

Board of Governors of the Federal Reserve System



Annual Report of Holding Companies—FR Y-6

Report at the close of business as of the end of fiscal year

This Report is required by law: Section 5(c)(1)(A) of the Bank Holding Company Act (12 U.S.C. § 1844(c)(1)(A)); sections 8(a) and 13(a) of the International Banking Act (12 U.S.C. §§ 3106(a) and 3108(a)); sections 11(a)(1), 25, and 25A of the Federal Reserve Act (12 U.S.C. §§ 248(a)(1), 602, and 611a); and sections 113, 165, 312, 618, and 809 of the Dodd-Frank Act (12 U.S.C. §§ 5361, 5365, 5412, 1850a(c)(1), and 5468(b)(1)). Return to the appropriate Federal Reserve Bank the original and the number of copies specified.

NOTE: The *Annual Report of Holding Companies* must be signed by one director of the top-tier holding company. This individual should also be a senior official of the top-tier holding company. In the event that the top-tier holding company does not have an individual who is a senior official and is also a director, the chairman of the board must sign the report. If the holding company is an ESOP/ESOT formed as a corporation or is an LLC, see the General Instructions for the authorized individual who must sign the report.

I, Olen Thompson
 Name of the Holding Company Director and Official
Director/President
 Title of the Holding Company Director and Official

attest that the *Annual Report of Holding Companies* (including the supporting attachments) for this report date has been prepared in conformance with the instructions issued by the Federal Reserve System and are true and correct to the best of my knowledge and belief.

With respect to information regarding individuals contained in this report, the Reporter certifies that it has the authority to provide this information to the Federal Reserve. The Reporter also certifies that it has the authority, on behalf of each individual, to consent or object to public release of information regarding that individual. The Federal Reserve may assume, in the absence of a request for confidential treatment submitted in accordance with the Board's "Rules Regarding Availability of Information," 12 C.F.R. Part 261, that the Reporter and individual consent to public release of all details in the report concerning that individual.

[Signature]
 Signature of Holding Company Director and Official
3/23/2020
 Date of Signature

For holding companies not registered with the SEC—
 Indicate status of Annual Report to Shareholders:

is included with the FR Y-6 report
 will be sent under separate cover
 is not prepared

For Federal Reserve Bank Use Only

RSSD ID _____
 C.I. _____

This report form is to be filed by all top-tier bank holding companies, top-tier savings and loan holding companies, and U.S. intermediate holding companies organized under U.S. law, and by any foreign banking organization that does not meet the requirements of and is not treated as a qualifying foreign banking organization under Section 211.23 of Regulation K (12 C.F.R. § 211.23). (See page one of the general instructions for more detail of who must file.) The Federal Reserve may not conduct or sponsor, and an organization (or a person) is not required to respond to, an information collection unless it displays a currently valid OMB control number.

Date of Report (top-tier holding company's fiscal year-end):
December 31, 2020

Month / Day / Year
n/a

Reporter's Legal Entity Identifier (LEI) (20-Character LEI Code)

Reporter's Name, Street, and Mailing Address
Texas Heritage Bancshares, Inc.

Legal Title of Holding Company

P O Box 340
 (Mailing Address of the Holding Company) Street / P.O. Box

Hondo Texas 78861
 City State Zip Code

1112 18th Street
 Physical Location (if different from mailing address)

Person to whom questions about this report should be directed:
Olen Thompson President/CEO
 Name Title

830-426-3355
 Area Code / Phone Number / Extension

830-426-7272
 Area Code / FAX Number

olen@myhnb.com
 E-mail Address

n/a
 Address (URL) for the Holding Company's web page

Is confidential treatment requested for any portion of this report submission? 0=No 1=Yes 0

In accordance with the General Instructions for this report (check only one),

1. a letter justifying this request is being provided along with the report

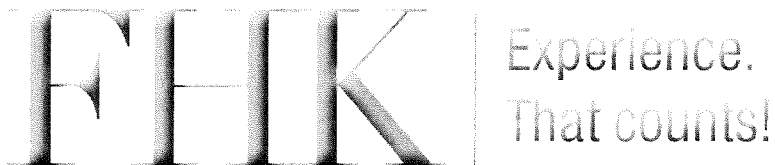
2. a letter justifying this request has been provided separately ...

NOTE: Information for which confidential treatment is being requested must be provided separately and labeled as "confidential."

**TEXAS HERITAGE BANCSHARES, INC.
AND SUBSIDIARY**

CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 31, 2020 AND 2019



CERTIFIED PUBLIC ACCOUNTANTS

TABLE OF CONTENTS

Report of Independent Auditors	1
Consolidated Balance Sheets	3
Consolidated Statements of Income	4
Consolidated Statements of Comprehensive Income	5
Consolidated Statements of Changes in Shareholders' Equity	6
Consolidated Statements of Cash Flows	7
Notes to the Consolidated Financial Statements	8-42

SUPPLEMENTARY INFORMATION

Consolidating Balance Sheet	44
Consolidating Statement of Income	45
Graphs	46-50

REPORT OF INDEPENDENT AUDITORS

Board of Directors
Texas Heritage Bancshares, Inc. and Subsidiary
Hondo, Texas

Report on the Financial Statements

We have audited the accompanying consolidated financial statements of Texas Heritage Bancshares, Inc. and Subsidiary (the "Company"), which comprise the consolidated balance sheets as of December 31, 2020 and 2019, and the related consolidated statements of income, comprehensive income, changes in shareholders' equity, and cash flows for the years then ended, and the related notes to the consolidated financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with U.S. generally accepted accounting principles; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We conducted our audits in accordance with U.S. generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Texas Heritage Bancshares, Inc. and Subsidiary as of December 31, 2020 and 2019, and the results of their operations and their cash flows for the years then ended in accordance with U.S. generally accepted accounting principles.

Report of Supplementary Information

Our audit was conducted for the purpose of forming an opinion on the consolidated financial statements as a whole. The accompanying supplementary information is presented for purposes of additional analysis and is not a required part of the consolidated financial statements. Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the consolidated financial statements. The information has been subjected to the auditing procedures applied, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the financial statements or to the consolidated financial statements themselves, and other additional procedures in accordance with U.S. generally accepted auditing standards. In our opinion, the information is fairly stated in all material respects in relation to the consolidated financial statements as a whole.

Fisher, Herbst + Kemble, P.C.

San Antonio, Texas
February 5, 2021

TEXAS HERITAGE BANCSHARES, INC. AND SUBSIDIARY

CONSOLIDATED BALANCE SHEETS

December 31,	2020	2019
ASSETS		
Cash and Cash Equivalents		
Cash and due from banks	\$ 5,373,224	\$ 6,911,389
Interest-bearing deposits in other financial institutions	35,211,819	14,285,658
Federal funds sold	1,100,000	6,675,000
Total cash and cash equivalents	<u>41,685,043</u>	<u>27,872,047</u>
Securities available-for-sale, at estimated market value	110,994,741	52,568,626
Securities held-to-maturity, at cost	1,713,870	2,293,336
Loans, net	154,311,940	175,314,185
Premises and equipment, net	4,257,891	3,870,111
Accrued interest receivable	1,517,309	1,617,072
Other real estate owned, net	285,457	132,150
Cash surrender value of life insurance	5,850,235	6,339,363
Goodwill	120,416	120,416
Restricted stock	1,283,704	1,274,204
Other assets	85,767	173,541
Total assets	<u>\$ 322,106,373</u>	<u>\$ 271,575,051</u>
LIABILITIES AND SHAREHOLDERS' EQUITY		
Deposits:		
Non-interest bearing	\$ 81,456,746	\$ 65,348,125
Interest bearing	211,272,563	178,524,140
Total deposits	<u>292,729,309</u>	<u>243,872,265</u>
Accrued interest payable	61,809	97,739
Deferred compensation	357,903	245,561
Other liabilities	356,105	336,355
Total liabilities	<u>293,505,126</u>	<u>244,551,920</u>
Shareholders' Equity		
Common stock, par value \$1 per share: authorized 2,000,000 shares; 783,000 issued; 782,051 outstanding in 2020 and 781,551 outstanding in 2019	783,000	783,000
Additional paid-in capital	3,005,020	3,005,020
Treasury stock (at cost), 949 shares in 2020 and 1,449 shares in 2019	(36,537)	(55,787)
Retained earnings	23,480,075	23,062,310
Accumulated other comprehensive income	1,369,689	228,588
Total shareholders' equity	<u>28,601,247</u>	<u>27,023,131</u>
Total liabilities and shareholders' equity	<u>\$ 322,106,373</u>	<u>\$ 271,575,051</u>

See notes to the consolidated financial statements.

TEXAS HERITAGE BANCSHARES, INC. AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF INCOME

Years Ended December 31,	2020	2019
INTEREST INCOME		
Loans, including fees	\$ 9,258,740	\$ 10,252,890
Investment securities:		
Taxable	586,947	331,541
Tax-exempt	1,005,255	1,017,001
Federal funds sold	56,073	145,763
Other	76,728	160,669
Total interest income	<u>10,983,743</u>	<u>11,907,864</u>
INTEREST EXPENSE		
Deposits	<u>1,816,712</u>	<u>2,026,048</u>
Total interest expense	<u>1,816,712</u>	<u>2,026,048</u>
NET INTEREST INCOME	9,167,031	9,881,816
PROVISION FOR LOAN LOSSES	<u>725,000</u>	<u>1,287,000</u>
NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES	<u>8,442,031</u>	<u>8,594,816</u>
NON-INTEREST INCOME		
Service charges on deposit accounts	277,845	362,446
ATM and debit card service charges	524,269	478,601
Service fees	62,583	80,323
Other	19,843	21,456
Gain on sale of other real estate	-	8
Gain on sale of available-for-sale securities	60,337	-
Gain on sale of loans	42,445	20,548
Gain on sale of assets	-	8,824
Capital stock dividend	34,569	40,821
Earnings on cash surrender value	174,890	184,586
Total non-interest income	<u>1,196,781</u>	<u>1,197,613</u>
NON-INTEREST EXPENSE		
Salaries, wages and benefits	4,488,792	4,896,532
Occupancy and equipment	957,791	986,278
Other	2,607,148	2,199,101
Total non-interest expense	<u>8,053,731</u>	<u>8,081,911</u>
INCOME BEFORE INCOME TAXES	1,585,081	1,710,518
STATE INCOME TAX EXPENSE	<u>2,560</u>	<u>3,226</u>
NET INCOME	<u>\$ 1,582,521</u>	<u>\$ 1,707,292</u>

See notes to the consolidated financial statements.

TEXAS HERITAGE BANCSHARES, INC. AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

Years Ended December 31,	2020	2019
NET INCOME	\$ 1,582,521	\$ 1,707,292
OTHER ITEMS OF COMPREHENSIVE INCOME		
Adjustment for gain on sale of available-for-sale securities	(60,337)	-
Unrealized holding gain arising during period	<u>1,201,438</u>	<u>846,514</u>
Total other items of comprehensive income	<u>1,141,101</u>	<u>846,514</u>
Comprehensive income	<u><u>\$ 2,723,622</u></u>	<u><u>\$ 2,553,806</u></u>

See notes to the consolidated financial statements.

TEXAS HERITAGE BANCSHARES, INC. AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

Years Ended December 31, 2020 and 2019

	Common Stock	Additional Paid-In Capital	Treasury Stock	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total Shareholders' Equity
Balance at January 1, 2019	\$ 783,000	\$ 3,005,020	\$ -	\$ 22,693,947	\$ (617,926)	\$ 25,864,041
Net income	-	-	-	1,707,292	-	1,707,292
Change in other comprehensive income	-	-	-	-	846,514	846,514
Distributions to shareholders	-	-	-	(1,338,929)	-	(1,338,929)
Treasury stock purchased	-	-	(55,787)	-	-	(55,787)
Balance at December 31, 2019	783,000	3,005,020	(55,787)	23,062,310	228,588	27,023,131
Net income	-	-	-	1,582,521	-	1,582,521
Change in other comprehensive income	-	-	-	-	1,141,101	1,141,101
Distributions to shareholders	-	-	-	(1,164,756)	-	(1,164,756)
Treasury stock sold	-	-	19,250	-	-	19,250
Balance at December 31, 2020	<u>\$ 783,000</u>	<u>\$ 3,005,020</u>	<u>\$ (36,537)</u>	<u>\$ 23,480,075</u>	<u>\$ 1,369,689</u>	<u>\$ 28,601,247</u>

See notes to the consolidated financial statements.

