

FIRST FINANCIAL BANKSHARES INC  
Form 10-Q  
October 31, 2008

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549  
FORM 10-Q  
QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF  
THE SECURITIES EXCHANGE ACT OF 1934  
For the quarterly period ended September 30, 2008  
Commission file number 0-7674  
FIRST FINANCIAL BANKSHARES, INC.  
(Exact name of registrant as specified in its charter)**

Texas

75-0944023

(State or other jurisdiction of incorporation  
or organization)

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

**400 Pine Street, Abilene, Texas 79601**  
(Address of principal executive offices)  
(Zip Code)  
**(325) 627-7155**

**(Registrant's telephone number, including area code)**

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

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

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes  No   
Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of October 30, 2008:

Class	Number of Shares Outstanding
Common Stock, \$0.01 par value per share	20,793,647

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**CAUTIONARY STATEMENT REGARDING  
FORWARD-LOOKING STATEMENTS**

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

General economic conditions, including our local and national real estate markets;

Volatility and disruption in national and international financial markets;

Legislative and regulatory actions and reforms;

Political instability;

The ability of the Federal government to deal with the national economic slowdown;

Competition from other financial institutions and financial holding companies;

The effects of and changes in trade, monetary and fiscal policies and laws, including interest rate policies of the Federal Reserve Board;

Changes in the demand for loans;

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

Soundness of other financial institutions with which we have transactions;

Inflation, interest rate, market and monetary fluctuations;

Changes in consumer spending, borrowing and savings habits;

Legislative changes and other developments in student loan originations and sales;

Anticipated increases in FDIC deposit insurance assessments;

Our ability to attract deposits;

Consequences of continued bank mergers and acquisitions in our market area, resulting in fewer but much larger and stronger competitors;

Expansion of operations, including branch openings, new product offerings and expansion into new markets;

Acquisitions and integration of acquired businesses; and

Acts of God or of war or terrorism.

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

**PART I**  
**FINANCIAL INFORMATION**

**Item 1. Financial Statements.**

The consolidated balance sheets of First Financial Bankshares, Inc. at September 30, 2008 and 2007 and December 31, 2007, and the consolidated statements of earnings and comprehensive earnings for the three and nine months ended September 30, 2008 and 2007, and changes in shareholders' equity and cash flows for the nine months ended September 30, 2008 and 2007, follow on pages 4 through 8.

**FIRST FINANCIAL BANKSHARES, INC. AND SUBSIDIARIES**  
**CONSOLIDATED BALANCE SHEETS**

	2008	September, 2007 (Unaudited)	December 31, 2007
<b>ASSETS</b>			
Cash and due from banks	\$ 113,067,036	\$ 105,789,167	\$ 163,559,942
Federal funds sold	55,675,000	49,955,000	99,450,000
Interest-bearing deposits in banks	3,922,022	1,808,313	1,878,434
 Total cash and cash equivalents	 172,664,058	 157,552,480	 264,888,376
Investment securities:			
Securities held-to-maturity (market value of \$24,271,778, \$27,275,637 and \$27,249,367 at September 30, 2008 and 2007 and December 31, 2007, respectively)	23,575,687	26,555,645	26,415,040
Securities available-for-sale, at fair value	1,134,632,127	1,096,669,451	1,094,496,701
Trading securities, at fair value	95,737,085		
 Total investment securities	 1,253,944,899	 1,123,225,096	 1,120,911,741
Loans			
Held for investment	1,522,416,156	1,423,426,527	1,492,223,308
Held for sale	45,310,536	33,710,683	35,796,281
	1,567,726,692	1,457,137,210	1,528,019,589
Less: Allowance for loan losses	(20,048,219)	(16,728,185)	(17,461,514)
 Net loans	 1,547,678,473	 1,440,409,025	 1,510,558,075
Bank premises and equipment, net			
Intangible assets	65,531,388	61,430,954	61,670,159
Other assets	64,290,370	65,567,251	65,207,169
	44,478,758	46,305,857	47,073,892
 <b>TOTAL ASSETS</b>	 <b>\$ 3,148,587,946</b>	 <b>\$ 2,894,490,663</b>	 <b>\$ 3,070,309,412</b>
 <b>LIABILITIES</b>			
Noninterest-bearing deposits	\$ 769,114,908	\$ 657,861,485	\$ 739,180,980
Interest-bearing deposits	1,794,437,339	1,724,739,681	1,806,902,038
 Total deposits	 2,563,552,247	 2,382,601,166	 2,546,083,018
Dividends payable			
Short-term borrowings	7,069,840	5,784,087	6,645,590
Other liabilities	196,838,548	168,675,974	166,266,426
	30,710,467	15,427,525	15,818,916

Total liabilities	2,798,171,102	2,572,488,752	2,734,813,950
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**COMMITMENTS AND CONTINGENCIES****SHAREHOLDERS EQUITY**

Common stock \$0.01 par value, authorized 40,000,000 shares; 20,793,647, 20,764,492, and 20,766,848 shares issued at September 30, 2008 and 2007 and December 31, 2007, respectively	207,936	207,645	207,669
Capital surplus	267,927,363	267,019,351	267,136,338
Retained earnings	83,669,522	58,473,397	64,333,921
Treasury stock (shares at cost: 158,846, 155,822, and 155,415 at September 30, 2008 and 2007, and December 31, 2007, respectively)	(3,410,582)	(3,130,476)	(3,170,304)
Deferred compensation	3,410,582	3,130,476	3,170,304
Accumulated other comprehensive income (loss)	(1,387,977)	(3,698,482)	3,817,534
 Total shareholders equity	 350,416,844	 322,001,911	 335,495,462

**TOTAL LIABILITIES AND SHAREHOLDERS  
EQUITY**

	\$ 3,148,587,946	\$ 2,894,490,663	\$ 3,070,309,412
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See notes to consolidated financial statements.

**FIRST FINANCIAL BANKSHARES, INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF EARNINGS (UNAUDITED)**

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
<b>INTEREST INCOME</b>				
Interest and fees on loans	\$ 25,772,830	\$ 28,894,071	\$ 79,814,100	\$ 84,822,056
Interest on investment securities:				
Taxable	9,269,433	9,842,029	27,657,940	29,254,249
Exempt from federal income tax	3,488,941	3,163,144	10,275,868	9,138,071
Trading securities	352,487		457,246	
Interest on federal funds sold and interest-bearing deposits in banks	334,057	656,389	1,709,881	2,672,656
Total interest income	39,217,748	42,555,633	119,915,035	125,887,032
<b>INTEREST EXPENSE</b>				
Interest on deposits	7,312,185	13,028,181	26,891,154	39,325,569
Other	506,335	1,787,913	1,774,802	5,002,844
Total interest expense	7,818,520	14,816,094	28,665,956	44,328,413
<b>NET INTEREST INCOME</b>				
Provision for loan losses	31,399,228	27,739,539	91,249,079	81,558,619
	1,764,547	475,000	4,273,798	954,672
<b>NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES</b>				
	29,634,681	27,264,539	86,975,281	80,603,947
<b>NONINTEREST INCOME</b>				
Trust fees	2,501,240	2,158,161	7,229,598	6,530,496
Service charges on deposit accounts	5,808,933	6,074,041	17,005,316	16,766,280
ATM and credit card fees	2,328,072	1,938,018	6,623,132	5,515,828
Real estate mortgage operations	648,682	1,021,529	2,017,915	2,623,500
Net gain (loss) on sale of securities	146,269	(4,928)	705,326	79,854
Net gain on sale of student loans	2,665	36,147	1,717,260	1,816,280
Net gain on sale of other real estate	26,680	13,044	115,905	47,680
Other	828,093	754,676	2,643,717	2,502,813
Total noninterest income	12,290,634	11,990,688	38,058,169	35,882,731
<b>NONINTEREST EXPENSE</b>				
Salaries and employee benefits	12,451,597	11,722,663	37,544,690	34,610,047
Net occupancy expense	1,826,387	1,503,791	5,069,110	4,357,980
Equipment expense	1,890,550	1,848,436	5,602,657	5,405,588
Printing, stationery and supplies	482,208	552,456	1,432,994	1,544,287
Correspondent bank service charges	303,287	269,456	868,380	888,267

