

FIRST FINANCIAL BANKSHARES INC  
Form 10-Q  
November 02, 2010

**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, 2010  
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 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 Regulations S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  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.

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 the latest practicable date:

Class  
Common Stock, \$0.01 par value per share

Outstanding at November 2, 2010  
20,852,152

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

**Item 1. Financial Statements.**

The consolidated balance sheets of First Financial Bankshares, Inc. (the Company ) at September 30, 2010 and 2009 and December 31, 2009, the consolidated statements of earnings and comprehensive earnings for the three and nine months ended September 30, 2010 and 2009, and changes in shareholders' equity and cash flows for the nine months ended September 30, 2010 and 2009, follow on pages 4 through 8.

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**FIRST FINANCIAL BANKSHARES, INC. AND SUBSIDIARIES**  
**CONSOLIDATED BALANCE SHEETS**  
(Dollars in thousands, except per share amounts)

	September 30, 2010                      2009 (Unaudited)		December 31, 2009
<b>ASSETS</b>			
CASH AND DUE FROM BANKS	\$ 91,492	\$ 89,326	\$ 139,915
FEDERAL FUNDS SOLD	6,135	38,045	14,290
INTEREST-BEARING DEPOSITS IN BANKS	231,532	23,884	167,336
Total cash and cash equivalents	329,159	151,255	321,541
TRADING SECURITIES, at fair value		4,779	
SECURITIES HELD-TO-MATURITY (fair value of \$9,474, \$15,824 and \$15,674 at September 30, 2010 and 2009 and December 31, 2009, respectively)	9,229	15,324	15,273
SECURITIES AVAILABLE-FOR-SALE, at fair value	1,412,173	1,303,347	1,270,104
<b>LOANS</b>			
Held for investment	1,528,761	1,449,343	1,510,046
Held for sale	8,947	5,054	4,323
	1,537,708	1,454,397	1,514,369
Less: Allowance for loan losses	(30,013)	(25,532)	(27,612)
Net loans	1,507,695	1,428,865	1,486,757
BANK PREMISES AND EQUIPMENT, net	67,387	63,659	64,363
INTANGIBLE ASSETS	62,690	63,351	63,152
OTHER ASSETS	59,150	45,613	58,266
Total assets	\$ 3,447,483	\$ 3,076,193	\$ 3,279,456
<b>LIABILITIES AND SHAREHOLDERS EQUITY</b>			
NONINTEREST-BEARING DEPOSITS	\$ 781,228	\$ 719,266	\$ 836,323
INTEREST-BEARING DEPOSITS	1,957,417	1,739,637	1,848,434
Total deposits	2,738,645	2,458,903	2,684,757
DIVIDENDS PAYABLE	7,090	7,080	7,081

SHORT-TERM BORROWINGS	178,097	160,401	146,094
OTHER LIABILITIES	72,720	34,275	25,822
Total liabilities	2,996,552	2,660,659	2,863,754

**COMMITMENTS AND CONTINGENCIES****SHAREHOLDERS EQUITY**

Common stock \$0.01 par value, authorized 40,000,000 shares;  
20,852,152, 20,822,396, and 20,826,431 shares issued at  
September 30, 2010 and 2009 and December 31, 2009,

respectively	208	208	208
Capital surplus	270,355	269,073	269,294
Retained earnings	138,002	109,663	115,123
Treasury stock (shares at cost: 165,376, 161,546, and 162,836 at September 30, 2010 and 2009, and December 31, 2009, respectively)	(4,115)	(3,746)	(3,833)
Deferred compensation	4,115	3,746	3,833
Accumulated other comprehensive earnings	42,366	36,590	31,077

Total shareholders equity	450,931	415,534	415,702
Total liabilities and shareholders equity	\$ 3,447,483	\$ 3,076,193	\$ 3,279,456

See notes to consolidated financial statements.

**FIRST FINANCIAL BANKSHARES, INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF EARNINGS (UNAUDITED)**  
(Dollars in thousands, except per share amounts)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2010	2009	2010	2009
<b>INTEREST INCOME:</b>				
Interest and fees on loans	\$ 23,093	\$ 22,642	\$ 68,259	\$ 68,385
Interest on investment securities:				
Taxable	9,026	9,144	27,229	27,951
Exempt from federal income tax	4,758	4,705	14,068	13,332
Interest on trading securities		11		151
Interest on federal funds sold and interest-bearing deposits in banks	382	96	1,102	209
<b>Total interest income</b>	<b>37,259</b>	<b>36,598</b>	<b>110,658</b>	<b>110,028</b>
<b>INTEREST EXPENSE:</b>				
Interest on deposits	3,249	3,836	10,247	12,768
Other	96	179	394	633
<b>Total interest expense</b>	<b>3,345</b>	<b>4,015</b>	<b>10,641</b>	<b>13,401</b>
<b>Net interest income</b>	<b>33,914</b>	<b>32,583</b>	<b>100,017</b>	<b>96,627</b>
<b>PROVISION FOR LOAN LOSSES</b>	<b>1,988</b>	<b>3,706</b>	<b>6,971</b>	<b>7,054</b>
<b>Net interest income after provision for loan losses</b>	<b>31,926</b>	<b>28,877</b>	<b>93,046</b>	<b>89,573</b>
<b>NONINTEREST INCOME:</b>				
Trust fees	2,706	2,328	7,904	6,570
Service charges on deposit accounts	5,100	5,732	15,252	16,294
ATM and credit card fees	2,915	2,427	8,255	7,062
Real estate mortgage operations	1,154	731	2,571	2,177
Net gain on securities transactions	7	897	79	1,645
Net gain on sale of student loans		273		889
Net gain (loss) on sale of foreclosed assets	313	(127)	383	(187)
Other	731	618	2,164	2,086
<b>Total noninterest income</b>	<b>12,926</b>	<b>12,879</b>	<b>36,608</b>	<b>36,536</b>
<b>NONINTEREST EXPENSE:</b>				
Salaries and employee benefits	13,126	12,201	38,624	36,434
Net occupancy expense	1,654	1,599	4,793	4,785
Equipment expense	1,851	1,920	5,542	5,828

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Printing, stationery and supplies	425	508	1,283	1,405
FDIC insurance premiums	975	818	2,953	4,074
Correspondent bank service charges	192	204	564	839
ATM and interchange expense	890	708	2,419	2,127
Professional and service fees	712	603	2,042	1,941
Amortization of intangible assets	151	214	463	652
Other expenses	4,730	4,243	13,312	12,240
<b>Total noninterest expense</b>	<b>24,706</b>	<b>23,018</b>	<b>71,995</b>	<b>70,325</b>
<b>EARNINGS BEFORE INCOME TAXES AND EXTRAORDINARY ITEM</b>	<b>20,146</b>	<b>18,738</b>	<b>57,659</b>	<b>55,784</b>
<b>INCOME TAX EXPENSE</b>	<b>5,213</b>	<b>4,752</b>	<b>14,811</b>	<b>14,528</b>
<b>NET EARNINGS BEFORE EXTRAORDINARY ITEM</b>	<b>14,933</b>	<b>13,986</b>	<b>42,848</b>	<b>41,256</b>
<b>EXTRAORDINARY ITEM EXPROPRIATION OF LAND, NET OF INCOME TAXES OF \$697</b>	<b>1,296</b>		<b>1,296</b>	
<b>NET EARNINGS</b>	<b>\$ 16,229</b>	<b>\$ 13,986</b>	<b>\$ 44,144</b>	<b>\$ 41,256</b>
<b>EARNINGS PER SHARE, BASIC BEFORE EXTRAORDINARY ITEM</b>	<b>\$ 0.72</b>	<b>\$ 0.67</b>	<b>\$ 2.06</b>	<b>\$ 1.98</b>
<b>EARNINGS PER SHARE, ASSUMING DILUTION BEFORE EXTRAORDINARY ITEM</b>	<b>\$ 0.72</b>	<b>\$ 0.67</b>	<b>\$ 2.05</b>	<b>\$ 1.98</b>
<b>EARNINGS PER SHARE, BASIC</b>	<b>\$ 0.78</b>	<b>\$ 0.67</b>	<b>\$ 2.12</b>	<b>\$ 1.98</b>
<b>EARNINGS PER SHARE, ASSUMING DILUTION</b>	<b>\$ 0.78</b>	<b>\$ 0.67</b>	<b>\$ 2.12</b>	<b>\$ 1.98</b>
<b>DIVIDENDS PER SHARE</b>	<b>\$ 0.34</b>	<b>\$ 0.34</b>	<b>\$ 1.02</b>	<b>\$ 1.02</b>

See notes to consolidated financial statements.

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

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2010	2009	2010	2009
<b>NET EARNINGS</b>	\$ 16,229	\$ 13,986	\$ 44,144	\$ 41,256
<b>OTHER ITEMS OF COMPREHENSIVE EARNINGS:</b>				
Change in unrealized gain on investment securities available-for-sale, before income taxes	16,201	30,594	17,447	41,245
Reclassification adjustment for realized gains on investment securities included in net earnings, before income tax	(7)	(897)	(79)	(1,645)
Total other items of comprehensive earnings	16,194	29,697	17,368	39,600
Income tax expense related to other items of comprehensive earnings	(5,668)	(10,394)	(6,079)	(13,860)
<b>COMPREHENSIVE EARNINGS</b>	<b>\$ 26,755</b>	<b>\$ 33,289</b>	<b>\$ 55,433</b>	<b>\$ 66,996</b>

See notes to consolidated financial statements.



**FIRST FINANCIAL BANKSHARES, INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY**  
(Dollars in thousands, except per share amounts)

	Common Shares	Stock Amount	Capital Surplus	Retained Earnings	Treasury Shares	Stock Amount	Deferred Compensation	Accumulated Other Comprehensive Earnings	Total Shareholders' Equity
Balances at December 31, 2008	20,799,198	\$ 208	\$ 268,087	\$ 89,637	(158,811)	\$ (3,500)	\$ 3,500	\$ 10,850	\$ 368,782
Net earnings (unaudited)				41,256					41,256
Stock issuances (unaudited)	23,198		583						583
Cash dividends declared, \$1.02 per share (unaudited)				(21,230)					(21,230)
Change in unrealized gain in investment securities available-for-sale, net of related income taxes (unaudited)								25,740	25,740
Additional tax benefit related to directors' deferred compensation plan (unaudited)			195						195
Shares purchased in connection with directors' deferred compensation plan, net (unaudited)					(2,735)	(246)	246		
Stock option expense (unaudited)			208						208

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Balances at September 30, 2009 (unaudited)	20,822,396	\$ 208	\$ 269,073	\$ 109,663	(161,546)	\$ (3,746)	\$ 3,746	\$ 36,590	\$ 415,534
Balances at December 31, 2009	20,826,431	\$ 208	\$ 269,294	\$ 115,123	(162,836)	\$ (3,833)	\$ 3,833	\$ 31,077	\$ 415,702
Net earnings (unaudited)				44,144					44,144
Stock issuances (unaudited)	25,721		658						658
Cash dividends declared, \$1.02 per share (unaudited)				(21,265)					(21,265)
Change in unrealized gain in investment securities available-for-sale, net of related income taxes (unaudited)								11,289	11,289
Additional tax benefit related to directors' deferred compensation plan (unaudited)			113						113
Shares purchased in connection with directors' deferred compensation plan, net (unaudited)					(2,540)	(282)	282		
Stock option expense (unaudited)			290						290
Balances at September 30, 2010 (unaudited)	20,852,152	\$ 208	\$ 270,355	\$ 138,002	(165,376)	\$ (4,115)	\$ 4,115	\$ 42,366	\$ 450,931

See notes to consolidated financial statements.

