taxable income. Although realization is not assured, management believes it is more likely than not that all of the net deferred tax assets will be realized. Interest and/or penalties related to income taxes are reported as a component of income tax expense. Beginning in 2017, the income tax effects related to settlements of share-based payment awards are reported in earnings as an increase (or decrease) to income tax expense (see Note 11 - Income Taxes).

Stock-Based Compensation—The Company accounts for stock-based employee compensation plans using the fair value-based method of accounting. The expense associated with stock-based compensation is recognized over the vesting period of each individual arrangement. The fair value of stock options granted is estimated at the date of grant using the Black-Scholes option-pricing model. This model requires the input of subjective assumptions. The fair value of restricted stock awards is based on the current market price on the date of grant.

Cash and Cash Equivalents—For purposes of reporting cash flows, cash and cash equivalents include cash and due from banks as well as federal funds sold that mature in three days or less.

Earnings Per Common Share—Basic earnings per common share are calculated using the two-class method. The two-class method provides that unvested share-based payment awards that contain nonforfeitable rights to dividends or dividend equivalents (whether paid or unpaid) are participating securities and shall be included in the computation of basic earnings per share.

Diluted earnings per common share is computed using the weighted-average number of shares determined for the basic earnings per common share computation plus the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock using the treasury stock method. As of December 31, 2017, all outstanding stock options issued by the Company have been exercised and there is no potential dilution of weighted-average shares.

The following table illustrates the computation of basic and diluted earnings per share:

	Year Ended December 31,					
	2017		2016		2015	
	Amount	Per Share Amount	Amount	Per Share Amount	Amount	Per Share Amount
	(Amounts in thousands, except per share data)					
Net income	<u>\$272,165</u>		<u>\$274,466</u>		<u>\$286,646</u>	
Basic:						
Weighted average shares outstanding	69,484	<u>\$ 3.92</u>	69,674	<u>\$ 3.94</u>	70,033	<u>\$ 4.09</u>
Diluted:						
Add incremental shares for:						
Effect of dilutive securities - options	<u>—</u>		<u>6</u>		<u>16</u>	
Total	<u>69,484</u>	<u>\$ 3.92</u>	<u>69,680</u>	<u>\$ 3.94</u>	<u>70,049</u>	<u>\$ 4.09</u>

There were no stock options exercisable at December 31, 2017, 2016 and 2015 that would have had an anti-dilutive effect on the above computation.

New Accounting Standards

Accounting Standards Updates (“ASU”)

ASU 2018-02, “Income Statement-Reporting Comprehensive Income (Topic 220): Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income.” The amendments of ASU 2018-02 allow a reclassification from accumulated other comprehensive income to retained earnings for stranded tax effects resulting from the Tax Cuts and Jobs Act. ASU 2018-02 is effective for all entities beginning January 1, 2019 and is not expected to have a significant impact on the Company’s financial statements.

ASU 2017-04, “Intangibles—Goodwill and Other (Topic 350).” ASU 2017-04 simplifies the subsequent measurement of goodwill by eliminating the second step of the goodwill impairment test, which required computing the implied fair value of goodwill.

Under the amendments in this update, an entity should perform its annual, or interim, goodwill impairment test by comparing the fair value of a reporting unit with its carrying amount. An impairment charge should be recognized for the amount by which the carrying amount exceeds the reporting unit’s fair value; however, the loss recognized should not exceed the total amount of goodwill allocated to that reporting unit. ASU 2017-04 will be effective for the Company on January 1, 2020 and is not expected to have a significant impact on the Company’s financial statements.

ASU 2017-01, "Business Combinations (Topic 805)." ASU 2017-01 is intended to clarify or correct unintended application of *ASU 2014-09 "Revenue from Contract with Customers (Topic 606)."* ASU 2017-01 clarifies the definition of a business with the objective of adding guidance to assist entities with evaluating whether transactions should be accounted for as acquisitions (or disposals) of assets or businesses. Additionally, the amendments in this update provide a more robust framework to assist entities in evaluating whether a set of assets and activities constitutes a business. Lastly, the amendments in this update narrow the definition of the term output so that the term is consistent with how outputs are described in Topic 606. ASU 2017-01 is effective for the Company on January 1, 2018 and is not expected to have a significant impact on the Company's financial statements.

ASU 2016-18, "Statement of Cash Flows (Topic 230) – Restricted Cash." ASU 2016-18 requires the Statement of Cash Flows to explain the change during the period in the total of cash, cash equivalents and amounts generally described as restricted cash or restricted cash equivalents. Therefore, restricted cash or cash equivalents should be included with cash and cash equivalents when recording the beginning-of-period and end-of-period total amounts on the Statement of Cash Flows. ASU 2016-18 is effective for the Company on January 1, 2018 and is not expected to have a significant impact on the Company's financial statements.

ASU 2016-15, "Statement of Cash Flows (Topic 230) - Classification of Certain Cash Receipts and Cash Payments." ASU 2016-15 addresses certain cash receipts and cash payments with the objective of reducing the existing diversity in practice. ASU 2016-15 is effective for the Company on January 1, 2018 and is not expected to have a significant impact on the Company's financial statements.

ASU 2016-13, "Financial Instruments – Credit Losses (Topic 326)—Measurement of Credit Losses on Financial Instruments." ASU 2016-13 requires a financial asset (or a group of financial assets) measured at amortized cost basis to be presented at the net amount expected to be collected. The measurement of expected credit losses is based on relevant information about past events, including historical experience, current conditions, and reasonable and supportable forecasts that affect the collectability of the reported amount. An entity must use judgment in determining the relevant information and estimation methods that are appropriate in its circumstances. Additionally, available for sale debt securities may realize value either through collection of contractual cash flows or through sale of the security at fair value. Therefore, the amendments limit the amount of the allowance for credit losses to the difference between amortized cost and fair value. ASU 2016-13 will be effective for the Company as of January 1, 2020. The Company is currently evaluating the potential impact of ASU 2016-13 on the Company's financial statements.

ASU 2016-09, "Compensation - Stock Compensation (Topic 718)—Improvements to Employee Share-Based Payment Accounting." ASU 2016-09 simplifies the accounting for share-based awards paid to employees. The amended guidance 1) requires excess tax benefits and tax deficiencies on share-based awards payments to employees to be recognized directly to income tax expense or benefit in the Consolidated Statement of Income rather than to capital surplus; 2) requires excess tax benefits to be included as operating activities on the Consolidated Statements of Cash Flows; 3) provides entities with the option of making an accounting policy election to account for forfeitures of share-based payments as they occur instead of estimating the awards expected to be forfeited; and 4) changes the threshold to qualify for equity classification to permit withholdings up to the maximum statutory tax rate in the applicable jurisdiction. In addition, excess tax benefits and tax deficiencies are considered discrete items in the reporting period they occur and are not included in the estimate of an entity's annual effective tax rate. The Company adopted ASU 2016-09 on January 1, 2017 and elected to recognize forfeitures as they occur. Implementation of ASU 2016-09 will add volatility to tax expense as the Company's stock price changes. The adoption of ASU 2016-09 did not have a significant impact on the Company's financial statements.

ASU 2016-02, "Leases (Topic 842)." ASU 2016-02 requires that lessees and lessors recognize lease assets and lease liabilities on the balance sheet and disclose key information about leasing arrangements. ASU 2016-02 is effective for public companies for annual periods beginning January 1, 2019, including interim periods within those fiscal years. The Company is currently evaluating the potential impact of ASU 2016-02 on the Company's financial statements.

ASU 2016-01 “Financial Instruments—Overall (Subtopic 825-10) Recognition and Measurement of Financial Assets and Financial Liabilities” ASU 2016-01 addresses certain aspects of recognition, measurement, presentation, and disclosure of financial instruments. ASU 2016-01 (1) requires equity investments (except those accounted for under the equity method of accounting or those that result in consolidation of the investee) to be measured at fair value with changes in fair value recognized in net income; (2) simplifies the impairment assessment of equity investments without readily determinable fair values by requiring a qualitative assessment to identify impairment; (3) eliminates the requirement to disclose the fair value of financial instruments measured at amortized cost for entities that are not public business entities; (4) eliminates the requirement for public business entities to disclose the method(s) 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; (5) requires public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes; (6) 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; (7) requires separate presentation of financial assets and financial liabilities by measurement category and form of financial asset (that is, securities or loans and receivables) on the balance sheet or the accompanying notes to the financial statements; and (8) clarifies that an entity should evaluate the need for a valuation allowance on a deferred tax asset related to available-for-sale securities in combination with the entity’s other deferred tax assets. The amendments in this update affect all entities that hold financial assets or owe financial liabilities. ASU 2016-01 is effective for the Company on January 1, 2018 and is not expected to have a significant impact on the Company’s financial statements.

ASU 2014-09, “Revenue from Contracts with Customers (Topic 606).” ASU 2014-09 supersedes the revenue recognition requirements in Revenue Recognition (Topic 605), and most industry-specific guidance throughout the Industry Topics of the Codification. The core principle of ASU 2014-09 is 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. In addition, the FASB has issued targeted updates to clarify specific implementation issues of ASU 2014-09. These updates include ASU 2016-08 - *Principal versus Agent Considerations (Reporting Revenue Gross versus Net)*, ASU 2016-10 - *Identifying Performance Obligations and Licensing*, ASU 2016-12 - *Narrow-Scope Improvements and Practical Expedients* and ASU 2016-20 - *Technical Corrections and Improvements to Topic 606 - Revenue from Contract with Customers*. These amendments do not change the core principles in ASU 2014-09. The Company’s primary sources of revenue are comprised of net interest income on financial assets and liabilities, which are not within the scope of ASU 2014-09. ASU 2014-09 is effective for the Company on January 1, 2018, with a cumulative-effect adjustment, and will not have a significant impact on the financial statements.

2. ACQUISITIONS

Acquisitions are an integral part of the Company’s growth strategy. All acquisitions were accounted for using the acquisition method of accounting. Accordingly, the assets and liabilities of the acquired entities were recorded at their fair values at the acquisition date. The excess of the purchase price over the estimated fair value of the net assets for tax-free acquisitions was recorded as goodwill, none of which is deductible for tax purposes. The excess of the purchase price over the estimated fair value of the net assets for taxable acquisitions was also recorded as goodwill, and is deductible for tax purposes. The identified core deposit intangibles for each acquisition are being amortized using a non-pro rata basis over an estimated life of 10 to 15 years. The results of operations for each acquisition have been included in the Company’s consolidated financial results beginning on the respective acquisition date.

The measurement period for the Company to determine the fair values of acquired identifiable assets and assumed liabilities will end at the earlier of (1) twelve months from the date of the acquisition or (2) as soon as the Company receives the information it was seeking about facts and circumstances that existed as of the acquisition date or learns that more information is not obtainable. The following acquisitions were completed on the dates indicated:

2016 Acquisition

Acquisition of Tradition Bancshares, Inc. — On January 1, 2016, the Company completed the acquisition of Tradition Bancshares, Inc. (“Tradition”) and its wholly-owned subsidiary Tradition Bank, headquartered in Houston, Texas. Tradition Bank operated 7 banking offices in the Houston, Texas area, including its main office in Bellaire, 3 banking centers in Katy and 1 banking center in The Woodlands. The acquisition was not considered significant to the Company’s financial statements and therefore pro forma financial data and related disclosures are not included.

The Company acquired loans and deposits with fair values of \$239.7 million and \$489.7 million, respectively, at acquisition date. Under the terms of the definitive agreement, Bancshares issued 679,528 shares of its common stock plus \$39.0 million in cash for all outstanding shares of Tradition capital stock, for total merger consideration of \$71.5 million, based on Bancshares’ closing stock price of \$47.86 on December 31, 2015. During 2016, the Company recognized goodwill of \$32.0 million, which is calculated as the excess of both the consideration exchanged and liabilities assumed as compared to the fair value of identifiable assets acquired, none of which is expected to be deductible for tax purposes. Additionally, the Company recognized \$5.6 million of core deposit intangibles during 2016.

Merger-Related Expenses: The Company did not incur merger-related expenses during 2017. During 2016, the Company incurred \$670 thousand of pre-tax merger-related expenses attributable to the Tradition acquisition. The merger-related expenses are reflected on the Company’s income statement for the applicable periods and are reported primarily in the categories of salaries and benefits, data processing and travel and development. There were no other merger-related costs incurred during 2016.

Acquired Loans

Acquired loans were preliminarily recorded at fair value based on a discounted cash flow valuation methodology that considers, among other things, interest rates, projected default rates, loss given default and recovery rates, with no carryover of any existing allowance for credit losses from the acquisition completed during 2016. During the valuation process, the Company identified PCI and Non-PCI loans in the acquired loan portfolios. PCI loan identification considers the following factors: payment history and past due status, debt service coverage, loan grading, collateral values and other factors that may indicate deterioration of credit quality since origination. Non-PCI loan identification considers the following factors: account types, remaining terms, annual interest rates or coupons, current market rates, interest types, past delinquencies, timing of principal and interest payments, loan to value ratios, loss exposures and remaining balances. Accretion of purchased discounts on PCI loans will be based on estimated future cash flows, regardless of contractual maturities. Accretion of purchased discounts on Non-PCI loans will be recognized on a level-yield basis based on contractual maturity of individual loans.

PCI Loans. The carrying amount of PCI loans included in the consolidated balance sheets and the related outstanding balances at December 31, 2017 and 2016 are presented in the table below. The outstanding balance represents the total amount owed as of December 31, 2017 and 2016.

	<u>December 31, 2017</u>	<u>December 31, 2016</u>
	(Dollars in thousands)	
PCI loans:		
Outstanding balance	\$ 36,199	\$ 51,640
Discount	(14,215)	(24,007)
Recorded investment	<u>\$ 21,984</u>	<u>\$ 27,633</u>

Changes in the accretable yield for PCI loans for the years ended December 31, 2017 and 2016 were as follows:

	<u>Year Ended December 31,</u>	
	<u>2017</u>	<u>2016</u>
	<u>(Dollars in thousands)</u>	
Balance at beginning of period	\$ 9,778	\$ 5,664
Additions	—	10,222
Reclassifications from nonaccretable	5,401	11,114
Accretion	<u>(7,058)</u>	<u>(17,222)</u>
Balance at December 31	<u>\$ 8,121</u>	<u>\$ 9,778</u>

Income recognition on PCI loans is subject to the Company's ability to reasonably estimate both the timing and amount of future cash flows. PCI loans for which the Company is accruing interest income are not considered non-performing or impaired. The non-accretable difference represents contractual principal and interest the Company does not expect to collect.