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Amortization of intangible assets	302,038	374,720	916,799	1,134,848
Other expenses	6,128,635	5,711,097	17,620,552	16,155,541
Total noninterest expense	23,384,702	21,982,619	69,055,182	64,096,558
<b>EARNINGS BEFORE INCOME TAXES</b>				
Income tax expense	18,540,613	17,272,608	55,978,268	52,390,120
	5,179,134	5,021,823	15,852,974	15,406,629
<b>NET EARNINGS</b>	\$ 13,361,479	\$ 12,250,785	\$ 40,125,294	\$ 36,983,491
<b>EARNINGS PER SHARE, BASIC</b>	\$ 0.64	\$ 0.59	\$ 1.93	\$ 1.78
<b>EARNINGS PER SHARE, ASSUMING DILUTION</b>	\$ 0.64	\$ 0.59	\$ 1.93	\$ 1.77
<b>DIVIDENDS PER SHARE</b>	\$ 0.34	\$ 0.32	\$ 1.00	\$ 0.94

See notes to consolidated financial statements.



**FIRST FINANCIAL BANKSHARES, INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF COMPREHENSIVE EARNINGS (UNAUDITED)**

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
<b>NET EARNINGS</b>	\$ 13,361,479	\$ 12,250,785	\$ 40,125,294	\$ 36,983,491
<b>OTHER ITEMS OF COMPREHENSIVE EARNINGS:</b>				
Change in unrealized gain (loss) on investment securities available-for-sale, before income taxes	221,754	14,889,823	(7,303,154)	4,515,857
Reclassification adjustment for realized (gains) losses on investment securities included in net earnings, before income tax	(146,269)	4,928	(705,326)	(79,854)
Total other items of comprehensive earnings	75,485	14,894,751	(8,008,480)	4,436,003
Income tax benefit (expense) related to other items of comprehensive earnings	(26,420)	(5,213,163)	2,802,968	(1,552,601)
<b>COMPREHENSIVE EARNINGS</b>	<b>\$ 13,410,544</b>	<b>\$ 21,932,373</b>	<b>\$ 34,919,782</b>	<b>\$ 39,866,893</b>

See notes to consolidated financial statements.

**FIRST FINANCIAL BANKSHARES, INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY**

	Common Stock		Capital	Retained	Treasury Stock		Deferred	Accumulated Other Comprehensive Earnings	Total
	Shares	Amount	Surplus	Earnings	Shares	Amounts	Compensation	(Losses)	Shareholders' Equity
Shares at December 31,	20,739,127	\$ 207,392	\$ 266,271,930	\$ 41,003,600	(153,187)	\$ (2,911,506)	\$ 2,911,506	\$ (6,581,884)	\$ 300,901,000
Earnings (Audited)				36,983,491					36,983,491
Share issuances (Audited)	25,365	253	480,864						481,382
Dividends paid, \$0.94 per share (Audited)				(19,513,694)					(19,513,694)
Change in realized gain in investment properties available-for-sale, net of related income taxes (Audited)								2,883,402	2,883,402
Provisional tax credit related to employee deferred compensation plan (Audited)			102,845						102,845
Shares purchased in connection with employee deferred compensation plan (Audited)					(2,635)	(218,970)	218,970		
Share based option exercise (Audited)			163,712						163,712
Shares at December 30, (unaudited)	20,764,492	\$ 207,645	\$ 267,019,351	\$ 58,473,397	(155,822)	\$ (3,130,476)	\$ 3,130,476	\$ (3,698,482)	\$ 322,001,000
Shares at December 31,	20,766,848	\$ 207,669	\$ 267,136,338	\$ 64,333,921	(155,415)	\$ (3,170,304)	\$ 3,170,304	\$ 3,817,534	\$ 335,495,000

earnings (audited)				40,125,294						40,125,294
issuances (audited)	26,799	267	519,913							520,983
dividends paid, \$1.00 per share (audited)				(20,789,693)						(20,789,693)
change in unrealized gain in investment securities available-for-sale, net of related income taxes (audited)								(5,205,511)		(5,205,511)
profit related to employee stock ownership plan (audited)			101,801							101,801
shares purchased in connection with employee stock ownership plan (audited)					(3,431)	(240,278)	240,278			
changes at September 30, (unaudited)	20,793,647	\$ 207,936	\$ 267,927,363	\$ 83,669,522	(158,846)	\$ (3,410,582)	\$ 3,410,582	\$ (1,387,977)		\$ 350,416,000

See notes to consolidated financial statements.

**FIRST FINANCIAL BANKSHARES, INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)**

	Nine Months Ended September 30,	
	2008	2007
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>		
Net earnings	\$ 40,125,294	\$ 36,983,491
Adjustments to reconcile net earnings to net cash provided by (used in) operating activities:		
Depreciation and amortization	5,985,192	5,820,133
Provision for loan losses	4,273,798	954,672
Securities premium amortization (discount accretion), net	418,416	(436,300)
Gain on sale of assets, net	(2,695,408)	(1,934,897)
Deferred federal income tax expense	59,712	104,131
Trading securities activity, net	(95,737,085)	
Loans originated for resale	(154,828,708)	(155,880,669)
Proceeds from sales of loans held for resale	146,809,643	158,671,315
Decrease in other assets	4,025,859	5,468,294
Increase (decrease) in other liabilities	3,924,276	(942,242)
 Total adjustments	 (87,764,305)	 11,824,437
 Net cash provided by (used in) operating activities	 (47,639,011)	 48,807,928
 <b>CASH FLOWS FROM INVESTING ACTIVITIES</b>		
Activity in available-for-sale securities:		
Sales	73,150,665	10,734,972
Maturities	179,294,394	269,836,372
Purchases	(286,336,808)	(277,513,563)
Activity in held-to-maturity securities:		
Maturities	2,840,503	1,425,587
Purchases		(1,000,000)
Net increase in loans	(34,181,586)	(87,446,531)
Purchases of bank premises and equipment and computer software	(9,523,116)	(6,285,727)
Proceeds from sale of other assets	1,974,552	615,291
 Net cash used in investing activities	 (72,781,396)	 (89,633,599)
 <b>CASH FLOWS FROM FINANCING ACTIVITIES</b>		
Net increase (decrease) in noninterest-bearing deposits	29,933,928	(27,474,258)
Net increase (decrease) in interest-bearing deposits	(12,464,699)	26,051,377
Net increase in short-term borrowings	30,572,122	25,431,627
Proceeds from stock issuances	520,180	481,117
Dividends paid	(20,365,442)	(19,088,365)
 Net cash provided by financing activities	 28,196,089	 5,401,498

Net decrease in cash and cash equivalents	(92,224,318)	(35,424,173)
<b>CASH AND CASH EQUIVALENTS AT BEGINNING OF YEAR</b>	264,888,376	192,976,653
<b>CASH AND CASH EQUIVALENTS AT END OF PERIOD</b>	\$ 172,664,058	\$ 157,552,480

**SUPPLEMENTAL INFORMATION AND NONCASH  
TRANSACTIONS**

Interest paid	\$ 26,615,657	\$ 44,487,903
Federal income tax paid	15,507,566	15,405,750
Assets acquired through foreclosure	2,523,712	2,642,283
Investment securities purchased but not settled	18,151,271	1,915,105
See notes to consolidated financial statements.		