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

	Nine Months Ended September 30,	
	2010	2009
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>		
Net earnings	\$ 44,144	\$ 41,256
Adjustments to reconcile net earnings to net cash provided by operating activities:		
Depreciation and amortization	5,275	5,842
Provision for loan losses	6,971	7,054
Securities premium amortization (discount accretion), net	3,236	923
Gain on sale of assets, net	(2,570)	(2,391)
Deferred federal income tax expense (benefit)	254	(104)
Trading securities activity, net		51,212
Loans originated for resale	(102,860)	(146,500)
Proceeds from sales of loans held for resale	98,236	196,979
Change in other assets	3,930	5,974
Change in other liabilities	5,136	3,522
 Total adjustments	 17,608	 122,511
 Net cash provided by operating activities	 61,752	 163,767
 <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Activity in available-for-sale securities:		
Sales	17,403	44,904
Maturities	145,720	144,712
Purchases	(255,153)	(214,507)
Activity in held-to-maturity securities maturities	6,049	8,175
Net decrease (increase) in loans	(33,107)	55,269
Purchases of bank premises and equipment and computer software	(9,090)	(2,504)
Proceeds from sale of other assets	8,750	2,237
 Net cash provided by (used in) investing activities	 (119,428)	 38,287
 <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>		
Net decrease in noninterest-bearing deposits	(55,095)	(77,811)
Net increase (decrease) in interest-bearing deposits	108,984	(46,039)
Net increase (decrease) in short-term borrowings	32,003	(75,197)
Common stock transactions:		
Proceeds from stock issuances	658	583
Dividends paid	(21,256)	(21,222)
 Net cash provided by (used in) financing activities	 65,294	 (219,687)

<b>NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS</b>	7,618	(17,633)
<b>CASH AND CASH EQUIVALENTS, beginning of period</b>	321,541	168,888
<b>CASH AND CASH EQUIVALENTS, end of period</b>	\$ 329,159	\$ 151,255

**SUPPLEMENTAL INFORMATION AND NONCASH  
TRANSACTIONS**

Interest paid	\$ 10,830	\$ 14,190
Federal income tax paid	12,994	14,147
Transfer of loans to foreclosed assets	9,822	3,836
Investment securities purchased but not settled	35,830	
See notes to consolidated financial statements.		

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

**Note 1 Basis of Presentation**

The consolidated financial statements include the accounts of the Company, a Texas corporation and a financial holding company registered under the Bank Holding Company Act of 1956, or BHCA, and its wholly-owned subsidiaries: First Financial Bankshares of Delaware, Inc.; First Financial Investments of Delaware, Inc.; First Financial Bank, National Association, Abilene, Texas; First Financial Bank, Hereford, Texas; First Financial Bank, National Association, Sweetwater, Texas; First Financial Bank, National Association, Eastland, Texas; First Financial Bank, National Association, Cleburne, Texas; First Financial Bank, National Association, Stephenville, Texas; First Financial Bank, National Association, San Angelo, Texas; First Financial Bank, National Association, Weatherford, Texas; First Financial Bank, National Association, Southlake, Texas; First Financial Bank, National Association, Mineral Wells, Texas; First Technology Services, Inc.; First Financial Trust & Asset Management Company, National Association; First Financial Investments, Inc.; and First Financial Insurance Agency, Inc.

Through our subsidiary banks, we conduct a full-service commercial banking business. Our service centers are located primarily in North Central and West Texas. Including the branches and locations of all our bank subsidiaries, as of September 30, 2010, we had 50 financial centers across Texas, with ten locations in Abilene, two locations in Cleburne, three locations in Stephenville, three locations in Granbury, two locations in San Angelo, three locations in Weatherford, and one location each in Mineral Wells, Hereford, Sweetwater, Eastland, Ranger, Rising Star, Southlake, Aledo, Willow Park, Brock, Alvarado, Burleson, Keller, Trophy Club, Boyd, Bridgeport, Decatur, Roby, Trent, Merkel, Clyde, Moran, Albany, Midlothian, Glen Rose, Odessa and Fort Worth. Our trust subsidiary has six locations in Abilene, San Angelo, Stephenville, Sweetwater, Fort Worth and Odessa, all in Texas.

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 and should be read in conjunction with the Company's consolidated financial statements, and notes thereto, for the year ended December 31, 2009. All adjustments were of a normal recurring nature, except for the extraordinary item discussed in Note 6. However, the results of operations for the three and nine months ended September 30, 2010, are not necessarily indicative of the results to be expected for the year ending December 31, 2010, due to seasonality, changes in economic conditions and loan credit quality, interest rate fluctuations, regulatory and legislative changes 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 ( U.S. GAAP ) have been condensed or omitted under SEC rules and regulations. The Company evaluated subsequent events for potential recognition and/or disclosure through the date the consolidated financial statements were issued.

Goodwill and other intangible assets are evaluated annually for impairment as of the end of the second quarter. No such impairment has been noted in connection with these evaluations.

**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 presented. In computing diluted earnings per common share for the three and nine months ended September 30, 2010 and 2009, the Company assumes that all dilutive outstanding options to purchase common stock have been exercised at the beginning of the period (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, 2010 and 2009, were 20,849,902 and 20,819,398 shares, respectively. The weighted average common shares outstanding used in computing basic earnings per common share for the nine months ended September 30, 2010 and 2009, were 20,844,258 and 20,810,112 shares, respectively. The weighted average common shares outstanding used in computing fully diluted earnings per common share for the three months ended September 30, 2010 and 2009, were 20,854,489 and 20,844,567, respectively. The weighted average common shares outstanding used in computing fully diluted earnings per common share for the nine months ended September 30, 2010 and 2009, were 20,863,935 and 20,830,932, respectively

**Note 3 Securities**

A summary of available-for-sale and held-to-maturity securities follows (in thousands):

		September 30, 2010		
	Amortized	Gross	Gross	Estimated
	Cost Basis	Unrealized	Unrealized	Fair Value
		Holding	Holding	
		Gains	Losses	
Securities held-to-maturity:				
Obligations of states and political subdivisions	\$ 8,693	\$ 227	\$	\$ 8,920
Residential mortgage-backed securities	536	18		554
Total debt securities held-to-maturity	\$ 9,229	\$ 245	\$	\$ 9,474
Securities available-for-sale:				
U. S. Treasury securities and obligations of U.S. government sponsored-enterprises and agencies	\$ 307,761	\$ 11,234	\$	\$ 318,995
Obligations of states and political subdivisions	486,067	32,388	(40)	518,415
Corporate bonds and other	64,088	5,566		69,654
Residential mortgage-backed securities	481,033	24,077	(1)	505,109
Total securities available-for-sale	\$ 1,338,949	\$ 73,265	\$ (41)	\$ 1,412,173

	Amortized Cost Basis	December 31, 2009		Estimated Fair Value
		Gross Unrealized Holding Gains	Gross Unrealized Holding Losses	
Securities held-to-maturity:				
Obligations of states and political subdivisions	\$ 14,652	\$ 392	\$ (6)	\$ 15,038
Residential mortgage-backed securities	621	16	(1)	636
<b>Total debt securities held-to-maturity</b>	<b>\$ 15,273</b>	<b>\$ 408</b>	<b>\$ (7)</b>	<b>\$ 15,674</b>
Securities available-for-sale:				
Obligations of U.S. government sponsored-enterprises and agencies	\$ 260,018	\$ 12,050	\$	\$ 272,068
Obligations of states and political subdivisions	437,550	18,643	(561)	455,632
Corporate bonds and other	73,858	5,028		78,886
Residential mortgage-backed securities	442,823	20,995	(300)	463,518
<b>Total securities available-for-sale</b>	<b>\$ 1,214,249</b>	<b>\$ 56,716</b>	<b>\$ (861)</b>	<b>\$ 1,270,104</b>

The Company invests in mortgage-backed securities that have expected maturities that differ from their contractual maturities. These differences arise because borrowers may have the right to call or prepay obligations with or without a prepayment penalty. These securities include collateralized mortgage obligations (CMOs) and other asset backed securities. The expected maturities of these securities at September 30, 2010, were computed by using scheduled amortization of balances and historical prepayment rates. At September 30, 2010 and December 31, 2009, the Company did not hold any CMOs that entail higher risks than standard mortgage-backed securities.

The amortized cost and estimated fair value of debt securities at September 30, 2010, by contractual and expected maturity, are shown below (in thousands):

	Held-to-Maturity		Available-for-Sale	
	Amortized Cost Basis	Estimated Fair Value	Amortized Cost Basis	Estimated Fair Value
Due within one year	\$ 7,049	\$ 7,189	\$ 150,107	\$ 153,275
Due after one year through five years	1,644	1,731	394,321	415,762
Due after five years through ten years			282,963	305,884
Due after ten years			30,525	32,143
Mortgage-backed securities	536	554	481,033	505,109
<b>Total</b>	<b>\$ 9,229</b>	<b>\$ 9,474</b>	<b>\$ 1,338,949</b>	<b>\$ 1,412,173</b>

During the quarter ended September 30, 2010 and 2009, sales of investment securities that were classified as available-for-sale totaled \$2.4 million and \$9.5 million, respectively. Gross realized gains from 2010 and 2009 securities sales during the third quarter totaled \$7 thousand and \$897 thousand, respectively. There were no losses realized on securities sales during these periods. During the nine-months ended September 30, 2010 and 2009, sales of investment securities that were classified as available-for-sale totaled \$17.4 million and \$44.9 million, respectively. Gross realized gains from 2010 and 2009 securities sales during the nine months totaled \$79 thousand and



\$1.6 million, respectively. There were no losses realized on securities sales during these periods. The specific identification method was used to determine cost in order to compute the realized gains.

The following tables disclose, as of September 30, 2010 and December 31, 2009, our available-for-sale and held-to-maturity securities that have been in a continuous unrealized-loss position for less than 12 months and those that have been in a continuous unrealized-loss position for 12 or more months (in thousands):

	Less than 12 Months Unrealized		12 Months or Longer Unrealized		Total Unrealized	
	Fair Value	Loss	Fair Value	Loss	Fair Value	Loss
<b>September 30, 2010</b>						
Obligations of states and political subdivisions	\$ 3,751	\$ 3	\$ 2,227	\$ 37	\$ 5,978	\$ 40
Residential mortgage-backed securities	513	1			513	1
Total	\$ 4,264	\$ 4	\$ 2,227	\$ 37	\$ 6,491	\$ 41

	Less than 12 Months Unrealized		12 Months or Longer Unrealized		Total Unrealized	
	Fair Value	Loss	Fair Value	Loss	Fair Value	Loss
<b>December 31, 2009</b>						
Obligations of states and political subdivisions	\$ 21,703	\$ 428	\$ 2,798	\$ 139	\$ 24,501	\$ 567
Residential mortgage-backed securities	27,619	300	82	1	27,701	301
Total	\$ 49,322	\$ 728	\$ 2,880	\$ 140	\$ 52,202	\$ 868

The number of investment positions in this unrealized loss position totaled ten at September 30, 2010. We do not believe these unrealized losses are other than temporary as (1) we do not have the intent to sell our securities prior to recovery and/or maturity and (2) it is more likely than not that we will not have to sell our securities prior to recovery and/or maturity. The unrealized losses noted are interest rate related due to the level of interest rates at September 30, 2010 compared to the time of purchase. We have reviewed the ratings of the issuers and have not identified any issues related to the ultimate repayment of principal as a result of credit concerns on these securities. Our mortgage related securities are backed by GNMA, FNMA and FHLMC or are collateralized by securities backed by these agencies. As of September 30, 2009, trading securities totaled \$4.8 million. No amounts were held in trading securities at September 30, 2010 or December 31, 2009. The trading securities portfolio was a government securities money market fund comprised primarily of U.S. government agency securities and repurchase agreements collateralized by U.S. government agency securities. The trading securities were carried at estimated fair value with unrealized gains and losses included in earnings. The Company invested in trading securities in 2008 and part of 2009 to improve its yield on daily funds and to lower its exposure on Federal funds. However, due to significantly lower interest rates, the Company has deployed these funds into our investment portfolio and into FDIC fully insured certificates of deposit at unaffiliated banks.