Non-PCI Loans. The carrying amount of Non-PCI loans included in the consolidated balance sheets and the related outstanding balances at December 31, 2017 and 2016 are presented in the table below. The outstanding balance represents the total amount owed as of December 31, 2017 and 2016.

	<u>December 31, 2017</u>	<u>December 31, 2016</u>
	<u>(Dollars in thousands)</u>	
Non-PCI loans:		
Outstanding balance	\$ 738,706	\$ 1,115,061
Discount	<u>(20,533)</u>	<u>(35,401)</u>
Recorded investment	<u>\$ 718,173</u>	<u>\$ 1,079,660</u>

Changes in the discount accretion for Non-PCI loans for the years ended December 31, 2017 and 2016 were as follows:

	<u>Year Ended December 31,</u>	
	<u>2017</u>	<u>2016</u>
	<u>(Dollars in thousands)</u>	
Balance at beginning of period	\$ 35,401	\$ 54,734
Additions	—	3,491
Accretion charge-offs	(20)	(1,076)
Accretion	<u>(14,848)</u>	<u>(21,748)</u>
Balance at December 31	<u>\$ 20,533</u>	<u>\$ 35,401</u>

At December 31, 2017, the Company had \$34.7 million of total outstanding discounts on Non-PCI and PCI loans, of which \$28.7 million was accretable.

3. GOODWILL AND CORE DEPOSIT INTANGIBLES

Changes in the carrying amount of the Company's goodwill and core deposit intangibles for fiscal years 2017 and 2016 were as follows:

	<u>Goodwill</u>	<u>Core Deposit</u>
	<u>(Dollars in thousands)</u>	<u>Intangibles</u>
Balance as of December 31, 2015	\$ 1,868,827	\$ 49,417
Less:		
Amortization	—	(9,200)
Add:		
Acquisition of Tradition Bancshares, Inc.	<u>32,018</u>	<u>5,567</u>
Balance as of December 31, 2016	1,900,845	45,784
Less:		
Amortization	—	(6,942)
Balance as of December 31, 2017	<u>\$ 1,900,845</u>	<u>\$ 38,842</u>

Management performs an evaluation annually and more frequently if a triggering event occurs, of whether any impairment of the goodwill and other intangibles has occurred. If any such impairment is determined, a write down is recorded. As of December 31, 2017, there was no impairment recorded on goodwill and core deposit intangibles.

Core deposit intangibles are being amortized on a non-pro rata basis over their estimated lives, which the Company believes is between 10 and 15 years. The estimated aggregate future amortization expense for core deposit intangibles remaining as of December 31, 2017 is as follows (dollars in thousands):

2018	\$ 5,959
2019	5,051
2020	4,483
2021	4,022
Thereafter	<u>19,327</u>
Total	<u>\$ 38,842</u>

4. CASH AND DUE FROM BANKS

The Federal Reserve Bank requires banks to maintain minimum average reserve balances. The amount of the required reserve balance for the Bank was \$112.4 million and \$120.7 million at December 31, 2017 and 2016, respectively.

5. SECURITIES

The amortized cost and fair value of investment securities were as follows:

	December 31, 2017			
	Amortized	Gross	Gross	Fair Value
	Cost	Unrealized	Unrealized	
(Dollars in thousands)				
Available for Sale				
States and political subdivisions	\$ 1,817	\$ 3	\$ —	\$ 1,820
Collateralized mortgage obligations	99,996	122	(57)	100,061
Mortgage-backed securities	103,612	1,204	(1,327)	103,489
Other securities	12,588	13	(101)	12,500
Total	<u>\$ 218,013</u>	<u>\$ 1,342</u>	<u>\$ (1,485)</u>	<u>\$ 217,870</u>
Held to Maturity				
U.S. Treasury securities and obligations of U.S.				
Government agencies	\$ 32,235	\$ 150	\$ (5)	\$ 32,380
States and political subdivisions	328,666	4,263	(807)	332,122
Collateralized mortgage obligations	653	2	(5)	650
Mortgage-backed securities	9,092,692	9,382	(143,744)	8,958,330
Other securities	—	—	—	—
Total	<u>\$ 9,454,246</u>	<u>\$ 13,797</u>	<u>\$ (144,561)</u>	<u>\$ 9,323,482</u>
December 31, 2016				
	Amortized	Gross	Gross	Fair Value
	Cost	Unrealized	Unrealized	
(Dollars in thousands)				
Available for Sale				
States and political subdivisions	\$ 1,915	\$ 5	\$ —	\$ 1,920
Collateralized mortgage obligations	120,478	240	(119)	120,599
Mortgage-backed securities	84,024	2,004	(165)	85,863
Other securities	12,588	252	(46)	12,794
Total	<u>\$ 219,005</u>	<u>\$ 2,501</u>	<u>\$ (330)</u>	<u>\$ 221,176</u>
Held to Maturity				
U.S. Treasury securities and obligations of U.S.				
Government agencies	\$ 33,523	\$ 497	\$ —	\$ 34,020
States and political subdivisions	384,015	3,934	(1,328)	386,621
Collateralized mortgage obligations	850	6	(5)	851
Mortgage-backed securities	9,086,422	30,880	(199,439)	8,917,863
Other securities	100	—	—	100
Total	<u>\$ 9,504,910</u>	<u>\$ 35,317</u>	<u>\$ (200,772)</u>	<u>\$ 9,339,455</u>

Management evaluates securities for other-than-temporary impairment at least on a quarterly basis, and more frequently when economic or market conditions warrant such an evaluation. The investment securities portfolio is evaluated for OTTI by segregating the portfolio into two general segments and applying the appropriate OTTI analysis. Investment securities classified as available for sale or held to maturity are evaluated for OTTI under Financial Accounting Standards Board (“FASB”): ASC Topic 320, “Investments—Debt and Equity Securities.”

In determining OTTI, management considers many factors, including: (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, (3) whether the market decline was affected by macroeconomic conditions and (4) whether the entity has the intent to sell the debt security or more likely than not will be required to sell the debt security before its anticipated recovery. The assessment of whether an other-than-temporary decline exists involves a high degree of subjectivity and judgment and is based on the information available to management at the time of such determination.

When OTTI occurs, the amount of the other-than-temporary impairment recognized in earnings depends on whether an entity intends to sell the security or more likely than not will be required to sell the security before recovery of its amortized cost basis less any current-period credit loss.

Management has the ability and intent to hold the securities classified as held-to-maturity until they mature, at which time the Company will receive full value for the securities. Furthermore, as of December 31, 2017, management does not have the intent to sell any of the securities classified as available for sale before a recovery of cost. In addition, management believes it is more likely than not that the Company will not be required to sell any of its investment securities before a recovery of cost. The unrealized losses are largely due to increases in market interest rates over the yields available at the time the underlying securities were purchased. The fair value is expected to recover as the securities approach their maturity date or repricing date or if market yields for such investments decline. Management does not believe any of the securities are impaired due to reasons of credit quality. Accordingly, as of December 31, 2017, management believes any impairment in the Company's securities is temporary and no impairment loss has been realized in the Company's consolidated statements of income.

Securities with unrealized losses segregated by length of time such securities have been in a continuous loss position were as follows:

	December 31, 2017					
	Less than 12 Months		More than 12 Months		Total	
	Estimated Fair Value	Unrealized Losses	Estimated Fair Value	Unrealized Losses	Estimated Fair Value	Unrealized Losses
	(Dollars in thousands)					
Available for Sale						
Collateralized mortgage obligations	\$ 5,753	\$ (13)	\$ 2,544	\$ (44)	\$ 8,297	\$ (57)
Mortgage-backed securities	42,289	(1,323)	2,054	(4)	44,343	(1,327)
Other securities	1,636	(101)	—	—	1,636	(101)
Total	<u>\$ 49,678</u>	<u>\$ (1,437)</u>	<u>\$ 4,598</u>	<u>\$ (48)</u>	<u>\$ 54,276</u>	<u>\$ (1,485)</u>
Held to Maturity						
U.S. Treasury securities and obligations of U.S. Government agencies	\$ 4,934	\$ (5)	\$ —	\$ —	\$ 4,934	\$ (5)
States and political subdivisions	160,392	(773)	3,686	(34)	164,078	(807)
Collateralized mortgage obligations	373	(2)	100	(3)	473	(5)
Mortgage-backed securities	<u>3,940,075</u>	<u>(34,159)</u>	<u>3,883,266</u>	<u>(109,585)</u>	<u>7,823,341</u>	<u>(143,744)</u>
Total	<u>\$4,105,774</u>	<u>\$ (34,939)</u>	<u>\$3,887,052</u>	<u>\$ (109,622)</u>	<u>\$7,992,826</u>	<u>\$ (144,561)</u>
	December 31, 2016					
	Less than 12 Months		More than 12 Months		Total	
	Estimated Fair Value	Unrealized Losses	Estimated Fair Value	Unrealized Losses	Estimated Fair Value	Unrealized Losses
	(Dollars in thousands)					
Available for Sale						
Collateralized mortgage obligations	\$ 10,723	\$ (119)	\$ —	\$ —	\$ 10,723	\$ (119)
Mortgage-backed securities	45,456	(160)	2,334	(5)	47,790	(165)
Other securities	—	—	1,691	(46)	1,691	(46)
Total	<u>\$ 56,179</u>	<u>\$ (279)</u>	<u>\$ 4,025</u>	<u>\$ (51)</u>	<u>\$ 60,204</u>	<u>\$ (330)</u>
Held to Maturity						
U.S. Treasury securities and obligations of U.S. Government agencies	—	—	—	—	—	—
States and political subdivisions	115,132	(1,288)	5,080	(40)	120,212	(1,328)
Collateralized mortgage obligations	589	(4)	44	(1)	633	(5)
Mortgage-backed securities	<u>6,903,919</u>	<u>(195,556)</u>	<u>90,293</u>	<u>(3,883)</u>	<u>6,994,212</u>	<u>(199,439)</u>
Total	<u>\$7,019,640</u>	<u>\$ (196,848)</u>	<u>\$ 95,417</u>	<u>\$ (3,924)</u>	<u>\$7,115,057</u>	<u>\$ (200,772)</u>

At December 31, 2017 and 2016 there were 308 securities and 276 securities, respectively, in an unrealized loss position for more than 12 months.

The amortized cost and fair value of investment securities at December 31, 2017, by contractual maturity, are shown below. Actual maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations at any time with or without call or prepayment penalties.

	<u>Held to Maturity</u>		<u>Available for Sale</u>	
	<u>Amortized Cost</u>	<u>Fair Value</u>	<u>Amortized Cost</u>	<u>Fair Value</u>
	(Dollars in thousands)			
Due in one year or less	\$ 33,019	\$ 33,163	\$ 13,098	\$ 13,010
Due after one year through five years	182,931	183,412	1,307	1,310
Due after five years through ten years	128,457	130,991	—	—
Due after ten years	16,494	16,936	—	—
Subtotal	360,901	364,502	14,405	14,320
Mortgage-backed securities and collateralized mortgage obligations	9,093,345	8,958,980	203,608	203,550
Total	<u>\$9,454,246</u>	<u>\$9,323,482</u>	<u>\$ 218,013</u>	<u>\$ 217,870</u>

The Company recorded a gain on sale of securities of \$3.3 million for the year ended December 31, 2017. The gain resulted from the sale of seven mortgage-backed securities with a total book value of \$77.6 million. Under ASC Topic 320 "Investments – Debt and Equity Securities," selling a debt security after 85% of the principal outstanding has been collected is considered the equivalent to holding the security to maturity. The Company sold these securities, which had paid down over 85% of their principal, because they no longer represented an efficient investment due to the safekeeping and administrative cost required to maintain them. The Company recorded no gain or loss on sale of securities for the years ended December 31, 2016 and 2015.

At December 31, 2017 and 2016, the Company did not own securities of any one issuer (other than the U.S. government and its agencies) for which aggregate adjusted cost exceeded 10% of the consolidated shareholders' equity at such respective dates.

Securities with an amortized cost of \$5.94 billion and \$5.64 billion and a fair value of \$5.84 billion and \$5.51 billion at December 31, 2017 and 2016, respectively, were pledged to collateralize public deposits and for other purposes required or permitted by law.

6. LOANS AND ALLOWANCE FOR CREDIT LOSSES

The loan portfolio consists of various types of loans made principally to borrowers located within the states of Texas and Oklahoma and is categorized by major type as follows:

	<u>December 31,</u>	
	<u>2017</u>	<u>2016</u>
	(Dollars in thousands)	
Residential mortgage loans held for sale	\$ 31,389	\$ 26,975
Commercial and industrial	1,479,910	1,539,439
Real estate:		
Construction, land development and other land loans	1,509,137	1,263,923
1-4 family residential (including home equity)	2,708,471	2,690,856
Commercial real estate (including multi-family residential)	3,315,627	3,162,109
Farmland	502,841	484,588
Agriculture	187,277	187,748
Consumer and other	286,121	266,422
Total loans held for investment	<u>9,989,384</u>	<u>9,595,085</u>
Total	<u>\$ 10,020,773</u>	<u>\$ 9,622,060</u>

Loan Origination/Risk Management. The Company has certain lending policies and procedures in place that are designed to maximize loan income within an acceptable level of risk. Management reviews and approves these policies and procedures on a regular basis. A reporting system supplements the review process by providing management with frequent reports related to loan production, loan quality, concentrations of credit, loan delinquencies and non-performing and potential problem loans. Diversification in the loan portfolio is a means of managing risk associated with fluctuations in economic conditions. Loans to borrowers with aggregate debt relationships over \$1.0 million and below \$3.5 million are evaluated and acted upon on a daily basis by two of the company-wide loan concurrence officers. Loans to borrowers with aggregate debt relationships above \$3.5 million are evaluated and acted upon by an officers' loan committee that meets weekly. In addition to the officers' loan committee evaluation, loans to borrowers with aggregate debt relationships from \$25.0 million to \$50.0 million are evaluated and acted upon by the directors' loan committee which consists of three directors of the Bank and meets as necessary. Loans to borrowers with aggregate debt relationships over \$50.0 million are evaluated and acted upon by the Bank's Board of Directors either at a regularly scheduled monthly board meeting or by teleconference or written consent.

The Company maintains an independent loan review department that reviews and validates the credit risk program on a periodic basis. Results of these reviews are presented to management. The loan review process complements and reinforces the risk identification and assessment decisions made by lenders and credit personnel, as well as the Company's policies and procedures.