TEXAS HERITAGE BANCSHARES, INC. AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF CASH FLOWS

Years Ended December 31,	2020	2019
OPERATING ACTIVITIES		
Net income	\$ 1,582,521	\$ 1,707,292
Adjustments to reconcile net income to net cash provided by operating activities:		
Net amortization of investment premiums	881,708	363,195
Depreciation and amortization	367,369	362,750
Provision for loan losses	725,000	1,287,000
Gain on sale of securities	(60,337)	-
Gain on sale of loans	(42,445)	(20,548)
Gain on sale of assets	-	(8,824)
Gain on sale of other real estate	-	(8)
Earnings on cash surrender value of life insurance	(174,890)	(184,586)
Net change in:		
Accrued interest receivable	99,763	46,230
Accrued interest payable	(35,930)	32,100
Other assets and other liabilities	219,866	(5,657)
Loans held-for-sale (cost)	(95,011,048)	(673,000)
Loans held-for-sale (proceeds)	95,053,493	693,548
Net cash provided by operating activities	<u>3,605,070</u>	<u>3,599,492</u>
INVESTING ACTIVITIES		
Activity in securities available-for-sale:		
Sales proceeds from investment securities	2,081,024	-
Maturities, prepayments and calls	208,559,050	144,421,918
Purchases	(268,741,213)	(140,862,371)
Activity in securities held-to-maturity:		
Maturities, prepayments and calls	574,220	655,295
Purchase of Federal Home Loan Bank stock	(9,500)	(22,200)
Net change in loans	20,123,938	(7,060,008)
Purchase of bank premises and equipment	(755,149)	(301,027)
Proceeds from sale of bank premises and equipment	-	21,000
Proceeds from cash surrender life insurance	664,018	42,562
Net cash used by investing activities	<u>(37,503,612)</u>	<u>(3,104,831)</u>
FINANCING ACTIVITIES		
Net change in deposits	48,857,044	14,233,855
Distributions paid to shareholders	(1,164,756)	(1,338,929)
Purchase of treasury stock	-	(55,787)
Sale of treasury stock	19,250	-
Net cash provided by financing activities	<u>47,711,538</u>	<u>12,839,139</u>
INCREASE IN CASH AND CASH EQUIVALENTS	13,812,996	13,333,800
CASH AND CASH EQUIVALENTS AT BEGINNING OF YEAR	27,872,047	14,538,247
CASH AND CASH EQUIVALENTS AT END OF YEAR	<u>\$ 41,685,043</u>	<u>\$ 27,872,047</u>
SUPPLEMENTAL CASH DISCLOSURES		
Loan foreclosures	\$ 153,307	\$ 132,150
Deferred gain on other real estate owned	\$ -	\$ 8
Cash paid for taxes	\$ 2,560	\$ 3,226

See notes to the consolidated financial statements.

TEXAS HERITAGE BANCSHARES, INC. AND SUBSIDIARY

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2020 and 2019

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Nature of Operations – Texas Heritage Bancshares, Inc. and Subsidiary (the “Company”) provides loan and banking services to consumers and commercial customers throughout Medina, Uvalde, Real, Bandera and Blanco Counties in South Texas. The accounting and reporting policies of the Company conform with U.S. generally accepted accounting principles (“GAAP”) and to general practices of the banking industry. Policies and practices which materially affect the determination of financial position, results of operations and cash flows are summarized as follows:

Principles of Consolidation – The consolidated financial statements include the accounts of Texas Heritage Bancshares, Inc. and the accounts of its wholly-owned subsidiary, The Hondo National Bank (the “Bank”). All significant intercompany balances and transactions have been eliminated in consolidation.

Use of Estimates – In preparing consolidated financial statements in conformity with U.S. generally accepted accounting principles, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities as of the date of the balance sheet and reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change in the near term relate to the determination of the allowance for loan losses and the estimate of the fair value of securities.

Significant Group Concentrations of Credit Risk – Most of the Company’s activities are with customers located in Medina, Uvalde, Real, Bandera and Blanco Counties in South Texas. The types of securities that the Company invests in are described in Note 2. The types of lending that the Company engages in are described in Note 3.

Cash and Cash Equivalents – For the purpose of presentation in the consolidated financial statements of cash flows, cash and cash equivalents are defined as those amounts included in the balance sheet captions “cash and due from banks” and “federal funds sold”. Generally, federal funds are purchased and sold in one-day periods. The Company considers all highly liquid investments with original maturities of three months or less to be cash equivalents. As of December 31, 2020, the FDIC Deposit insurance coverage was \$250,000.

The majority of cash and cash equivalents of the Company are maintained with major financial institutions in the United States. As such, interest bearing, non-transaction account deposits with these financial institutions may exceed the amount of insurance provided on such deposits; however, these deposits typically may be redeemed upon demand and therefore, bear minimal risk. As of December 31, 2020, the maximum credit risk exposure is **\$352,792**. In monitoring this credit risk, the Company periodically evaluates the stability of the financial institutions with which it has deposits.

Investment Securities – Certain debt securities that management has the positive intent and ability to hold to maturity are classified as “held-to-maturity” and are recorded at amortized cost.

Securities not classified as held-to-maturity, are classified as “available-for-sale” and recorded at fair value, with unrealized gains and losses excluded from earnings and reported in other comprehensive income.

TEXAS HERITAGE BANCSHARES, INC. AND SUBSIDIARY

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2020 and 2019

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Purchase premiums and discounts are recognized as interest income using the interest method over the terms of the securities. Declines in the fair value of held-to-maturity and available-for-sale securities below their cost that are deemed to be other than temporary, if any, are reflected in earnings as realized losses. In determining whether other-than-temporary impairment exists, management considers many factors, including the length of time and the extent to which the fair value has been less than cost, the financial condition and near term prospects of the issuer, and the intent and ability of the Company to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value. Gains and losses on the sale of securities are recorded on the trade date and are determined using the specific identification method.

Mortgage-backed securities represent participating interests in pools of long-term first mortgage loans originated and serviced by the issuers of the securities. Market interest rate fluctuations can affect the prepayment speed of principal and the yield on the security.

Loans – The Company grants mortgage, commercial and consumer loans to customers. A substantial portion of the loan portfolio is represented by real estate loans throughout Medina, Uvalde, Real, Bandera and Blanco Counties in South Texas. The ability of the Company's debtors to honor their contracts is dependent upon the general economic conditions in these areas.

Loans that management has the intent and ability to hold for the foreseeable future or until maturity or pay-off generally are reported at their outstanding unpaid principal balances adjusted for net charge-offs, and the allowance for loan losses.

Interest on loans is accrued on a daily basis. The accrual of interest on loans is discontinued at the time when, in management's opinion, the borrower may be unable to meet payments as they become due. All interest accrued but not collected for loans that are placed on nonaccrual or charged off are reversed against interest income. The interest on these loans is accounted for on the cash-basis or cost-recovery method, until qualifying for return to accrual. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured.

Fees and costs associated with originating loans are recognized as income and expense generally in the period in which fees are received and costs are incurred. Under U.S. generally accepted accounting principles, such net fees or costs generally are deferred and recognized over the life of the loan as an adjustment of yield. Management believes that not deferring such fees and costs and amortizing them over the life of the related loans does not materially affect the financial position or results of operations of the Company.

Troubled debt restructurings are loans for which concessions in terms have been made as a result of the borrower experiencing financial difficulty. Generally, concessions granted to customers include lower interest rates and modification of the payment stream to lower or defer payments. The Bank did not have any troubled debt restructurings for the years ended December 31, 2020 and 2019.

TEXAS HERITAGE BANCSHARES, INC. AND SUBSIDIARY

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2020 and 2019

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Interest on troubled debt restructurings is accrued under the new terms if the loans are performing and full collection of principal and interest is expected. However, interest accruals are discontinued on troubled debt restructurings that meet the Company's nonaccrual criteria.

Allowance for Loan Losses – The allowance for loan losses is a reserve established through a provision for loan losses charged to expense, which represents management's best estimate of probable losses that have been incurred within the existing portfolio of loans. The allowance, in the judgment of management, is necessary to reserve for estimated loan losses inherent in the loan portfolio. The level of the allowance reflects management's continuing evaluation of industry concentrations, specific credit risks, loan loss experience, current loan portfolio quality, present economic, political and regulatory conditions and unidentified losses inherent in the current loan portfolio, as well as trends in the foregoing. Portions of the allowance may be allocated for specific credits; however, the entire allowance is available for any credit that, in management's judgment, should be charged off. While management utilizes its best judgment and information available, the ultimate adequacy of the allowance is dependent upon a variety of factors beyond the Company's control, including the performance of the Company's loan portfolio, the economy, changes in interest rates and the view of the regulatory authorities toward loan classifications.

Loans Held-for-Sale – Loans held-for-sale, which are primarily mortgage loans, are reported at the lower of cost or market value on an aggregate loan portfolio basis. Gains or losses realized on the sales of loans are recognized at the time of sale and are determined by the difference between the net sales proceeds and the carrying value of the loans sold including any deferred origination fees and costs. Any gains and losses recognized on sales of mortgage loans are included in earnings. Gains on the sale of various loans were \$42,445 and \$20,548 as of December 31 2020 and 2019, respectively.

Advertising – Advertising costs are expensed as incurred. Advertising expense totaled \$210,597 and \$197,935 for the years ended December 31, 2020 and 2019, respectively and was included in other operating expenses on the consolidated statements of income.

Financial Instruments – In the ordinary course of business the Company has entered into commitments to extend credit, including commercial letters of credit and standby letters of credit. Such financial instruments are recorded when they are funded.

Premises and Equipment – Land is carried at cost. Buildings and equipment are carried at cost, less accumulated depreciation computed on the straight-line method over the estimated useful lives of the assets.

Buildings and improvements	10-40 years
Furniture and equipment	5-10 years

When an asset is sold, retired, or otherwise disposed of, cost and related accumulated depreciation are removed from the accounts and any resulting gain or loss is included in current operations. Repairs and maintenance are charged to expense as incurred and expenditures for renewals and betterments are capitalized.

TEXAS HERITAGE BANCSHARES, INC. AND SUBSIDIARY

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2020 and 2019

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Other Real Estate Owned – Assets acquired through foreclosure are initially recorded at fair value less estimated selling cost at the date of foreclosure. All write-downs based on the asset's fair value at the date of acquisition are charged to the allowance for loan losses. After foreclosure, property held-for-sale is carried at the lower of the new cost basis or fair value less cost to sell and depreciation is not recorded. Impairment losses on property to be held and used are measured as the amount by which the carrying amount of a property exceeds its fair value and depreciated based on the remaining useful life. Costs of significant property improvements are capitalized, whereas costs relating to holding property are expensed. Valuations are periodically performed by management, and any subsequent write-downs are recorded as a charge to operations, if necessary, to reduce the carrying value of a property to the lower of its cost or fair value less cost to sell.

Cash Surrender Value of Life Insurance – The Company has purchased life insurance policies on certain executives. Life insurance policies are initially recorded at cost at the date of purchase. Subsequent to purchase, the policies are periodically adjusted for changes in the contract value. The adjustment to contract value increases or decreases the carrying value of the policies and is recorded as income or expense on the consolidated statement of income.