Securities, carried at approximately \$766.0 million at September 30, 2010, were pledged as collateral for public or trust fund deposits, repurchase agreements and for other purposes required or permitted by law.

**Note 4 Loans And Allowance for Loan Losses**

Major classifications of loans are as follows (dollars in thousands):

	September 30,		December 31,
	2010	2009	2009
Commercial, financial and agricultural	\$ 462,024	\$ 463,723	\$ 508,431
Real estate construction	85,145	98,736	77,711
Real estate mortgage	807,256	709,866	752,735
Consumer	183,283	182,072	175,492
Total Loans	\$ 1,537,708	\$ 1,454,397	\$ 1,514,369

Included in real estate-mortgage loans above are \$8.9 million and \$4.3 million, respectively, in loans held for sale at September 30, 2010 and December 31, 2009 in which the carrying amounts approximate fair value. Included in real estate-mortgage and consumer loans above are \$3.5 million and \$1.5 million, respectively, in loans held for sale at September 30, 2009, in which the carrying amounts approximate fair value.

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

September 30, 2010		September 30, 2009		December 31, 2009	
Recorded Investment	Valuation Allowance	Recorded Investment	Valuation Allowance	Recorded Investment	Valuation Allowance
\$ 14,110	\$ 2,633	\$ 14,585	\$ 2,907	\$ 18,540	\$ 3,340

The allowance for loan losses as of September 30, 2010 and 2009 and December 31, 2009, is presented below. 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. Management has evaluated the adequacy of the allowance for loan losses by estimating the probable losses in various categories of the loan portfolio, which are identified below (in thousands):

	September 30,		December 31,
	2010	2009	2009
Allowance for loan losses provided for:			
Loans specifically evaluated as impaired	\$ 2,633	\$ 2,907	\$ 3,340
Remaining portfolio	27,380	22,625	24,272
Total allowance for loan losses	\$ 30,013	\$ 25,532	\$ 27,612

Changes in the allowance for loan losses are summarized as follows (in thousands):

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2010	2009	2010	2009
Balance at beginning of period	\$ 28,954	\$ 23,247	\$ 27,612	\$ 21,529
Add:				
Provision for loan losses	1,988	3,706	6,971	7,054
Loan recoveries	249	241	638	729
Deduct:				
Loan charge-offs	(1,178)	(1,662)	(5,208)	(3,780)
Balance at end of period	\$ 30,013	\$ 25,532	\$ 30,013	\$ 25,532

Nonaccrual loans, loans still accruing and past due 90 days or more, restructured loans and foreclosed assets are as follows (in thousands, except percentages):

	September 30,		December
	2010	2009	31, 2009
Nonaccrual loans	\$ 14,110	\$ 14,585	\$ 18,540
Loans still accruing and past due 90 days or more	69	56	15
Restructured loans			
Foreclosed assets	8,217	4,367	3,533
Total	\$ 22,396	\$ 19,008	\$ 22,088
As a % of total loans and foreclosed assets	1.45%	1.30%	1.46%
As a % of total assets	0.65%	0.62%	0.67%

Certain of our subsidiary banks have established lines of credit with the Federal Home Loan Bank of Dallas to provide liquidity and meet pledging requirements for those customers eligible to have securities pledged to secure certain uninsured deposits. At September 30, 2010, approximately \$293.7 million in loans held by these subsidiaries were subject to blanket liens as security for letters of credit issued under these lines of credit.

#### Note 5 Income Taxes

Income tax expense was \$5.2 million for the third quarter in 2010 as compared to \$4.8 million for the same period in 2009. Our effective tax rates on pretax income were 26.70% and 25.36% for the third quarters of 2010 and 2009, respectively. Income tax expense was \$14.8 million for the nine months ended September 30, 2010 as compared to \$14.5 million for the same period in 2009. Our effective tax rates on pretax income were 26.00% and 26.04% for the nine months ended September 30, 2010 and 2009, respectively. The effective tax rates differ from the statutory Federal 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 Texas state taxes. The above effective tax rates for 2010 reflect income taxes related to the extraordinary item.

The increase in the effective tax rate for the third quarter ended September 30, 2010 over the same period in 2009 was largely the result of the effect of the extraordinary item offset by an increase in tax exempt income. The small decrease in the effective tax rate for the nine-month period ended September 30, 2010 over the same period in 2009 was due to the same reasons.

**Note 6 Extraordinary Item**

In the third quarter of 2010, the Company recorded income from an extraordinary item in the amount of \$1.3 million, after income taxes, related to the expropriation of a portion of our real property. The Texas Department of Transportation (TXDOT) expropriated a portion of our real property at our Southlake bank location to expand highway access. As a result, our current location's accessibility significantly deteriorated and we have announced the construction of a new bank location in Southlake and will hold for sale the existing location. TXDOT paid \$2.2 million for land and damages to our existing property resulting in a net gain of \$2.0 million before income taxes.

**Note 7 Stock Based Compensation**

The Company grants incentive 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. No stock options have been granted in 2010. In May 2009, the Company granted incentive stock options to purchase 101,600 shares of Company common stock with an exercise price of \$50.33 per share. The fair value of the options granted was estimated using the Black-Scholes options pricing model with the following weighted-average assumptions: risk-free interest rate of 3.24%; expected dividend yield of 2.66%; expected life of 5.79 years; and expected volatility of 41.64%.

The Company recorded stock option expense totaling approximately \$97 thousand and \$71 thousand, respectively, for the three-month periods ended September 30, 2010 and 2009. The Company recorded stock option expense totaling approximately \$290 thousand and \$208 thousand, respectively, for the nine-month periods ended September 30, 2010 and 2009.

The additional disclosure requirements under authoritative accounting guidance have been omitted due to immateriality.

**Note 8 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 at the time. The benefits for each employee were based on years of service and a percentage of the employee's qualifying compensation during the final years of employment. The Company's funding policy was and is to contribute annually the amount necessary to satisfy the Internal Revenue Service's funding standards. Contributions to the pension plan, prior to freezing the plan, were intended to provide not only for benefits attributed to service to date but also for those expected to be earned in the future. As a result of the Pension Protection Act of 2006 (the Protection Act), the Company will be required to contribute amounts in future years to fund any shortfalls. The Company has evaluated the provisions of the Protection Act as well as the Internal Revenue Service's funding standards to develop a preliminary plan for funding in future years. The Company made a contribution totaling \$1.0 million in March 2010 and \$1.4 million in April 2009 and continues to evaluate future funding amounts.

Net periodic benefit costs totaling \$99 thousand and \$80 thousand were recorded, respectively, for the three months ended September 30, 2010 and 2009. Net periodic benefit costs totaling \$299 thousand and \$241 thousand were recorded, respectively, for the nine months ended September 30, 2010 and 2009.

**Note 9 Recently Issued Authoritative Accounting Guidance**

In 2010, the Financial Accounting Standards Board (FASB) issued authoritative guidance expanding disclosures related to fair value measurements including (i) the amounts of significant transfers of assets or liabilities between Levels 1 and 2 of the fair value hierarchy and the reasons for the transfers, (ii) the reasons for transfers of assets or liabilities in or out of Level 3 of the fair value hierarchy, with significant transfers disclosed separately, (iii) the policy for determining when transfers between levels of the fair value hierarchy are recognized and (iv) for recurring fair value measurements of assets and liabilities in Level 3 of the fair value hierarchy, a gross presentation of information about purchases, sales, issuances and settlements. The new guidance further clarifies that (i) fair value measurement disclosures should be provided for each class of assets and liabilities (rather than major category), which would generally be a subset of assets or liabilities within a line item in the statement of financial position and (ii) disclosures should be provided about the valuation techniques and inputs used to measure fair value for both recurring and nonrecurring fair value measurements for each class of assets and liabilities included in Levels 2 and 3 of the fair value hierarchy. The disclosures related to the gross presentation of purchases, sales, issuances and settlements of assets and liabilities included in Level 3 of the fair value hierarchy will be required beginning January 1, 2011. The remaining disclosure requirements and clarifications made by the new guidance became effective on January 1, 2010. In 2010, the FASB issued authoritative guidance that requires entities to provide enhanced disclosures in the financial statements about their loans including credit risk exposures and the allowance for loan losses. While some of the required disclosures are already included in the management discussion and analysis section of our interim and annual filings, the new guidance will require inclusion of such analyses in the notes to the financial statements. Included in the new guidance are credit quality information, impaired loan information, loan modification information and nonaccrual and past due information. The period-end information will be required to be disclosed for the year ending December 31, 2010 and the activity-related information will be required to be disclosed beginning with the first quarter of 2011. The Company does not expect the adoption of this authoritative guidance to have a significant effect on the financial condition and results of operations.

**Note 10 Fair Value Disclosures**

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

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

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 2 investments consist primarily of obligations of U.S. government sponsored enterprises and agencies, obligations of state and municipal subdivisions, corporate bonds and mortgage backed securities.

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

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

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

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

There were no transfers between Level 2 and Level 3 during the quarter and the nine-months ended September 30, 2010.

The following table summarizes financial assets and financial liabilities measured at fair value on a recurring basis as of September 30, 2010, 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
Available for sale investment securities:				
U. S. Treasury securities and obligations of U. S. government sponsored-enterprises and agencies	\$ 15,626	\$ 303,369	\$	\$ 318,995
Obligations of states and political subdivisions	23,300	495,115		518,415
Corporate bonds and other	3,933	65,721		69,654
Residential mortgage-backed securities	29,942	475,167		505,109
	\$ 72,801	\$ 1,339,372	\$	\$ 1,412,173

Certain financial assets and financial liabilities are measured at fair value on a nonrecurring basis, that is, the instruments are not measured at fair value on an ongoing basis but are subject to fair value adjustments in certain circumstances (for example, when there is evidence of impairment). Financial assets and financial liabilities measured at fair value on a non-recurring basis include the following at September 30, 2010:

**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 input based on the discounting of the collateral measured by appraisals. At September 30, 2010, impaired loans with a carrying value of \$14.1 million were reduced by specific valuation allowances totaling \$2.6 million resulting in a net fair value of \$11.5 million, based on Level 3 inputs.

**Loans Held for Sale** Loans held for sale are reported at the lower of cost or fair value. In determining whether the fair value of loans held for sale is less than cost when quoted market prices are not available, the Company considers investor commitments/contracts. These loans are considered Level 2 of the fair value hierarchy. At September 30, 2010, the Company's mortgage loans held for sale were recorded at cost as fair value exceeded cost.

Certain non-financial assets and non-financial liabilities measured at fair value on a recurring and non-recurring basis include other real estate owned, goodwill and other intangible assets and other non-financial long-lived assets. Such amounts were not significant to the Company at September 30, 2010.

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

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



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

Financial instruments with stated maturities have been valued using a present value discounted cash flow with a discount rate approximating current market for similar assets and liabilities. Financial instrument liabilities with no stated maturities have an estimated fair value equal to both the amount payable on demand and the carrying value. The carrying value and the estimated fair value of the Company's contractual off-balance-sheet unfunded lines of credit, loan commitments and letters of credit, which are generally priced at market at the time of funding, are not material.