(i) Commercial and Industrial Loans. In nearly all cases, the Company's commercial loans are made in the Company's market areas and are underwritten on the basis of the borrower's ability to service the debt from income. As a general practice, the Company takes as collateral a lien on any available real estate, equipment or other assets owned by the borrower and obtains a personal guaranty of the borrower or principal. Working capital loans are primarily collateralized by short-term assets whereas term loans are primarily collateralized by long-term assets. In general, commercial loans involve more credit risk than residential mortgage loans and commercial mortgage loans and, therefore, usually yield a higher return. The increased risk in commercial loans is due to the type of collateral securing these loans as well as the expectation that commercial loans generally will be serviced principally from the operations of the business, and those operations may not be successful. Historical trends have shown these types of loans to have higher delinquencies than mortgage loans. As a result of these additional complexities, variables and risks, commercial loans require more thorough underwriting and servicing than other types of loans.

(ii) Commercial Real Estate. The Company makes commercial real estate loans collateralized by owner-occupied and nonowner-occupied real estate to finance the purchase of real estate. The Company's commercial real estate loans are collateralized by first liens on real estate, typically have variable interest rates (or five year or less fixed rates) and amortize over a 15-to 20-year period. Payments on loans secured by nonowner-occupied properties are often dependent on the successful operation or management of the properties. Accordingly, repayment of these loans may be subject to adverse conditions in the real estate market or the economy to a greater extent than other types of loans. The Company seeks to minimize these risks in a variety of ways, including giving careful consideration to the property's operating history, future operating projections, current and projected occupancy, location and physical condition in connection with underwriting these loans. The underwriting analysis also includes credit verification, analysis of global cash flow, appraisals and a review of the financial condition of the borrower. At December 31, 2017, approximately 46.0% of the outstanding principal balance of the Company's commercial real estate loans were secured by owner-occupied properties.

(iii) 1-4 Family Residential Loans. The Company's lending activities also include the origination of 1-4 family residential mortgage loans (including home equity loans) collateralized by owner-occupied residential properties located in the Company's market areas. The Company offers a variety of mortgage loan portfolio products which generally are amortized over five to 25 years. Loans collateralized by 1-4 family residential real estate generally have been originated in amounts of no more than 89% of appraised value or have mortgage insurance. The Company requires mortgage title insurance and hazard insurance. The Company retains these portfolio loans for its own account rather than selling them into the secondary market. By doing so, the Company incurs interest rate risk as well as the risks associated with nonpayments on such loans. The Company's Home Loan Center offers a variety of mortgage loan products which are generally amortized over 30 years, including FHA and VA loans. The Company sells the loans originated by the Home Loan Center into the secondary market.

(iv) Construction, Land Development and Other Land Loans. The Company makes loans to finance the construction of residential and, to a lesser extent, nonresidential properties. Construction loans generally are collateralized by first liens on real estate and have floating interest rates. The Company conducts periodic inspections, either directly or through an agent, prior to approval of periodic draws on these loans. Underwriting guidelines similar to those described above are also used in the Company's construction lending activities. Construction loans involve additional risks attributable to the fact that loan funds are advanced upon the security of a project under construction, and the project is of uncertain value prior to its completion. Because of uncertainties inherent in estimating construction costs, the market value of the completed project and the effects of governmental regulation on real property, it can be difficult to accurately evaluate the total funds required to complete a project and the related loan to value ratio. As a result of these uncertainties, construction lending often involves the disbursement of substantial funds with repayment dependent, in part, on the success of the ultimate project rather than the ability of a borrower or guarantor to repay the loan. If the Company is forced to foreclose on a project prior to completion, the Company may not be able to recover all of the unpaid portion of the loan. In addition, the Company may be required to fund additional amounts to complete a project and may have to hold the property for an indeterminate period of time. Although the Company has underwriting procedures designed to identify what it believes to be acceptable levels of risks in construction lending, these procedures may not prevent losses from the risks described above.

(v) Agriculture Loans. The Company provides agriculture loans for short-term beef and crop production, including rice, cotton, milo and corn, farm equipment financing and agriculture real estate financing. The Company evaluates agriculture borrowers primarily based on their historical profitability, level of experience in their particular agriculture industry, overall financial capacity and the availability of secondary collateral to withstand economic and natural variations common to the industry. Because agriculture loans present a higher level of risk associated with events caused by nature, the Company routinely makes on-site visits and inspections in order to identify and monitor such risks.

(vi) Consumer Loans. Consumer loans made by the Company include direct "A"-credit automobile loans, recreational vehicle loans, boat loans, home improvement loans, personal loans (collateralized and uncollateralized), credit cards and deposit account collateralized loans. The terms of these loans typically range from 12 to 180 months and vary based upon the nature of collateral and size of loan. Generally, consumer loans entail greater risk than do real estate secured loans, particularly in the case of consumer loans that are unsecured or collateralized by rapidly depreciating assets such as automobiles. In such cases, any repossessed collateral for a defaulted consumer loan may not provide an adequate source of repayment for the outstanding loan balance. The remaining deficiency often does not warrant further substantial collection efforts against the borrower beyond obtaining a deficiency judgment. In addition, consumer loan collections are dependent on the borrower's continuing financial stability, and thus are more likely to be adversely affected by job loss, divorce, illness or personal bankruptcy. Furthermore, the application of various federal and state laws may limit the amount which can be recovered on such loans.

The contractual maturity ranges of the Company's loan portfolio by type of loan and the amount of such loans with predetermined interest rates and floating rates in each maturity range as of December 31, 2017 are summarized in the following table. Contractual maturities are based on contractual amounts outstanding and do not include loan purchase discounts of \$34.7 million or loans held for sale of \$31.4 million at December 31, 2017:

	<u>One Year or Less</u>	<u>After One Year Through Five Years</u>	<u>After Five Years</u>	<u>Total</u>
	(Dollars in thousands)			
Commercial and industrial	\$ 515,223	\$ 453,988	\$ 516,837	\$ 1,486,048
Real estate:				
Construction, land development and other land loans	401,352	267,000	843,226	1,511,578
1-4 family residential (includes home equity)	17,054	115,979	2,581,171	2,714,204
Commercial (includes multi-family residential)	72,072	285,509	2,974,839	3,332,420
Agriculture (includes farmland)	152,082	62,196	478,858	693,136
Consumer and other	78,385	103,458	104,903	286,746
Total	<u>\$ 1,236,168</u>	<u>\$ 1,288,130</u>	<u>\$ 7,499,834</u>	<u>\$ 10,024,132</u>
Loans with a predetermined interest rate	\$ 274,095	\$ 709,811	\$ 3,078,157	\$ 4,062,063
Loans with a floating interest rate	962,073	578,319	4,421,677	5,962,069
Total	<u>\$ 1,236,168</u>	<u>\$ 1,288,130</u>	<u>\$ 7,499,834</u>	<u>\$ 10,024,132</u>

Concentrations of Credit. Most of the Company's lending activity occurs within the states of Texas and Oklahoma. Commercial real estate loans, 1-4 family residential loans and construction, land development and other land loans make up 75.2% of the Company's total loan portfolio at December 31, 2017. As of December 31, 2017 and 2016, there were no concentrations of loans related to any single industry in excess of 10% of total loans.

Foreign Loans. The Company has U.S. dollar-denominated loans and commitments to borrowers in Mexico. The outstanding balance of these loans and the unfunded amounts available under these commitments was not significant at December 31, 2017 or 2016.

Related Party Loans. As of December 31, 2017 and 2016, loans outstanding to directors, officers and their affiliates totaled \$2.7 million and \$4.5 million, respectively. All transactions between the Company and such related parties are conducted in the ordinary course of business and made on the same terms and conditions as similar transactions with unaffiliated persons.

An analysis of activity with respect to these related-party loans is as follows:

	<u>As of and for the year ended December 31,</u>	
	<u>2017</u>	<u>2016</u>
	(Dollars in thousands)	
Beginning balance on January 1	\$ 4,493	\$ 4,063
New loans	175	699
Repayments and reclassified related loans	(1,974)	(269)
Ending balance	<u>\$ 2,694</u>	<u>\$ 4,493</u>

Nonperforming Assets and Nonaccrual and Past Due Loans. The Company has several procedures in place to assist it in maintaining the overall quality of its loan portfolio. The Company has established underwriting guidelines to be followed by its officers, and the Company also monitors its delinquency levels for any negative or adverse trends. Nevertheless, the Company's loan portfolio could become subject to increasing pressures from deteriorating borrower credit due to general economic conditions.

The Company generally places a loan on nonaccrual status and ceases accruing interest when the payment of principal or interest is delinquent for 90 days, or earlier in some cases, unless the loan is in the process of collection and the underlying collateral fully supports the carrying value of the loan.

The Company requires appraisals on loans collateralized by real estate. With respect to potential problem loans, an evaluation of the borrower's overall financial condition is made to determine the need, if any, for possible writedowns or appropriate additions to the allowance for credit losses.

An aging analysis of past due loans, segregated by category of loan, is presented below:

	December 31, 2017					
	Loans Past Due and Still Accruing					
	30-89 Days	90 or More Days	Total Past Due Loans	Nonaccrual Loans	Current Loans	Total Loans
	(Dollars in thousands)					
Construction, land development and other land loans	\$ 8,046	\$ 588	\$ 8,634	\$ 583	\$1,499,920	\$ 1,509,137
Agriculture and agriculture real estate (includes farmland)	562	—	562	132	689,424	690,118
1-4 family (includes home equity) ⁽¹⁾	7,550	416	7,966	5,117	2,726,777	2,739,860
Commercial real estate (includes multi-family residential)	6,995	—	6,995	3,932	3,304,700	3,315,627
Commercial and industrial	17,728	—	17,728	15,277	1,446,905	1,479,910
Consumer and other	605	—	605	223	285,293	286,121
Total	<u>\$ 41,486</u>	<u>\$ 1,004</u>	<u>\$ 42,490</u>	<u>\$ 25,264</u>	<u>\$9,953,019</u>	<u>\$10,020,773</u>
	December 31, 2016					
	Loans Past Due and Still Accruing					
	30-89 Days	90 or More Days	Total Past Due Loans	Nonaccrual Loans	Current Loans	Total Loans
	(Dollars in thousands)					
Construction, land development and other land loans	\$ 8,766	\$ 514	\$ 9,280	\$ 73	\$1,254,570	\$1,263,923
Agriculture and agriculture real estate (includes farmland)	1,813	381	2,194	161	669,981	672,336
1-4 family (includes home equity) ⁽¹⁾	8,645	53	8,698	3,726	2,705,407	2,717,831
Commercial real estate (includes multi-family residential)	4,250	—	4,250	3,528	3,154,331	3,162,109
Commercial and industrial	8,290	8	8,298	23,999	1,507,142	1,539,439
Consumer and other	886	—	886	155	265,381	266,422
Total	<u>\$ 32,650</u>	<u>\$ 956</u>	<u>\$ 33,606</u>	<u>\$ 31,642</u>	<u>\$9,556,812</u>	<u>\$9,622,060</u>

(1) Includes \$31.4 million and \$27.0 million of residential mortgage loans held for sale at December 31, 2017 and December 31, 2016, respectively.

The following table presents information regarding nonperforming assets at the dates indicated:

	December 31,				
	2017	2016	2015	2014	2013
	(Dollars in thousands)				
Nonaccrual loans ⁽¹⁾	\$ 25,264	\$ 31,642	\$ 39,711	\$ 31,422	\$ 10,231
Accruing loans 90 or more days past due	1,004	956	614	2,193	4,947
Total nonperforming loans	26,268	32,598	40,325	33,615	15,178
Reposessed assets	35	241	171	67	27
Other real estate	11,152	15,463	2,963	3,237	7,299
Total nonperforming assets	<u>\$ 37,455</u>	<u>\$ 48,302</u>	<u>\$ 43,459</u>	<u>\$ 36,919</u>	<u>\$ 22,504</u>
Nonperforming assets to total loans and other real estate	0.37%	0.50%	0.46%	0.40%	0.29%

(1) Includes troubled debt restructurings of \$53 thousand, \$97 thousand, \$681 thousand, \$ 911 thousand and \$1.4 million for the years ended December 31, 2017, 2016, 2015, 2014 and 2013, respectively.

The Company had \$37.5 million in nonperforming assets at December 31, 2017 compared with \$48.3 million at December 31, 2016 and \$43.5 million at December 31, 2015. Nonperforming assets were 0.37% of total loans and other real estate at December 31, 2017 compared with 0.50% of total loans and other real estate at December 31, 2016 and 0.46% of total loans and other real estate at December 31, 2015. The nonperforming assets consisted of 99 separate credits or other real estate properties at December 31, 2017, compared with 158 at December 31, 2016 and 147 at December 31, 2015.

If interest on nonaccrual loans had been accrued under the original loan terms, approximately \$2.7 million, \$3.2 million, and \$3.9 million would have been recorded as income for the years ended December 31, 2017, 2016 and 2015, respectively.

Impaired Loans. Loans are considered impaired when, based on current information and events, it is probable the Company will be unable to collect all amounts due in accordance with the original contractual terms of the loan agreement, including scheduled principal and interest payments. Impairment is evaluated in total for smaller-balance loans of a similar nature and on an individual loan basis for other loans. If a loan is impaired, a specific valuation allowance is allocated, if necessary, so that the loan is reported net, at the present value of estimated future cash flows using the loan's existing rate or at the fair value of collateral if repayment is expected solely from the collateral. 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 uncollectible.

Year-end impaired loans are set forth in the following tables. No interest income was recognized on impaired loans subsequent to their classification as impaired. The average recorded investment presented in the tables below is reported on a year-to-date basis.