**FIRST FINANCIAL BANKSHARES, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**

**Note 1 Basis of Presentation**

In the opinion of management, the unaudited consolidated financial statements reflect all adjustments necessary for a fair presentation of the Company's financial position and unaudited results of operations. All adjustments were of a normal recurring nature. However, the results of operations for the three and nine months ended September 30, 2008, are not necessarily indicative of the results to be expected for the year ending December 31, 2008, due to seasonality, changes in economic conditions and credit quality, interest rate fluctuations and other factors. Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States have been condensed or omitted under SEC rules and regulations. Certain reclassifications have been made to the 2007 financial statements to conform to the 2008 presentation.

**Note 2 Earnings Per Share**

Basic earnings per common share is computed by dividing net income available to common shareholders by the weighted average number of shares outstanding during the periods. In computing diluted earnings per common share for the three and nine months ended September 30, 2008 and 2007, the Company assumes that all dilutive outstanding options to purchase common stock have been exercised at the beginning of the year (or the time of issuance, if later). The dilutive effect of the outstanding options is reflected by application of the treasury stock method, whereby the proceeds from the exercised options are assumed to be used to purchase common stock at the average market price during the respective periods. The weighted average common shares outstanding used in computing basic earnings per common share for the three months ended September 30, 2008 and 2007, were 20,793,197 and 20,761,799 shares, respectively. The weighted average common shares outstanding used in computing basic earnings per share for the nine months ended September 30, 2008 and 2007, were 20,784,711 and 20,755,331, respectively. The weighted average common shares outstanding used in computing fully diluted earnings per common share for the three months ended September 30, 2008 and 2007, were 20,853,539 and 20,891,357, respectively. The weighted average common shares outstanding used in computing fully diluted earnings per common share for the nine months ended September 30, 2008 and 2007, were 20,831,128 and 20,879,709, respectively.

**Note 3 Stock Based Compensation**

The Company grants stock options for a fixed number of shares with an exercise price equal to the fair value of the shares at the date of grant to employees. The Company recorded stock option expense totaling \$56 thousand for both the three month periods ended September 30, 2008 and 2007. The Company recorded stock option expense totaling \$169 thousand and \$164 thousand, respectively, for the nine month periods ended September 30, 2008 and 2007, respectively.

The additional disclosure requirements of Statement of Financial Accounting Standard (SFAS) No. 123R,

Share-Based Payment have been omitted due to immateriality.

**Note 4 Pension Plan**

The Company's defined benefit pension plan was frozen effective January 1, 2004 whereby no additional years of service will accrue to participants, unless the pension plan is reinstated at a future date. The pension plan covered substantially all of the Company's employees. The benefits were based on years of service and a percentage of the employee's qualifying compensation during the final years of employment. The Company's funding policy was and is to contribute annually the amount necessary to

satisfy the Internal Revenue Service's funding standards. Contributions to the pension plan, prior to freezing the plan, were intended to provide not only for benefits attributed to service to date but also for those expected to be earned in the future. As a result of freezing the pension plan, we did not expect contributions or pension expense to be significant in future years. However as a result of the Pension Protection Act of 2006, the Company will be required to contribute amounts over seven years to fund any shortfalls. The Company evaluated the provisions of the Act as well as the Internal Revenue Service's funding standards to develop a preliminary plan for funding in future years. The Company made a contribution totaling \$800,000 in the nine month period ended September 30, 2008 and \$1.5 million in the year ended December 31, 2007, and continues to evaluate future funding amounts. Net periodic benefit costs totaling \$79,000 and \$84,000 were recorded, respectively, for the three months ended September 30, 2008 and 2007. Net periodic benefit costs totaling \$236,000 and \$253,000 were recorded, respectively, in the nine months ended September 30, 2008 and 2007.

**Note 5 Related Party Transactions**

During the nine months ended September 30, 2008 and 2007, the Company sold student loans totaling approximately \$63.6 million and \$60.4 million, respectively, recognizing net gains of \$1.7 million and \$1.8 million, respectively, to a higher education authority of which an executive officer of one of our wholly owned subsidiary banks was a board member. In the opinion of management, these loan sales are on substantially the same terms as those prevailing at the time for comparable transactions with unaffiliated persons.

**Note 6 Recently Issued Pronouncements**

In December 2007, the Financial Accounting Standards Board (FASB) issued SFAS No. 141(R), Business Combinations a replacement of FASB No. 141. SFAS 141R replaces SFAS 141, Business Combinations, and applies to all transactions and other events in which one entity obtains control over one or more other businesses. SFAS 141R requires an acquirer, upon initially obtaining control of another entity, to recognize the assets, liabilities and any non-controlling interest in the acquiree at fair value as of the acquisition date. Contingent consideration is required to be recognized and measured at fair value on the date of acquisition rather than at a later date when the amount of that consideration may be determinable beyond a reasonable doubt. This fair value approach replaces the cost-allocation process required under SFAS 141 whereby the cost of an acquisition was allocated to the individual assets acquired and liabilities assumed based on their estimated fair value. SFAS 141R requires acquirers to expense acquisition-related costs as incurred rather than allocating such costs to the assets acquired and liabilities assumed, as was previously the case under SFAS 141. Under SFAS 141R, the requirements of SFAS 146, Accounting for Costs Associated with Exit or Disposal Activities, would have to be met in order to accrue for a restructuring plan in purchase accounting. Pre-acquisition contingencies are to be recognized at fair value, unless it is a non-contractual contingency that is not likely to materialize, in which case, nothing should be recognized in purchase accounting and, instead, that contingency would be subject to the probable and estimable recognition criteria of SFAS 5, Accounting for Contingencies. SFAS 141R is expected to have an impact on the Company's accounting for business combinations closing on or after January 1, 2009.

In March 2008, the FASB issued SFAS No. 161, Disclosures About Derivative Instruments and Hedging Activities, an Amendment of FASB Statement No. 133. SFAS 161 amends SFAS 133, Accounting for Derivative Instruments and Hedging Activities, to amend and expand the disclosure requirements of SFAS 133 to provide greater transparency about (i) how and why an entity uses derivative instruments, (ii) how derivative instruments and related hedge items are accounted for under SFAS 133 and its related interpretations, and (iii) how derivative instruments and related hedged items affect an entity's financial position, results of operations and cash flows. To meet those objectives, SFAS 161 requires qualitative disclosures about objectives and strategies for using derivatives, quantitative disclosures about fair value

amounts of gains and losses on derivative instruments and disclosures about credit-risk-related contingent features in derivative agreements. SFAS 161 is effective for the Company on January 1, 2009 and is not expected to have a significant impact on the Company's financial position, results of operations or cash flows.