Goodwill – Goodwill arises from business combinations and is generally determined as the excess of the fair value of the consideration transferred, plus the fair value of any non-controlling interests in the acquiree, over the fair value of the net assets acquired and liabilities assumed as of the acquisition date. Goodwill acquired in a purchase business combination and determined to have an indefinite useful life are not amortized, but tested for impairment at least annually or more frequently if events and circumstances indicate that a goodwill impairment test should be performed. The Company has selected December 31, 2020 and 2019 and does not believe Goodwill to be impaired.

Reclassifications

Other Assets – Purchase of Federal Home Loan Bank stock was reclassified on the 2019 consolidated statement of cash flows out of operating activities in the amount of \$22,200 included in other assets, and reclassified in investing activities to conform to current year presentation. Reclassification had no effect on prior year net income or shareholder equity.

Cash and Cash equivalents – The interest bearing deposits in other financial institutions totaling \$14,285,628 was reclassified from cash and due from banks on the 2019 consolidated balance sheet to conform to current financial presentation. Reclassification had no effect on prior year net income or shareholder equity.

TEXAS HERITAGE BANCSHARES, INC. AND SUBSIDIARY

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2020 and 2019

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Restricted Stock

Federal Home Loan Bank (“FHLB”) Stock – The Company is a member of the FHLB system. Members are required to own a certain amount of stock based on the level of borrowings and other factors, and may invest in additional amounts. FHLB stock is carried at cost, classified as a restricted security, and periodically evaluated for impairment based on ultimate recovery of par value. Both cash and stock dividends are reported as income. FHLB stock had a carrying value of **\$970,400** and \$960,900 as of December 31, 2020 and 2019, respectively.

Federal Reserve Bank (“FRB”) Stock – The Company is a member of its regional Federal Reserve Bank. FRB stock is carried at cost, classified as a restricted security, and periodically evaluated for impairment based on ultimate recovery of par value. Both cash and stock dividends are reported as income. FRB stock had a carrying value of **\$188,650** as of December 31, 2020 and 2019.

The Independent Bankers (“TIB”) Capital Fund Stock – The Company is a member of the TIB system. TIB stock is carried at cost, classified as a restricted security, and periodically evaluated for impairment based on ultimate recovery of par value. Both cash and stock dividends are reported as income. TIB stock had a carrying value of **\$124,654** as of December 31, 2020 and 2019.

Income Taxes – The Company and its principal subsidiary, Hondo National Bank will file a consolidated corporate federal income tax return. The Company elected to be taxed as a Sub-Chapter S Corporation under the Internal Revenue Code, effective January 1, 2010. Under those provisions, the Company’s income, deductions, losses, and credits flow directly to the shareholders. The Company does pay franchise taxes which are considered state income taxes on the consolidated statements of income.

U.S. generally accepted accounting principles require the Company management to evaluate tax positions taken by the Company and recognize a tax liability (or asset) if the Company has taken an uncertain position that more likely than not would not be sustained upon examination by the Internal Revenue Service. The Company’s management has analyzed the tax positions taken by the Company, and has concluded that as of December 31, 2020 and 2019, there are no uncertain positions taken or expected to be taken that would require recognition of a liability (or asset) or disclosure in the consolidated financial statements.

The Company is subject to routine audits by taxing jurisdictions; however, there are currently no audits for any tax periods in progress. The Company’s management believes it is no longer subject to income tax examinations for years prior to 2017.

TEXAS HERITAGE BANCSHARES, INC. AND SUBSIDIARY

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2020 and 2019

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Adoption of New Accounting Standards - In January 2017, the FASB issued ASU No. 2017-04, “Intangibles – Goodwill and Other: Simplifying the Test for Goodwill Impairment”, which amended existing guidance to simplify the subsequent measurement of goodwill by eliminating Step 2 from the goodwill impairment test. The amendments require an entity to perform an annual, or interim, goodwill impairment test by comparing fair value of a reporting unit with its carrying amount and recognizing an impairment charge for the amount by which the carrying amount exceeds the reporting unit’s fair value, not to exceed the total amount of goodwill allocated to that reporting unit. Additionally, an entity should consider income tax effects from any tax deductible goodwill on the carrying amount of the reporting unit when measuring the goodwill impairment loss, if applicable. The amendments also eliminate the requirement for any reporting unit with a zero or negative carrying amount to perform a qualitative assessment and, if it fails that qualitative test, to perform Step 2 of the goodwill impairment test. The amendment was effective for annual periods beginning after December 15, 2019 and the adoption of the guidance did not have an impact on the Company’s consolidated financial statements.

2. INVESTMENT SECURITIES

The following table summarizes the amortized cost and market value of securities available-for-sale and securities held-to-maturity at December 31, 2020 and 2019 and the corresponding amounts of gross unrealized gains and losses recognized in accumulated other comprehensive income (loss) and gross unrecognized gains and losses.

Investment securities **available-for-sale** consisted of the following:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Market Value
December 31, 2020				
Mortgage-backed securities	\$ 59,880,596	\$ 586,994	\$ 118,430	\$ 60,349,160
State and political subdivisions	49,744,456	962,480	61,355	50,645,581
Total	<u>\$ 109,625,052</u>	<u>\$ 1,549,474</u>	<u>\$ 179,785</u>	<u>\$ 110,994,741</u>
December 31, 2019				
Mortgage-backed securities	\$ 20,199,290	\$ 105,838	\$ 68,964	\$ 20,236,164
State and political subdivisions	32,140,748	235,638	43,924	32,332,462
Total	<u>\$ 52,340,038</u>	<u>\$ 341,476</u>	<u>\$ 112,888</u>	<u>\$ 52,568,626</u>

TEXAS HERITAGE BANCSHARES, INC. AND SUBSIDIARY

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2020 and 2019

2. INVESTMENT SECURITIES (continued)

Investment securities **held-to-maturity** consisted of the following:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Market Value
December 31, 2020				
Mortgage-backed securities	\$ 863,870	\$ 11,882	\$ -	\$ 875,752
State and political subdivisions	<u>850,000</u>	<u>-</u>	<u>-</u>	<u>850,000</u>
Total	<u>\$ 1,713,870</u>	<u>\$ 11,882</u>	<u>\$ -</u>	<u>\$ 1,725,752</u>
December 31, 2019				
Mortgage-backed securities	\$ 1,344,336	\$ 3,093	\$ -	\$ 1,347,429
State and political subdivisions	<u>949,000</u>	<u>-</u>	<u>-</u>	<u>949,000</u>
Total	<u>\$ 2,293,336</u>	<u>\$ 3,093</u>	<u>\$ -</u>	<u>\$ 2,296,429</u>

The proceeds from sales and calls of securities and the associated gains and losses are listed below:

	<u>2020</u>	<u>2019</u>
Sale proceeds from sale of available-for-sale securities	\$ 2,081,024	\$ -
Gross gains on sale of available-for-sale securities	\$ 60,337	\$ -

TEXAS HERITAGE BANCSHARES, INC. AND SUBSIDIARY

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2020 and 2019

2. INVESTMENT SECURITIES (continued)

The amortized cost and estimated market value of securities at December 31, 2020, by contractual maturities, are shown below. Expected maturities may differ from contractual maturities if borrowers have the right to call or prepay obligations with or without call or prepayment penalties.

Investment securities **available-for-sale**:

	Amortized Cost	Estimated Market Value
Due in one year or less	\$ 3,590,702	\$ 3,603,278
Due in one to five years	15,067,299	15,329,901
Due in five to ten years	13,706,803	13,921,848
Due in over ten years or more	<u>17,379,652</u>	<u>17,790,554</u>
Mortgage-backed securities	49,744,456	50,645,581
	<u>59,880,596</u>	<u>60,349,160</u>
Total	<u>\$ 109,625,052</u>	<u>\$ 110,994,741</u>

Investment securities **held-to-maturity**:

	Amortized Cost	Estimated Market Value
Due in one year or less	\$ 96,000	\$ 96,000
Due in one to five years	324,000	324,000
Due in five to ten years	205,000	205,000
Due in ten years or more	<u>225,000</u>	<u>225,000</u>
Mortgage-backed securities	850,000	850,000
	<u>863,870</u>	<u>875,752</u>
Total	<u>\$ 1,713,870</u>	<u>\$ 1,725,752</u>

TEXAS HERITAGE BANCSHARES, INC. AND SUBSIDIARY

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2020 and 2019

2. INVESTMENT SECURITIES (continued)

Investment securities were pledged to secure public deposits and for other purposes as required or permitted by law with a carrying value of \$42,825,928 and \$27,241,617 at December 31, 2020 and 2019, respectively.

The following table shows investments gross unrealized losses and fair value, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, at December 31, 2020 and 2019.

Available-for-sale

	<u>Less than 12 months</u>		<u>12 months or more</u>		<u>Total</u>	
	<u>Fair Value</u>	<u>Unrealized Losses</u>	<u>Fair Value</u>	<u>Unrealized Losses</u>	<u>Fair Value</u>	<u>Unrealized Losses</u>
December 31, 2020						
Mortgage-backed securities (7)	\$ 16,163,244	\$ 118,430	\$ -	\$ -	\$ 16,163,244	\$ 118,430
State and political subdivision (19)	<u>6,387,272</u>	<u>58,284</u>	<u>183,955</u>	<u>3,071</u>	<u>6,571,227</u>	<u>61,355</u>
Total	<u>\$ 22,550,516</u>	<u>\$ 176,714</u>	<u>\$ 183,955</u>	<u>\$ 3,071</u>	<u>\$ 22,734,471</u>	<u>\$ 179,785</u>
December 31, 2019						
Mortgage-backed securities (3)	\$ 5,533,546	\$ 68,964	\$ -	\$ -	\$ 5,533,546	\$ 68,964
State and political subdivision (38)	<u>7,647,850</u>	<u>25,104</u>	<u>3,867,474</u>	<u>18,820</u>	<u>11,515,324</u>	<u>43,924</u>
Total	<u>\$ 13,181,396</u>	<u>\$ 94,068</u>	<u>\$ 3,867,474</u>	<u>\$ 18,820</u>	<u>\$ 17,048,870</u>	<u>\$ 112,888</u>

Unrealized Losses – The unrealized losses on the Company’s investments were caused by interest rate changes. The Company purchased some of these investments at a premium relative to their face amount. At December 31, 2020, the outstanding premium related to investments in a loss position are as follows:

	<u>Premium</u>
Mortgage-backed securities	\$ 662,997
State and political subdivisions	\$ 376,556

TEXAS HERITAGE BANCSHARES, INC. AND SUBSIDIARY

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2020 and 2019

2. INVESTMENT SECURITIES (continued)

Accordingly, it is expected that the securities with premiums could be settled at a price less than the amortized cost of the Company's investment. Because the decline in market value is attributable to changes in interest rates and not credit quality and because the Company has the ability and intent to hold these investments until a recovery of fair value, which may be maturity, the Company does not consider these investments to be other-than-temporarily impaired at December 31, 2020.

Other-than-temporary Impairment – Management evaluates securities for other-than-temporary impairment at least quarterly, and more frequently when economic or market concerns warrant such evaluation. Consideration is given to (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, and (3) evaluation by the Company of (a) its intent to sell a debt security prior to recovery and (b) whether it is more likely than not the Company will have to sell the debt security prior to recovery. As of December 31, 2020, no investment securities were other-than-temporarily impaired.

3. LOANS AND ALLOWANCE FOR LOAN LOSSES

Loans consisted of the following at December 31, 2020 and 2019:

	<u>2020</u>	<u>2019</u>
Commercial	\$ 27,622,839	\$ 29,944,146
Real estate	100,110,473	116,273,220
Agriculture	22,886,991	24,227,742
Consumer and other	<u>6,527,283</u>	<u>6,676,828</u>
Total loans	157,147,586	177,121,936
Less: Allowance for loan losses	<u>(2,835,646)</u>	<u>(1,807,751)</u>
Total loans, net	<u>\$ 154,311,940</u>	<u>\$ 175,314,185</u>

Loan Origination/Risk Management – The Company has certain lending policies and procedures in place that are designed to maximize loan income within an acceptable level of risk. Management reviews and approves these policies and procedures on an annual basis. A reporting system supplements the review process by providing management with frequent reports related to loan production, loan quality, concentrations of credit, loan delinquencies, and non-performing and potential problem loans.