	December 31, 2017			
	Recorded Investment	Unpaid Contractual Principal Balance	Related Allowance	Average Recorded Investment
	(Dollars in thousands)			
With no related allowance recorded:				
Construction, land development and other land loans	\$ 583	\$ 600	\$ —	\$ 298
Agriculture and agriculture real estate (includes farmland)	132	178	—	70
1-4 family (includes home equity)	3,920	4,181	—	3,185
Commercial real estate (includes multi-family residential)	2,222	2,254	—	2,703
Commercial and industrial	7,846	10,460	—	8,386
Consumer and other	222	269	—	170
Total	<u>14,925</u>	<u>17,942</u>	<u>—</u>	<u>14,812</u>
With an allowance recorded:				
Construction, land development and other land loans	—	—	—	—
Agriculture and agriculture real estate (includes farmland)	—	—	—	77
1-4 family (includes home equity)	1,191	1,213	559	814
Commercial real estate (includes multi-family residential)	1,486	1,499	366	887
Commercial and industrial	6,152	6,373	2,654	9,740
Consumer and other	—	—	—	2
Total	<u>8,829</u>	<u>9,085</u>	<u>3,579</u>	<u>11,520</u>
Total:				
Construction, land development and other land loans	583	600	—	298
Agriculture and agriculture real estate (includes farmland)	132	178	—	147
1-4 family (includes home equity)	5,111	5,394	559	3,999
Commercial real estate (includes multi-family residential)	3,708	3,753	366	3,590
Commercial and industrial	13,998	16,833	2,654	18,126
Consumer and other	222	269	—	172
	<u>\$ 23,754</u>	<u>\$ 27,027</u>	<u>\$ 3,579</u>	<u>\$ 26,332</u>

	December 31, 2016			
	Recorded Investment	Unpaid Contractual Principal Balance (Dollars in thousands)	Related Allowance	Average Recorded Investment
With no related allowance recorded:				
Construction, land development and other land loans	\$ 14	\$ 220	\$ —	\$ 24
Agriculture and agriculture real estate (includes farmland)	7	12	—	14
1-4 family (includes home equity)	2,450	2,682	—	1,828
Commercial real estate (includes multi-family residential)	3,184	3,327	—	9,150
Commercial and industrial	8,925	9,446	—	5,139
Consumer and other	119	157	—	88
Total	<u>14,699</u>	<u>15,844</u>	<u>—</u>	<u>16,243</u>
With an allowance recorded:				
Construction, land development and other land loans	—	—	—	3
Agriculture and agriculture real estate (includes farmland)	154	181	17	171
1-4 family (includes home equity)	437	449	150	408
Commercial real estate (includes multi-family residential)	288	288	178	275
Commercial and industrial	13,327	13,821	2,851	13,961
Consumer and other	4	4	1	93
Total	<u>14,210</u>	<u>14,743</u>	<u>3,197</u>	<u>14,911</u>
Total:				
Construction, land development and other land loans	14	220	—	27
Agriculture and agriculture real estate (includes farmland)	161	193	17	185
1-4 family (includes home equity)	2,887	3,131	150	2,236
Commercial real estate (includes multi-family residential)	3,472	3,615	178	9,425
Commercial and industrial	22,252	23,267	2,851	19,100
Consumer and other	123	161	1	181
	<u>\$ 28,909</u>	<u>\$ 30,587</u>	<u>\$ 3,197</u>	<u>\$ 31,154</u>

Credit Quality Indicators. As part of the on-going monitoring of the credit quality of the Company's loan portfolio and methodology for calculating the allowance for credit losses, management assigns and tracks loan grades to be used as credit quality indicators.

The following is a general description of the loan grades used:

Grade 1—Credits in this category have risk potential that is virtually nonexistent. These loans may be secured by insured certificates of deposit, insured savings accounts, U.S. Government securities and highly rated municipal bonds.

Grade 2—Credits in this category are of the highest quality. These borrowers represent top-rated companies and individuals with unquestionable financial standing with excellent global cash flow coverage, net worth, liquidity and collateral coverage.

Grade 3—Credits in this category are not immune from risk but are well protected by the collateral and paying capacity of the borrower. These loans may exhibit a minor unfavorable credit factor, but the overall credit is sufficiently strong to minimize the possibility of loss.

Grade 4—Credits in this category are considered to be of acceptable credit quality with moderately greater risk than Grade 3 and receiving closer monitoring. Loans in this category have sources of repayment that remain sufficient to preclude a larger than normal probability of default and secondary sources are likewise currently of sufficient quantity, quality, and liquidity to protect the Company against loss of principal and interest. These borrowers have specific risk factors, but the overall strength of the credit is acceptable based on other mitigating credit and/or collateral factors and can repay the debt in the normal course of business.

Grade 5—Credits in this category constitute an undue and unwarranted credit risk; however, the factors do not rise to a level of substandard. These credits have potential weaknesses and/or declining trends that, if not corrected, could expose the Bank to risk at a future date. These loans are monitored on the Bank’s internally generated watch list and evaluated on a quarterly basis.

Grade 6—Credits in this category are considered “substandard” but “non-impaired” loans in accordance with regulatory guidelines. Loans in this category have well-defined weakness that, if not corrected, could make default of principal and interest possible. Loans in this category are still accruing interest and may be dependent upon secondary sources of repayment and/or collateral liquidation.

Grade 7—Credits in this category are deemed “substandard” and “impaired” pursuant to regulatory guidelines. As such, the Bank has determined that it is probable that less than 100% of the contractual principal and interest will be collected. These loans are individually evaluated for a specific reserve and will typically have the accrual of interest stopped.

Grade 8—Credits in this category include “doubtful” loans in accordance with regulatory guidance. Such loans are no longer accruing interest and factors indicate a loss is imminent. These loans are also deemed “impaired.” While a specific reserve may be in place while the loan and collateral is being evaluated these loans are typically charged down to an amount the Bank estimates is collectible.

Grade 9—Credits in this category are deemed a “loss” in accordance with regulatory guidelines and have been charged off or charged down. The Bank may continue collection efforts and may have partial recovery in the future.

The following table presents risk grades and PCI loans by category of loan at December 31, 2017. Impaired loans include loans in risk grades 7, 8 and 9, as well as any PCI loan that has a specific reserve allocated to it.

	Construction, Land Development and Other Land Loans	Agriculture and Real Estate (includes Farmland)	1-4 Family (includes Home Equity) (1)	Commercial Real Estate (includes Multi-Family Residential)	Commercial and Industrial	Consumer and Other	Total
	(Dollars in thousands)						
Grade 1	\$ —	\$ 14,084	\$ —	\$ —	\$ 50,174	\$ 38,029	\$ 102,287
Grade 2	1,848	4,190	28,053	18,953	20,561	52,210	125,815
Grade 3	1,419,648	594,082	2,632,788	2,955,774	1,084,580	180,494	8,867,366
Grade 4	78,117	68,019	61,146	272,848	209,279	10,226	699,635
Grade 5	788	7,964	3,558	34,811	58,655	3,200	108,976
Grade 6	7,284	1,266	4,640	16,415	39,611	1,740	70,956
Grade 7	583	132	4,681	3,708	13,755	222	23,081
Grade 8	—	—	430	—	243	—	673
Grade 9	—	—	—	—	—	—	—
PCI Loans ⁽²⁾	869	381	4,564	13,118	3,052	—	21,984
Total	<u>\$ 1,509,137</u>	<u>\$ 690,118</u>	<u>\$2,739,860</u>	<u>\$ 3,315,627</u>	<u>\$1,479,910</u>	<u>\$ 286,121</u>	<u>\$10,020,773</u>

(1) Includes \$31.4 million of residential mortgage loans held for sale at December 31, 2017.

(2) Of the total PCI loans, \$1.5 million were classified as substandard at December 31, 2017, with no specific reserves allocated to them.

The following table presents risk grades and PCI loans by category of loan at December 31, 2016. Impaired loans include loans in risk grades 7, 8 and 9.

	Construction, Land Development and Other Land Loans	Agriculture and Agriculture Real Estate (includes Farmland)	1-4 Family (includes Home Equity) (1)	Commercial Real Estate (includes Multi-Family Residential)	Commercial and Industrial	Consumer and Other	Total
	(Dollars in thousands)						
Grade 1	\$ —	\$ 14,616	\$ —	\$ —	\$ 54,908	\$ 40,688	\$ 110,212
Grade 2	2,261	4,218	22,863	8,317	12,772	11,041	61,472
Grade 3	1,200,623	570,324	2,622,304	2,859,433	1,143,634	194,210	8,590,528
Grade 4	54,380	74,079	55,367	220,533	176,287	16,095	596,741
Grade 5	2,525	7,703	3,605	45,533	57,283	2,403	119,052
Grade 6	2,690	847	5,095	8,401	68,682	1,829	87,544
Grade 7	13	161	2,857	3,472	21,475	156	28,134
Grade 8	—	—	30	—	714	—	744
Grade 9	—	—	—	—	—	—	—
PCI Loans ⁽²⁾	1,431	388	5,710	16,420	3,684	—	27,633
Total	<u>\$ 1,263,923</u>	<u>\$ 672,336</u>	<u>\$ 2,717,831</u>	<u>\$ 3,162,109</u>	<u>\$ 1,539,439</u>	<u>\$ 266,422</u>	<u>\$ 9,622,060</u>

(1) Includes \$27.0 million of residential mortgage loans held for sale at December 31, 2016.

(2) Of the total PCI loans, \$2.7 million were classified as substandard at December 31, 2016, which includes \$31 thousand with specific reserves allocated to them.

Allowance for Credit Losses. The allowance for credit losses is a valuation established through charges to earnings in the form of a provision for credit losses. Management has established an allowance for credit losses which it believes is adequate as of December 31, 2017 for estimated losses in the Company's loan portfolio. The amount of the allowance for credit losses is affected by the following: (1) charge-offs of loans that occur when loans are deemed uncollectible and decrease the allowance, (2) recoveries on loans previously charged off that increase the allowance and (3) provisions for credit losses charged to earnings that increase the allowance. Based on an evaluation of the loan portfolio and consideration of the factors listed below, management presents a quarterly review of the allowance for credit losses to the Bank's Board of Directors, indicating any change in the allowance since the last review and any recommendations as to adjustments in the allowance. Although management believes it uses the best information available to make determinations with respect to the allowance for credit losses, future adjustments may be necessary if economic conditions or the borrower's performance differ from the assumptions used in making the initial determinations.

The Company's allowance for credit losses consists of two components: (1) a specific valuation allowance based on probable losses on specifically identified loans and (2) a general valuation allowance based on historical loan loss experience, general economic conditions and other qualitative risk factors both internal and external to the Company.

In setting the specific valuation allowance, the Company follows a loan review program to evaluate the credit risk in the total loan portfolio and assigns risk grades to each loan. Through this loan review process, the Company maintains an internal list of impaired loans which, along with the delinquency list of loans, helps management assess the overall quality of the loan portfolio and the adequacy of the allowance for credit losses. All loans that have been identified as impaired are reviewed on a quarterly basis in order to determine whether a specific reserve is required. For certain impaired loans, the Company allocates a specific loan loss reserve primarily based on the value of the collateral securing the impaired loan in accordance with ASC Topic 310-10, "Receivables." The specific reserves are determined on an individual loan basis. Loans for which specific reserves are provided are excluded from the general valuation allowance described below.

In connection with this review of the loan portfolio, the Company considers risk elements attributable to particular loan types or categories in assessing the quality of individual loans. Some of the risk elements include:

- for 1-4 family residential mortgage loans, the borrower's ability to repay the loan, including a consideration of the debt to income ratio and employment and income stability, the loan to value ratio, and the age, condition and marketability of collateral;
- for commercial real estate loans and multifamily residential loans, the debt service coverage ratio (income from the property in excess of operating expenses compared to loan payment requirements), operating results of the owner in the case of owner-occupied properties, the loan to value ratio, the age and condition of the collateral and the volatility of income, property value and future operating results typical of properties of that type;
- for construction, land development and other land loans, the perceived feasibility of the project including the ability to sell developed lots or improvements constructed for resale or the ability to lease property constructed for lease, the quality and nature of contracts for presale or prelease, if any, experience and ability of the developer and loan to value ratio;
- for commercial and industrial loans, the operating results of the commercial, industrial or professional enterprise, the borrower's business, professional and financial ability and expertise, the specific risks and volatility of income and operating results typical for businesses in that category and the value, nature and marketability of collateral;
- for agricultural real estate loans, the experience and financial capability of the borrower, projected debt service coverage of the operations of the borrower and loan to value ratio; and
- for non-real estate agricultural loans, the operating results, experience and financial capability of the borrower, historical and expected market conditions and the value, nature and marketability of collateral.

In addition, for each category, the Company considers secondary sources of income and the financial strength and credit history of the borrower and any guarantors.

In determining the amount of the general valuation allowance, management considers factors such as historical loan loss experience, concentration risk of specific loan types, the volume, growth and composition of the Company's loan portfolio, current economic conditions that may affect the borrower's ability to pay and the value of collateral, the evaluation of the Company's loan portfolio through its internal loan review process, general economic conditions and other qualitative risk factors both internal and external to the Company and other relevant factors in accordance with ASC Topic 450, "*Contingencies*." Based on a review of these factors for each loan type, the Company applies an estimated percentage to the outstanding balance of each loan type, excluding any loan that has a specific reserve allocated to it. Allocation of a portion of the allowance to one category of loans does not preclude its availability to absorb losses in other categories. The Company uses this information to establish the amount of the general valuation allowance.

A change in the allowance for credit losses can be attributable to several factors, most notably (1) specific reserves identified for impaired loans, (2) historical credit loss information, (3) changes in environmental factors and (4) growth in the balance of legacy loans and the renewal or substantial modification of acquired loans (Non-PCI and PCI loans as discussed in Note 2) into the loan portfolio subject to the allowance methodology.

Changes in the Company's asset quality are reflected in the allowance in several ways. Specific reserves that are calculated on a loan-by-loan basis and the qualitative assessment of all other loans reflect current changes in the credit quality of the loan portfolio. Historical credit losses, on the other hand, are based on a three-year look back period, which are then applied to estimate current credit losses inherent in the loan portfolio. A deterioration in the credit quality of the loan portfolio in the current period would increase the historical credit loss factor to be applied in future periods, just as an improvement in credit quality would decrease the historical credit loss factor.

The allowance for credit losses is further determined by the size of the loan portfolio subject to the allowance methodology and environmental factors that include Company-specific risk indicators and general economic conditions, both of which are constantly changing. The Company evaluates the economic and portfolio-specific factors on a quarterly basis to determine a qualitative component of the general valuation allowance. The factors include economic metrics, business conditions, delinquency trends, credit concentrations, nature and volume of the portfolio and other adjustments for items not covered by specific reserves and historical loss experience. Management's assessment of qualitative factors is a statistically based approach to determine the inherent probable loss associated with such factors. Based on the Company's actual historical loan loss experience relative to economic and loan portfolio-specific factors at the time the losses occurred, management is able to identify the probabilities of default and loss severity based on current economic conditions. The correlation of historical loss experience with current economic conditions provides an estimate of inherent and probable losses that has not been previously factored into the general valuation allowance by the determination of specific reserves and recent historical losses. Additionally, the Company considers qualitative factors not easily quantified and the possibility of model imprecision.

Utilizing the aggregation of specific reserves, historical loss experience and a qualitative component, management is able to determine the valuation allowance to reflect the full inherent probable loss.

Loans acquired in business combinations are initially recorded at fair value, which includes an estimate of inherent credit losses expected to be realized over the remaining lives of the loans, and therefore no corresponding allowance for credit losses is recorded for these loans at acquisition. When a fair-valued acquired loan is renewed at its maturity date, the loan is re-categorized and is subject to the allowance methodology. When a fair-valued acquired loan is modified after acquisition, the loan is independently evaluated subsequent to the modification decision to determine whether the modification was, substantial, and therefore, requires that the loan be re-categorized as an acquired legacy loan. The determination is based on a discounted cash-flow analysis. Generally, when a change in discounted cash-flow of greater than 10% is identified, the fair-valued acquired loan becomes re-categorized and is evaluated at the time of renewal or modification in accordance with the Company's allowance for credit losses methodology described above.