In October 2008, the FASB issued FSP No. FAS 157-3, *Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active*. This FSP clarifies the application of SFAS No. 157 in a market that is not active and provides an example to illustrate key considerations in determining the fair value of a financial asset when the market for that financial asset is not active. This FSP was effective for the Company upon issuance, including prior periods for which financial statements have not been issued; and, therefore was effective for the Company's financial statements as of and for the three and nine month periods ended September 30, 2008. Adoption of FSP No. FAS 157-3 did not have a significant impact on the Company's financial position, results of operations or cash flows.

**Note 7 Fair Value Disclosures**

SFAS 157 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. A fair value measurement assumes that the transaction to sell the asset or transfer the liability occurs in the principal market for the asset or liability or, in the absence of a principal market, the most advantageous market for the asset or liability. The price in the principal (or most advantageous) market used to measure the fair value of the asset or liability shall not be adjusted for transaction costs. An orderly transaction is a transaction that assumes exposure to the market for a period prior to the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets and liabilities; it is not a forced transaction. Market participants are buyers and sellers in the principal market that are (i) independent, (ii) knowledgeable, (iii) able to transact and (iv) willing to transact.

SFAS 157 requires the use of valuation techniques that are consistent with the market approach, the income approach and/or the cost approach. The market approach uses prices and other relevant information generated by market transactions involving identical or comparable assets and liabilities. The income approach uses valuation techniques to convert future amounts, such as cash flows or earnings, to a single present amount on a discounted basis. The cost approach is based on the amount that currently would be required to replace the service capacity of an asset (replacement costs). Valuation techniques should be consistently applied. Inputs to valuation techniques refer to the assumptions that market participants would use in pricing the asset or liability. Inputs may be observable, meaning those that reflect the assumptions market participants would use in pricing the asset or liability developed based on market data obtained from independent sources, or unobservable, meaning those that reflect the reporting entity's own assumptions about the assumptions market participants would use in pricing the asset or liability developed based on the best information available in the circumstances. In that regard, SFAS 157 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:

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

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

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



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

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

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

**Impaired Loans** Impaired loans are reported at the fair value of the underlying collateral if repayment is expected solely from the collateral. Collateral values are estimated using Level 3 inputs based on internally customized discounting criteria.

**Loans Held for Sale** These loans are reported at the lower of cost or fair value. Fair value is determined based on expected proceeds based on sales contracts and commitments and are considered Level 2 inputs.

**Real Estate Owned** These assets are reported at estimated fair value, less estimated selling costs. Fair value is based on third party or internally developed appraisals considering the assumptions in the valuation and are considered Level 2 or Level 3 inputs.

The following table summarizes financial assets and financial liabilities measured at fair value on a recurring basis as of September 30, 2008, segregated by the level of the valuation inputs within the fair value hierarchy utilized to measure fair value (dollars in thousands):

	Level 1 Inputs	Level 2 Inputs	Level 3 Inputs	Total Fair Value
Investment securities available for sale	\$55,394	\$1,079,238	\$	\$1,134,632
Trading investment securities	95,737			95,737
Impaired loans			5,971	5,971

Certain financial assets and financial liabilities are measured at fair value on a nonrecurring basis, that is, the instruments are not measured at fair value on an ongoing basis but are subject to fair value adjustments in certain circumstances (for example, when there is evidence of impairment). Financial assets and financial liabilities measured at fair value on a non-recurring basis were not significant at September 30, 2008.

Certain non-financial assets and non-financial liabilities measured at fair value on a recurring and non-recurring basis include goodwill and other intangible assets and other non-financial long-lived assets. As stated above, SFAS 157 will be applicable to these fair value measurements beginning January 1, 2009.

## **Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

### **Introduction**

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

The following discussion of operations and financial condition should be read in conjunction with the financial statements and accompanying footnotes included in Item 1 of this Form 10-Q as well as those included in the Company's 2007 Annual Report on Form 10-K.

### **Recent Developments**

The U. S. and global economies have experienced and are experiencing significant stress and disruptions in the financial sector. Dramatic slowdowns in the housing industry with falling home prices and increasing foreclosures and unemployment have resulted in major issues for financial institutions, including government-sponsored entities and investment banks. These issues have caused many financial institutions to seek additional capital, to merge with larger and stronger institutions and, in some cases, to fail.

In response to the financial crisis affecting the banking and financial markets, in October 2008, the Emergency Economic Stabilization Act of 2008 (the EESA) was signed into law. Pursuant to the EESA, the U. S. Treasury (the Treasury) will have the authority to, among other things, purchase up to \$700 billion of mortgages, mortgage-backed securities and certain other financial instruments from financial institutions for the purpose of stabilizing and providing liquidity to the U. S. financial markets.

In addition, the Treasury announced that it has been authorized to purchase equity stakes in U. S. financial institutions. Under this program, known as the Troubled Asset Relief Program Capital Purchase Program (the TARP Capital Purchase Program), from the \$700 billion authorized by the EESA, the Treasury will make \$250 billion of capital available to U. S. financial institutions in the form of preferred stock. In conjunction with the purchase of preferred stock, the Treasury will receive warrants to purchase common stock with an aggregate market price equal to 15% of the total amount of the preferred investment. Participating financial institutions will be required to adopt the Treasury's standards for executive compensation and corporate governance for the period during which the Treasury holds equity issued under the TARP Capital Purchase Program and be restricted from increasing dividends to common shareholders or repurchasing common stock for three years without the consent of the Treasury.

Further, after receiving a recommendation from the boards of the Federal Deposit Insurance Corporation (the FDIC) and the Federal Reserve System (the Federal Reserve), the Treasury signed the systemic risk exception to the FDIC Act, enabling the FDIC to temporarily provide a 100% guarantee of the senior debt of all FDIC-insured institutions and their holding companies, as well as deposits in non-interest bearing transaction deposit accounts under a Temporary Liquidity Guarantee Program. Coverage under the Temporary Liquidity Guarantee Program is available for 30 days without charge and thereafter at a cost of 75 basis points per annum for senior unsecured debt and 10 basis points per annum for non-interest bearing transaction deposits.

The Company has made a decision to participate in the Temporary Liquidity Guarantee Program and continues to assess its participation in the TARP Capital Purchase Program but has not made a definitive decision as to whether it will participate.

It is not clear at this time what impact the EESA, the TARP Capital Purchase Program, the Temporary Liquidity Guarantee Program, other liquidity and funding initiatives of the Federal Reserve and other agencies that have been previously announced, and any additional programs that may be initiated in the future will have on the Company and the U. S. and global financial markets.

#### **Critical Accounting Policies**

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

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

The following discussion addresses our allowance for loan losses and its provision for loan losses, which we deem to be our most critical accounting policy. We have other significant accounting policies and continue to evaluate the materiality of their impact on our consolidated financial statements, but we believe these other policies either do not generally require us to make estimates and judgments that are difficult or subjective, or it is less likely they would have a material impact on our reported results for a given period.