Commercial loans are underwritten by evaluating and understanding the borrower's ability to repay the loan through operating profitably and effectively growing its business. The Company's management examines current and projected cash flows to determine the ability of the borrower to repay their obligations as agreed. Commercial loans are primarily made based on the credit quality and global cash flows of the borrower and secondarily on the underlying collateral provided by the borrower.

TEXAS HERITAGE BANCSHARES, INC. AND SUBSIDIARY

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2020 and 2019

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (continued)

The cash flows of borrowers, however, may not be as expected and the collateral securing these loans may also fluctuate in value. Most commercial loans are secured by the assets being financed or other business assets such as accounts receivable or inventory and may incorporate a personal guarantee to add strength to the credit and reduce the risk on a transaction to an acceptable level; however, some short-term loans may be made on an unsecured basis to the most credit worthy borrowers. In the case of loans secured by accounts receivable, the availability of funds for the repayment of these loans may be substantially dependent on the ability of the borrower to collect amounts due from its customers. Due to the nature of accounts receivable and inventory secured loans, the Company closely monitors credit availability and collateral through the use of various tools, including but not limited to borrowing-base formulas, periodic accounts receivable aging, periodic inventory audits, and/or collateral inspections.

Commercial real estate loans are subject to underwriting standards and processes similar to commercial loans. Commercial real estate lending typically involves higher loan principal amounts and the repayment of these loans is generally largely dependent on the successful operation of the property securing the loan or the business conducted on the property securing the loan. Commercial real estate loans may be more adversely affected by conditions in the real estate markets or in the general economy. Management monitors and evaluates commercial real estate loans based on collateral and risk grade criteria. As a general rule, the Company avoids financing special use projects unless strong secondary support is present to help mitigate risk.

With respect to loans to developers and builders, the Company generally requires the borrower to have a proven record of success and an expertise in the building industry. Construction loans are underwritten utilizing feasibility studies, independent appraisal reviews, sensitivity analysis of absorption and lease rates and financial analysis of the developers and property owners. Construction loans are generally based upon estimates of costs and value associated with the complete project. These estimates may be inaccurate.

Construction loans often involve the disbursement of substantial funds with repayment substantially dependent on the success of the ultimate project. Sources of repayment for these types of loans may be pre-committed permanent loans from approved long-term lenders, sales of developed property, or an interim loan commitment from the Company until permanent financing is obtained. These loans are closely monitored by on-site inspections and are considered to have higher risks than other real estate loans due to their ultimate repayment being sensitive to interest rate changes, governmental regulation of real property, general economic conditions and the availability of long-term financing.

Consumer real estate loans are subject to the underwriting standards developed by the Federal National Mortgage Association for prime mortgages. These standards place a premium on the borrower's current ability to service debt and a proven track record of servicing debt in the past. The Company's policies and procedures discourage the underwriting of sub-prime mortgages. The Company periodically monitors its loans for deterioration in the borrower's financial strength and deterioration in property values.

TEXAS HERITAGE BANCSHARES, INC. AND SUBSIDIARY

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2020 and 2019

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (continued)

The Company's non-real estate consumer loans are based on the borrower's proven earning capacity over the term of the loan. The Company monitors payment performance periodically for consumer loans to identify any deterioration in the borrower's financial strength. To monitor and manage consumer loan risk, policies and procedures are developed and modified, as needed, jointly by management and staff. This activity, coupled with a relatively small volume of consumer loans, minimizes risk.

Agricultural loans are made to sound and prudent farmers and ranchers within the Company's market area even though agriculture may be an unstable industry. In order to minimize risk, sound lending policies are extremely important, taking into consideration not only the value of collateral offered but also the performance history and anticipated cash flow from a given farming or ranching operation. All agricultural loan applications require a cash flow projection for the coming farming season, and the projection must show a margin between income and expense that is sufficient to repay the loan from normal farm operations. All agriculture loans will be supported by a perfected first security interest position in the products being produced.

The Company engages an external consulting firm to complete an independent loan review that reviews and validates the credit risk program on a periodic basis. Results of these reviews are presented to management and the Board of Directors. The loan review process complements and reinforces the risk ratings and credit quality assessment decisions made by lenders and credit personnel, as well as the Company's policies and procedures.

In the ordinary course of business, the Company makes loans to executive officers and directors. These loans are made on substantially the same terms, including interest and collateral, as those prevailing at the time for comparable transactions with other customers. Loans to these related parties, including companies in which they are principal owners are as follows:

	<u>2020</u>	<u>2019</u>
Principal outstanding, beginning of year	\$ 2,477,756	\$ 2,865,524
Loans no longer considered related party	-	(70,050)
New related party loan added	30,000	-
New loans made in current year	5,109,453	648,045
Repayments	<u>(4,440,460)</u>	<u>(965,763)</u>
Principal outstanding, end of year	<u>\$ 3,176,749</u>	<u>\$ 2,477,756</u>

TEXAS HERITAGE BANCSHARES, INC. AND SUBSIDIARY

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2020 and 2019

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (continued)

An age analysis of past due loans, segregated by class of loans, as of December 31, 2020 and 2019, were as follows:

	30-59 Days Past Due	60-89 Days Past Due	Greater Than 90 Days	Total Past Due	Current	Total Loans	Recorded Investment > 90 Days and Still Accruing
December 31, 2020							
Commercial	\$ 21,176	\$ -	\$ -	\$ 21,176	\$ 27,601,663	\$ 27,622,839	\$ -
Real estate	646,148	-	102,043	748,191	99,362,282	100,110,473	-
Agriculture	-	958,605	-	958,605	21,928,386	22,886,991	-
Consumer and other	42,323	-	-	42,323	6,484,960	6,527,283	-
Total	<u>\$ 709,647</u>	<u>\$ 958,605</u>	<u>\$ 102,043</u>	<u>\$ 1,770,295</u>	<u>\$ 155,377,291</u>	<u>\$ 157,147,586</u>	<u>\$ -</u>
December 31, 2019							
Commercial	\$ 3,072	\$ -	\$ -	\$ 3,072	\$ 29,941,074	\$ 29,944,146	\$ -
Real estate	422,267	-	230,353	652,620	115,620,600	116,273,220	-
Agriculture	207,601	9,471	-	217,072	24,010,670	24,227,742	-
Consumer and other	93,505	883	-	94,388	6,582,440	6,676,828	-
Total	<u>\$ 726,445</u>	<u>\$ 10,354</u>	<u>\$ 230,353</u>	<u>\$ 967,152</u>	<u>\$ 176,154,784</u>	<u>\$ 177,121,936</u>	<u>\$ -</u>

TEXAS HERITAGE BANCSHARES, INC. AND SUBSIDIARY

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2020 and 2019

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (continued)

All non-accrual loans are considered impaired, as of December 31, 2020 and 2019, were as follows:

	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
December 31, 2020					
With no related allowance:					
Commercial	\$ -	\$ -	\$ -	\$ -	\$ -
Real estate	5,677,063	5,677,063	-	2,953,708	317,513
Agriculture	4,185,570	4,185,570	-	4,082,896	193,785
Consumer and other	-	-	-	-	-
With a related allowance:					
Commercial	\$ -	\$ -	\$ -	\$ -	\$ -
Real estate	-	-	-	-	-
Agriculture	-	-	-	-	-
Consumer and other	-	-	-	-	-
Total:					
Commercial	\$ -	\$ -	\$ -	\$ -	\$ -
Real estate	5,677,063	5,677,063	-	2,953,708	317,513
Agriculture	4,185,570	4,185,570	-	4,082,896	193,785
Consumer and other	-	-	-	-	-
Total	<u>\$ 9,862,633</u>	<u>\$ 9,862,633</u>	<u>\$ -</u>	<u>\$ 7,036,604</u>	<u>\$ 511,298</u>
December 31, 2019					
With no related allowance:					
Commercial	\$ -	\$ -	\$ -	\$ -	\$ -
Real estate	230,352	230,352	-	115,176	-
Agriculture	3,980,222	3,980,222	-	2,295,622	-
Consumer and other	-	-	-	-	-
With a related allowance:					
Commercial	\$ -	\$ -	\$ -	\$ -	\$ -
Real estate	-	-	-	-	-
Agriculture	-	-	-	-	-
Consumer and other	-	-	-	-	-
Total:					
Commercial	\$ -	\$ -	\$ -	\$ -	\$ -
Real estate	230,352	230,352	-	115,176	-
Agriculture	3,980,222	3,980,222	-	2,295,622	-
Consumer and other	-	-	-	-	-
Total	<u>\$ 4,210,574</u>	<u>\$ 4,210,574</u>	<u>\$ -</u>	<u>\$ 2,410,798</u>	<u>\$ -</u>

TEXAS HERITAGE BANCSHARES, INC. AND SUBSIDIARY

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2020 and 2019

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (continued)

There was no material effect of not recognizing interest income on nonaccrual loans in accordance with the original terms during the years ended December 31, 2020 and 2019.

Credit Quality Indicators – As part of the on-going monitoring of the credit quality of the Company's loan portfolio, the Company utilizes a risk grading system to assign a risk grade to each of its loans. Accurate and timely credit grading is a primary component of an effective loan review system. Loans are graded on a scale of 1 to 7. A description of the general characteristics of the 7 risk grades are as follows:

Grade 1 – PASS – This grade consists of loans that represent the least possible credit risk in the market for the Company. More specifically, these loans are secured by either cash deposits of the Company or marketable securities on a recognized exchange which are published on a daily basis. This collateral should include margins with no possible constraints in liquidation.

Grade 2 – PASS – This grade consists of loans that represent a completely acceptable asset and have no identifiable present or significant potential risk of non-collection. The loan must conform in all respects to established underwriting policy standards for that type of loan. Existing credit and/or collateral exceptions should not exist.

Grade 3 – PASS/WATCH – This grade consists of loans that are currently protected but possess a potential weakness. These assets continue an undue and unwanted credit risk but not to the point justifying a classification of special mention. The potential weakness may, if not checked or corrected, weaken the credit's quality and/or collateral position at some future date. Instances of credits which may be a grade 3 include; loans containing outstanding exceptions, conditions of and control over collateral, failure to obtain proper documentation, deviations from prudent lending practice and/or adverse trends in the obligor's operations or financial condition.

Grade 4 – SPECIAL MENTION – This grade consists of potentially weak loans which present an unwarranted credit risk. These loans require management's special attention. These loans have borrowers that are experiencing difficulties repaying and have the potential to threaten the Company's position.

Grade 5 – SUBSTANDARD – This grade consists of performing loans which are classified substandard. A substandard credit is inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Loans so classified must have a positive and well-defined weakness or weaknesses that jeopardize the liquidation of the debt. Potential, but unrealized, weaknesses are not sufficient cause for a substandard classification.

Grade 6 – DOUBTFUL – This grade is for "doubtful" in accordance with regulatory guidelines. An asset classified doubtful has all the weaknesses inherent in a substandard classification with the added factor that the weaknesses are pronounced to the point where, on the basis of current facts, conditions and values, collection or liquidation in full is highly questionable or improbable. While the possibility of loss is extremely high, the existence of specific pending factors, which may work to the obligor's advantage, warrants that the estimated loss be deferred until a more exact status is determined.

TEXAS HERITAGE BANCSHARES, INC. AND SUBSIDIARY

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2020 and 2019

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (continued)

Pending factors include, but are not limited to; merger, acquisition, liquidation, capital injection, perfecting liens on additional collateral, and refinancing plans. In instances when collection of a specific portion appears highly improbable, the entire credit should not automatically be classified as doubtful. Furthermore, the length of time a loan is classified Doubtful is a matter of judgment. However, a conclusion should be reached within a reasonable period of time (6 to 12 months) whether to upgrade the classification.