Non-PCI loans that were not deemed impaired subsequent to the acquisition date are considered non-impaired and are evaluated as part of the general valuation allowance. Non-PCI loans that have not become impaired subsequent to acquisition are segregated into a pool for each acquisition for allowance calculation purposes. For each pool, the Company estimates a hypothetical allowance for credit losses also referred to as an "indicated reserve" that is calculated in accordance with GAAP requirements. The Company uses the acquired bank's past loss history adjusted for qualitative factors to establish the indicated reserve. The indicated reserve for each pool of Non-PCI loans is compared with the remaining discount for the respective pool to test for credit quality deterioration and the possible need for a loan loss provision. To the extent the remaining discount of the pool is greater than the indicated reserve, no additional allowance is necessary. If the remaining discount of the pool is less than the indicated reserve, the difference results in an increase to the allowance recorded through a provision for credit losses.

Non-PCI loans that have deteriorated to an impaired status subsequent to acquisition are evaluated for a specific reserve on a quarterly basis which, when identified, is added to the allowance for credit losses. The Company reviews impaired Non-PCI loans on a loan-by-loan basis and determines the specific reserve based on the difference between the recorded investment in the loan and one of three factors: expected future cash flows, observable market price or fair value of the collateral. Because essentially all of the Company's impaired Non-PCI loans have been collateral-dependent, the amount of the specific reserve historically has been determined by comparing the fair value of the collateral securing the Non-PCI loan with the recorded investment in such loan. In the future, the Company will continue to analyze impaired Non-PCI loans on a loan-by-loan basis and may use an alternative measurement method to determine the specific reserve, as appropriate and in accordance with applicable accounting standards.

PCI loans are individually monitored on a quarterly basis to assess for deterioration subsequent to acquisition and are only subject to the Company's allowance methodology when a deterioration in projected cash flows is identified. In the event that a deterioration in cash flows is identified, an additional provision for credit losses is made. PCI loans were recorded at their acquisition date fair values, which were based on expected cash flows and included estimates of expected future credit losses. The Company's estimates of loan fair values at the acquisition date may be adjusted for a period of up to one year as the Company continues to evaluate its estimate of expected future cash flows at the acquisition date. If the Company determines that losses arose after the acquisition date, the additional losses will be reflected as a provision for credit losses. An allowance for credit losses is not calculated for PCI loans that have not experienced deterioration subsequent to the acquisition date.

At December 31, 2017, the allowance for credit losses totaled \$84.0 million or 0.84% of total loans, including acquired loans with discounts. At December 31, 2016, the allowance for credit losses totaled \$85.3 million or 0.89% of total loans, and at December 31, 2015, the allowance aggregated \$81.4 million or 0.86% of total loans, both including acquired loans with discounts. The allowance for credit losses totaled \$84.0 million at December 31, 2017 compared with \$85.3 million at December 31, 2016, a decrease of \$1.3 million or 1.5%.

The following tables detail the recorded investment in loans, excluding \$31.4 million and \$27.0 million of residential mortgage loans held for sale, and activity in the allowance for credit losses by category of loan for the years ended December 31, 2017 and 2016, respectively.

	Construction, Land Development and Other Land Loans	Agriculture and Agriculture Real Estate (includes Farmland)	1-4 Family (includes Home Equity)	Commercial Real Estate (includes Multi- Family Residential)	Commercial and Industrial	Consumer and Other	Total
	(Dollars in thousands)						
Allowance for credit losses:							
Balance January 1, 2017	\$ 14,984	\$ 4,073	\$ 16,571	\$ 12,256	\$ 35,836	\$ 1,606	\$ 85,326
Provision for credit losses	(297)	(458)	(2,008)	(1,476)	16,047	2,517	14,325
Charge-offs	(9)	(53)	(229)	(155)	(14,836)	(3,652)	(18,934)
Recoveries	137	210	156	3	1,763	1,055	3,324
Net charge-offs	128	157	(73)	(152)	(13,073)	(2,597)	(15,610)
Balance December 31, 2017	<u>\$ 14,815</u>	<u>\$ 3,772</u>	<u>\$ 14,490</u>	<u>\$ 10,628</u>	<u>\$ 38,810</u>	<u>\$ 1,526</u>	<u>\$ 84,041</u>
Allowance for credit losses related to:							
December 31, 2017							
Individually evaluated for impairment	\$ —	\$ —	\$ 559	\$ 366	\$ 2,654	\$ —	\$ 3,579
Collectively evaluated for impairment	14,815	3,772	13,931	10,262	36,156	1,526	80,462
PCI loans	—	—	—	—	—	—	—
Total allowance for credit losses	<u>\$ 14,815</u>	<u>\$ 3,772</u>	<u>\$ 14,490</u>	<u>\$ 10,628</u>	<u>\$ 38,810</u>	<u>\$ 1,526</u>	<u>\$ 84,041</u>
Recorded investment in loans:							
December 31, 2017							
Individually evaluated for impairment	\$ 583	\$ 132	\$ 5,111	\$ 3,708	\$ 13,998	\$ 222	\$ 23,754
Collectively evaluated for impairment	1,507,685	689,605	2,698,796	3,298,801	1,462,860	285,899	9,943,646
PCI loans	869	381	4,564	13,118	3,052	—	21,984
Total loans evaluated for impairment	<u>\$ 1,509,137</u>	<u>\$ 690,118</u>	<u>\$ 2,708,471</u>	<u>\$ 3,315,627</u>	<u>\$ 1,479,910</u>	<u>\$ 286,121</u>	<u>\$ 9,989,384</u>

	<u>Construction, Land Development and Other Land Loans</u>	<u>Agriculture and Agriculture Real Estate (includes Farmland)</u>	<u>1-4 Family (includes Home Equity)</u>	<u>Commercial Real Estate (includes Multi- Family Residential)</u>	<u>Commercial and Industrial</u>	<u>Consumer and Other</u>	<u>Total</u>
(Dollars in thousands)							
Allowance for credit losses:							
Balance January 1, 2016	\$ 14,882	\$ 3,845	\$ 14,891	\$ 12,996	\$ 33,409	\$ 1,361	\$ 81,384
Provision for credit losses	(2,399)	6,795	1,598	(444)	13,986	4,464	24,000
Charge-offs	(7)	(7,375)	(116)	(298)	(14,371)	(5,346)	(27,513)
Recoveries	2,508	808	198	2	2,812	1,127	7,455
Net charge-offs	2,501	(6,567)	82	(296)	(11,559)	(4,219)	(20,058)
Balance December 31, 2016	<u>\$ 14,984</u>	<u>\$ 4,073</u>	<u>\$ 16,571</u>	<u>\$ 12,256</u>	<u>\$ 35,836</u>	<u>\$ 1,606</u>	<u>\$ 85,326</u>
Allowance for credit losses related to:							
December 31, 2016							
Individually evaluated for impairment	\$ —	\$ 17	\$ 150	\$ 178	\$ 2,820	\$ 1	\$ 3,166
Collectively evaluated for impairment	14,984	4,056	16,421	12,078	32,985	1,605	82,129
PCI loans	—	—	—	—	31	—	31
Total allowance for credit losses	<u>\$ 14,984</u>	<u>\$ 4,073</u>	<u>\$ 16,571</u>	<u>\$ 12,256</u>	<u>\$ 35,836</u>	<u>\$ 1,606</u>	<u>\$ 85,326</u>
Recorded investment in loans:							
December 31, 2016							
Individually evaluated for impairment	\$ 14	\$ 161	\$ 2,887	\$ 3,472	\$ 22,221	\$ 123	\$ 28,878
Collectively evaluated for impairment	1,262,478	671,787	2,682,259	3,142,217	1,513,534	266,299	9,538,574
PCI loans	1,431	388	5,710	16,420	3,684	—	27,633
Total loans evaluated for impairment	<u>\$ 1,263,923</u>	<u>\$ 672,336</u>	<u>\$2,690,856</u>	<u>\$ 3,162,109</u>	<u>\$ 1,539,439</u>	<u>\$ 266,422</u>	<u>\$9,595,085</u>

An analysis of activity in the allowance for credit losses for the year ended December 31, 2015 is as follows:

	<u>Construction, Land Development and Other Land Loans</u>	<u>Agriculture and Agriculture Real Estate (includes Farmland)</u>	<u>1-4 Family (includes Home Equity)</u>	<u>Commercial Real Estate (includes Multi- Family Residential)</u>	<u>Commercial and Industrial</u>	<u>Consumer and Other</u>	<u>Total</u>
	(Dollars in thousands)						
Allowance for credit losses:							
Balance January 1, 2015	\$ 15,825	\$ 3,722	\$ 16,377	\$ 12,744	\$ 30,002	\$ 2,092	\$ 80,762
Provision for credit losses	(736)	(137)	(1,277)	646	7,781	1,283	7,560
Charge-offs	(366)	(24)	(262)	(498)	(7,696)	(3,304)	(12,150)
Recoveries	159	284	53	104	3,322	1,290	5,212
Net charge-offs	(207)	260	(209)	(394)	(4,374)	(2,014)	(6,938)
Balance December 31, 2015	<u>\$ 14,882</u>	<u>\$ 3,845</u>	<u>\$ 14,891</u>	<u>\$ 12,996</u>	<u>\$ 33,409</u>	<u>\$ 1,361</u>	<u>\$ 81,384</u>
Allowance for credit losses related to:							
December 31, 2015							
Individually evaluated for impairment	\$ 2	\$ 52	\$ 93	\$ 262	\$ 7,082	\$ 44	\$ 7,535
Collectively evaluated for impairment	14,880	3,793	14,798	12,734	25,491	1,317	73,013
PCI loans	—	—	—	—	836	—	836
Total allowance for credit losses	<u>\$ 14,882</u>	<u>\$ 3,845</u>	<u>\$ 14,891</u>	<u>\$ 12,996</u>	<u>\$ 33,409</u>	<u>\$ 1,361</u>	<u>\$ 81,384</u>
Recorded investment in loans:							
December 31, 2015							
Individually evaluated for impairment	\$ 40	\$ 209	\$ 1,585	\$ 15,377	\$ 15,948	\$ 239	\$ 33,398
Collectively evaluated for impairment	1,072,238	648,214	2,609,878	3,098,076	1,660,686	252,340	9,341,432
PCI loans	920	395	5,269	17,630	15,612	—	39,826
Total loans evaluated for impairment	<u>\$ 1,073,198</u>	<u>\$ 648,818</u>	<u>\$2,616,732</u>	<u>\$ 3,131,083</u>	<u>\$ 1,692,246</u>	<u>\$ 252,579</u>	<u>\$9,414,656</u>

Troubled Debt Restructurings. The restructuring of a loan is considered a “troubled debt restructuring” if both (1) the borrower is experiencing financial difficulties and (2) the creditor has granted a concession. Concessions may include interest rate reductions or below market interest rates, principal forgiveness, restructuring amortization schedules and other actions intended to minimize potential losses. Under ASC topic 310-40 “*Receivables—Troubled Debt Restructurings by Creditors*,” the Company evaluates all loan modifications for identification as troubled debt restructurings. At December 31, 2017 and 2016, the Company had \$53 thousand and \$97 thousand, respectively, in outstanding troubled debt restructurings. The following table presents information regarding the recorded investment at December 31, 2017 and 2016 of loans modified in a troubled debt restructuring during the years ended December 31, 2017 and 2016:

	Years Ended December 31,					
	2017			2016		
	Number of Loans	Recorded Investment at Date of Restructure	Recorded Investment at Year- End	Number of Loans	Recorded Investment at Date of Restructure	Recorded Investment at Year- End
	(Dollars in thousands)					
Troubled Debt Restructurings						
Construction, land development and other land loans	—	\$ —	\$ —	—	\$ —	\$ —
Agriculture and agriculture real estate (includes farmland)	—	—	—	1	154	—
1-4 Family (includes home equity)	—	—	—	—	—	—
Commercial real estate (commercial mortgage and multi-family)	—	—	—	—	—	—
Commercial and industrial	3	8,656	—	—	—	—
Consumer and other	—	—	—	—	—	—
Total	<u>3</u>	<u>\$ 8,656</u>	<u>\$ —</u>	<u>1</u>	<u>\$ 154</u>	<u>\$ —</u>

For the year ended December 31, 2017, the Company added 3 loans totaling \$8.7 million as new troubled debt restructurings, none of which remained outstanding at December 31, 2017. During the year ended December 31, 2017, the Company fully charged off two loans with a recorded investment of \$4.3 million at the time of charge off. These two loans were modified as troubled debt restructurings during the first quarter of 2017 and had defaulted in payment prior to the charge off. As of December 31, 2017 there have been no other defaults on any loans that were modified as troubled debt restructurings during the preceding twelve months. Default is determined at 90 or more days past due. There were no charge-offs related to restructured loans recognized during the year ended December 31, 2016. The modifications primarily related to extending the amortization periods of the loans, which includes loans modified during bankruptcy. The Company did not grant principal reductions on any restructured loans. These modifications did not have a material impact on the Company’s determination of the allowance for credit losses.

7. FAIR VALUE

The Company uses fair value measurements to record fair value adjustments to certain assets and to determine fair value disclosures. Fair values represent the estimated price that would be received from selling an asset or paid to transfer a liability, otherwise known as an “exit price.” Securities available for sale are recorded at fair value on a recurring basis. Additionally, from time to time, the Company may be required to record at fair value other assets on a nonrecurring basis. These nonrecurring fair value adjustments typically involve application of lower-of-cost-or-market accounting or write downs of individual assets. ASC Topic 820, “*Fair Value Measurements and Disclosures*” 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:

Fair Value Hierarchy

The Company groups financial assets and financial liabilities measured at fair value in three levels, based on the markets in which the assets and liabilities are traded and the reliability of the assumptions used to determine fair value. These levels are:

- Level 1—Quoted prices in active markets for identical assets or liabilities.
- Level 2—Other significant observable inputs (including quoted prices in active markets for similar assets or liabilities) or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities.
- Level 3—Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities.

The fair value of an asset or liability is the price that would be received to sell that asset or paid to transfer that liability in an orderly transaction occurring in the principal market (or most advantageous market in the absence of a principal market) for such asset or liability. In estimating fair value, the Company utilizes valuation techniques that are consistent with the market approach, the income approach and/or the cost approach. Such valuation techniques are consistently applied. Inputs to valuation techniques include the assumptions that market participants would use in pricing an asset or liability.