The estimated fair values and carrying values of all financial instruments under current authoritative guidance at September 30, 2010 and 2009, were as follows (in thousands):

	September 30,			
	2010		2009	
	Carrying Value	Estimated Fair Value	Carrying Value	Estimated Fair Value
Cash and due from banks	\$ 91,492	\$ 91,492	\$ 89,326	\$ 89,326
Federal funds sold	6,135	6,135	38,045	38,045
Interest-bearing deposits in banks	231,532	231,532	23,884	23,884
Trading securities			4,779	4,779
Held to maturity securities	9,229	9,474	15,324	15,824
Available for sale securities	1,412,173	1,412,173	1,303,347	1,303,347
Loans	1,507,695	1,507,816	1,428,865	1,420,993
Accrued interest receivable	18,528	18,528	18,873	18,873
Deposits with stated maturities	801,806	804,754	686,131	688,924
Deposits with no stated maturities	1,936,839	1,936,839	1,772,772	1,772,772
Short term borrowings	178,097	178,097	160,401	160,401
Accrued interest payable	1,318	1,318	1,492	1,492

#### **Note 11 Acquisition Subsequent Event**

On November 1, 2010, the Company completed the acquisition of Sam Houston Financial Corp., the parent of The First State Bank, Huntsville, Texas for a combined cash and stock price of \$22.2 million. At September 30, 2010, The First State Bank had loans of \$104.8 million and deposits of \$145.5 million.

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

### **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 and employment trends;
- volatility and disruption in national and international financial markets;
- the effects of recent legislative, tax, accounting and regulatory actions and reforms, including the Dodd-Frank Act and Basel III;
- political instability;
- the ability of the Federal government to deal with the national economic slowdown and the effect of stimulus packages enacted by Congress as well as future stimulus packages, if any;
- 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 Board of Governors of the Federal Reserve System;
- changes in the demand for loans;
- fluctuations in the value of collateral securing our loan portfolio and in the level of the allowance for loan losses;
- the accuracy of our estimates of future loan losses;
- the accuracy of our estimates and assumptions regarding the performance of our securities portfolio;
- soundness of other financial institutions with which we have transactions;
- inflation, interest rate, market and monetary fluctuations;
- changes in consumer spending, borrowing and savings habits;
- continued 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.

## **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. Our primary source of funding for our loans and investments are deposits held by 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 2009 Annual Report on Form 10-K.

## **Regulatory Reform and Legislation**

Congress and the regulators for financial institutions have proposed and passed significant changes to the laws, rules and regulations governing financial institutions. Most recently, the House of Representatives and Senate passed the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act) which the President has signed. Prior to the Dodd-Frank Act, Congress and the financial institution regulators made other significant changes affecting many aspects of banking. These recent actions address many issues including capital, interchange fees, compliance and risk management, debit card interchange fees, overdraft fees, the establishment of a new consumer regulator, healthcare, incentive compensation, expanded disclosures and corporate governance. While many of the new regulations are for financial institutions with assets greater than \$10 billion, we expect the new regulations to reduce our revenues and increase our expenses in the future. We are closely monitoring those actions to determine the appropriate response to comply and at the same time minimize the adverse effect on our banks.

On September 12, 2010, the Group of Governors and Heads of Supervision, the oversight body of the Basel Committee, announced agreement on the calibration and phase in arrangements for a strengthened set of capital requirements, known as Basel III. Basel III increases the minimum Tier 1 common equity ratio to 4.5%, net of regulatory deductions, and introduces a capital conservation buffer of an additional 2.5% of common equity to risk weighted assets, raising the target minimum common equity ratio to 7%. This capital conservation buffer also increases the minimum Tier 1 capital ratio from 6% to 8.5% and the minimum total capital ratio from 8% to 10.5%. In addition, Basel III introduces a countercyclical capital buffer of up to 2.5% of common equity or other fully loss absorbing capital for periods of excess credit growth. Basel III also introduces a non-risk adjusted Tier 1 leverage ratio of 3%, based on a measure of total exposure rather than total assets, and new liquidity standards. The Basel III capital and liquidity standards will be phased in over a multi-year period. The final package of Basel III reforms will be submitted to the Seoul G20 Leaders Summit in November 2010 for endorsement by G20 leaders, and then will be subject to individual adoption by member nations, including the United States. The Federal Reserve will likely implement changes to the capital adequacy standards applicable to the Company and our subsidiary banks in light of Basel III.

## **Acquisition Subsequent Event**

On November 1, 2010, the Company completed the acquisition of Sam Houston Financial Corp., the parent of The First State Bank, Huntsville, Texas for a combined cash and stock price of \$22.2 million. At September 30, 2010, The First State Bank had loans of \$104.8 million and deposits of \$145.5 million.

### **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 (1) our allowance for loan losses and our provision for loan losses and (2) our valuation of securities, which we deem to be our most critical accounting policies. 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.

*Allowance for Loan Losses.* The allowance for loan losses is an amount we believe will be adequate to absorb probable losses on existing loans in which full collectibility 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 charge-offs (net of recoveries).

Our methodology is based on current authoritative accounting guidance, including guidance from the SEC. We also follow the guidance of the Interagency Policy Statement on the Allowance for Loan and Lease Losses, issued jointly by the Office of the Comptroller of the Currency ( OCC ), the Federal Reserve Board, the FDIC, the National Credit Union Administration and the Office of Thrift Supervision. We have developed a 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 current authoritative accounting guidance based on probable losses on specific classified loans; (ii) general reserves determined in accordance with current authoritative accounting guidance that consider historical loss rates; and (iii) a qualitative reserve determined in accordance with current authoritative accounting guidance 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 probable 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, including unemployment, 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 further 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 principal and interest is doubtful or generally if the loan is 90 days past due.

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.

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

When the fair value of a security is below its amortized cost, and depending on the length of time the condition exists and the extent the fair value is below amortized cost, additional analysis is performed to determine whether another-than-temporary impairment condition exists. Available-for-sale and held-to-maturity securities are analyzed quarterly for possible other-than-temporary impairment. The analysis considers (i) whether we have the intent to sell our securities prior to recovery and/or maturity and (ii) whether it is more likely than not that we will have to sell our securities prior to recovery and/or maturity. 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.

### **Results of Operations**

*Performance Summary.* Net earnings for the third quarter of 2010 were \$16.2 million compared to \$14.0 million for the same period in 2009, or a 16.0% increase over the same period in 2009. Net earnings before extraordinary item for the third quarter of 2010 were \$14.9 million, or a 6.8% increase over the same period in 2009.

Net earnings included income from an extraordinary item totaling \$1.3 million, after related income taxes, related to the expropriation of a portion of our real property. The Texas Department of Transportation (TXDOT) expropriated a portion of real property at our Southlake bank location to expand highway access. As a result, our current location's accessibility significantly deteriorated and we have announced the construction of a new bank location in Southlake and will hold for sale the existing location. TXDOT paid \$2.2 million for land and damages to our existing property resulting in a net gain of \$2.0 million before income taxes.

Net earnings for the third quarter of 2010 compared to the same period in 2009 were positively impacted by a 4.1% increase in net interest income, a \$1.7 million decrease in the provision for loan losses and the extraordinary item (discussed above). Partially offsetting these factors was a 7.3% increase in noninterest expense.

Basic earnings per share for the third quarter of 2010 were \$0.78 compared to \$0.67 for the same quarter last year. Basic earnings per share before extraordinary item for the third quarter of 2010 were \$0.72. The return on average assets was 1.91% for the third quarter of 2010, as compared to 1.81% for the same quarter of 2009. The return (based on net earnings before extraordinary item) on average assets was 1.76% for the third quarter of 2010. The return on average equity was 14.62% for the third quarter of 2010 as compared to 13.99% for the same quarter of 2009. The return (based on net earnings before extraordinary item) on average equity was 13.46% for the third quarter of 2010. Net earnings for the nine-month period ended September 30, 2010 were \$44.1 million, an increase of \$2.9 million, or 7.0% compared to net earnings for the nine-month period ended September 30, 2009 of \$41.3 million. Net earnings before extraordinary item for the nine months ended September 30, 2010 were \$42.8 million, a 3.9% increase over the same period in 2009.

Net earnings for the nine months ended September 30, 2010 compared to the same period in 2009 were positively impacted by a 3.5% increase in net interest income, a \$1.3 million increase in trust fees, a \$1.1 million decrease in FDIC premiums and the extraordinary item discussed above. Partially offsetting these factors was a decrease in gain from sale of student loans of \$889 thousand, a decrease in net gain on securities transactions of \$1.6 million, and a \$2.8 million increase in non-interest expense, exclusive of the FDIC insurance premiums.

Basic earnings per share basis, net earnings were \$2.12 for the nine-months of 2010 as compared to \$1.98 for the same period of 2009. Basic earnings per share before extraordinary item for the nine months ended September 30, 2010 were \$2.06. The return on average assets was 1.77% for the first nine-months of 2010, as compared to 1.78% for the same period of 2009. The return on average assets (based on net earnings before extraordinary item) was 1.72% for the nine months ended September 30, 2010. The return on average equity was 13.78% for the first nine-months of 2010, as compared to 14.18% for the same period of 2009. The return on average equity (based on net earnings before extraordinary item) was 13.38% for the nine months ended September 30, 2010.

*Net Interest Income.* Net interest income is the difference between interest income on earning assets and interest expense on liabilities incurred to fund those assets. Our earning assets consist primarily of loans and investment securities. Our liabilities to fund those assets consist primarily of noninterest-bearing and interest-bearing deposits. Tax-equivalent net interest income was \$36.6 million for the third quarter of 2010, as compared to \$35.2 million for the same period last year. The increase in 2010 compared to 2009 was largely attributable to an increase in the volume of earning assets. Average earning assets increased \$276.4 million for the third quarter of 2010 over the same period in 2009. Average short-term investments, average taxable securities and average loans increased \$103.9 million, \$78.0 million and \$68.2 million, respectively, for the third quarter of 2010 over the third quarter of 2009. Average interest bearing liabilities increased \$194.8 million for the third quarter of 2010, as compared to the same period in 2009. The yield on earning assets decreased 38 basis points during the third quarter of 2010, whereas the rate paid on interest-bearing liabilities decreased only 21 basis points in the third quarter of 2010 primarily due to the effects of lower interest rates.

Tax-equivalent net interest income was \$108.0 million for the first nine months of 2010, as compared to \$103.9 million for the same period last year. The increase in 2010 compared to 2009 was largely attributable to an increase in the volume of interest earning assets. Average interest earning assets increased \$221.5 million for the first nine months of 2010 over the same period in 2009. Average short-term investments, average taxable securities, and average tax exempt securities increased \$137.5 million, \$38.6 million and \$36.9 million, respectively, for the first nine months of 2010 over the first nine months of 2009. Average interest bearing liabilities increased \$146.0 million for the first nine months of 2010, as compared to the same period in 2009. The yield on earning assets decreased 34 basis points, whereas the rate paid on interest-bearing liabilities decreased only 25 basis points in the first nine months of 2010, primarily due to the effects of lower interest rates.

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

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

	Three Months Ended September 30, 2010			Nine Months Ended September 30, 2010		
	Compared to Three Months Ended September 30, 2009			Compared to Nine Months Ended September 30, 2009		
	Change Attributable			Change Attributable		
	to	Total	to	Total		
	Volume	Rate	Change	Volume	Rate	Change
Short-term investments	\$ 568	\$ (283)	\$ 285	\$ 2,065	\$ (1,173)	\$ 892
Taxable investment securities (1)	835	(964)	(129)	1,229	(2,101)	(872)
Tax-exempt investment securities (2)	413	(291)	122	1,727	(475)	1,252
Loans (2) (3)	1,064	(532)	532	394	(339)	55
Interest income	2,880	(2,070)	810	5,415	(4,088)	1,327
Interest-bearing deposits	462	(1,049)	(587)	1,228	(3,748)	(2,520)
Short-term borrowings	(14)	(68)	(82)	(72)	(168)	(240)
Interest expense	448	(1,117)	(669)	1,156	(3,916)	(2,761)
Net interest income	\$ 2,432	\$ (953)	\$ 1,479	\$ 4,259	\$ (172)	\$ 4,087

(1) Trading securities are included in taxable investment securities.

(2) Computed on a tax-equivalent basis assuming a marginal tax rate of 35%.