Grade 7 – LOSS – This grade consist of loans that are considered uncollectible and cannot be considered a bankable asset. Placing a loan in this category does not preclude the chance for recovery, but rather requires that the loan be taken off the books in case of a long-term potential recovery.

	<u>Commercial</u>	<u>Real Estate</u>	<u>Agricultural</u>	<u>Consumer and other</u>	<u>Total</u>
December 31, 2020					
<i>Credit Risk Profile by Internally Assigned Grade</i>					
Grade:					
Pass	\$ 26,088,505	\$ 78,218,385	\$ 13,220,014	\$ 6,527,283	\$ 124,054,187
Pass/Watch	1,261,449	13,592,888	4,246,623	-	19,100,960
Special mention	272,885	2,221,776	43,734	-	2,538,395
Substandard	-	6,077,424	5,376,620	-	11,454,044
Doubtful	-	-	-	-	-
Loss	-	-	-	-	-
Total	<u>\$ 27,622,839</u>	<u>\$ 100,110,473</u>	<u>\$ 22,886,991</u>	<u>\$ 6,527,283</u>	<u>\$ 157,147,586</u>
<i>Credit Risk Profile Based on Payment Activity</i>					
Performing	\$ 27,601,663	\$ 99,362,282	\$ 21,928,386	\$ 6,484,960	\$ 155,377,291
Nonperforming	<u>21,176</u>	<u>748,191</u>	<u>958,605</u>	<u>42,323</u>	<u>1,770,295</u>
Total	<u>\$ 27,622,839</u>	<u>\$ 100,110,473</u>	<u>\$ 22,886,991</u>	<u>\$ 6,527,283</u>	<u>\$ 157,147,586</u>

TEXAS HERITAGE BANCSHARES, INC. AND SUBSIDIARY

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2020 and 2019

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (continued)

	<u>Commercial</u>	<u>Real Estate</u>	<u>Agricultural</u>	<u>Consumer and other</u>	<u>Total</u>
December 31, 2019					
<i>Credit Risk Profile by</i>					
<i>Internally Assigned Grade</i>					
Grade:					
Pass	\$ 29,944,146	\$ 113,373,974	\$ 18,587,869	\$ 6,676,828	\$ 168,582,817
Pass/Watch	-	-	-	-	-
Special mention	-	1,120,358	423,346	-	1,543,704
Substandard	-	1,778,888	5,216,527	-	6,995,415
Doubtful	-	-	-	-	-
Loss	-	-	-	-	-
Total	<u>\$ 29,944,146</u>	<u>\$ 116,273,220</u>	<u>\$ 24,227,742</u>	<u>\$ 6,676,828</u>	<u>\$ 177,121,936</u>
<i>Credit Risk Profile Based on</i>					
<i>Payment Activity</i>					
Performing	\$ 29,941,074	\$ 115,620,600	\$ 24,010,670	\$ 6,582,440	\$ 176,154,784
Nonperforming	<u>3,072</u>	<u>652,620</u>	<u>217,072</u>	<u>94,388</u>	<u>967,152</u>
Total	<u>\$ 29,944,146</u>	<u>\$ 116,273,220</u>	<u>\$ 24,227,742</u>	<u>\$ 6,676,828</u>	<u>\$ 177,121,936</u>

Allowance for Loan Losses – The allowance for loan losses is a reserve established through a provision for loan losses charged to expense, which represents management’s best estimate of probable losses that have been incurred within the existing portfolio of loans. The allowance, in the judgment of management, is necessary to reserve for estimated loan losses and risks inherent in the loan portfolio. The Company’s allowance for loan loss methodology includes allowance allocations calculated in accordance with ASC Topic 310, “Receivables” and allowance allocations calculated in accordance with ASC Topic 450, “Contingencies.” Accordingly, the methodology is based on historical loss experience by type of credit and internal risk grade, changes in the composition and volume of the portfolio, and specific loss allocations, with adjustments for current events and conditions. The Company’s process for determining the appropriate level of the allowance for loan losses is designed to account for credit deterioration as it occurs.

The provision for loan losses reflects management’s periodic evaluation of individual loans and changes to the required allowance for specific loans, economic factors, past loan loss experience, loan quality trends, including the levels of and trends related to non-accrual loans, past due loans, potential problem loans, criticized loans and net charge-offs or recoveries, among other factors.

TEXAS HERITAGE BANCSHARES, INC. AND SUBSIDIARY

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2020 and 2019

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (continued)

The level of the allowance reflects management's continuing evaluation of industry concentrations, specific credit risks, loan loss experience, current loan portfolio quality, present economic, political and regulatory conditions and unidentified losses inherent in the current loan portfolio. Portions of the allowance may be allocated for specific credits; however, the entire allowance is available for any credit that, in management's judgment, should be charged off. While management utilizes its best judgment and information available, the ultimate adequacy of the allowance is dependent upon a variety of factors beyond the Company's control, including, among other things, the performance of the Company's loan portfolio, the economy, changes in interest rates and the view of the regulatory authorities toward loan classifications.

The Company's allowance for loan losses consists of three elements: (i) specific valuation allowances determined in accordance with ASC Topic 310 based on probable losses on specific loans; (ii) historical valuation allowances determined in accordance with ASC Topic 450 based on historical loan loss experience for similar loans with similar characteristics and trends, adjusted, as necessary, to reflect the impact of current conditions; and (iii) general valuation allowances determined in accordance with ASC Topic 450 based on general economic conditions and other qualitative risk factors both internal and external to the Company.

The allowances established for probable losses on specific loans are based on a regular analysis and evaluation of problem loans. Loans are classified based on an internal credit risk grading process that evaluates, among other things: (i) the borrower's ability to repay; (ii) the underlying collateral, if any; and (iii) the economic environment and industry in which the borrower operates. The initial analysis is performed by the relationship manager and credit rating is reviewed and approved by the Chief Lending Officer.

Specific valuation allowances are determined by analyzing the borrower's ability to repay amounts owed, collateral deficiencies, the relative risk grade of the loan and economic conditions affecting the borrower's industry, among other things. The Company calculates historical loss ratios for classifications of similar loans based on the proportion of actual charge-offs experienced to the total population of loans in the category. The historical loss ratios are periodically updated based on actual charge-off experience.

The Company's categories of similar loans include similarly risk-graded groups of commercial loans, commercial real estate loans, consumer real estate loans and consumer and other loans. General valuation allowances are based on general economic conditions and other qualitative risk factors both internal and external to the Company. In general, such valuation allowances are determined by evaluating, among other things: (i) the experience, ability and effectiveness of the Company's lending management and staff; (ii) the effectiveness of the Company's loan policies, procedures and internal controls; (iii) changes in asset quality; (iv) changes in nature and loan portfolio volume; (v) the composition and concentrations of credit; (vi) the effectiveness of the loan review function; (vii) the impact of national and local economic business conditions; and (viii) the impact of external factors, such as competition or legal and regulatory requirements. The results are then input into a "general allocation matrix" to determine an appropriate general valuation allowance. Loans identified as losses by management, external loan review and/or bank examiners are charged-off. Furthermore, consumer loan accounts are charged-off automatically based on regulatory requirements.

TEXAS HERITAGE BANCSHARES, INC. AND SUBSIDIARY

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2020 and 2019

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (continued)

The following table details activity in the allowance for loan losses by portfolio segment for the years ended December 31, 2020 and 2019. Allocation of a portion of the allowance to one category of loans does not preclude its availability to absorb losses in other categories.

Allowance for Loan Loss

	Commercial	Real Estate	Agriculture	Consumer and other	Unallocated	Total
December 31, 2020						
Beginning balance	\$ 361,557	\$ 657,884	\$ 584,057	\$ 109,507	\$ 94,746	\$ 1,807,751
Charge-offs	-	(27,926)	(34,112)	(80,814)	-	(142,852)
Recoveries	16,318	27,926	359,991	41,512	-	445,747
Provision	65,208	795,726	(81,485)	40,297	(94,746)	725,000
Ending balance	<u>\$ 443,083</u>	<u>\$ 1,453,610</u>	<u>\$ 828,451</u>	<u>\$ 110,502</u>	<u>\$ -</u>	<u>\$ 2,835,646</u>
Ending balance allocated to loans individually evaluated for impairment	\$ 8,187	\$ 377,939	\$ 276,702	\$ -	\$ -	\$ 662,828
Ending balance allocated to loans collectively evaluated for impairment	<u>434,896</u>	<u>1,075,671</u>	<u>551,749</u>	<u>110,502</u>	<u>-</u>	<u>2,172,818</u>
Total ALLL at December 31, 2020	<u>\$ 443,083</u>	<u>\$ 1,453,610</u>	<u>\$ 828,451</u>	<u>\$ 110,502</u>	<u>\$ -</u>	<u>\$ 2,835,646</u>
December 31, 2019						
Beginning balance	\$ 398,158	\$ 380,019	\$ 482,995	\$ 122,070	\$ 52,077	\$ 1,435,319
Charge-offs	(27,551)	-	(880,317)	(88,346)	-	(996,214)
Recoveries	23,577	-	5,000	53,069	-	81,646
Provision	(32,627)	277,865	976,379	22,714	42,669	1,287,000
Ending balance	<u>\$ 361,557</u>	<u>\$ 657,884</u>	<u>\$ 584,057</u>	<u>\$ 109,507</u>	<u>\$ 94,746</u>	<u>\$ 1,807,751</u>
Ending balance allocated to loans individually evaluated for impairment	\$ -	\$ 122,555	\$ 273,527	\$ -	\$ -	\$ 396,082
Ending balance allocated to loans collectively evaluated for impairment	<u>361,557</u>	<u>535,329</u>	<u>310,530</u>	<u>109,507</u>	<u>94,746</u>	<u>1,411,669</u>
Total ALLL at December 31, 2019	<u>\$ 361,557</u>	<u>\$ 657,884</u>	<u>\$ 584,057</u>	<u>\$ 109,507</u>	<u>\$ 94,746</u>	<u>\$ 1,807,751</u>

TEXAS HERITAGE BANCSHARES, INC. AND SUBSIDIARY

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2020 and 2019

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (continued)

The Company's recorded investment in loans as of December 31, 2020 and 2019 related to each balance in the allowance for loan losses by portfolio segment and disaggregated on the basis of the Company's impairment methodology was as follows:

Loans Receivable

	<u>Commercial</u>	<u>Real Estate</u>	<u>Agriculture</u>	<u>Consumer and other</u>	<u>Total</u>
December 31, 2020					
Ending balance of loans individually evaluated for impairment	\$ 272,885	\$ 8,299,200	\$ 5,420,354	\$ -	\$ 13,992,439
Ending balance of loans collectively evaluated for impairment	<u>27,349,954</u>	<u>91,811,273</u>	<u>17,466,637</u>	<u>6,527,283</u>	<u>143,155,147</u>
Ending balance	<u>\$ 27,622,839</u>	<u>\$ 100,110,473</u>	<u>\$ 22,886,991</u>	<u>\$ 6,527,283</u>	<u>\$ 157,147,586</u>
December 31, 2019					
Ending balance of loans individually evaluated for impairment	\$ -	\$ 2,899,246	\$ 5,639,873	\$ -	\$ 8,539,119
Ending balance of loans collectively evaluated for impairment	<u>29,944,146</u>	<u>113,373,974</u>	<u>18,587,869</u>	<u>6,676,828</u>	<u>168,582,817</u>
Ending balance	<u>\$ 29,944,146</u>	<u>\$ 116,273,220</u>	<u>\$ 24,227,742</u>	<u>\$ 6,676,828</u>	<u>\$ 177,121,936</u>

During 2020, the Small Business Administration ("SBA") offered the Paycheck Protection Program ("PPP") in response to the global pandemic. The SBA program offered unsecured PPP loans with an interest rate of 1% and, depending on the origination date, a maturity date of two years or five years. Loan payments were deferred for borrowers who apply for forgiveness of the loan from the SBA. If no forgiveness is applied for, payments are deferred for ten months after the end of the covered period. As of December 31, 2020, outstanding PPP loans not yet forgiven by the SBA were **\$120,841** and included within the Commercial loan category. Included in Commercial loans as of December 31, 2020 is **\$76,769** which represents the funds to be received from the SBA for PPP loans which have been forgiven by the SBA and included in the net loan balance on the statement of condition as of December 31, 2020.