The fair value disclosures below represent the Company’s estimates based on relevant market information and information about the financial instruments. Fair value estimates are based on judgments regarding current economic conditions, risk characteristics of the various instruments, and other factors. These estimates are subjective in nature and involve uncertainties and matters of significant judgment and therefore cannot be determined with precision. Changes in the above methodologies and assumptions could significantly affect the estimates.

The following tables present fair values for assets measured at fair value on a recurring basis:

	As of December 31, 2017			
	Level 1	Level 2	Level 3	Total
		(Dollars in thousands)		
Available for sale securities:				
States and political subdivisions	\$ —	\$ 1,820	\$ —	\$ 1,820
Collateralized mortgage obligations	—	100,061	—	100,061
Mortgage-backed securities	—	103,489	—	103,489
Other securities	12,500	—	—	12,500

	As of December 31, 2016			
	Level 1	Level 2	Level 3	Total
	(Dollars in thousands)			
Available for sale securities:				
States and political subdivisions	\$ —	\$ 1,920	\$ —	\$ 1,920
Collateralized mortgage obligations	—	120,599	—	120,599
Mortgage-backed securities	—	85,863	—	85,863
Other securities	12,794	—	—	12,794

Certain assets and 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). These instruments include other real estate owned, repossessed assets, held to maturity debt securities, loans held for sale, and impaired loans. For the year ended December 31, 2017, the Company had additions to other real estate owned of \$1.6 million, of which \$923 thousand were outstanding as of December 31, 2017. For the year ended December 31, 2017, the Company had additions to impaired loans of \$20.9 million, of which \$17.6 million were outstanding as of December 31, 2017. The remaining financial assets and liabilities measured at fair value on a non-recurring basis that were recorded in 2017 and remained outstanding at December 31, 2017 were not significant.

The following tables summarize the carrying values and estimated fair values of certain financial instruments not recorded at fair value on a recurring basis:

	As of December 31, 2017				
	Carrying Amount	Estimated Fair Value			Total
		Level 1	Level 2	Level 3	
	(Dollars in thousands)				
Assets					
Cash and due from banks	\$ 391,616	\$ 391,616	\$ —	\$ —	\$ 391,616
Federal funds sold	697	697	—	—	697
Held to maturity securities	9,454,246	—	9,323,482	—	9,323,482
Loans held for sale	31,389	—	31,389	—	31,389
Loans held for investment, net of allowance	9,905,343	—	—	9,923,556	9,923,556
Other real estate owned	11,152	—	11,152	—	11,152
Liabilities					
Deposits:					
Noninterest-bearing	\$ 5,623,322	\$ —	\$ 5,623,322	\$ —	\$ 5,623,322
Interest-bearing	12,198,138	—	12,173,164	—	12,173,164
Other borrowings	505,223	—	505,390	—	505,390
Securities sold under repurchase agreements	324,154	—	324,118	—	324,118

As of December 31, 2016

	Carrying Amount	Estimated Fair Value			Total
		Level 1	Level 2	Level 3	
(Dollars in thousands)					
Assets					
Cash and due from banks	\$ 436,203	\$ 436,203	\$ —	\$ —	\$ 436,203
Federal funds sold	1,178	1,178	—	—	1,178
Held to maturity securities	9,504,910	—	9,339,455	—	9,339,455
Loans held for sale	26,975	—	26,975	—	26,975
Loans held for investment, net of allowance	9,509,759	—	—	9,533,310	9,533,310
Other real estate owned	15,463	—	15,463	—	15,463
Liabilities					
Deposits:					
Noninterest-bearing	\$ 5,190,973	\$ —	\$ 5,190,973	\$ —	\$ 5,190,973
Interest-bearing	12,116,329	—	12,121,157	—	12,121,157
Other borrowings	990,781	—	991,181	—	991,181
Securities sold under repurchase agreements	320,430	—	320,428	—	320,428

Entities may choose to measure eligible financial instruments at fair value at specified election dates. The fair value measurement option (1) may be applied instrument by instrument, with certain exceptions, (2) is generally irrevocable and (3) is applied only to entire instruments and not to portions of instruments. Unrealized gains and losses on items for which the fair value measurement option has been elected must be reported in earnings at each subsequent reporting date. During the reported periods, the Company had no financial instruments measured at fair value under the fair value measurement option.

The fair value estimates presented herein are based on pertinent information available to management as of the dates indicated. Although management is not aware of any factors that would significantly affect the estimated fair value amounts, such amounts have not been comprehensively revalued for purposes of these financial statements since those dates and, therefore, current estimates of fair value may differ significantly from the amounts presented herein.

The following is a description of valuation methodologies used for assets and liabilities recorded at fair value, non-financial assets and non-financial liabilities, and for estimating fair value for financial instruments not recorded at fair value:

Cash and due from banks—For these short-term instruments, the carrying amount is a reasonable estimate of fair value. The Company classifies the estimated fair value of these instruments as Level 1.

Federal funds sold—For these short-term instruments, the carrying amount is a reasonable estimate of fair value. The Company classifies the estimated fair value of these instruments as Level 1.

Securities—Fair value measurements based upon quoted prices are considered Level 1 inputs. Level 1 securities consist of U.S. Treasury securities and certain equity securities which are included in the available for sale portfolio. For all other available for sale and held to maturity securities, if quoted prices are not available, fair values are measured using Level 2 inputs. For these securities, the Company generally obtains fair value measurements from an independent pricing service. The fair value measurements consider observable data that may include dealer quotes, market spreads, cash flows, the U.S. Treasury yield curve, live trading levels, trade execution data, market consensus prepayment speeds, credit information and the bond's terms and conditions, among other things. The Company reviews the prices supplied by the independent pricing service, as well as their underlying pricing methodologies, for reasonableness.

Securities available for sale are recorded at fair value on a recurring basis.

Loans held for sale—Loans held for sale are carried at the lower of cost or estimated fair value. Fair value for consumer mortgages held for sale is based on commitments on hand from investors or prevailing market prices. As such, the Company classifies loans subjected to nonrecurring fair value adjustments as Level 2.

Loans held for investment—The Company does not record loans at fair value on a recurring basis. As such, valuation techniques discussed herein for loans are primarily for estimating fair value disclosures. However, from time to time, the Company records nonrecurring fair value adjustments to impaired loans to reflect (1) partial write downs that are based on the observable market price or current appraised value of the collateral, or (2) the full charge-off of the loan carrying value. Where appraisals are not available, estimated cash flows are discounted using a rate commensurate with the credit risk associated with those cash flows. Assumptions regarding credit risk, cash flows and discount rates are judgmentally determined using available market information and specific borrower information.

The estimated fair value approximates carrying value for variable-rate loans that reprice frequently and with no significant change in credit risk. The fair value of fixed-rate loans and variable-rate loans which reprice on an infrequent basis is estimated by discounting future cash flows using the current interest rates at which similar loans with similar terms would be made to borrowers of similar credit quality. An overall valuation adjustment is made for specific credit risks as well as general portfolio credit risk. The Company classifies the estimated fair value of loans held for investment as Level 3.

Other real estate owned—Other real estate owned is primarily foreclosed properties securing residential loans and commercial real estate. Foreclosed assets are adjusted to fair value less estimated costs to sell upon transfer of the loans to other real estate owned. Subsequently, these assets are carried at the lower of carrying value or fair value less estimated costs to sell. Other real estate carried at fair value based on an observable market price or a current appraised value is classified by the Company as Level 2. When management determines that the fair value of other real estate requires additional adjustments, either as a result of a non-current appraisal or when there is no observable market price, the Company classifies the other real estate as Level 3.

Deposits—The fair value of demand deposits, savings accounts and certain money market deposits is the amount payable on demand at the reporting date. The fair value of fixed-maturity certificates of deposit is estimated using the rates currently offered for deposits of similar remaining maturities. Deposits fair value measurements utilize Level 2 inputs.

Other borrowings—Rates currently available to the Company for debt with similar terms and remaining maturities are used to estimate the fair value of other borrowings using a discounted cash flows methodology and are measured utilizing Level 2 inputs.

Securities sold under repurchase agreements—The fair value of securities sold under repurchase agreements is the amount payable on demand at the reporting date and are measured utilizing Level 2 inputs.

Off-balance sheet financial instruments—The fair value of commitments to extend credit and standby letters of credit is estimated using the fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreement and the present creditworthiness of the counterparties. The Company has reviewed the unfunded portion of commitments to extend credit as well as standby and other letters of credit, and has determined that the fair value of such financial instruments is not material. The Company classifies the estimated fair value of credit-related financial instruments as Level 3.

8. PREMISES AND EQUIPMENT

Premises and equipment are summarized as follows:

	December 31,	
	2017	2016
	(Dollars in thousands)	
Land	\$ 88,040	\$ 90,696
Buildings	204,922	205,500
Furniture, fixtures and equipment	68,858	65,027
Construction in progress	6,537	643
Total	368,357	361,866
Less accumulated depreciation	(111,292)	(99,783)
Premises and equipment, net	<u>\$ 257,065</u>	<u>\$ 262,083</u>

Depreciation expense was \$12.2 million, \$13.1 million and \$13.0 million for the years ended December 31, 2017, 2016 and 2015, respectively.

9. DEPOSITS

Included in interest-bearing deposits are certificates of deposit in amounts of \$100,000 or more. These certificates and their remaining maturities at December 31, 2017 were as follows (dollars in thousands):

Three months or less	\$ 360,625	27.7%
Over three through six months	291,117	22.4
Over six through 12 months	351,823	27.0
Over 12 months	298,476	22.9
Total	<u>\$ 1,302,041</u>	<u>100.00%</u>

Interest expense for certificates of deposit in excess of \$100,000 was \$10.3 million, \$9.7 million and \$9.6 million for the years ended December 31, 2017, 2016 and 2015, respectively.

As of December 31, 2017, the Company had \$76.9 million of deposits classified as brokered deposits for regulatory purposes, and there are no major concentrations of deposits with any one depositor.

10. OTHER BORROWINGS AND SECURITIES SOLD UNDER REPURCHASE AGREEMENTS

The Company utilizes borrowings to supplement deposits to fund its lending and investment activities. Borrowings consist of funds from the Federal Home Loan Bank ("FHLB") and securities sold under repurchase agreements.

The following table presents the Company's borrowings at December 31, 2017 and 2016:

	December 31,	
	2017	2016
	(Dollars in thousands)	
FHLB advances	\$ 500,000	\$ 985,000
FHLB long-term notes payable	5,223	5,781
Total other borrowings	505,223	990,781
Securities sold under repurchase agreements	324,154	320,430
Total	<u>\$ 829,377</u>	<u>\$ 1,311,211</u>

FHLB advances and long-term notes payable—The Company has an available line of credit with the FHLB of Dallas, which allows the Company to borrow on a collateralized basis. FHLB advances are considered short-term borrowings and used to manage liquidity as needed. Maturing advances are replaced by drawing on available cash, making additional borrowings or through increased customer deposits. At December 31, 2017, the Company had total funds of \$5.77 billion available under this agreement, of which a total amount of \$505.2 million was outstanding at December 31, 2017. FHLB advances were \$500.0 million at December 31, 2017, with a weighted average interest rate of 1.21%. Long-term notes payable were \$5.2 million at December 31, 2017, with a weighted average interest rate of 5.70%. The maturity dates on the FHLB notes payable range from the years 2018 to 2027 and have interest rates ranging from 4.51% to 6.10%.

Securities sold under repurchase agreements with Company customers—At December 31, 2017, the Company had \$324.2 million in securities sold under repurchase agreements compared with \$320.4 million at December 31, 2016, with average rates paid of 0.39% and 0.29% for the years ended December 31, 2017 and 2016, respectively. Repurchase agreements are generally settled on the following business day; however, approximately \$9.8 million of repurchase agreements outstanding at December 31, 2017 have maturity dates ranging from 6 to 24 months. All securities sold under agreements to repurchase are collateralized by certain pledged securities.

11. INCOME TAXES

The components of the provision for federal income taxes are as follows:

	Year Ended December 31,		
	2017	2016	2015
	(Dollars in thousands)		
Current	\$ 123,371	\$ 115,145	\$ 108,550
Deferred	10,534	19,047	34,999
Total	<u>\$ 133,905</u>	<u>\$ 134,192</u>	<u>\$ 143,549</u>

The provision for federal income taxes differs from the amount computed by applying the federal income tax statutory rate of 35% to income before income taxes as follows:

	Year Ended December 31,		
	2017	2016	2015
	(Dollars in thousands)		
Taxes calculated at statutory rate	\$ 142,125	\$ 143,030	\$ 150,568
(Decrease) increase resulting from:			
Excess FMV on restricted stock vesting	(442)	—	—
Tax-exempt interest	(6,724)	(7,234)	(6,351)
Qualified School Construction Bond credit	(1,239)	(1,218)	(1,239)
Non taxable death benefits	(5)	(295)	(60)
BOLI income	(1,901)	(1,982)	(1,917)
Qualified stock options	—	—	2
Leverage lease items	(549)	—	—
State tax, net	106	1,188	1,193
Other, net	1,103	703	1,353
Tax rate change	1,431	—	—
Total	<u>\$ 133,905</u>	<u>\$ 134,192</u>	<u>\$ 143,549</u>

Income tax expense for 2017 was impacted by the adjustment of deferred tax assets and liabilities related to the reduction in the U.S. federal statutory income tax rate to 21% under the Tax Cuts and Jobs Act, which was enacted on December 22, 2017. As a result of the new law, which is more fully discussed below, the Company recognized a net tax expense totaling \$1.4 million, as presented in the table above. During 2017, the Company adopted a new accounting standard that requires the income tax effects associated with stock-based compensation to be recognized as a component of income tax expense. The Company recognized net tax benefits related to stock-based compensation totaling \$442 thousand in 2017, as presented in the table above. See Note 1 - Significant Accounting Policies for additional information related to the accounting for the income tax effects of stock-based compensation.

Year-end deferred taxes are presented in the table below. As a result of the Tax Cuts and Jobs Act enacted on December 22, 2017, deferred taxes as of December 31, 2017 are based on the newly enacted U.S. statutory federal corporate income tax rate of 21%. Deferred taxes as of December 31, 2016 are based on the previously enacted U.S. statutory federal corporate income tax rate of 35%.