The allowance for loan losses is an amount we believe will be adequate to absorb inherent estimated losses on existing loans in which full collectability is unlikely based upon our review and evaluation of the loan portfolio. The allowance for loan losses is increased by charges to income and decreased by charged-off loans (net of recoveries).

Our methodology is based on guidance provide in SEC Staff Accounting Bulletin No. 102, Selected Loan Loss Allowance Methodology and Documentation Issues and includes allowance allocations calculated in accordance with Statement of Financial Accounting Standards (SFAS) No. 114, Accounting by Creditors for Impairment of a Loan, as amended by SFAS No. 118, and allowance allocations determined in accordance with SFAS No. 5, Accounting for Contingencies. We also follow the guidance of the Interagency Policy Statement on the Allowance for Loan and Lease Losses, issued jointly by the Office of Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the National Credit Union Administration and the Office of Thrift Supervision. We have developed a consistent, well-documented loan review methodology that includes allowances assigned to certain classified loans, allowances assigned based upon estimated loss factors and qualitative reserves. The level of the allowance reflects our periodic evaluation of general economic conditions, the financial condition of our borrowers, the value and liquidity of collateral, delinquencies, prior loan loss experience, and the results of periodic reviews of the portfolio by our independent loan review department and regulatory examiners. Our allowance for loan losses is comprised of three elements: (i) specific reserves determined in accordance with SFAS 114 and SFAS 5 based on probable losses on specific classified loans; (ii) general reserves determined in accordance with SFAS 5 that consider historical loss rates; and (iii) a qualitative

reserve determined in accordance with SFAS 5 based upon general economic conditions and other qualitative risk factors both internal and external to the Company. We regularly evaluate our allowance for loan losses to maintain an adequate level to absorb estimated loan losses inherent in the loan portfolio. Factors contributing to the determination of specific reserves include the credit-worthiness of the borrower, changes in the value of pledged collateral, and general economic conditions. All classified loans are specifically reviewed and a specific allocation is assigned based on the losses expected to be realized from those loans. For purposes of determining the general reserve, the loan portfolio less cash secured loans, government guaranteed loans and classified loans is multiplied by the Company's historical loss rates. The qualitative reserves are determined by evaluating such things as current economic conditions and trends, changes in lending staff, policies or procedures, changes in credit concentrations, changes in the trends and severity of problem loans and changes in trends in volume and terms of loans.

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

Accrual of interest is discontinued on a loan when management believes, after considering economic and business conditions and collection efforts, the borrower's financial condition is such that collection of interest is doubtful. Our policy requires measurement of the allowance for an impaired collateral dependent loan based on the fair value of the collateral. Other loan impairments are measured based on the present value of expected future cash flows or the loan's observable market price.

### **Operating Results**

#### **Three-months ended September 30, 2008 and 2007**

Net income for the third quarter of 2008 totaled \$13.4 million, an increase of \$1.1 million, or 9.1%, from the same period last year. This increase was principally attributable to an increase in net interest income of \$3.7 million and an increase in noninterest income of \$300 thousand. Offsetting these items were an increase in the provision for loan losses of \$1.3 million and an increase in noninterest expense of \$1.4 million.

Basic earnings per share were \$0.64 for the third quarter of 2008, as compared to \$0.59 for the third quarter of 2007. The return on average assets and return on average equity for the third quarter of 2008 were 1.74% and 15.31%, respectively. For the same period in 2007, the return on average assets and return on average equity amounted to 1.70% and 15.61%, respectively.

Tax equivalent net interest income for the third quarter of 2008 amounted to \$33.2 million as compared to \$29.1 million for the same period last year. Our yield on interest earning assets decreased approximately 87 basis points while our rates paid on interest bearing liabilities decreased 153 basis points. The increase in volume of average interest earning assets of \$195.4 million partially offset the decrease in rates, but resulted in a decrease of \$2.9 million in interest income. Average interest bearing liabilities increased \$62.2 million. The impact of the small increase in the volume of interest bearing liabilities was offset by a decrease in rates paid resulting in a decline in interest expense totaling \$7.0 million. Average earning assets were \$2.79 billion for the third quarter of 2008, which were 7.5% greater than for the third quarter of 2007. Average interest bearing

liabilities were \$1.94 billion for the third quarter of 2008, which were 3.3% greater than for the third quarter of 2007. The Company's interest spread increased to 4.24% for 2008 from 3.57% for 2007. The Company's net interest margin was 4.73% for the third quarter of 2008, an increase of 29 basis points compared to 4.45% for the same period of 2007, and up 12 basis points from the 4.61% level for the second quarter of 2008. Our net interest margin remained relatively consistent from prior periods despite the volatile interest rate environment which saw the Federal funds rate drop 325 basis points from September 2007 through September 2008. On October 8, 2008, the Federal Funds rate was reduced another 50 basis points. We have experienced loan growth in the past two years which has provided higher yields than our investment securities and have been able to lower deposit rates. The recent Federal Funds rate decrease and any further interest rate reductions will put pressure on our net interest margin as we work to reduce interest rates on deposits to compensate for lower rates on loans and investments.

The provision for loan losses for the third quarter of 2008 was \$1.8 million compared to \$475 thousand for the same period in 2007. The increase in the provision for loan losses recorded in the third quarter of 2008 resulted from concerns about a slowing national economy and growth in loans. Gross charge-offs for the quarter ended September 30, 2008 totaled \$646 thousand compared to \$342 thousand for the same period of 2007. Recoveries of previously charged-off loans totaled \$253 thousand in the quarter ended September 30, 2008, as compared to \$170 thousand in the same period of 2007. On an annualized basis, net charge-offs as a percentage of average loans were 0.10% for the third quarter of 2008, as compared to 0.05% for the same period in 2007. The Company's allowance for loan losses totaled \$20.0 million at September 30, 2008, up \$3.3 million from the balance of \$16.7 million at September 30, 2007 and up \$2.6 million from the balance of \$17.5 million at December 31, 2007. The Company's allowance as a percentage of nonperforming loans amounted to 245.7% at September 30, 2008 compared to 395.6% at September 30, 2007. As of September 30, 2008, management believes the allowance for loan losses was adequate to provide for loans existing in its portfolio that are deemed uncollectible.

Total noninterest income for the third quarter of 2008 was \$12.3 million, as compared to \$12.0 million for the same period last year. Trust fees totaled \$2.5 million for 2008, up \$343 thousand over the same period in 2007 due to increased volume of trust assets managed. The market value of trust assets managed totaled \$1.98 billion at September 30, 2008, compared to \$1.79 billion at September 30, 2007. Service charges on deposit accounts totaled \$5.8 million for the third quarter of 2008, compared to \$6.1 million for the same period of 2007, a decrease of \$265 thousand reflecting a decline in revenue from our overdraft privilege product. Fees from the Company's real estate mortgage operations of \$649 thousand represented a decrease of \$373 thousand from the \$1.0 million recognized in the third quarter of 2007 due to the slowdown in home sales. ATM and credit card fees increased 20.1% to \$2.3 million versus \$1.9 million a year ago, indicative of continued increases in the use of debit cards and growth in net new deposit accounts and merchant credit card customers.