- (3) Nonaccrual  
loans are  
included in  
loans.

The net interest margin for the third quarter of 2010 was 4.67%, a decrease of 25 basis points from the same period in 2009. The net interest margin for the nine months ended September 30, 2010, was 4.68%, a decrease of 17 basis points from the same period in 2009. These decreases are largely the result of the extended period of low short-term interest rates. The target Federal funds rate was reduced to a range of zero to 25 basis points in December 2008. The low level of interest rates has reduced the yields on our short-term investments and investment securities as the proceeds from maturing investment securities have been invested at lower rates. We have partially offset this effect by reducing rates paid on interest bearing liabilities. Should interest rates remain at the current low levels for an extended period, we anticipate added pressure on our interest margin.



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

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

	Three months ended September 30,					
	Average Balance	2010 Income/ Expense	Yield/ Rate	Average Balance	2009 Income/ Expense	Yield/ Rate
<b>Assets</b>						
Short-term investments (1)	\$ 168,709	\$ 381	0.90%	\$ 64,838	\$ 96	0.59%
Taxable investment securities (2)(3)	933,394	9,026	3.87	855,409	9,155	4.28
Tax-exempt investment securities (3)(4)	476,889	7,182	6.02	450,508	7,060	6.27
Loans (4)(5)	1,533,624	23,389	6.05	1,465,423	22,857	6.19
Total earning assets	3,112,616	39,978	5.10%	2,836,178	39,168	5.48%
Cash and due from banks	101,173			95,935		
Bank premises and equipment, net	66,195			63,795		
Other assets	50,926			36,079		
Goodwill and other intangible assets, net	62,766			63,461		
Allowance for loan losses	(29,444)			(23,674)		
Total assets	\$ 3,364,232			\$ 3,071,774		
<b>Liabilities and Shareholders Equity</b>						
Interest-bearing deposits	\$ 1,939,078	\$ 3,249	0.66%	\$ 1,730,708	\$ 3,836	0.88%
Short-term borrowings	158,051	97	0.24	171,621	179	0.41
Total interest-bearing liabilities	2,097,129	3,346	0.63%	1,902,329	4,015	0.84%
Noninterest-bearing deposits	787,069			738,625		
Other liabilities	39,756			34,143		
Total liabilities	2,923,954			2,675,097		
Shareholders equity	440,278			396,677		
Total liabilities and shareholders equity	\$ 3,364,232			\$ 3,071,774		
Net interest income		\$ 36,632			\$ 35,153	
<b>Rate Analysis:</b>						
Interest income/earning assets			5.10%			5.48%
Interest expense/earning assets			0.43			0.56
Net yield on earning assets			4.67%			4.92%

	Nine months ended September 30,					
	2010			2009		
	Average Balance	Income/ Expense	Yield/ Rate	Average Balance	Income/ Expense	Yield/ Rate
<b>Assets</b>						
Short-term investments (1)	\$ 186,560	\$ 1,102	0.79%	\$ 49,109	\$ 209	0.57%
Taxable investment securities (2) (3)	920,279	27,229	3.95	881,726	28,102	4.25
Tax-exempt investment securities (3) (4)	463,508	21,209	6.10	426,621	19,958	6.24
Loans (4)(5)	1,512,992	69,070	6.10	1,504,400	69,015	6.13
<b>Total earning assets</b>	<b>3,083,339</b>	<b>118,610</b>	<b>5.14%</b>	<b>2,861,856</b>	<b>117,284</b>	<b>5.48%</b>
Cash and due from banks	104,661			102,907		
Bank premises and equipment, net	65,820			64,526		
Other assets	49,741			36,754		
Goodwill and other intangible assets, net	62,917			63,674		
Allowance for loan losses	(29,055)			(22,900)		
<b>Total assets</b>	<b>\$ 3,337,423</b>			<b>\$ 3,106,817</b>		
<b>Liabilities and Shareholders Equity</b>						
Interest-bearing deposits	\$ 1,912,051	10,247	0.72%	\$ 1,744,336	\$ 12,768	0.98%
Short-term borrowings	169,692	393	0.31	191,376	633	0.44
<b>Total interest-bearing liabilities</b>	<b>2,081,743</b>	<b>10,640</b>	<b>0.68</b>	<b>1,935,712</b>	<b>13,401</b>	<b>0.93%</b>
Noninterest-bearing deposits	792,042			749,383		
Other liabilities	35,379			32,801		
<b>Total liabilities</b>	<b>2,909,164</b>			<b>2,717,896</b>		
Shareholders equity	428,259			388,921		
<b>Total liabilities and shareholders equity</b>	<b>\$ 3,337,423</b>			<b>\$ 3,106,817</b>		
<b>Net interest income</b>		<b>\$ 107,970</b>			<b>\$ 103,883</b>	
<b>Rate Analysis:</b>						
Interest income/earning assets			5.14%			5.48%
Interest expense/earning assets			0.46			0.63
<b>Net yield on earning assets</b>			<b>4.68%</b>			<b>4.85%</b>

(1) Short-term investments are comprised of Federal funds

sold and  
interest-bearing  
deposits in banks.

- (2) Trading securities  
are included in  
taxable  
investment  
securities.
- (3) Average balances  
include  
unrealized gains  
and losses on  
available-for-sale  
securities.
- (4) Computed on a  
tax-equivalent  
basis assuming a  
marginal tax rate  
of 35%.
- (5) Nonaccrual loans  
are included in  
loans.

*Noninterest Income.* Noninterest income for the third quarter of 2010 was \$12.9 million, a slight increase over the same period in 2009. Trust fees increased \$378 thousand, real estate mortgage operations increased \$423 thousand and ATM and credit card fees increased \$488 thousand. The increase in trust fees reflects higher oil and gas prices, the migration of non-managed accounts to fully managed and fee based accounts and an increase in assets under management over the prior year. The fair value of our trust assets managed, which are not reflected in our consolidated balance sheet, totaled \$2.22 billion at September 30, 2010 as compared to \$2.03 billion for the same date in 2009. Real estate mortgage income increased due to the lower rate mortgage environment and resultant refinancing. The increase in ATM and credit card fees is primarily a result of increased use of debit cards and an increase in net new accounts. Offsetting these increases was a 2009 third quarter net gain on securities transactions of \$897 thousand compared to only \$7 thousand in the third quarter of 2010 and a decrease in service charge income of \$632 thousand, primarily from decreased customer use of overdraft services and changes in overdraft regulations. The Company cannot provide any assurance as to the ultimate impact of these new regulations on the amount of service charge income reported in future periods.

Noninterest income for the nine-month period ended September 30, 2010, was \$36.6 million, a slight increase over the same period in 2009. Trust fees increased \$1.3 million, real estate mortgage operations increased \$394 thousand, ATM and credit card fees increased \$1.2 million and an improved disposition of foreclosed assets of \$570 thousand. The increase in trust fees reflects higher oil and gas prices, the migration of non-managed accounts to fully managed and fee based accounts and an increase in assets under management over the prior year. The fair value of our trust assets managed, which are not reflected in our consolidated balance sheet, totaled \$2.22 billion at September 30, 2010 as compared to \$2.03 billion for the same date in 2009. Real estate mortgage income increased due to the low rate mortgage environment and resultant volume of refinancing. The increase in ATM and credit card fees is primarily a result of increased use of debit cards and an increase in net new accounts. Offsetting these increases were decreases in the gain on sale of student loans, gains on securities transactions and service charges on deposits. In the first three quarters of 2009, we recorded a gain of \$889 thousand on the sale of approximately \$84.3 million in student loans, which represented substantially our entire student loan portfolio. The Company suspended its student loan origination activities as a result of changes mandated by the Department of Education and Congress which transferred the student loan program into direct lending with the government. At September 30, 2010, the Company held no student loans and had no student loan transactions in 2010. Securities transactions gains totaled \$1.6 million in the nine-month period of 2009 compared to only \$79 thousand for the same period in 2010. Service charges on deposit accounts decreased of \$1.0 million compared to the same period in 2009, primarily from decreased customer use of overdraft services and changes in overdraft regulations. The Company cannot provide any assurance as to the ultimate impact of these new regulations on the amount of service charge income reported in future periods.

**Table 3 Noninterest Income (in thousands):**

	Three Months Ended			Nine Months Ended September 30,		
	2010	Increase (Decrease)	2009	2010	Increase (Decrease)	2009
Trust fees	\$ 2,706	\$ 378	\$ 2,328	\$ 7,904	\$ 1,334	\$ 6,570
Service charges on deposit accounts	5,100	(632)	5,732	15,252	(1,042)	16,294
Real estate mortgage operations	1,154	423	731	2,571	394	2,177
Gain on sale of student loans		(273)	273		(889)	889
ATM and credit card fees	2,915	488	2,427	8,255	1,193	7,062
Net gain on securities transactions	7	(890)	897	79	(1,566)	1,645
Net gain (loss) on sale of foreclosed assets	313	440	(127)	383	570	(187)
Other:						
Check printing fees	45	(60)	105	172	(141)	313
Safe deposit rental fees	91	1	90	357	1	356
Exchange fees	28	1	27	77	8	69
Credit life and debt protection fees	43	(31)	74	125	(38)	163
Brokerage commissions	66	(23)	89	215	15	200
Interest on loan recoveries	69	26	43	361	132	229
Miscellaneous income	389	199	190	857	101	756
Total other	731	113	618	2,164	78	2,086

Total Noninterest Income	\$ 12,926	\$	47	\$ 12,879	\$ 36,608	\$	72	\$ 36,536
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*Noninterest Expense.* Total noninterest expense for the third quarter of 2010 was \$24.7 million, an increase of \$1.7 million, or 7.3%, as compared to the same period in 2009. An important measure in determining whether a banking company effectively manages noninterest expenses is the efficiency ratio, which is calculated by dividing noninterest expense by the sum of net interest income on a tax-equivalent basis and noninterest income. Lower ratios indicate better efficiency since more income is generated with a lower noninterest expense total. Our efficiency ratio for the third quarter of 2010 was 47.92%, unchanged from the same period in 2009. The efficiency ratio for 2010 include the income from the extraordinary item.

Salaries and employee benefits for the third quarter of 2010 totaled \$13.1 million, an increase of \$925 thousand, or 7.6%, as compared to 2009. The increase was largely the result of an increase in profit sharing plan expense. All other categories of noninterest expense for the third quarter of 2010 totaled \$11.6 million, an increase of \$763 thousand, or 7.1%, as compared to the same period in 2009. Categories of noninterest expense with increases included FDIC insurance premiums, ATM and interchange expense, professional and service fees, legal fees and other real estate expenses. FDIC insurance increased \$157 thousand, primarily as a result of the increase in deposits. ATM and interchange expense increased \$182 thousand, primarily a result of increased use of debit cards. Professional and service fees were \$109 thousand higher, largely as a result of volume-related increases in expenses related to internet banking services. Legal fees increased \$111 thousand, largely as a result of expenses related to the pending acquisition of The First State Bank, Huntsville, Texas. Other real estate expenses increased \$262 thousand due to higher other real estate owned and related holding costs.

Total noninterest expense for the first nine-months of 2010 was \$72.0 million, an increase of \$1.7 million, or 2.4%, as compared to the same period in 2009. Our efficiency ratio for the first nine-months of 2010 was 49.12% compared to 50.08% for the same period in 2009. The efficiency ratio for 2010 include the income from the extraordinary item. Salaries and employee benefits for the first nine-months of 2010 totaled \$38.6 million, an increase of \$2.2 million, or 6.0%, as compared to 2009. The increase was largely the result of increases in profit sharing plan expense and employee medical expenses.