The Company earned processing fees on each originated loan between 1% and 5%, depending on the size of the loan. Fees for individual loans which totaled less than or equal to \$1,000 were recognized on the statement of income at time of origination. Fees for individual loans which totaled greater than \$1,000 was deferred and recognized over the life of the loan or until forgiven by the SBA. Total fees recognized for the year ended December 31, 2020, were **\$41,022** and are included within interest and fees on loans on the statement of income. No interest expense or fees on loans was deferred as of December 31, 2020.

TEXAS HERITAGE BANCSHARES, INC. AND SUBSIDIARY

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2020 and 2019

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (continued)

Additionally, the Company is working with borrowers impacted by COVID-19 and providing modifications to include principal and interest deferral of payments. The Company is following guidance of the FFIEC which exempts the COVID-19 modifications from being reported and accounted for as a Troubled Debt Restructure (“TDR”). These modifications are excluded from troubled debt restructuring classification under Section 4013 of the CARES Act or under applicable interagency guidance of the federal banking regulators. As of December 31, 2020, the Company modified 146 commercial and consumer loans with outstanding balances of \$19,655,774.

4. PREMISES AND EQUIPMENT

Premises and equipment consisted of the following at December 31, 2020 and 2019:

	<u>2020</u>	<u>2019</u>
Land	\$ 871,764	\$ 871,764
Buildings and improvements	4,375,043	3,850,567
Furniture and equipment	<u>2,790,372</u>	<u>2,559,698</u>
Total premises and equipment	<u>8,037,179</u>	<u>7,282,029</u>
Less: Accumulated depreciation	<u>(3,779,288)</u>	<u>(3,411,918)</u>
Total premises and equipment, net	<u>\$ 4,257,891</u>	<u>\$ 3,870,111</u>

	<u>2020</u>	<u>2019</u>
Depreciation expense	\$ 367,369	\$ 362,750
Proceeds on sale of assets	\$ -	\$ 21,000
Gross gain	\$ -	\$ 8,824

TEXAS HERITAGE BANCSHARES, INC. AND SUBSIDIARY
 NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2020 and 2019

5. OTHER REAL ESTATE

Transactions in other real estate for the years ended December 31, are summarized as follows:

	<u>2020</u>	<u>2019</u>
Balance at beginning of year	\$ 132,150	\$ -
Foreclosures	<u>153,307</u>	<u>132,150</u>
Balance at end of year	<u>\$ 285,457</u>	<u>\$ 132,150</u>

Deferred gains from previous years' sales of \$8 were recognized in 2019.

6. DEPOSITS

Deposits consisted of the following at December 31, 2020 and 2019:

	<u>2020</u>	<u>2019</u>
Non-interest bearing:		
Demand accounts	<u>\$ 81,456,746</u>	<u>\$ 65,348,125</u>
Interest bearing:		
NOW accounts	58,972,065	47,409,412
Money market accounts	73,512,249	53,799,372
Savings accounts	20,079,246	15,336,778
Certificates of deposit	<u>58,709,003</u>	<u>61,978,578</u>
	<u>211,272,563</u>	<u>178,524,140</u>
Total	<u>\$ 292,729,309</u>	<u>\$ 243,872,265</u>

TEXAS HERITAGE BANCSHARES, INC. AND SUBSIDIARY
 NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2020 and 2019

6. DEPOSITS (continued)

At December 31, 2020, the schedule of maturities of certificates of deposits were as follows:

2021	\$ 49,057,214
2022	7,601,242
2023	1,271,261
2024	280,206
2025	<u>499,080</u>
Total	<u>\$ 58,709,003</u>

	<u>2020</u>	<u>2019</u>
Paid interest on deposits	\$ 1,852,642	\$ 1,993,948
Related party deposits (executive officers and directors)	\$ 18,747,511	\$ 12,103,443
Certificates \$250,000 or greater	\$ 23,700,648	\$ 25,142,107

7. OTHER BORROWINGS

The Company has an available line of credit at the Federal Home Loan Bank for a maximum of \$78.8 million as of December 31, 2020. The advances are secured by specific mortgage loans of the Company. The amount of loans pledged as collateral under the agreements approximates \$78.8 million at December 31, 2020. As of December 31, 2020 and 2019, the Company had no outstanding advances.

The Company has a federal fund line of credit from Frost National Bank in the amount of \$3,000,000 with an expiration of July 31, 2021, and with TIB for \$2,000,000 with no expiration date. As of December 31, 2020 and 2019, the Company had no federal funds purchased balance outstanding.

8. EMPLOYEE BENEFIT PLAN

The Company has a 401(k) retirement plan for all employees. The 401(k) Plan allows employees to contribute to the plan subject to Internal Revenue Code (“IRC”) limitations. The Company contributes a matching amount up to 4% of each eligible employee’s compensation. The Company contributed matching contributions to the 401(k) plan as follows:

	<u>2020</u>	<u>2019</u>
Matching contributions	\$ 86,737	\$ 79,186

TEXAS HERITAGE BANCSHARES, INC. AND SUBSIDIARY

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2020 and 2019

9. DEFERRED COMPENSATION PLANS

Deferred Compensation Plans for Future Benefit

Effective July 1, 2017, the Company started a salary continuation plan for three of the Company's key management, which is funded by insurance policies with the Company named as beneficiary. The Company will payout deferred salary upon retirement of members of key management. The deferred compensation liability related to this plan for December 31, 2020 and 2019 was **\$234,554** and **\$163,309**, respectively, and is included in deferred compensation.

In 2017, the Company approved an executive bonus plan which includes a deferred compensation plan based upon the performance of the Company for seven officers of the Company starting on January 1, 2018. The deferred compensation liability related to this plan for December 31, 2020 and 2019 was **\$123,349** and **\$82,252**, respectively, and is included in deferred compensation.

10. LEASES

The Company's leased space agreement ended in 2020, and had no future rental expense related to leased space as of December 31, 2020. Rental expense was **\$5,925** and **\$4,740** for 2020 and 2019, respectively. The Company did not receive any rental income for 2020 and 2019.

11. FINANCIAL INSTRUMENTS WITH OFF-BALANCE-SHEET RISK AND CONCENTRATIONS OF CREDIT RISK

In the normal course of business, the Company makes various commitments and incurs certain contingent liabilities that are not presented in the accompanying consolidated financial statements. The commitments and contingent liabilities include various guarantees, commitments to extend credit, and standby letters of credit.

The Company's exposure to credit loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit and standby letters of credit is represented by the contractual amount of those instruments. The Company uses the same credit policies in making commitments and conditional obligations as it does for on-balance-sheet instruments. The Company does not anticipate any material losses as a result of the commitments.

	<u>2020</u>	<u>2019</u>
Unfunded loan commitments	\$ 26,255,363	\$ 32,827,260
Standby letters of credit	\$ 325,000	\$ 380,000

TEXAS HERITAGE BANCSHARES, INC. AND SUBSIDIARY

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2020 and 2019

11. FINANCIAL INSTRUMENTS WITH OFF-BALANCE-SHEET RISK AND CONCENTRATIONS OF CREDIT RISK (continued)

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. 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. The Company evaluates each customer's credit worthiness on a case-by-case basis. The amount and type of collateral obtained, if deemed necessary by the Company upon extension of credit, varies and is based on management's credit evaluation of the counterparty.

Standby letters of credit are conditional commitments issued by the Company to guarantee the performance of a customer to a third party. Standby letters of credit generally have fixed expiration dates or other termination clauses and may require payment of a fee. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. The Company's policy for obtaining collateral, and the nature of such collateral, is essentially the same as that involved in making commitments to extend credit.

12. REGULATORY MATTERS

Cash Reserve Requirements – The Bank is required to maintain average cash reserve balances with the Federal Reserve Bank or depository banks thereof. There is no balance required at December 31, 2020. In 2019, the cash reserve requirement was \$394,000.

Capital Requirements – The Bank is subject to various regulatory capital requirements administered by state and federal banking agencies. Capital adequacy guidelines and prompt corrective action regulations, involve quantitative measures of assets, liabilities, and certain off-balance-sheet items calculated under regulatory accounting practices. Capital amounts and classifications are also subject to qualitative judgments by regulators about components, risk weighting and other factors.

The Basel III Capital Rules became effective for the Bank on January 1, 2015 (subject to a phase-in period for certain provisions). Quantitative measures established by the Basel III Capital Rules to ensure capital adequacy require the maintenance of minimum amounts and ratios (set forth in the table below) of Common Equity Tier 1 capital, Tier 1 capital and Total capital (as defined in the regulations) to risk-weighted assets (as defined), and of Tier 1 capital to adjusted quarterly average assets (as defined).

The Bank's Common Equity Tier 1 capital consists of common stock and related paid-in capital, net of treasury stock (if any), and retained earnings. In connection with the adoption of the Basel III Capital Rules, the election was made to opt-out of the requirement to include most components of accumulated other comprehensive income in Common Equity Tier 1. Common Equity Tier 1 for the Bank is reduced by goodwill (if any) and other intangible assets (if any), net of associated deferred tax liabilities (if any) and subject to transition provisions.

TEXAS HERITAGE BANCSHARES, INC. AND SUBSIDIARY

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2020 and 2019

12. REGULATORY MATTERS (continued)

Tier 1 capital includes Common Equity Tier 1 capital and additional Tier 1 capital as allowed by regulation. The Bank did not have any additional Tier 1 capital beyond Common Equity Tier 1 as of December 31, 2020. Total capital includes Tier 1 capital and Tier 2 capital. Tier 2 capital for the Bank includes a permissible portion of the allowance for loan losses.

The Common Equity Tier 1, Tier 1 and Total capital ratios are calculated by dividing the respective capital amounts by risk-weighted assets. Risk-weighted assets are calculated based on regulatory requirements and include total assets, excluding goodwill (if any) and other intangible assets (if any), allocated by risk weight category, and certain off-balance-sheet items, among other things. The leverage ratio is calculated by dividing Tier 1 capital by adjusted quarterly average total assets, which exclude goodwill (if any) and other intangible assets (if any), among other things.

As of January 1, 2019, the Basel III Capital Rules require the Bank to maintain (i) a minimum ratio of Common Equity Tier 1 capital to risk-weighted assets of at least 4.5%, plus a 2.5% “capital conservation buffer” (which is added to the 4.5% Common Equity Tier 1 capital ratio resulting in a minimum ratio of Common Equity Tier 1 capital to risk-weighted assets of at least 7.0%), (ii) a minimum ratio of Tier 1 capital to risk-weighted assets of at least 6.0%, plus the capital conservation buffer (which is added to the 6.0% Tier 1 capital ratio resulting in a minimum Tier 1 capital ratio of 8.5%), (iii) a minimum ratio of Total capital (that is, Tier 1 plus Tier 2) to risk-weighted assets of at least 8.0%, plus the capital conservation buffer (which is added to the 8.0% total capital ratio resulting in a minimum total capital ratio of 10.5%) and (iv) a minimum leverage ratio of 4.0%, calculated as the ratio of Tier 1 capital to average quarterly assets.

The aforementioned capital conservation buffer is designed to absorb losses during periods of economic stress. Banking institutions with a ratio of Common Equity Tier 1 capital to risk-weighted assets above the minimum but below the conservation buffer will face constraints on dividends, equity repurchases and compensation based on the amount of the shortfall.