	<u>December 31,</u>	
	<u>2017</u>	<u>2016</u>
	<u>(Dollars in thousands)</u>	
Deferred tax assets:		
Loan purchase discounts	\$ 7,297	\$ 20,793
Allowance for credit losses	16,897	28,745
Accrued liabilities	1,476	2,985
Restricted stock	5,640	10,088
Deferred compensation	2,433	4,100
Certificates of Deposit	22	113
Net operating losses	129	424
ORE write-downs	710	—
Investments in partnerships	106	213
Unrealized loss on available for sale securities	30	—
Other	19	162
Total deferred tax assets	<u>34,759</u>	<u>67,623</u>
Deferred tax liabilities:		
Goodwill and core deposit intangibles	(22,664)	(35,813)
Bank premises and equipment	(7,252)	(13,504)
Securities	(494)	(1,517)
Unrealized gain on available for sale securities	—	(760)
Prepaid expenses	(566)	(1,295)
Deferred loan fees and costs	(4,091)	(5,300)
Total deferred tax liabilities	<u>(35,067)</u>	<u>(58,189)</u>
Net deferred tax (liabilities) assets	<u>\$ (308)</u>	<u>\$ 9,434</u>

The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. Management considers the scheduled reversal of deferred tax liabilities, projected future taxable income, and tax planning strategies in making this assessment. Based upon the level of historical taxable income and estimates of future taxable income over the periods for which the deferred tax assets are deductible, management believes it is more likely than not the Company will realize the benefits of these deductible differences at December 31, 2017.

Benefits from tax positions are 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 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 are 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 are derecognized in the first subsequent financial reporting period in which that threshold is no longer met. The Company had no tax positions at December 31, 2017 or December 31, 2016 that did not meet the more-likely-than-not recognition threshold. ASC Topic 740 "Income Taxes" also provides guidance on the accounting for and disclosure of unrecognized tax benefits, interest and penalties. The Company's policy for recording interest and penalties associated with audits is to record such items as a component of income before taxes. Penalties are recorded in other (gains) losses and interest paid or received is recorded in interest expense or interest income, respectively, in the consolidated statement of income. As of December 31, 2017 and 2016, the Company has not accrued any interest and penalties related to unrecognized tax benefits. The Company has identified its federal tax return and its state tax returns in Texas, Oklahoma and Arkansas as "major" tax jurisdictions, as defined. The periods subject to examination for the Company's federal return are the 2014 through 2017 tax years. The Company has assumed to net operating loss

carryforwards, “acquired NOLs”, through its acquisitions. The tax periods of the acquired entities from which these acquired NOLs originated are considered open years for purposes of adjusting the amount of the acquired NOLs used in the Company’s open years. Net operating loss carryforwards expire in tax years beginning in 2028 through 2031.

Tax Cuts and Jobs Act. The Tax Cuts and Jobs Act was enacted on December 22, 2017. Among other things, the new law (i) establishes a new, flat federal statutory corporate income tax rate of 21%, (ii) eliminates the corporate alternative minimum tax and allows the use of any such carryforwards to offset regular tax liability for any taxable year, (iii) limits the deduction for net interest expense incurred by U.S. corporations, (iv) allows businesses to immediately expense, for tax purposes, the cost of new investments in certain qualified depreciable assets, (v) eliminates or reduces certain deductions related to meals and entertainment expenses, (vi) modifies the limitation on excessive employee remuneration to eliminate the exception for performance-based compensation and clarifies the definition of a covered employee and (vii) limits the deductibility of deposit insurance premiums. The Tax Cuts and Jobs Act also significantly changes U.S. tax law related to foreign operations, however, such changes do not currently impact the Company. As stated above, as a result of the enactment of the Tax Cuts and Jobs Act on December 22, 2017, the Company remeasured its deferred tax assets and liabilities based upon the newly enacted U.S. statutory federal corporate income tax rate of 21%, which is the tax rate at which these assets and liabilities are expected to reverse in the future. The Company is still analyzing certain aspects of the new law and refining its calculations, which could affect the measurement of these deferred tax assets and liabilities or give rise to new deferred tax amounts. The Company recognized a one-time non-cash income tax expense related to the remeasurement of its deferred tax assets and liabilities totaling \$1.4 million during the year ended December 31, 2017.

12. STOCK INCENTIVE PROGRAMS

At December 31, 2017, the Company had two stock-based employee compensation plans with awards outstanding. One of these plans has expired and therefore no additional awards may be issued under that plan. The Company accounts for stock-based employee compensation plans using the fair value-based method of accounting. The Company recognized stock-based compensation expense of \$6.9 million, \$9.5 million and \$11.1 million for the years ended December 31, 2017, 2016 and 2015, respectively. There was approximately \$2.4 million, \$3.3 million and \$3.9 million of income tax benefit recorded for the stock-based compensation expense for the same periods, respectively.

In December 2004, Bancshares’ Board of Directors established the Prosperity Bancshares, Inc. 2004 Stock Incentive Plan (the “2004 Plan”), which was approved by Bancshares’ shareholders on February 23, 2005. The 2004 Plan authorized the issuance of up to 1,250,000 shares of common stock upon the exercise of options granted under the 2004 Plan or upon the grant or exercise, as the case may be, of other awards granted under the 2004 Plan. The 2004 Plan provided for grants of incentive and nonqualified stock options to employees and nonqualified stock options to directors who are not employees. The 2004 Plan also provided for grants of shares of restricted stock, stock appreciation rights, phantom stock awards and performance awards on substantially similar terms. A total of 191,625 options and 793,218 shares of restricted stock have been granted under the 2004 Plan as of December 31, 2017. No options granted under the 2004 Plan were outstanding at December 31, 2017. The 2004 Plan has expired and therefore no additional shares may be issued under the 2004 Plan.

On February 22, 2012, Bancshares’ Board of Directors adopted the Prosperity Bancshares, Inc. 2012 Stock Incentive Plan (the “2012 Plan”), which was approved by Bancshares’ shareholders on April 17, 2012. The 2012 Plan authorizes the issuance of up to 1,250,000 shares of common stock upon the exercise of options granted under the 2012 Plan or pursuant to the grant or exercise, as the case may be, of other awards granted under the 2012 Plan, including restricted stock, stock appreciation rights, phantom stock awards and performance awards. A total of 359,133 shares of restricted stock have been granted under the 2012 Plan as of December 31, 2017.

Stock Options

Stock options are issued at the current market price on the date of the grant, subject to a pre-determined vesting period with a contractual term of 10 years. Options assumed in connection with acquisitions have contractual terms as established in the original option grant agreements entered into prior to acquisition. The fair value of stock options granted is estimated at the date of grant using the Black-Scholes option-pricing model. The Black-Scholes pricing model utilizes certain assumptions including expected life of the option, risk free interest rate, volatility and dividend yield. Stock-based compensation expense is recognized ratably over the requisite service period for all awards. There were no options issued for the years ended December 31, 2017, 2016 and 2015 and the Company had no options outstanding at December 31, 2017.

A summary of changes in outstanding vested and unvested options during the three-year period ended December 31, 2017 is set forth below:

	<u>Number of Options</u> (In thousands)	<u>Weighted Average Exercise Price</u>	<u>Weighted Average Contractual Term</u> (In years)	<u>Aggregate Intrinsic Value</u> (In thousands)
Options outstanding, December 31, 2014	53	\$ 27.68	2.69	\$ 1,473
Options granted	—	—		
Options forfeited	(15)	27.15		
Options exercised	(9)	29.92		
Options outstanding, December 31, 2015	29	\$ 32.14	2.60	453
Options granted	—	—		
Options forfeited	—	—		
Options exercised	(24)	32.65		
Options outstanding, December 31, 2016	5	\$ 29.69	2.75	210
Options granted	—	—		
Options forfeited	—	—		
Options exercised	(5)	29.69		
Options outstanding, December 31, 2017	—	\$ —	—	\$ —
Shares vested or expected to vest, December 31, 2017	—	\$ —	—	\$ —
Shares exercisable, December 31, 2017	—	\$ —	—	\$ —

The total intrinsic value of the options exercised during the years ended December 31, 2017 and 2016 was \$202 thousand and \$931 thousand, respectively. No options vested during the year ended December 31, 2017, as all options vested prior to 2017. There were no unvested options forfeited during the years ended December 31, 2017 and 2016.

The Company received \$148 thousand, \$778 thousand and \$290 thousand in cash from the exercise of stock options during the years ended December 31, 2017, 2016 and 2015, respectively. There was no tax benefit realized from exercises of the stock-based compensation arrangements during the years ended December 31, 2017, 2016 and 2015.

Restricted Stock

The Company has granted shares of restricted stock pursuant to the 2004 and 2012 Plans. These shares of restricted stock generally vest over a period of one to five years. The Company accounts for restricted stock grants by recording the fair value of the grant as compensation expense over the vesting period. Compensation expense related to restricted stock was \$6.9 million, \$9.5 million and \$11.1 million for the years ended December 31, 2017, 2016 and 2015, respectively.

A summary of the status of nonvested shares of restricted stock as of December 31, 2017, and changes during the year then ended is as follows:

	Number of Shares	Weighted Average Grant Date Fair Value
	(Shares in thousands)	
Nonvested share awards outstanding, December 31, 2016	503	\$ 45.35
Share awards granted	21	66.52
Unvested share awards forfeited	(26)	60.99
Share awards vested	(80)	53.90
Nonvested share awards outstanding, December 31, 2017	<u>418</u>	<u>\$ 56.53</u>

The total fair value of restricted stock awards that fully vested during the year ended December 31, 2017 was \$5.4 million.

As of December 31, 2017, there was \$28.8 million of total unrecognized compensation expense related to stock-based compensation arrangements. That cost is expected to be recognized over a weighted average period of 1.94 years.

13. OTHER NONINTEREST INCOME AND EXPENSE

Other noninterest income and expense totals are more fully detailed in the following tables. Any components of these totals exceeding 1% of the aggregate of total net interest income and total noninterest income for any of the years presented, as well as amounts the Company elected to present, are stated separately.

	Years Ended December 31,		
	2017	2016	2015
	(Dollars in thousands)		
Other noninterest income			
Banking related service fees	\$ 6,107	\$ 4,825	\$ 4,690
Bank Owned Life Insurance (BOLI)	5,430	5,663	5,548
Rental income	1,946	2,484	2,594
Other	8,492	7,893	10,930
Total	<u>\$ 21,975</u>	<u>\$ 20,865</u>	<u>\$ 23,762</u>
Other noninterest expense			
Advertising	\$ 2,932	\$ 2,845	\$ 2,974
Losses	2,519	2,439	3,361
Printing and supplies	2,035	2,334	2,158
Professional and legal fees	4,843	4,346	3,044
Property taxes	7,424	7,770	7,028
Travel and development	4,398	4,455	4,434
Other	9,578	9,089	9,577
Total	<u>\$ 33,729</u>	<u>\$ 33,278</u>	<u>\$ 32,576</u>

14. PROFIT SHARING PLAN

The Company has adopted a profit sharing plan pursuant to Section 401(k) of the Internal Revenue Code (the "Code"), whereby the participants may contribute a percentage of their compensation as permitted under the Code. Matching contributions are made at the discretion of the Company. Presently, the Company matches 50% of an employee's contributions, up to 15% of such employee's compensation, not to exceed the maximum allowable pursuant to the Code and excluding catch-up contributions. Such matching contributions were approximately \$4.3 million, \$4.4 million and \$4.3 million for the years ended December 31, 2017, 2016 and 2015, respectively.

15. OFF-BALANCE SHEET ARRANGEMENTS, COMMITMENTS AND CONTINGENCIES

The following table summarizes the Company's contractual obligations and other commitments to make future payments as of December 31, 2017 (other than deposit obligations and securities sold under repurchase agreements). The Company's future cash payments associated with its contractual obligations pursuant to its FHLB notes payable and operating leases as of December 31, 2017 are summarized below. The future interest payments were calculated using the current rate in effect at December 31, 2017. Payments for FHLB notes payable include interest of \$364 thousand that will be paid over the future periods. Payments related to leases are based on actual payments specified in underlying contracts.

	<u>1 year or less</u>	<u>More than 1 year but less than 3 years</u>	<u>3 years or more but less than 5 years</u>	<u>5 years or more</u>	<u>Total</u>
	(Dollars in thousands)				
Federal Home Loan Bank notes payable	\$ 504,330	\$ 980	\$ 125	\$ 152	\$ 505,587
Operating leases	5,019	7,781	4,106	6,256	23,162
Total	<u>\$ 509,349</u>	<u>\$ 8,761</u>	<u>\$ 4,231</u>	<u>\$ 6,408</u>	<u>\$ 528,749</u>

Off-Balance Sheet Items

In the normal course of business, the Company enters into various transactions, which, in accordance with GAAP, are not included in its consolidated balance sheets. The Company enters into these transactions to meet the financing needs of its customers. These transactions include commitments to extend credit and standby letters of credit, which involve, to varying degrees, elements of credit risk and interest rate risk in excess of the amounts recognized in the consolidated balance sheets.

The Company's commitments associated with outstanding standby letters of credit and commitments to extend credit expiring by period as of December 31, 2017 are summarized below.

	<u>1 year or less</u>	<u>More than 1 year but less than 3 years</u>	<u>3 years or more but less than 5 years</u>	<u>5 years or more</u>	<u>Total</u>
	(Dollars in thousands)				
Standby letters of credit	\$ 64,799	\$ 7,133	\$ 488	\$ —	\$ 72,420
Commitments to extend credit	908,606	394,752	211,191	864,275	2,378,824
Total	<u>\$ 973,405</u>	<u>\$ 401,885</u>	<u>\$ 211,679</u>	<u>\$ 864,275</u>	<u>\$ 2,451,244</u>

Standby Letters of Credit. Standby letters of credit are written conditional commitments issued by the Company to guarantee the payment by or performance of a customer to a third party. In the event the customer does not perform in accordance with the terms of the agreement with the third party, the Company would be required to fund the commitment. The maximum potential amount of future payments the Company could be required to make is represented by the contractual amount of the commitment. If the commitment is funded, the Company would be entitled to seek recovery from the customer. The Company's policies generally require that standby letter of credit arrangements contain security and debt covenants similar to those contained in loan agreements.

Commitments to Extend Credit. The Company enters into contractual commitments to extend credit, normally with fixed expiration dates or termination clauses, at specified rates and for specific purposes. Substantially all of the Company's commitments to extend credit are contingent upon customers maintaining specific credit standards at the time of loan funding. The Company minimizes its exposure to loss under these commitments by subjecting them to credit approval and monitoring procedures. Management assesses the credit risk associated with certain commitments to extend credit in determining the level of the allowance for credit losses. Since many of the commitments are expected to expire without being fully drawn upon, the total commitment amounts disclosed above do not necessarily represent future cash funding requirements.

At December 31, 2017, \$225.2 million of commitments to extend credit and standby letters of credit have fixed rates ranging from 1.6% to 21.0%.