Noninterest expense for the third quarter of 2008 amounted to \$23.4 million, as compared to \$22.0 million for the same period in 2007. Salaries and employee benefits expense, the Company's largest noninterest expense item, increased 6.2% to \$12.5 million in 2008, up \$729 thousand over the same period in 2007. The increase in salaries and benefits expense reflected increases in annual salaries, healthcare costs and employee profit sharing. Net occupancy expense was \$1.8 million for the third quarter of 2008, an increase of \$323 thousand over the same period last year. Contributing to the increase in net occupancy expense were two additional new branches, higher utilities rates and increased property taxes. Equipment expense was \$1.9 million for the quarter ended September 30, 2008, an increase of \$42 thousand over the third quarter of 2007.

The Company's other categories of noninterest expense increased \$308 thousand in the third quarter of 2008, compared to the third quarter of 2007. Contributing to this increase were a volume related increase of \$165 thousand in ATM and credit card expenses, an increase of \$45 thousand in legal, tax and professional fees, and increases in certain other components of noninterest expense, none of which were

individually significant. Offsetting these increases were a decrease in the amortization of intangible assets of \$72 thousand, a decrease in printing, stationery and supplies of \$70 thousand and small declines in various other categories of expense.

Income tax expense was \$5.2 million for the third quarter of 2008, as compared to \$5.0 million for the same period in 2007. Our effective tax rates on pretax income were 27.9%, and 29.1% for the third quarters of 2008 and 2007, respectively. The effective tax rates differ from the federal statutory tax rate of 35% largely due to tax exempt interest income earned on certain investment securities and loans, the deductibility of dividends paid to our employee stock ownership plan and the Texas margin tax.

We believe a key indicator of our operating efficiency is expressed by the ratio that is calculated by dividing noninterest expense by the sum of net interest income (on a tax equivalent basis) and noninterest income. This ratio in effect measures the amount of funds expended to generate revenue. Our efficiency ratio was 51.42% for the third quarter of 2008 and 53.53% for the third quarter of 2007.

#### **Nine-months ended September 30, 2008 and 2007**

Net income for the first nine months of 2008 totaled \$40.1 million, an increase of \$3.1 million, or 8.5%, from the same period last year. This increase was principally attributable to an increase in net interest income of \$9.7 million and an increase in noninterest income of \$2.2 million. Offsetting these items were an increase in the provision for loan losses of \$3.3 million and an increase in noninterest expense of \$5.0 million.

Basic earnings per share were \$1.93 for the first nine months of 2008, as compared to \$1.78 for the first nine months of 2007. The return on average assets and return on average equity for the first nine months of 2008 were 1.77% and 15.42%, respectively. For the same period in 2007, the return on average assets and return on average equity amounted to 1.73% and 16.10%, respectively.

Tax equivalent net interest income for the first nine months of 2008 amounted to \$96.3 million as compared to \$85.4 million for the same period last year. Our yield on interest earning assets decreased approximately 66 basis points while our rates paid on interest bearing liabilities decreased 117 basis points. The increase in volume of average interest earning assets of \$174.9 million partially offset the decrease in rates but still resulted in a decrease of \$4.8 million in interest income. Average interest bearing liabilities increased \$53.9 million. The impact of the increase in the volume of interest bearing liabilities was, however, offset by a significant decrease in rates paid resulting in a decline in interest expense totaling \$15.7 million. Average earning assets were \$2.77 billion for the first nine months of 2008, which were 6.7% greater than for the first nine months of 2007. Average interest bearing liabilities were \$1.94 billion for the first nine months of 2008, which were 2.9% greater than for the first nine months of 2007. The Company's interest spread increased to 4.04% for 2008 from 3.53% for 2007. The Company's net interest margin was 4.64% for the first nine months of 2008, an increase of 24 basis points compared to 4.40% for the same period of 2007. Our net interest margin remained relatively consistent from prior periods despite the volatile interest rate environment which saw the Federal funds rate drop 325 basis points from September 2007 through September 2008. On October 8, 2008, the Federal funds rate was reduced another 50 basis points. We have experienced loan growth in the past two years which provides higher yields than our investment securities and have been able to lower rates paid on deposits and short-term borrowings. The recent Federal funds rate decrease and any interest rate reductions will put pressure on our net interest margin as we work to reduce interest rates on deposits to compensate for lower rates on loans and investments.

The provision for loan losses for the first nine months of 2008 was \$4.3 million compared to \$955 thousand for the same period in 2007. The provision for loan losses recorded in the first nine months of 2008 resulted from concerns about a slowing national economy, growth in loans and an increase in nonperforming loans. Gross charge-offs for the first nine months ended September 30, 2008 totaled \$2.3 million compared to \$994 thousand for the same period of 2007. Recoveries of previously charged-off loans totaled \$621 thousand in the

first nine months ended September 30, 2008, as compared to \$567 thousand in the same period of 2007. On an annualized basis, net charge-offs as a percentage of average loans were 0.15% for the first nine months of 2008, as compared to 0.04% for the same period in 2007. The Company's allowance for loan losses totaled \$20.0 million at September 30, 2008, up \$3.3 million from the balance of \$16.7 million at September 30, 2007 and up \$2.6 million from the balance of \$17.5 million at December 31, 2007. The Company's allowance as a percentage of nonperforming loans amounted to 245.7% at September 30, 2008 compared to 395.6% at September 30, 2007. As of September 30, 2008, management believes the allowance for loan losses was adequate to provide for loans existing in its portfolio that are deemed uncollectible.

Total noninterest income for the first nine months of 2008 was \$38.1 million, as compared to \$35.9 million for the same period last year. Trust fees totaled \$7.2 million for 2008, up \$699 thousand over the same period in 2007 due to increased volume of trust assets managed. The market value of trust assets managed totaled \$1.98 billion at September 30, 2008 compared to \$1.78 billion at September 30, 2007. Service charges on deposit accounts totaled \$17.0 million for the first nine months of 2008, compared to \$16.8 million for the same period of 2007, an increase of \$239 thousand reflecting the higher volume of noninterest bearing deposit accounts. The gain on sale of student loans totaled \$1.7 million for the nine months ended September 30, 2008, compared to \$1.8 million for the same period in 2007. The Company sold student loans totaling \$63.6 million during the first nine months of 2008 compared to \$60.4 million during the same period in 2007. Fees from the Company's real estate mortgage operations of \$2.0 million represented a decrease of \$606 thousand from the amount recognized in the nine months ended September 30, 2007, reflecting a slow down in the sale of residential real estate. ATM and credit card fees increased 20.1% to \$6.6 million versus \$5.5 million a year ago, indicative of continued increases in the use of debit cards and growth in net new deposit accounts and merchant credit card customers.

Noninterest expense for the first nine months of 2008 amounted to \$69.1 million, as compared to \$64.1 million for the same period in 2007. Salaries and employee benefits expense, the Company's largest noninterest expense item, increased 8.5% to \$37.5 million in 2008, up \$2.9 million over the same period in 2007. The increase in salaries and benefits expense reflected increases in annual salaries, healthcare costs and employee profit sharing. Net occupancy expense was \$5.1 million for the nine months of 2008, an increase of \$711 thousand over the same period last year. Contributing to the increase in net occupancy expense were three additional new branches, higher utility rates and increased property taxes. Equipment expense was \$5.6 million for the nine months ended September 30, 2008, an increase of \$197 thousand over the first nine months of 2007. The increase in equipment expense reflects the new branches and continuing investments in technology.