All other categories of noninterest expense for the first nine-months of 2010 totaled \$33.4 million, a decrease of \$520 thousand, or 1.5%, as compared to the same period in 2009. Other categories of noninterest expense with increases included ATM and interchange expense, professional and service fees, advertising, legal fees and other real estate expenses. ATM and interchange expense increased \$292 thousand, primarily a result of increased use of debit cards. Professional and service fees were \$101 thousand higher, largely as a result of volume-related increases in expenses related to internet banking services. Advertising expense increased \$350 thousand reflecting marketing efforts to capitalize on our being recognized in January 2010 as the best-performing bank in the nation in the \$3 billion-plus publicly traded category by *Bank Director Magazine*. Legal fees increased \$183 thousand, largely as a result of expenses related to the acquisition of The First State Bank, Huntsville, Texas. Other real estate expenses increased \$461 thousand due to higher other real estate owned and related holding costs. Offsetting these increases were a reduction in FDIC insurance premiums. FDIC insurance premium expense was \$3.0 million in the first nine months of 2010, a decrease of \$1.1 million compared to the same period of 2009. In the first nine months of 2009, the Company's banks paid an FDIC special assessment of \$1.4 million. There was no special assessment in the first nine months of 2010.

**Table 4 Noninterest Expense (in thousands):**

	Three Months Ended September 30,			Nine Months Ended September 30,		
	2010	Increase (Decrease)	2009	2010	Increase (Decrease)	2009
Salaries	\$ 9,868	\$ 195	\$ 9,673	\$ 29,134	\$ 367	\$ 28,767
Medical	963	221	742	2,766	358	2,408
Profit sharing	1,148	459	689	2,967	1,229	1,738
Pension	99	19	80	299	58	241
401(k) match expense	292	1	291	908	17	891
Payroll taxes	659	4	655	2,260	79	2,181
Stock option expense	97	26	71	290	82	208
<b>Total salaries and employee benefits</b>	<b>13,126</b>	<b>925</b>	<b>12,201</b>	<b>38,624</b>	<b>2,190</b>	<b>36,434</b>
Net occupancy expense	1,654	55	1,599	4,793	8	4,785
Equipment expense	1,851	(69)	1,920	5,542	(286)	5,828
Intangible amortization	151	(63)	214	463	(189)	652
FDIC assessment fees	975	157	818	2,953	(1,121)	4,074
Printing, stationery and supplies	425	(83)	508	1,283	(122)	1,405
Correspondent bank service charges	192	(12)	204	564	(275)	839
ATM and interchange expense	890	182	708	2,419	292	2,127
Professional and service fees	712	109	603	2,042	101	1,941
<b>Other:</b>						
Postage	383	16	367	1,071	(41)	1,112
Advertising	397	91	306	1,180	350	830
Credit card fees	95	(7)	102	316	(19)	335
Telephone	343	16	327	1,020	27	993
Public relations and business development	405	51	354	1,108	155	953
Directors' fees	179	21	158	563	31	532
Audit and accounting fees	246	(46)	292	742	(98)	840
Legal fees	244	111	133	588	183	405
Regulatory exam fees	220	9	211	652	(3)	655
Travel	150	7	143	445	54	391
Courier expense	152	16	136	434	3	431
Operational and other losses	291	(53)	344	691	(133)	824
Other real estate	414	262	152	887	461	426
Other miscellaneous expense	1,211	(7)	1,218	3,615	102	3,513
<b>Total other</b>	<b>4,730</b>	<b>487</b>	<b>4,243</b>	<b>13,312</b>	<b>1,072</b>	<b>12,240</b>
<b>Total Noninterest Expense</b>	<b>\$ 24,706</b>	<b>\$ 1,688</b>	<b>\$ 23,018</b>	<b>\$ 71,995</b>	<b>\$ 1,670</b>	<b>\$ 70,325</b>

*Income Taxes.* Income tax expense was \$5.2 million for the third quarter in 2010 as compared to \$4.8 million for the same period in 2009. Our effective tax rates on pretax income were 26.70% and 25.36% for the third quarters of 2010 and 2009, respectively. Income tax expense was \$14.8 million for the first nine-months in 2010 as compared to \$14.5 million for the same period in 2009. Our effective tax rates on pretax income were 26.00% and 26.04% for the

nine month periods of 2010 and 2009, respectively. The effective tax rates differ from the statutory Federal 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 Texas state taxes. The effective tax rates for 2010 reflect income taxes related to the extraordinary item.



The increase in the effective tax rate for the third quarter ended September 30, 2010 over the same period in 2009 were largely the result of the effect of the extraordinary item offset by an increase in tax exempt income. The small decrease in the effective tax rate for the nine-month period ended September 30, 2010 over the same period in 2009 was due to the same reasons.

### Balance Sheet Review

*Loans.* Our portfolio is comprised of loans made to businesses, professionals, individuals, and farm and ranch operations located in the primary trade areas served by our subsidiary banks. Real estate loans represent loans primarily for 1-4 family residences and owner-occupied commercial real estate. The structure of loans in the real estate mortgage classification generally provides repricing intervals to minimize the interest rate risk inherent in long-term fixed rate loans. As of September 30, 2010, total loans were \$1.5 billion, an increase of \$23.3 million, as compared to December 31, 2009. As compared to December 31, 2009, commercial, financial and agricultural loans decreased \$46.4 million, real estate construction loans increased \$7.4 million, real estate mortgage loans increased \$54.5 million, and consumer loans increased \$7.8 thousand. Loans averaged \$1.5 billion during the third quarter of 2010, an increase of \$68.2 million from the prior year third quarter average balances. Loans averaged \$1.513 billion during the nine-month period ended September 30, 2010, an increase of \$8.6 million over the same period in 2009.

**Table 5 Composition of Loans (in thousands):**

	<b>September 30,</b>		<b>December</b>
	<b>2010</b>	<b>2009</b>	<b>31,</b>
			<b>2009</b>
Commercial, financial and agricultural	\$ 462,024	\$ 463,723	\$ 508,431
Real estate construction	85,145	98,736	77,711
Real estate mortgage	807,256	709,866	752,735
Consumer	183,283	182,072	175,492
	\$ 1,537,708	\$ 1,454,397	\$ 1,514,369

At September 30, 2010, our real estate loans represent approximately 58.0% of our loan portfolio and are comprised of (i) commercial real estate loans of 32.7%, generally owner occupied, (ii) 1-4 family residence loans of 36.0%, (iii) residential development and construction loans of 7.8%, which includes our custom and speculation home construction loans, (iv) commercial development and construction loans of 4.3% and (v) other loans of 19.2%.

*Asset Quality.* Loan portfolios of each of our subsidiary banks are subject to periodic reviews by our centralized independent loan review group as well as periodic examinations by state and Federal bank regulatory agencies. Loans are placed on nonaccrual status when, in the judgment of management, the collectibility of principal or interest under the original terms becomes doubtful. Nonperforming assets, which are comprised of nonaccrual loans, loans still accruing and past due 90 days or more and foreclosed assets, were \$22.4 million at September 30, 2010, as compared to \$19.0 million at September 30, 2009. As a percent of loans and foreclosed assets, nonperforming assets were 1.45% at September 30, 2010, as compared to 1.30% at September 30, 2009. The increased level of nonperforming assets is a result of ongoing weakness in real estate markets and in the general economy.

**Table 6 Nonaccrual Loans, Loans Still Accruing and Past Due 90 Days or More, Restructured Loans and Foreclosed Assets (in thousands, except percentages):**

	September 30,		December
	2010	2009	31, 2009
Nonaccrual loans	\$ 14,110	\$ 14,585	\$ 18,540
Loans still accruing and past due 90 days or more	69	56	15
Restructured loans			
Foreclosed assets	8,217	4,367	3,533
<b>Total</b>	<b>\$ 22,396</b>	<b>\$ 19,008</b>	<b>\$ 22,088</b>
As a % of loans and foreclosed assets	1.45%	1.30%	1.46%
As a % of total assets	0.65%	0.62%	0.67%

The majority of our nonaccrual loans are in our bank subsidiaries closer to Dallas-Fort Worth where we have experienced more credit deterioration in our loan portfolio. The major categories of nonaccrual loans at September 30, 2010 are (i) 1-4 family residences (50.8%), (ii) ranches (21.9%), (iii) equipment (10.8%) and (iv) lots for development (5.0%).

We record interest payments received on impaired loans as interest income unless collections of the remaining recorded investment are placed on nonaccrual, at which time we record payments received as reductions of principal. Interest income amounts related to these non-accrual loans were not significant for the third quarter and nine-month periods ended September 30, 2010 and 2009.

*Provision and Allowance for Loan Losses.* The allowance for loan losses is the amount we determine as of a specific date to be adequate to absorb probable losses on existing loans in which full collectability is unlikely based on our review and evaluation of the loan portfolio. For a discussion of our methodology, see Critical Accounting Policies Allowance for Loan Losses earlier in this section. The provision for loan losses was \$2.0 million for the third quarter of 2010, as compared to \$3.7 million for the third quarter of 2009. The provision for loan losses was \$7.0 million for the first nine months of 2010 as compared to \$7.1 million for the first nine months of 2009. As a percent of average loans, net loan charge-offs were 0.24% for the third quarter of 2010 compared to 0.38% during the third quarter of 2009. As a percent of average loans, net loan charge-offs were 0.40% for the nine-month period of 2010 compared to 0.27% for the same period in 2009. The increase in the level of net charge-offs for nine months of 2010 over 2009 was primarily from one commercial customer resulting in a \$1.8 million charge-off. The allowance for loan losses as a percent of loans was 1.95% as of September 30, 2010, as compared to 1.76% as of September 30, 2009. Included in Table 7 is further analysis of our allowance for loan losses compared to charge-offs.

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. The current downturn in the economy or higher unemployment could result in increased levels of nonperforming assets and charge-offs and increased loan loss provisions, with corresponding reductions in net income. Additionally, as an integral part of their examination process, bank regulatory agencies periodically review the adequacy of our allowance for loan losses. The banking agencies could require the recognition of additions to the loan loss allowance based on their judgment of information available to them at the time of their examination.

**Table 7 Loan Loss Experience and Allowance for Loan Losses (in thousands, except percentages):**

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2010	2009	2010	2009
Balance at beginning of period	\$ 28,954	\$ 23,247	\$ 27,612	\$ 21,529
Charge-offs:				
Commercial, financial and agricultural	183	323	2,457	843
Real Estate	739	785	1,734	1,468
Consumer	256	554	1,017	1,469
Total charge-offs	1,178	1,662	5,208	3,780
Recoveries:				
Commercial, financial and agricultural	101	20	192	169
Real Estate	23	55	89	90
Consumer	125	166	357	470
Total recoveries	249	241	638	729
Net charge-offs	929	1,421	4,570	3,051
Provision for loan losses	1,988	3,706	6,971	7,054
Balance at September 30	\$ 30,013	\$ 25,532	\$ 30,013	\$ 25,532
Loans at period end	1,537,708	1,454,397	1,537,708	1,454,397
Average loans	1,533,624	1,465,423	1,512,992	1,504,400
Net charge-offs/average loans (annualized)	0.24%	0.38%	0.40%	0.27%
Allowance for loan losses/period-end loans	1.95	1.76	1.95	1.76
Allowance for loan losses/nonaccrual loans, past due 90 days still accruing and restructured loans	211.7	174.4	211.7	174.4

The ratio of our allowance to nonaccrual, past due 90 days still accruing and restructured loans has trended downward since 2007, as the economic conditions worsened. Although the ratio declined somewhat in 2010 and 2009 from prior years when net charge-offs and nonperforming asset levels were historically low, management believes the allowance for loan losses is adequate at September 30, 2010 in spite of these trends.