TEXAS HERITAGE BANCSHARES, INC. AND SUBSIDIARY

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2020 and 2019

12. REGULATORY MATTERS (continued)

The following table presents actual and required capital ratios as of December 31, 2020 and 2019 for the Bank under the Basel III Capital Rules. The minimum required capital amounts presented include the minimum required capital levels as of December 31, 2020 and 2019 based on the minimum requirements for capital adequacy purposes and the minimum requirements with the capital conservation buffer. Capital levels required to be considered well capitalized are based upon prompt corrective action regulations, as amended to reflect the changes under the Basel III Capital Rules.

	Actual		Minimum Capital Required - For Capital Adequacy Purposes		Minimum Capital Required - With Capital Conservation Buffer		Required to be Considered Well Capitalized	
	Amount	Ratio	Amount	Ratio	Amount	Ratio	Amount	Ratio
As of December 31, 2020								
Common Equity Tier I Capital (to Risk-Weighted Assets)	\$ 27,025,870	14.53%	\$ 8,370,022	4.50%	\$ 13,020,034	7.00%	\$ 12,090,031	6.50%
Tier I Capital (to Risk-Weighted Assets)	\$ 27,025,870	14.53%	\$ 11,160,029	6.00%	\$ 15,810,041	8.50%	\$ 14,880,039	8.00%
Total Capital (to Risk-Weighted Assets)	\$ 29,350,208	15.78%	\$ 14,879,700	8.00%	\$ 19,529,606	10.50%	\$ 18,599,625	10.00%
Tier I Capital (to Average Assets)	\$ 27,025,870	8.43%	\$ 12,823,663	4.00%	\$ 12,823,663	4.00%	\$ 16,029,579	5.00%
As of December 31, 2019								
Common Equity Tier I Capital (to Risk-Weighted Assets)	\$ 26,669,847	12.74%	\$ 9,420,276	4.50%	\$ 14,653,762	7.00%	\$ 13,607,065	6.50%
Tier I Capital (to Risk-Weighted Assets)	\$ 26,669,847	12.74%	\$ 12,560,368	6.00%	\$ 17,793,854	8.50%	\$ 16,747,157	8.00%
Total Capital (to Risk-Weighted Assets)	\$ 28,581,570	13.66%	\$ 16,738,840	8.00%	\$ 21,969,728	10.50%	\$ 20,923,551	10.00%
Tier I Capital (to Average Assets)	\$ 26,669,847	10.02%	\$ 10,646,646	4.00%	\$ 10,646,646	4.00%	\$ 13,308,307	5.00%

As of December 31, 2020, capital levels at the Bank exceed all capital adequacy requirements under the Basel III Capital Rules. Based on the ratios presented above, capital levels as of December 31, 2020 at the Bank exceed the minimum levels necessary to be considered “well capitalized.”

The Bank is subject to the regulatory capital requirements administered by the Office of the Comptroller of the Currency (“OCC”) and the Federal Deposit Insurance Corporation (“FDIC”). Regulatory authorities can initiate certain mandatory actions if the Bank fails to meet the minimum capital requirements, which could have a direct material effect on our financial statements. Management believes, as of December 31, 2020, that the Bank meets all capital adequacy requirements to which it is subject.

TEXAS HERITAGE BANCSHARES, INC. AND SUBSIDIARY

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2020 and 2019

13. RESTRICTIONS ON DIVIDENDS

The Bank, as a National Bank, is subject to the dividend restrictions set forth by the Comptroller of the Currency. Under such restrictions, the Bank may not, without the prior approval of the Comptroller of the Currency, declare dividends in excess of the sum of the current year's net income plus the retained net income (as defined in the regulations) from the prior two years. The additional dividends as of December 31, 2020 that the Bank could declare, without the approval of the Comptroller of the Currency, were approximately **\$2,600,000**. Actual dividends available to be distributed are also subject to the Bank maintaining required regulatory capital ratios.

14. REVENUE FROM CONTRACTS WITH CUSTOMERS

All of the Company's revenue from contracts with customers in the scope of ASC 606 is recognized within Non-Interest Income. The following table presents the Company's sources of Non-Interest Income for the years ended December 31, 2020 and 2019. Items outside the scope of ASC 606 are noted as such.

A description of the Company's revenue streams accounted for under ASC 606 follows:

	<u>2020</u>	<u>2019</u>
Service charge on deposit accounts	\$ 277,845	\$ 362,446
ATM and debit card service charges	524,269	478,601
Service fees	62,583	80,323
Other	19,843	21,456
Gain on sale of other real estate	-	8
Gain on sale of available-for-sale securities*	60,337	-
Gain on sale of assets	-	8,824
Gain on sale of loans*	42,445	20,548
Capital stock dividend*	34,569	40,821
Earnings on cash surrender value*	<u>174,890</u>	<u>184,586</u>
Total non-interest income	<u>\$ 1,196,781</u>	<u>\$ 1,197,613</u>

* - Not within scope of ASC 606

Service Charge on Deposit Accounts – The Company earns fees from its deposit customers for transaction-based, account maintenance, and overdraft services. Transaction-based fees, which include services such as, stop payment charges, statement rendering, NSF and returned check charges are recognized at the time the transaction is executed as that is the point in time the Company fulfills the customer's request. Account maintenance fees, which relate primarily to monthly maintenance, are earned over the course of a month, representing the period over which the Company satisfies the performance obligation. Overdraft fees are recognized at the point in time that the overdraft occurs. Service charges on deposits are withdrawn from the customer's account balance monthly or quarterly.

TEXAS HERITAGE BANCSHARES, INC. AND SUBSIDIARY

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2020 and 2019

14. REVENUE FROM CONTRACTS WITH CUSTOMERS (continued)

ATM and Debit Card Service Charges – The Company earns interchange fees from debit and credit cardholder transactions conducted through the Plus and Pulse payment networks. Interchange fees from cardholder transactions represent a percentage of the underlying transaction value and are recognized daily, concurrently with the transaction processing services provided to the cardholder. The Company earns fees from the use of the Bank’s ATM’s by non-customers and from replacement card fees. Additionally, the category includes credit card income which is related to transaction based fees earned by the Company to process the credit card transactions at a customer’s business, charged on a monthly basis.

Service Fees – The Company earns fees from its deposit and non-deposit customers for service based fees. Service based fees such as cashier’s checks, traveler’s checks, money orders, wire transfers, check cashing, safe deposit boxes, and check orders are recognized at the time the transaction is executed as that is the point in time the Company fulfills the customer’s request.

Other – This category includes immaterial balances that are recognized as point in time transactions.

Gain on Sale of Other Real Estate – The Company records a gain or loss from the sale of Other Real Estate Owned (“OREO”) when control of the property transfers to the buyer, which generally occurs at the time of an executed deed. When the Company finances the sale of OREO to the buyer, the Company assesses whether the buyer is committed to perform their obligations under the contract and whether collectability of the transaction price is probable. Once these criteria are met, the OREO asset is derecognized and the gain or loss on sale is recorded upon the transfer of control of the property to the buyer. In determining the gain or loss on the sale, the Company adjusts the transaction price and related gain (loss) on sale if a significant financial component is present.

Gain on Sale of Assets – The Company recognizes gains associated with the sale of assets at the time title is transferred to the purchaser.

15. FAIR VALUE DISCLOSURES

The authoritative guidance on 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.

TEXAS HERITAGE BANCSHARES, INC. AND SUBSIDIARY

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2020 and 2019

15. FAIR VALUE DISCLOSURES (continued)

The authoritative guidance on fair value measurements 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 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 3 Inputs – Significant unobservable inputs that reflect an entity's own assumptions that market participants would use in pricing the assets or liabilities.

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.

TEXAS HERITAGE BANCSHARES, INC. AND SUBSIDIARY

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2020 and 2019

15. FAIR VALUE DISCLOSURES (continued)

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. There have been no changes in the methodologies used at December 31, 2020.

Financial Assets and Financial Liabilities

Financial assets and financial liabilities measured at fair value on a recurring and nonrecurring basis include the following:

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

Impaired Loans – A loan may be considered impaired when it is determined that it is probable that payment of interest and principal will not be made in accordance with the contractual terms of the loan agreement. Once a loan is identified as individually impaired, management measures for impairment using the practical expedients permitted by applicable authoritative accounting guidance, at the fair value of the loans collateral, if the loan is collateral dependent. If a loan is determined to be collateral dependent, the fair value of the collateral is determined by independent appraisals or valuations adjusted for costs related to the liquidation of the collateral and are classified as Level 3.

Other Real Estate – Certain foreclosed properties, upon initial recognition and subsequent remeasurement were valued and reported at fair value through charge-offs to the allowance for loan losses and writedowns included in current period earnings. The fair value of such other real estate owned, upon initial recognition and subsequent remeasurement, is estimated utilizing Level 3 inputs. Fair values were based primarily on third party appraisals; however, based on the current economic conditions, comparative sales data typically used in the appraisals may be unavailable or more subjective due to the lack of real estate market activity. See Note 5, for the activity that occurred in Other Real Estate for the years ended December 31, 2020 and 2019.

TEXAS HERITAGE BANCSHARES, INC. AND SUBSIDIARY

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2020 and 2019

15. FAIR VALUE DISCLOSURES (continued)

The following table summarizes financial assets and financial liabilities measured at fair value on a recurring basis, segregated by the level of the valuation inputs within the fair value hierarchy utilized to measure fair value:

	<u>Level 1 Inputs</u>	<u>Level 2 Inputs</u>	<u>Level 3 Inputs</u>	<u>Total Fair Value</u>
December 31, 2020				
Investment securities available-for-sale	\$ -	\$ 110,994,741	\$ -	\$ 110,994,741
December 31, 2019				
Investment securities available-for-sale	\$ -	\$ 52,568,626	\$ -	\$ 52,568,626

Certain financial assets are measured at fair value on a non-recurring 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).

The following table summarizes financial assets measured at fair value on a non-recurring basis, segregated by the level of the valuation inputs within the fair value hierarchy utilized to measure fair value:

	<u>Level 1 Inputs</u>	<u>Level 2 Inputs</u>	<u>Level 3 Inputs</u>	<u>Total Fair Value</u>
December 31, 2020				
Impaired loans	\$ -	\$ -	\$ 9,862,633	\$ 9,862,633
December 31, 2019				
Impaired loans	\$ -	\$ -	\$ 4,210,574	\$ 4,210,574

TEXAS HERITAGE BANCSHARES, INC. AND SUBSIDIARY

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2020 and 2019

15. FAIR VALUE DISCLOSURES (continued)

During the years ended December 31, 2020 and 2019, certain impaired loans were remeasured and reported at fair value through a specific valuation allowance allocation of the allowance for loan losses based upon the fair value of the underlying collateral based on collateral valuations utilizing Level 3 valuation inputs.

	<u>2020</u>	<u>2019</u>
Carrying value of impaired loans	\$ 9,862,633	\$ 4,210,574
Specific valuation allowance allocations	<u>-</u>	<u>-</u>
Fair value of impaired loans	<u>\$ 9,862,633</u>	<u>\$ 4,210,574</u>

Non-Financial Assets and Non-Financial Liabilities

The following table summarizes non-financial assets and non-financial liabilities measured at fair value on a recurring and non-recurring basis, segregated by the level of the valuation inputs within the fair value hierarchy utilized to measure fair value:

	<u>Level 1</u> <u>Inputs</u>	<u>Level 2</u> <u>Inputs</u>	<u>Level 3</u> <u>Inputs</u>	<u>Total Fair</u> <u>Value</u>
December 31, 2020				
Other real estate	\$ -	\$ -	\$ 285,457	\$ 285,457
December 31, 2019				
Other real estate	\$ -	\$ -	\$ 132,150	\$ 132,150

16. COVID-19

In 2020, the World Health Organization declared the spread of Coronavirus Diseases (“COVID-19”) a worldwide pandemic. The COVID-19 pandemic is having significant effects on global markets, supply chains, businesses and communities. Specific to the Company, COVID-19 may continue to impact various parts of its 2021 operations and financial results including but not limited to additional loan charge-offs, deferred loan payments, costs for emergency preparedness, or potential shortage of personnel. Management believes the Company is taking appropriate actions to mitigate the negative impact. However, the full impact of COVID-19 is unknown and cannot be reasonably estimated as these events are still occurring subsequent to year end.