The Company's other categories of noninterest expense increased \$1.1 million in the first nine months of 2008, compared to the first nine months of 2007. Contributing to this increase were a volume related increase of \$389 thousand related to ATM and credit card expenses, an increase of \$216 thousand in legal, tax and professional fees, an increase in advertising and public relations of \$134 thousand, and increases in certain other components of noninterest expense, none of which were individually significant. Offsetting these increases were a decrease in operational and other losses of \$230 thousand, a decrease in the amortization of intangible assets of \$218 thousand, a decrease in printing, stationery and supplies of \$111 thousand and small declines in various other categories of expense.

Income tax expense was \$15.9 million for the first nine months of 2008, as compared to \$15.4 million for the same period in 2007. Our effective tax rates on pretax income were 28.3%, and 29.4% for the first nine months of 2008 and 2007, respectively. The effective tax rates differ from the federal statutory tax rate of 35% largely due to tax exempt interest income earned on certain investment securities and loans, the deductibility of dividends paid to our employee stock ownership plan and the Texas margin tax.

We believe a key indicator of our operating efficiency is expressed by the ratio that is calculated by dividing noninterest expense by the sum of net interest income (on a tax equivalent basis) and noninterest income. This ratio in effect measures the amount of funds expended to generate revenue. Our efficiency ratio was 51.41% for the first nine months of 2008 and 52.85% for the first nine months of 2007.

### **Balance Sheet Review**

Total assets at September 30, 2008 amounted to \$3.15 billion as compared to \$3.07 billion at December 31, 2007, and \$2.89 billion at September 30, 2007. Deposits totaled \$2.56 billion at September 30, 2008, up \$17.5 million from December 31, 2007 amounts. Deposits at September 30, 2007 were \$2.38 billion.

Loans totaled \$1.57 billion, \$1.53 billion and \$1.46 billion at September 30, 2008, December 31, 2007 and September 30, 2007, respectively. Loans held for investment at September 30, 2008, were \$1.52 billion, an increase of \$99.0 million from the September 30, 2007 balance. As compared to September 30, 2007, loans held for investment at September 30, 2008, reflect (i) a \$32.8 million increase in commercial, financial and agricultural loans; (ii) a \$44.5 million increase in real estate loans; and (iii) a \$21.7 million increase in consumer loans. Loans held for sale at September 30, 2008, were \$45.3 million, an increase of \$11.6 million from the September 30, 2007 balance. At September 30, 2008, loans held for sale were comprised of \$42.2 million in student loans and \$3.1 million in residential mortgage loans.

Investment securities, including trading securities, at September 30, 2008, totaled \$1.25 billion as compared to \$1.12 billion at year-end 2007 and \$1.12 billion at September 30, 2007. The net unrealized gain in the investment portfolio at September 30, 2008, was \$3.1 million. At September 30, 2008, gross unrealized gains totaled \$12.7 million and gross unrealized losses totaled \$9.6 million. We do not believe these unrealized losses are other than temporary as (1) we have the ability and intent to hold the investments to maturity, or a period of time sufficient to allow for a recovery in market value and, (2) it is probable that we will be able to collect the amounts contractually due. The unrealized losses noted are interest rate related due to the level of short-term and intermediate interest rates at September 30, 2008. We have reviewed the ratings of the issuers and have not identified any issues related to the ultimate repayment of principal as a result of credit concerns on these securities. Our mortgage related securities are backed by GNMA, FNMA and FHLMC or are collateralized by securities backed by these agencies.

The portfolio had an overall tax equivalent yield of 5.10% at September 30, 2008. At September 30, 2008, the investment portfolio had a weighted average life of 4.61 years and modified duration of 3.91 years. At September 30, 2008, the Company did not hold any structured notes.

Nonperforming assets at September 30, 2008, totaled \$10.8 million (0.69% of loans plus foreclosed assets) as compared to \$4.7 million at December 31, 2007 and \$6.8 million at September 30, 2007.

Short-term borrowings were \$196.8 million at September 30, 2008 as compared to \$166.3 million at December 31, 2007, and \$168.7 million at September 30, 2007. At September 30, 2008, short-term borrowings included securities sold under repurchase agreements of \$170.7 million. These borrowings are generally with significant customers of the Company that require short-term liquidity for their funds.

### **Liquidity and Capital**

Liquidity is our ability to meet cash demands as they arise. Such needs can develop from loan demand, deposit withdrawals or acquisition opportunities. Potential obligations resulting from the issuance of standby letters of credit and commitments to fund future borrowings to our loan customers are other factors affecting our liquidity needs. Many of these obligations and commitments are expected to expire without being drawn upon; therefore the total commitment amounts do not necessarily represent future cash requirements affecting our liquidity position. The potential need for liquidity arising from these types of financial instruments is represented by the contractual notional amount of the instrument. Asset



liquidity is provided by cash and assets which are readily marketable or which will mature in the near future. Liquid assets include cash, federal funds sold, and short-term investments in time deposits in banks. Liquidity is also provided by access to funding sources, which include core depositors and correspondent banks that maintain accounts with, and sell federal funds to, our subsidiary banks. Other sources of funds include our ability to sell securities under agreements to repurchase, and an unfunded \$50 million line of credit which matures December 31, 2008, established with a nonaffiliated bank. One of our subsidiary banks also has federal funds purchased lines of credit with two non-affiliated banks totaling \$60 million.

Given the strong core deposit base and relatively low loan to deposit ratios maintained at our subsidiary banks, management considers the current liquidity position to be adequate to meet short- and long-term liquidity needs. We anticipate that any future acquisitions of financial institutions and expansion of branch locations could place a demand on our cash resources. Available cash at our parent company, available dividends from subsidiary banks, utilization of available lines of credit, and future debt or equity offerings are expected to be the sources of funding for these potential acquisitions or expansions.

The Company's consolidated statements of cash flows are presented on page 8 of this report. Total shareholders' equity amounted to \$350.4 million at September 30, 2008, which was up from \$335.5 million at year-end 2007 and \$322.0 million at September 30, 2007. The Company's total risk-based capital and leverage ratios at September 30, 2008 were 16.49% and 9.63%, respectively. The third quarter 2008 cash dividend of \$0.34 per share totaled \$7.1 million and represented 52.9 % of third quarter earnings.

#### **Interest Rate Risk**

Interest rate risk results when the maturity or repricing intervals of interest-earning assets and interest bearing liabilities are different. The Company's exposure to interest rate risk is managed primarily through the Company's strategy of selecting the types and terms of interest-earning assets and interest-bearing liabilities which generate favorable earnings, while limiting the potential negative effects of changes in market interest rates. The Company uses no off-balance-sheet financial instruments to manage interest rate risk.

Each of our subsidiary banks has an asset/liability committee that monitors interest rate risk and compliance with investment policies; there is also a holding company-wide committee that monitors the combined interest rate risk and compliance with investment policies across all of our subsidiary banks.

The Company and each subsidiary bank utilize an earnings simulation model as the primary quantitative tool in measuring the amount of interest rate risk associated with changing market rates. The model quantifies the effects of various interest rate scenarios on projected net interest income and net income over the next 12 months. The model measures the impact on net interest income relative to a base case scenario of hypothetical fluctuations in interest rates over the next 12 months. These simulations incorporate assumptions regarding balance sheet growth and mix, pricing and the repricing and maturity characteristics of the existing and projected balance sheet.