*Interest-Bearing Deposits in Banks.* As of September 30, 2010, our interest-bearing deposits were \$231.5 million compared with \$23.9 million and \$167.3 million as of September 30, 2009 and December 31, 2009, respectively. At September 30, 2010, interest-bearing deposits in banks included \$98.9 million invested in FDIC-insured certificates of deposit, \$50.0 million invested in money market accounts at a nonaffiliated regional bank, and \$81.6 million maintained at the Federal Reserve Bank of Dallas. The increase in our interest-bearing deposits in banks was the result of several factors including relatively lower loan demand, cash flows from maturing investment securities and growth in deposits.

*Trading Securities.* As of September 30, 2009, trading securities totaled \$4.8 million. No amounts were held in trading securities at September 30, 2010 or December 31, 2009. The trading securities portfolio was a government securities money market fund comprised primarily of U.S. government agency securities and repurchase agreements collateralized by U.S. government agency securities. The trading securities portfolio was carried at estimated fair value with unrealized gains and losses included in earnings. The Company invested in trading securities in 2008 and part of 2009 to improve its yield on daily funds and to lower its exposure on Federal funds. However, due to significantly lower interest rates, the Company has deployed these funds into our investment portfolio and into certificates of deposit at unaffiliated banks.

*Available-for-Sale and Held-to-Maturity Securities.* At September 30, 2010, securities with an amortized cost of \$9.2 million were classified as securities held-to-maturity and securities with a fair value of \$1.41 billion were classified as securities available-for-sale. As compared to December 31, 2009, the available for sale portfolio, carried at fair value, at September 30, 2010, reflected (i) an increase of \$46.9 million in U.S. Treasury securities and obligations of U.S. government sponsored-enterprises and agencies, (ii) an increase of \$62.8 million in obligations of states and political subdivisions, (iii) a \$9.2 million decrease in corporate and other bonds, and (iv) a \$41.6 million increase in mortgage-backed securities. Our mortgage related securities are backed by GNMA, FNMA or FHLMC or are collateralized by securities guaranteed by these agencies.

**Table 8 Composition of Available-for-Sale and Held-to-Maturity Securities (dollars in thousands):**

	September 30, 2010			
	Amortized Cost Basis	Gross Unrealized Holding Gains	Gross Unrealized Holding Losses	Estimated Fair Value
Securities held-to-maturity:				
Obligations of states and political subdivisions	\$ 8,693	\$ 227	\$	\$ 8,920
Residential mortgage-backed securities	536	18		554
<b>Total debt securities held-to-maturity</b>	<b>\$ 9,229</b>	<b>\$ 245</b>	<b>\$</b>	<b>\$ 9,474</b>
Securities available-for-sale:				
U.S. Treasury securities and obligations of U.S. government sponsored-enterprises and agencies	\$ 307,761	\$ 11,234	\$	\$ 318,995
Obligations of states and political subdivisions	486,067	32,388	(40)	518,415
Corporate bonds and other	64,088	5,566		69,654 -
Residential mortgage-backed securities	481,033	24,077	(1)	505,109
<b>Total securities available-for-sale</b>	<b>\$ 1,338,949</b>	<b>\$ 73,265</b>	<b>\$ (41)</b>	<b>\$ 1,412,173</b>
	December 31, 2009			
	Amortized Cost Basis	Gross Unrealized Holding Gains	Gross Unrealized Holding Losses	Estimated Fair Value
Securities held-to-maturity:				
Obligations of states and political subdivisions	\$ 14,652	\$ 392	\$ (6)	\$ 15,038
Residential mortgage-backed securities	621	16	(1)	636
<b>Total debt securities held-to-maturity</b>	<b>\$ 15,273</b>	<b>\$ 408</b>	<b>\$ (7)</b>	<b>\$ 15,674</b>
Securities available-for-sale:				
Obligations of U.S. government sponsored-enterprises and agencies	\$ 260,018	\$ 12,050	\$	\$ 272,068
Obligations of states and political subdivisions	437,550	18,643	(561)	455,632
Corporate bonds and other	73,858	5,028		78,886
Residential mortgage-backed securities	442,823	20,995	(300)	463,518
<b>Total securities available-for-sale</b>	<b>\$ 1,214,249</b>	<b>\$ 56,716</b>	<b>\$ (861)</b>	<b>\$ 1,270,104</b>

During the quarters ended September 30, 2010 and 2009, sales of investment securities that were classified as available-for-sale totaled \$2.4 million and \$9.5 million, respectively. Gross realized gains from 2010 and 2009 securities sales totaled \$7 thousand and \$897 thousand, respectively. There were no losses on securities sales during these periods. During the nine-months ended September 30, 2010 and 2009, sales of investment securities that were classified as available-for-sale totaled \$17.4 million and \$44.9 million, respectively. Gross realized gains from 2010 and 2009 securities sales totaled \$79 thousand and \$1.6 million, respectively. There were no losses realized on securities sales during these periods. The specific identification method was used to determine cost on computing the realized gains.

**Table 9 Maturities and Yields of Available-for-Sale and Held-to-Maturity Securities Held at September 30, 2010 (in thousands, except percentages):**

	One Year		After One Year Through Five Years		Maturing After Five Years Through Ten Years		After Ten Years		Total	
	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield
<b>Held-to-Maturity:</b>										
Obligations of states and political subdivisions	\$ 7,049	7.26%	\$ 1,644	6.85%	\$	%	\$	%	\$ 8,693	7.18%
Residential mortgage-backed securities	12	5.31	309	4.39	215	3.15			536	4.01
Total	\$ 7,061	7.26%	\$ 1,953	6.61%	\$ 215	3.15%	\$	%	\$ 9,229	7.00%
	One Year or Less		After One Year Through Five Years		Maturing After Five Years Through Ten Years		After Ten Years		Total	
	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield
<b>Available-for-Sale:</b>										
U. S. Treasury securities and obligations of U.S. government sponsored-enterprises and agencies	\$ 103,122	3.50%	\$ 215,873	2.93%	\$	%	\$	%	\$ 318,995	3.11%
Obligations of states and political subdivisions	27,873	5.73	159,584	5.59	298,815	6.12	32,143	6.54	518,415	5.95
Corporate bonds and other securities	22,279	3.31	40,306	4.79	7,069	7.08			69,654	4.13
Residential mortgage-backed securities	38,471	5.50	408,181	4.64	35,346	3.74	23,111	4.00	505,109	4.64

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Total \$ 191,745 4.06% \$ 823,944 4.33% \$ 341,230 5.90% \$ 55,254 5.48% \$ 1,412,173 4.73%

Total Available-for-Sale and Held- to-Maturity Securities:	One Year or Less		After One Year Through Five Years		Maturing After Five Years Through Ten Years		After Ten Years		Total	
	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield
U. S. Treasury securities and obligations of U.S. government sponsored-enterprises and agencies	\$ 103,122	3.50%	\$ 215,873	2.93%	\$	%\$	%\$	%\$	\$ 318,995	3.11%
Obligations of states and political subdivisions	34,922	6.04	161,228	5.60	298,815	6.12	32,143	6.54	527,108	5.97
Corporate bonds and other securities	22,279	3.31	40,306	4.79	7,069	7.08			69,654	4.13
Residential mortgage-backed securities	38,483	5.50	408,490	4.64	35,561	3.74	23,111	4.26	505,645	4.74
Total	\$ 198,806	4.16%	\$ 825,897	4.34%	\$ 341,445	5.73%	\$ 55,254	5.48%	\$ 1,421,402	4.75%

All yields are computed on a tax-equivalent basis assuming a marginal tax rate of 35%. Yields on available-for-sale securities are based on amortized cost. Maturities of mortgage-backed securities are based on contractual maturities and could differ due to prepayments of underlying mortgages. Maturities of other securities are reported at the sooner of maturity date or call date.



**Table 10 Disclosure of Available-for-Sale and Held-to-Maturity Securities with Continuous Unrealized Loss**

The following tables disclose, as of September 30, 2010 and December 31, 2009, our available-for-sale and held-to-maturity securities that have been in a continuous unrealized-loss position for less than 12 months and those that have been in a continuous unrealized-loss position for 12 or more months (in thousands):

	Less than 12 Months Unrealized		12 Months or Longer Unrealized		Total Unrealized	
	Fair Value	Loss	Fair Value	Loss	Fair Value	Loss
<b>September 30, 2010</b>						
Obligations of states and political subdivisions	\$ 3,751	\$ 3	\$ 2,227	\$ 37	\$ 5,978	\$ 40
Residential mortgage-backed securities	513	1			513	1
Total	\$ 4,264	\$ 4	\$ 2,227	\$ 37	\$ 6,491	\$ 41

	Less than 12 Months Unrealized		12 Months or Longer Unrealized		Total Unrealized	
	Fair Value	Loss	Fair Value	Loss	Fair Value	Loss
<b>December 31, 2009</b>						
Obligations of states and political subdivisions	\$ 21,703	\$ 428	\$ 2,798	\$ 139	\$ 24,501	\$ 567
Residential mortgage-backed securities	27,619	300	82	1	27,701	301
Total	\$ 49,322	\$ 728	\$ 2,880	\$ 140	\$ 52,202	\$ 868

The number of investment positions in this unrealized loss position totaled ten at September 30, 2010. We do not believe these unrealized losses are other than temporary as (i) we do not have the intent to sell our securities prior to recovery and/or maturity and (ii) it is more likely than not that we will not have to sell our securities prior to recovery and/or maturity. The unrealized losses noted are interest rate related due to the level of interest rates at September 30, 2010 compared to the time of purchase. We have reviewed the ratings of the issuers and have not identified any issues related to the ultimate repayment of principal as a result of credit concerns on these securities. Our mortgage related securities are guaranteed by GNMA, FNMA and FHLMC or are collateralized by securities backed by these agencies. As of September 30, 2010, the investment portfolio had an overall tax equivalent yield of 4.75%, a weighted average life of 3.7 years and modified duration of 3.2 years.

*Deposits.* Deposits held by subsidiary banks represent our primary source of funding. Total deposits were \$2.74 billion as of September 30, 2010, as compared to \$2.46 billion as of September 30, 2009. Table 11 provides a breakdown of average deposits and rates paid for the third quarter and nine-month period ended September 30, 2010 and 2009:

**Table 11 Composition of Average Deposits (in thousands, except percentages):**

	Three Months Ended September 30, 2010		2009	
	Average Balance	Average Rate	Average Balance	Average Rate
Noninterest-bearing deposits	\$ 787,069	%	\$ 738,625	%
Interest-bearing deposits				
Interest-bearing checking	659,051	0.26	584,036	0.32
Savings and money market accounts	471,859	0.27	447,013	0.40
Time deposits under \$100,000	344,155	1.23	356,442	1.57
Time deposits of \$100,000 or more	464,013	1.22	343,217	1.74
Total interest-bearing deposits	1,939,078	0.66%	1,730,708	0.88%
Total average deposits	\$ 2,726,147		\$ 2,469,333	
	Nine Months Ended September 30, 2010		2009	
	Average Balance	Average Rate	Average Balance	Average Rate
Noninterest-bearing deposits	\$ 792,042	%	\$ 749,383	%
Interest-bearing deposits				
Interest-bearing checking	667,247	0.29	602,970	0.34
Savings and money market accounts	461,747	0.31	437,080	0.44
Time deposits under \$100,000	346,772	1.31	363,083	1.77
Time deposits of \$100,000 or more	436,286	1.33	341,203	1.96
Total interest-bearing deposits	1,912,052	0.72%	1,744,336	0.98%
Total average deposits	\$ 2,704,094		\$ 2,493,719	

*Short-Term Borrowings.* Included in short-term borrowings were Federal funds purchased and securities sold under repurchase agreements of \$178.1 million and \$160.4 million at September 30, 2010 and 2009, respectively. Securities sold under repurchase agreements are generally with significant customers that require short-term liquidity for their funds which we pledge our securities that have a fair value equal to at least the amount of the short-term borrowing. The average balance of Federal funds purchased and securities sold under repurchase agreements was \$158.1 million and \$171.6 million in the third quarters of 2010 and 2009, respectively. The average rates paid on Federal funds purchased and securities sold under repurchase agreements were 0.24% and 0.41% for the third quarters of 2010 and 2009, respectively. The average balance of Federal funds purchased and securities sold under repurchase agreements was \$169.7 million and \$191.4 million in the first nine months of 2010 and 2009, respectively. The average rates paid on Federal funds purchased and securities sold under repurchase agreements were 0.31% and 0.44% for the first nine months of 2010 and 2009, respectively.