The Company evaluates customer creditworthiness on a case-by-case basis. The amount of collateral obtained, if considered necessary by the Company upon extension of credit, is based on management's credit evaluation of the customer.

Leases—The following table presents a summary of non-cancelable future operating lease commitments as of December 31, 2017 (dollars in thousands):

2018	\$ 5,019
2019	4,345
2020	3,436
2021	2,353
2022	1,753
Thereafter	<u>6,256</u>
	<u>\$ 23,162</u>

It is expected that in the normal course of business, expiring leases will be renewed or replaced by leases on other property or equipment.

Rent expense under all noncancelable operating lease obligations aggregated approximately \$6.7 million for the year ended December 31, 2017, \$7.4 million for the year ended December 31, 2016 and \$7.4 million for the year ended December 31, 2015.

Litigation—The Company and the Bank are defendants, from time to time, in legal actions arising from transactions conducted in the ordinary course of business. After consultations with legal counsel, the Company and the Bank believe that the ultimate liability, if any, arising from such actions will not have a material adverse effect on their financial statements.

16. OTHER COMPREHENSIVE (LOSS) INCOME

	For the Years Ended December 31,								
	2017			2016			2015		
	Before Tax Amount	Tax Benefit	Net of Tax Amount	Before Tax Amount	Tax Benefit	Net of Tax Amount	Before Tax Amount	Tax Benefit	Net of Tax Amount
Other comprehensive loss:									
Securities available for sale:									
Change in unrealized gain during period	\$(2,314)	\$ 790	\$(1,524)	\$ (967)	\$ 338	\$ (629)	\$(2,599)	\$ 910	\$(1,689)
Total securities available for sale	<u>(2,314)</u>	<u>790</u>	<u>(1,524)</u>	<u>(967)</u>	<u>338</u>	<u>(629)</u>	<u>(2,599)</u>	<u>910</u>	<u>(1,689)</u>
Total other comprehensive loss	<u>\$(2,314)</u>	<u>\$ 790</u>	<u>\$(1,524)</u>	<u>\$ (967)</u>	<u>\$ 338</u>	<u>\$ (629)</u>	<u>\$(2,599)</u>	<u>\$ 910</u>	<u>\$(1,689)</u>

Activity in accumulated other comprehensive income, net of tax, was as follows:

	<u>Securities Available for Sale</u>	<u>Accumulated Other Comprehensive Income</u>
	(Dollars in thousands)	
Balance at January 1, 2017	\$ 1,411	\$ 1,411
Other comprehensive loss	(1,524)	(1,524)
Balance at December 31, 2017	<u>\$ (113)</u>	<u>\$ (113)</u>
Balance at January 1, 2016	\$ 2,040	\$ 2,040
Other comprehensive loss	(629)	(629)
Balance at December 31, 2016	<u>\$ 1,411</u>	<u>\$ 1,411</u>
Balance at January 1, 2015	\$ 3,729	\$ 3,729
Other comprehensive loss	(1,689)	(1,689)
Balance at December 31, 2015	<u>\$ 2,040</u>	<u>\$ 2,040</u>

17. REGULATORY MATTERS

The Company and the Bank are subject to various regulatory capital requirements administered by the federal banking agencies. Any institution that fails to meet its minimum capital requirements is subject to actions by regulators that could have a direct material effect on the Company's financial statements. Under the capital adequacy guidelines and the regulatory framework for prompt corrective action, the Bank must meet specific capital guidelines based on the Bank's assets, liabilities and certain off-balance-sheet items as calculated under regulatory accounting practices. The Company's and the Bank's capital amounts and the Bank's classification under the regulatory framework for prompt corrective action are also subject to qualitative judgments by the regulators about the components, risk weightings and other factors.

The Basel III Capital Rules adopted by the federal regulatory authorities in 2013 substantially revised the risk-based capital requirements applicable to the Company and the Bank. The Basel III Capital Rules became effective for the Company and the Bank on January 1, 2015, subject to a phase-in period for certain provisions. Among other things, the Basel III Capital Rules introduced a new capital measure called "Common Equity Tier 1" ("CET1"), which is a comparison of the sum of certain equity capital components to total risk-weighted assets, and revised the risk-weighting approach of the capital ratios with a more risk-sensitive approach that expanded the risk-weighting categories from the previous Basel I derived categories to a much larger and more risk-sensitive number of categories, depending on the nature of the assets.

To meet the capital adequacy requirements, the Company and the Bank must maintain minimum capital amounts and ratios of CET1, Tier 1 and Total capital to risk weighted assets, and of Tier 1 capital to adjusted quarterly average assets as defined in the regulations. As of December 31, 2017, the Company and the Bank met all capital adequacy requirements to which they were subject.

The Basel III Capital Rules require a "capital conservation buffer," composed entirely of CET1, in addition to the minimum risk-weighted asset capital ratios. The implementation of the capital conservation buffer began on January 1, 2016 at the 0.625% level and is being phased in over a four-year period (increasing by that amount on each subsequent January 1, until it reaches 2.5% on January 1, 2019). The required phase-in buffer during 2017 was 1.25%.

The CET1, Tier 1 and total capital ratios are calculated by dividing the respective capital amounts by risk weighted assets. Risk weighted assets include total assets, excluding goodwill and other intangible assets, allocated by risk weight category, and certain off-balance-sheet items. The leverage ratio is calculated by dividing Tier 1 capital by adjusted quarterly average total assets, excluding goodwill and other intangible assets.

As of December 31, 2017, the most recent notification from the FDIC categorized the Bank as “well capitalized” under the regulatory framework for prompt corrective action. There have been no conditions or events since that notification which management believes have changed the Bank’s category. To be categorized as well capitalized the Bank must maintain minimum CET1 risk-based, Tier 1 risk-based, total risk-based and Tier 1 leverage ratios as set forth in the table below.

The following is a summary of the Company’s and the Bank’s capital ratios at December 31, 2017 and 2016:

	<u>Actual</u>		<u>Minimum Required For Capital Adequacy Purposes</u>		<u>Minimum Required Plus Capital Conservation Buffer for 2017</u>		<u>To Be Categorized As Well Capitalized Under Prompt Corrective Action Provisions</u>	
	<u>Amount</u>	<u>Ratio</u>	<u>Amount</u>	<u>Ratio</u>	<u>Amount</u>	<u>Ratio</u>	<u>Amount</u>	<u>Ratio</u>
(Dollars in thousands)								
CONSOLIDATED:								
As of December 31, 2017 ⁽¹⁾								
CET1 Capital (to Risk Weighted Assets)	\$ 1,898,009	15.08%	\$ 566,568	4.50%	\$ 723,948	5.750%	N/A	N/A
Tier 1 Capital (to Risk Weighted Assets)	1,898,009	15.08%	755,424	6.00%	912,805	7.250%	N/A	N/A
Total Capital (to Risk Weighted Assets)	1,982,051	15.74%	1,007,233	8.00%	1,164,613	9.250%	N/A	N/A
Tier 1 Capital (to Average Tangible Assets)	1,898,009	9.31%	815,633	4.00%	815,633	4.000%	N/A	N/A
As of December 31, 2016 ⁽¹⁾								
CET1 Capital (to Risk Weighted Assets)	\$ 1,721,055	14.48%	\$ 534,852	4.50%	\$ 609,136	5.125%	N/A	N/A
Tier 1 Capital (to Risk Weighted Assets)	1,721,055	14.48%	713,135	6.00%	787,420	6.625%	N/A	N/A
Total Capital (to Risk Weighted Assets)	1,806,382	15.20%	950,847	8.00%	1,025,132	8.625%	N/A	N/A
Tier 1 Capital (to Average Tangible Assets)	1,721,055	8.68%	793,457	4.00%	793,457	4.000%	N/A	N/A
BANK ONLY:								
As of December 31, 2017 ⁽¹⁾								
CET1 Capital (to Risk Weighted Assets)	\$ 1,884,811	14.98%	\$ 566,260	4.50%	\$ 723,554	5.750%	\$ 817,931	6.50%
Tier 1 Capital (to Risk Weighted Assets)	1,884,811	14.98%	755,013	6.00%	912,308	7.250%	1,006,684	8.00%
Total Capital (to Risk Weighted Assets)	1,968,852	15.65%	1,006,684	8.00%	1,163,979	9.250%	1,258,355	10.00%
Tier 1 Capital (to Average Tangible Assets)	1,884,811	9.25%	815,199	4.00%	815,199	4.000%	1,018,999	5.00%
As of December 31, 2016 ⁽¹⁾								
CET1 Capital (to Risk Weighted Assets)	\$ 1,704,620	14.35%	\$ 534,392	4.50%	\$ 608,613	5.125%	\$ 771,899	6.50%
Tier 1 Capital to Risk Weighted Assets)	1,704,620	14.35%	712,522	6.00%	786,743	6.625%	950,030	8.00%
Total Capital (to Risk Weighted Assets)	1,789,946	15.07%	950,030	8.00%	1,024,251	8.625%	1,187,537	10.00%
Tier 1 Capital (to Average Tangible Assets)	1,704,620	8.60%	793,006	4.00%	793,006	4.000%	991,257	5.00%

(1) Calculated pursuant to the phase-in provisions of the Basel III Capital Rules.

Dividends paid by Bancshares and the Bank are subject to restrictions by certain regulatory agencies. Dividends declared to be paid by Bancshares during the years ended December 31, 2017, 2016 and 2015 were \$95.9 million, \$86.2 million and \$78.3 million, respectively. Dividends paid by the Bank to Bancshares during the years ended December 31, 2017, 2016 and 2015 were \$95.0 million, \$141.5 million and \$258.3 million, respectively.

18. PARENT COMPANY ONLY FINANCIAL STATEMENTS

PROSPERITY BANCSHARES, INC. (Parent Company Only)

CONDENSED BALANCE SHEETS

	December 31,	
	2017	2016
	(Dollars in thousands)	
ASSETS		
Cash	\$ 3,528	\$ 1,950
Investment in subsidiary	3,806,973	3,621,893
Goodwill	3,982	3,982
Other assets	9,671	14,486
TOTAL	<u>\$ 3,824,154</u>	<u>\$ 3,642,311</u>
LIABILITIES AND SHAREHOLDERS' EQUITY		
LIABILITIES:		
Accrued interest payable and other liabilities	\$ —	\$ —
Total liabilities	—	—
SHAREHOLDERS' EQUITY:		
Common stock	69,491	69,491
Capital surplus	2,035,219	2,028,129
Retained earnings	1,719,557	1,543,280
Unrealized (loss) gain on available for sale securities, net of tax benefit	(113)	1,411
Total shareholders' equity	<u>3,824,154</u>	<u>3,642,311</u>
TOTAL	<u>\$ 3,824,154</u>	<u>\$ 3,642,311</u>

PROSPERITY BANCSHARES, INC.
(Parent Company Only)
CONDENSED STATEMENTS OF INCOME

	For the Years Ended December 31,		
	2017	2016	2015
	(Dollars in thousands)		
OPERATING INCOME:			
Dividends from subsidiary	\$ 95,000	\$ 141,456	\$ 258,250
Other income	32	34	69
Total income	95,032	141,490	258,319
OPERATING EXPENSE:			
Junior subordinated debentures interest expense	—	37	791
Stock based compensation expense (includes restricted stock)	6,942	9,547	11,095
Other expenses	597	613	526
Total operating expense	7,539	10,197	12,412
INCOME BEFORE INCOME TAX BENEFIT AND EQUITY IN UNDISTRIBUTED EARNINGS OF SUBSIDIARIES	87,493	131,293	245,907
FEDERAL INCOME TAX (EXPENSE) BENEFIT	(1,932)	3,568	4,331
INCOME BEFORE EQUITY IN UNDISTRIBUTED EARNINGS OF SUBSIDIARIES	85,561	134,861	250,238
EQUITY IN UNDISTRIBUTED EARNINGS OF SUBSIDIARIES	186,604	139,605	36,408
NET INCOME	\$ 272,165	\$ 274,466	\$ 286,646

PROSPERITY BANCSHARES, INC.
(Parent Company Only)

CONDENSED STATEMENTS OF COMPREHENSIVE INCOME

	For the Years Ended December 31,		
	2017	2016	2015
	(Dollars in thousands)		
Net income	\$ 272,165	\$ 274,466	\$ 286,646
Other comprehensive loss, before tax:			
Securities available for sale:			
Change in unrealized gain during period	(2,314)	(967)	(2,599)
Total other comprehensive loss	(2,314)	(967)	(2,599)
Deferred tax benefit related to other comprehensive loss	790	338	910
Other comprehensive loss, net of tax	(1,524)	(629)	(1,689)
Comprehensive income	<u>\$ 270,641</u>	<u>\$ 273,837</u>	<u>\$ 284,957</u>

PROSPERITY BANCSHARES, INC.
(Parent Company Only)
CONDENSED STATEMENTS OF CASH FLOWS

	<u>For the Years Ended December 31,</u>		
	<u>2017</u>	<u>2016</u>	<u>2015</u>
	(Dollars in thousands)		
CASH FLOWS FROM OPERATING ACTIVITIES:			
Net income	\$ 272,165	\$ 274,466	\$ 286,646
Adjustments to reconcile net income to net cash provided by operating activities:			
Equity in undistributed earnings of subsidiaries	(186,604)	(139,605)	(36,408)
Stock based compensation expense (includes restricted stock)	6,942	9,547	11,095
Decrease in other assets	4,815	41	3,298
Decrease in accrued interest payable and other liabilities	—	—	(309)
Net cash provided by operating activities	<u>97,318</u>	<u>144,449</u>	<u>264,322</u>
CASH FLOWS FROM INVESTING ACTIVITIES:			
Cash paid for acquisitions	—	(39,006)	—
Cash acquired from acquisitions	—	72	—
Net cash used in investing activities	<u>—</u>	<u>(38,934)</u>	<u>—</u>
CASH FLOWS FROM FINANCING ACTIVITIES:			
Redemption of junior subordinated debentures	—	(7,217)	(167,531)
Proceeds from stock option exercises	148	778	290
Repurchase of common stock	—	(51,057)	—
Payments of cash dividends	(95,888)	(86,226)	(78,258)
Net cash used in financing activities	<u>(95,740)</u>	<u>(143,722)</u>	<u>(245,499)</u>
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	1,578	(38,207)	18,823
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	<u>1,950</u>	<u>40,157</u>	<u>21,334</u>
CASH AND CASH EQUIVALENTS, END OF PERIOD	<u><u>\$ 3,528</u></u>	<u><u>\$ 1,950</u></u>	<u><u>\$ 40,157</u></u>