As of September 30, 2008, the model simulations projected that 100 and 200 basis point increases in interest rates would result in positive variances in net interest income of 2.18% and 4.36%, respectively, relative to the base case over the next 12 months, while decreases in interest rates of 100 and 200 basis points would result in negative variances in net interest income of 2.25% and 7.84%, respectively, relative to the base case over the next 12 months. These are good faith estimates and assume that the composition of our interest sensitive assets and liabilities existing at each year-end will remain constant over the

relevant twelve month measurement period and that changes in market interest rates are instantaneous and sustained across the yield curve regardless of duration of pricing characteristics of specific assets or liabilities. Also, this analysis does not contemplate any actions that we might undertake in response to changes in market interest rates. We believe these estimates are not necessarily indicative of what actually could occur in the event of immediate interest rate increases or decreases of this magnitude. As interest-bearing assets and liabilities reprice in different time frames and proportions to market interest rate movements, various assumptions must be made based on historical relationships of these variables in reaching any conclusion. Since these correlations are based on competitive and market conditions, we anticipate that our future results will likely be different from the foregoing estimates, and such differences could be material.

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

**Item 3. Quantitative and Qualitative Disclosures About Market Risk**

Management considers interest rate risk to be a significant market risk for the Company. See Item 2 Management's Discussion and Analysis of Financial Condition and Results of Operations for disclosure regarding this market risk.

**Item 4. Controls and Procedures**

As of September 30, 2008, we carried out an evaluation, under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, of the effectiveness of the design and operation of our disclosure controls and procedures pursuant to Rule 15d-15 of the Securities Exchange Act of 1934. Our management, which includes our principal executive officer and our principal financial officer, does not expect that our disclosure controls and procedures will prevent all errors and all fraud.

A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints; additionally, the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within the Company have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the controls. The design of any system of controls also is based, in part, upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions. Over time, controls may become inadequate due to changes in conditions; also the degree of compliance with policies or procedures may deteriorate. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected. Our principal executive officer and principal financial officer have concluded based on our evaluation of our disclosure controls and procedures, our disclosure controls and procedures under Rule 13a-15 and Rule 15d-15 of the Securities Exchange Act of 1934 are effective at the reasonable assurance level as of September 30, 2008.

Subsequent to our evaluation, there were no significant changes in internal controls or other factors that have materially affected, or are reasonably likely to materially affect, these internal controls.

**PART II**  
**OTHER INFORMATION**

**Item 5. Other Information**

Included in Exhibit 3.6 is an amendment to Company's Amended and Restated By-Laws related to transfer agent appointments.

**Item 6. Exhibits**

The following exhibits are filed as part of this report:

- 3.1 Amended and Restated Certificate of Formation (incorporated by reference from Exhibit 3.1 of the Registrant's Form 10-Q Quarterly Report for the quarter ended March 31, 2006).
- 3.2 Amended and Restated By-Laws, and all amendments thereto, of the Registrant (incorporated by reference from Exhibit 2 of the Registrant's Amendment No. 1 to Form 8-A filed on Form 8-A/A No. 1 on January 7, 1994).
- 3.3 Amendment to Amended and Restated By-Laws of the Registrant, dated April 27, 1994 (incorporated by reference from Exhibit 3.4 of the Registrant's Form 10-Q Quarterly Report for the quarter ended March 31, 2004).
- 3.4 Amendment to Amended and Restated By-Laws of the Registrant, dated October 23, 2001 (incorporated by reference from Exhibit 3.5 of the Registrant's Form 10-Q Quarterly Report for the quarter ended March 31, 2004).
- 3.5 Amendment to Amended and Restated By-Laws of the Registrant, dated October 23, 2007 (incorporated by reference from Exhibit 3.1 of the Registrant's Form 8-K filed October 24, 2007).
- \*3.6 Amendment to Amended and Restated By-Laws of the Registrant, dated October 28, 2008.
- 4.1 Specimen certificate of First Financial Common Stock (incorporated by reference from Exhibit 3 of the Registrant's Amendment No. 1 to Form 8-A filed on Form 8-A/A No. 1 on January 7, 1994).
- 10.1 Deferred Compensation Agreement, dated October 28, 1992, between the Registrant and Kenneth T. Murphy (incorporated by reference from Exhibit 10.1 of the Registrant's Form 10-K Annual Report for the year ended December 31, 2002).
- 10.2 Revised Deferred Compensation Agreement, dated December 28, 1995, between the Registrant and Kenneth T. Murphy (incorporated by reference from Exhibit 10.2 of the Registrant's Form 10-K Annual Report for the year ended December 31, 2002).
- 10.3 Executive Recognition Plan (incorporated by reference from Exhibit 10.1 of the Registrant's Form 8-K Report filed July 1, 2008).
- 10.4 1992 Incentive Stock Option Plan (incorporated by reference from Exhibit 10.5 of the Registrant's Form 10-K Annual Report for the fiscal year ended December 31, 1998).
- 10.5 2002 Incentive Stock Option Plan (incorporated by reference from Appendix A of the Registrant's Schedule 14A Definitive Proxy Statement for the 2002 Annual Meeting of Shareholders).
- 10.6

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Loan Agreement dated December 31, 2004, between First Financial Bankshares, Inc. and The Frost National Bank (incorporated by reference from Exhibit 10.1 of the Registrant's Form 8-K filed December 31, 2004).

- 10.7 First Amendment to Loan Agreement, dated December 28, 2005, between First Financial Bankshares, Inc. and The Frost National Bank (incorporated by reference from Exhibit 10.2 of the Registrant's Form 8-K filed December 28, 2005).
- 10.8 Second Amendment to Loan Agreement, dated December 31, 2006, between First Financial Bankshares, Inc. and The Frost National Bank (incorporated by reference from Exhibit 10.3 of the Registrant's Form 8-K filed December 31, 2006).
- 10.9 Third Amendment to Loan Agreement, dated December 31, 2007, between First Financial Bankshares, Inc. and The Frost National Bank (incorporated by reference from Exhibit 10.4 of the Registrant's Form 8-K filed December 31, 2007).

- 10.10 Fourth Amendment to Loan Agreement dated July 24, 2008, between First Financial Bankshares, Inc. and The Frost National Bank.
- \*31.1 Rule 13a-14(a) / 15(d)-14(a) Certification of Chief Executive Officer of First Financial Bankshares, Inc.
- \*31.2 Rule 13a-14(a) / 15(d)-14(a) Certification of Chief Financial Officer of First Financial Bankshares, Inc.
- \*32.1 Section 1350 Certification of Chief Executive Officer of First Financial Bankshares, Inc.
- \*32.2 Section 1350 Certification of Chief Financial Officer of First Financial Bankshares, Inc.

\* Filed herewith

**SIGNATURES**

**Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.**

**FIRST FINANCIAL BANKSHARES,  
INC.**

**Date: October 30, 2008**

**By: /s/ F. Scott Dueser  
F. Scott Dueser  
President and Chief Executive Officer**

**Date: October 30, 2008**

**By: /s/ J. Bruce Hildebrand  
J. Bruce Hildebrand  
Executive Vice President and  
Chief Financial Officer**