## Capital Resources

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

Total shareholders' equity was \$450.9 million, or 13.08% of total assets, at September 30, 2010, as compared to \$415.5 million, or 13.51% of total assets, at September 30, 2009. Included in shareholders' equity at September 30, 2010 and September 30, 2009, were \$47.6 million and \$42.4 million, respectively, in unrealized gains on investment securities available-for-sale, net of related income taxes. For the third quarter of 2010, total shareholders' equity averaged \$440.3 million, or 13.09% of average assets, as compared to \$396.7 million, or 12.91% of average assets, during the same period in 2009. For the nine months ended September 30, 2010, total shareholders' equity averaged \$428.3 million, or 12.83% of average assets, as compared to \$388.9 million, or 12.52% of average assets, during the same period in 2009.

Banking regulators measure capital adequacy by means of the risk-based capital ratio and leverage ratio. The risk-based capital rules provide for the weighting of assets and off-balance-sheet commitments and contingencies according to prescribed risk categories ranging from 0% to 100%. Regulatory capital is then divided by risk-weighted assets to determine the risk-adjusted capital ratios. The leverage ratio is computed by dividing shareholders' equity less intangible assets by quarter-to-date average assets less intangible assets. Regulatory minimums for total risk-based and leverage ratios are 8.00% and 3.00%, respectively. As of September 30, 2010, our total risk-based and leverage capital ratios were 19.45% and 10.89%, respectively, as compared to total risk-based and leverage capital ratios of 19.37% and 10.83% as of September 30, 2009. We believe by all measurements our capital ratios remain well above regulatory requirements to be considered well capitalized by the regulators.

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

Each of our subsidiary banks has an asset liability management committee that monitors interest rate risk and compliance with investment policies; there is also a holding company-wide committee that monitors the aggregate Company's interest rate risk and compliance with investment policies. 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 twelve months. The model measures the impact on net interest income relative to a base case scenario of hypothetical fluctuations in interest rates over the next twelve months. These simulations incorporate assumptions regarding balance sheet growth and mix, pricing and the repricing and maturity characteristics of the existing and projected balance sheet.

As of September 30, 2010, the model simulations projected that 100 and 200 basis point increases in interest rates would result in positive variances in net interest income of 0.15% and 1.06%, respectively, relative to the base case over the next twelve months, while decreases in interest rates of 50 basis points would result in a negative variance in a net interest income of 0.68% relative to the base case over the next twelve months. The likelihood of a decrease in interest rates beyond 50 basis points as of September 30, 2010 is considered remote given current interest rate levels. These are good faith estimates

and assume that the composition of our interest sensitive assets and liabilities existing at each year-end will remain constant over the relevant twelve month measurement period and that changes in market interest rates are instantaneous and sustained across the yield curve regardless of duration of pricing characteristics 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.

### **Liquidity**

Liquidity is our ability to meet cash demands as they arise. Such needs can develop from loan demand, deposit withdrawals or acquisition opportunities. Potential obligations resulting from the issuance of standby letters of credit and commitments to fund future borrowings to our loan customers are other factors affecting our liquidity needs. Many of these obligations and commitments are expected to expire without being drawn upon; therefore the total commitment amounts do not necessarily represent future cash requirements affecting our liquidity position. The potential need for liquidity arising from these types of financial instruments is represented by the contractual notional amount of the instrument. 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 borrow from short-term sources, such as purchasing Federal funds from correspondents and sales of securities under agreements to repurchase, which amounted to \$178.1 million at September 30, 2010, and an unfunded \$25.0 million line of credit established with a nonaffiliated bank which matures on June 30, 2011(see next paragraph). First Financial Bank, N. A., Abilene also has Federal funds purchased lines of credit with two non-affiliated banks totaling \$80.0 million. No amount was outstanding at September 30, 2010. Six of our subsidiary banks have available lines of credit totaling \$230.2 million secured by portions of their loan portfolios, of which there is no outstanding balance at September 30, 2010.

On December 30, 2009, we renewed our loan agreement, effective December 31, 2009, with The Frost National Bank. Under the loan agreement, as renewed and amended, we are permitted to draw up to \$25.0 million on a revolving line of credit. Prior to June 30, 2011, interest is paid quarterly at Wall Street Journal Prime, and the line of credit matures June 30, 2011. If a balance exists at June 30, 2011, the principal balance converts to a term facility payable quarterly over five years and interest is paid quarterly at our election at Wall Street Journal Prime plus 50 basis points or LIBOR plus 250 basis points. The line of credit is unsecured. Among other provisions in the credit agreement, we must satisfy certain financial covenants during the term of the loan agreement, including, without limitation, covenants that require us to maintain certain capital, tangible net worth, loan loss reserve, non-performing asset and cash flow coverage ratio. In addition, the credit agreement contains certain operational covenants, which among others, restricts the payment of dividends above 55% of consolidated net income, limits the incurrence of

debt (excluding any amounts acquired in an acquisition) and prohibits the disposal of assets except in the ordinary course of business. Since 1995, we have historically declared dividends as a percentage of our consolidated net income in a range of 37% (low) in 1995 to 53% (high) in 2003 and 2006. Management believes the Company was in compliance with the financial and operational covenants at September 30, 2010. There was no outstanding balance under the line of credit as of September 30, 2010, or December 31, 2009.

Given the strong core deposit base, relatively low loan to deposit ratios maintained at our subsidiary banks, available lines of credit, and dividend capacity of our subsidiary banks, we consider our current liquidity position to be adequate to meet our short- and long-term liquidity needs.

In addition, we anticipate that any future acquisition of financial institutions, expansion of branch locations or offering of new products could also place a demand on our cash resources. Available cash and interest-bearing deposits in banks at our parent company, which totaled \$51.8 million at September 30, 2010, investment securities which totaled \$13.9 million (of which 59% matures within 2 years and the remaining portion in 12 years), available dividends from subsidiary banks which totaled \$47.2 million at September 30, 2010, utilization of available lines of credit, and future debt or equity offerings are expected to be the source of funding for these potential acquisitions or expansions. Existing cash resources at our subsidiary banks may also be used as a source of funding for these potential acquisitions or expansions.

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

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

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

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

**Table 12 Commitments as of September 30, 2010 (in thousands):**

	<b>Total Notional Amounts Committed</b>
Unfunded lines of credit	\$ 303,800
Unfunded commitments to extend credit	58,590
Standby letters of credit	19,586
 Total commercial commitments	 \$ 381,976

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

*Parent Company Funding.* Our ability to fund various operating expenses, dividends to shareholders, and cash acquisitions is generally dependent on our own earnings (without giving effect to our subsidiaries), cash reserves and funds derived from our subsidiary banks. These funds historically have been produced by dividends from our subsidiary banks and management fees that are limited to reimbursement of actual expenses. We anticipate that our recurring cash sources will continue to include dividends and management fees from our subsidiary banks. At September 30, 2010, approximately \$47.2 million was available for the payment of intercompany dividends by the Company's subsidiaries without the prior approval of regulatory agencies.

*Dividends.* Our long-term dividend policy is to pay cash dividends to our shareholders of between 40% and 55% of net earnings while maintaining adequate capital to support growth. The cash dividend payout ratios have amounted to 48.17% and 51.46% of net earnings, respectively, for the first half of 2010 and the same period in 2009. Given our current capital position and projected earnings and asset growth rates, we do not anticipate any significant change in our current dividend policy.

Our state bank subsidiary, which is a member of the Federal Reserve System, and each of our national banking association subsidiaries are required by Federal law to obtain the prior approval of the Federal Reserve Board and the OCC, respectively, to declare and pay dividends if the total of all dividends declared in any calendar year would exceed the total of (1) such bank's net profits (as defined and interpreted by regulation) for that year plus (2) its retained net profits (as defined and interpreted by regulation) for the preceding two calendar years, less any required transfers to surplus. In addition, these banks may only pay dividends to the extent that retained net profits (including the portion transferred to surplus) exceed bad debts (as defined by regulation).

To pay dividends, we and our subsidiary banks must maintain adequate capital above regulatory guidelines. In addition, if the applicable regulatory authority believes that a bank under its jurisdiction is engaged in or is about to engage in an unsafe or unsound practice (which, depending on the financial condition of the bank, could include the payment of dividends), the authority may require, after notice and hearing, that such bank cease and desist from the unsafe practice. The Federal Reserve Board, the FDIC and the OCC have each indicated that paying dividends that deplete a bank's capital base to an inadequate level would be an unsafe and unsound banking practice. The Federal Reserve Board, the OCC and the FDIC have issued policy statements that recommend that bank holding companies and insured banks should generally only pay dividends out of current operating earnings. In addition, under the Texas Finance Code, a Texas banking association may not pay a dividend that would reduce its outstanding capital and surplus unless it obtains approval of the Texas Banking Commissioner.

**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 Capital Resources Interest Rate Risk for disclosure regarding this market risk.

**Item 4. Controls and Procedures**

As of September 30, 2010, 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 13a-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, that our disclosure controls and procedures, as defined, under Rule 13a-15 of the Securities Exchange Act of 1934, are effective at the reasonable assurance level as of September 30, 2010. 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 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 Bylaws, and all amendments thereto, of the Registrant (incorporated by reference from Exhibit 3.2 of the Registrant's Form 10-K Annual Report for the ended December 31, 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 Executive Recognition Plan (incorporated by reference from Exhibit 10.1 of the Registrant's Form 8-K Report filed July 1, 2010).
- 10.2 1992 Incentive Stock Option Plan (incorporated by reference from Exhibit 10.2 of the Registrant's Form 10-Q filed May 4, 2010).
- 10.3 2002 Incentive Stock Option Plan (incorporated by reference from Exhibit 10.3 of the Registrant's Form 10-Q filed May 4, 2010).
- 10.4 Loan agreement dated December 31, 2004, between First Financial Bankshares, Inc. and The Frost National Bank (incorporated by reference from Exhibit 10.4 of the Registrant's Form 10-Q filed May 4, 2010).
- 10.5 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).
- 10.6 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).
- 10.7 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).
- 10.8 Fourth Amendment to Loan Agreement, dated July 24, 2008, between First Financial Bankshares, Inc. and The Frost National Bank (incorporated by reference from Exhibit 10.10 of the Registrant's Form 10-Q filed July 25, 2008).
- 10.9 Fifth Amendment to Loan Agreement, dated December 19, 2008, between First Financial Bankshares, Inc. and The Frost National Bank (incorporated by reference from Exhibit 10.6 of the Registrant's Form 8-K filed December 22, 2008).
- 10.10



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Sixth Amendment to Loan Agreement, dated June 16, 2009, signed June 30, 2009, between First Financial Bankshares, Inc. and The Frost National Bank (incorporated by reference from Exhibit 10.7 of the Registrant's Form 8-K filed on June 30, 2009).

- 10.11 Seventh Amendment to Loan Agreement, dated December 30, 2009, between First Financial Bankshares, Inc. and The Frost National Bank (incorporated by reference from Exhibit 10.8 of the Registrant's Form 8-K filed December 30, 2009).
- \*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: November 2, 2010**

**By: /s/ F. Scott Dueser**

**F. Scott Dueser  
President and Chief Executive Officer**

**Date: November 2, 2010**

**By: /s/ J. Bruce Hildebrand**

**J. Bruce Hildebrand  
Executive Vice President and Chief  
Financial Officer**

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