TEXAS HERITAGE BANCSHARES, INC. AND SUBSIDIARY

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2020 and 2019

17. SUBSEQUENT EVENTS

The Company has performed a review of subsequent events through the date of the opinion, which is the date the financial statements were available for issuance, and concludes there were no events or transactions occurring during this period that required recognition or disclosure in the financial statements, except as noted below. Any events occurring after this date have not been factored into the financial statements being presented.

On August 24, 2020, the Texas Heritage Bancshares, Inc. (“THBI”) board of directors approved and signed a Business Combination Agreement with the directors of Medina Community Bancshares, Inc. (“MCBI”) to merge THBI and MCBI and their wholly owned subsidiary Community National Bank. THBI estimates to issue 566,313 shares of THBI common stock valued at approximately \$20,000,000 to holders of MCBI common stock. The transaction is pending final regulatory approval and is expected to be completed in 2021.

18. RECENTLY ISSUED AUTHORITATIVE GUIDANCE

ASU 2016-02, “Leases (Topic 842).” In February 2016, the FASB amended existing guidance that requires lessees recognize the following for all leases (with the exception of short term leases) at the commencement date (1) A lease liability, which is a lessee’s obligation to make lease payments arising from a lease, measured on a discounted basis; and (2) A right-of-use asset, which is an asset that represents the lessee’s right to use or control the use of a specified asset for the lease term. Under the new guidance, lessor accounting is largely unchanged. Certain targeted improvements were made to align, where necessary; lessor accounting with the lessee accounting model and Topic 606, Revenue from Contracts with Customers. The amendments will be effective for financial statements issued for fiscal years beginning after December 15, 2021. This guidance is not expected to have a significant impact on the Company’s consolidated financial statements.

ASU 2016-13, “Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments.” In June 2016, FASB issued guidance to replace the incurred loss model with an expected loss model, which is referred to as the current expected credit loss (“CECL”) model. The CECL model is applicable to the measurement of credit losses on financial assets measured at amortized cost, including loan receivables, held-to maturity debt securities, and reinsurance receivables. It also applies to off balance sheet credit exposures not accounted for as insurance and net investments in leases recognized by a lessor. The amendments will be effective for fiscal years beginning after December 15, 2022 and are expected to have a significant impact on the Company’s consolidated financial statements. The Company has formed a CECL committee that is assessing data and system needs in order to evaluate the impact of adopting the new guidance. Management expects to recognize a one-time cumulative effect adjustment to the allowance for loan losses as of the beginning of the first reporting period in which the new standard is effective. Management expects the adoption will result in a material increase to the allowance for loan losses balance.

TEXAS HERITAGE BANCSHARES, INC. AND SUBSIDIARY

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2020 and 2019

18. RECENTLY ISSUED AUTHORITATIVE GUIDANCE (continued)

ASU 2019-12, Income Taxes (Topic 740). The FASB amended the standard to simplify the accounting for income taxes without compromising information provided to users of financial statements. The amendments will be effective for financial statements issued for fiscal years beginning after December 15, 2021. This guidance is not expected to have a significant impact on the Company's consolidated financial statements.

ASU 2020-10, Codification Improvements. The FASB amendments improve consistency by amending the Codification to include all disclosure guidance in the appropriate disclosure sections and clarifies application of various provisions in the Codification by amending and adding new headings, cross referencing to other guidance, and refining or correcting terminology. The amendments will be effective for financial statements issued for fiscal years beginning after December 15, 2021. This guidance is not expected to have a significant impact on the Company's consolidated financial statements.

SUPPLEMENTARY INFORMATION

TEXAS HERITAGE BANCSHARES, INC. AND SUBSIDIARY

CONSOLIDATING BALANCE SHEET

December 31, 2020

	Texas Heritage Bancshares, Inc.	Hondo National Bank	Eliminations	Consolidated Balance
ASSETS				
Cash and Cash Equivalents				
Cash and due from banks	\$ 23,272	\$ 5,373,224	\$ (23,272)	\$ 5,373,224
Interest-bearing deposits in other financial institutions	-	35,211,819	-	35,211,819
Federal funds sold	-	1,100,000	-	1,100,000
Total cash and cash equivalents	<u>23,272</u>	<u>41,685,043</u>	<u>(23,272)</u>	<u>41,685,043</u>
Securities available-for-sale, at estimated market value	-	110,994,741	-	110,994,741
Securities held-to-maturity, at cost	-	1,713,870	-	1,713,870
Loans, net	-	154,311,940	-	154,311,940
Investment in subsidiary	28,577,975	-	(28,577,975)	-
Premises and equipment, net	-	4,257,891	-	4,257,891
Accrued interest receivable	-	1,517,309	-	1,517,309
Other real estate owned, net	-	285,457	-	285,457
Cash surrender value of life insurance	-	5,850,235	-	5,850,235
Goodwill	-	120,416	-	120,416
Restricted stock	-	1,283,704	-	1,283,704
Other assets	-	85,767	-	85,767
Total assets	<u>\$ 28,601,247</u>	<u>\$ 322,106,373</u>	<u>\$ (28,601,247)</u>	<u>\$ 322,106,373</u>
LIABILITIES AND SHAREHOLDERS' EQUITY				
Deposits:				
Non-interest bearing	\$ -	\$ 81,480,018	\$ (23,272)	\$ 81,456,746
Interest bearing	-	211,272,563	-	211,272,563
Total deposits	<u>-</u>	<u>292,752,581</u>	<u>(23,272)</u>	<u>292,729,309</u>
Accrued interest payable	-	61,809	-	61,809
Deferred compensation	-	357,903	-	357,903
Other liabilities	-	356,105	-	356,105
Total liabilities	<u>-</u>	<u>293,528,398</u>	<u>(23,272)</u>	<u>293,505,126</u>
Shareholders' Equity				
Common stock	783,000	812,153	(812,153)	783,000
Additional paid-in capital	3,005,020	5,474,364	(5,474,364)	3,005,020
Treasury stock (at cost)	(36,537)	-	-	(36,537)
Retained earnings	23,480,075	20,921,769	(20,921,769)	23,480,075
Accumulated other comprehensive income	1,369,689	1,369,689	(1,369,689)	1,369,689
Total shareholders' equity	<u>28,601,247</u>	<u>28,577,975</u>	<u>(28,577,975)</u>	<u>28,601,247</u>
Total liabilities and shareholders' equity	<u>\$ 28,601,247</u>	<u>\$ 322,106,373</u>	<u>\$ (28,601,247)</u>	<u>\$ 322,106,373</u>

See Report of Independent Auditors.

TEXAS HERITAGE BANCSHARES, INC. AND SUBSIDIARY

CONSOLIDATING STATEMENT OF INCOME

Year Ended December 31, 2020

	Texas Heritage Bancshares, Inc.	Hondo National Bank	Eliminations	Consolidated Balance
INTEREST INCOME				
Loans, including fees	\$ -	\$ 9,258,740	\$ -	\$ 9,258,740
Investment securities:				
Taxable	-	586,947	-	586,947
Tax-exempt	-	1,005,255	-	1,005,255
Federal funds sold	-	56,073	-	56,073
Other	-	76,728	-	76,728
Total interest income	<u>-</u>	<u>10,983,743</u>	<u>-</u>	<u>10,983,743</u>
INTEREST EXPENSE				
Deposits	-	1,816,712	-	1,816,712
Total interest expense	<u>-</u>	<u>1,816,712</u>	<u>-</u>	<u>1,816,712</u>
NET INTEREST INCOME	<u>-</u>	<u>9,167,031</u>	<u>-</u>	<u>9,167,031</u>
PROVISION FOR LOAN LOSSES	<u>-</u>	<u>725,000</u>	<u>-</u>	<u>725,000</u>
NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES	<u>-</u>	<u>8,442,031</u>	<u>-</u>	<u>8,442,031</u>
NON-INTEREST INCOME				
Dividends from subsidiaries	1,164,756	-	(1,164,756)	-
Undistributed earnings of subsidiaries	418,023	-	(418,023)	-
Service charges on deposit accounts	-	277,845	-	277,845
ATM and debit card service charges	-	524,269	-	524,269
Service fees	-	62,583	-	62,583
Other	-	19,843	-	19,843
Gain on sale of available-for-sale securities	-	60,337	-	60,337
Gain on sale of loans	-	42,445	-	42,445
Capital stock dividend	-	34,569	-	34,569
Earnings on cash surrender value	-	174,890	-	174,890
Total non-interest income	<u>1,582,779</u>	<u>1,196,781</u>	<u>(1,582,779)</u>	<u>1,196,781</u>
NON-INTEREST EXPENSE				
Salaries, wages and benefits	-	4,488,792	-	4,488,792
Occupancy and equipment	-	957,791	-	957,791
Other	258	2,606,890	-	2,607,148
Total non-interest expense	<u>258</u>	<u>8,053,473</u>	<u>-</u>	<u>8,053,731</u>
INCOME BEFORE INCOME TAXES	<u>1,582,521</u>	<u>1,585,339</u>	<u>(1,582,779)</u>	<u>1,585,081</u>
STATE INCOME TAX EXPENSE	<u>-</u>	<u>2,560</u>	<u>-</u>	<u>2,560</u>
NET INCOME	<u>\$ 1,582,521</u>	<u>\$ 1,582,779</u>	<u>\$ (1,582,779)</u>	<u>\$ 1,582,521</u>

See Report of Independent Auditors.

Texas Heritage Bancshares, Inc.

March 06, 2021

Shareholder's Meeting
Texas Heritage Bancshares, Inc.

Dear Valued Shareholders,

After several years of negotiations between Texas Heritage Bancshares and Medina Community Bancshares, the two holding companies agreed to merge. The holding companies merger will be followed by the merger their two banks, Hondo National Bank and Community National Bank, in the near future.

The reduction in earnings from prior years was a result of the Federal Reserve Banks 150 basis point drop in the Fed Funds rates in the first quarter of 2020 and the weak loan demand resulting from the economy being shut down as a result of Covid-19.

The Holding Company continues to be guided by outstanding Directors who understand our bank and our communities' needs.

Please consider attending our Annual Shareholders Meeting to be held Tuesday, March 16th, 2020 at 5:00 p.m. in the Hondo National Bank lobby in Hondo. We will enjoy seeing you and addressing any questions you may have about the Holding Company or the Bank.

Enclosed you will find your personal copy of Texas Heritage Bancshares, Inc.'s Audited Financial Statements as of December 31, 2020.

Also enclosed, please find a ledger sheet to help the bank's Accounting firm calculate each shareholders basis in their stock. You may notice that the basis is missing from this year's K-1 as a result of the bank's Accountants not willing to include it since they are concerned about it being inaccurate.

If you are unable to join us for the Shareholder's Meeting, please complete the enclosed proxy form and return same in the postage paid envelope.

We look forward to seeing you on March 16th. Remember, Shareholders continue to be the life blood of successful organizations. We appreciate and value each and every one of you.

Sincerely,



Olen Thompson
President/CEO

1112 18th Street • P.O. Box 340 • Hondo, Texas 78861
(830) 426-3355 • FAX (830) 741-4355

**NOTICE OF ANNUAL MEETING OF SHAREHOLDERS
TO BE HELD ON MARCH 16, 2021**

TO THE SHAREHOLDERS OF TEXAS HERITAGE BANCSHARES, INCORPORATED:

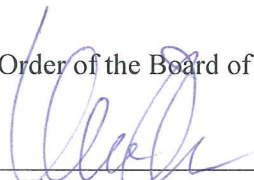
Notice is hereby given that the Annual Meeting of Shareholders (the "Meeting") of Texas Heritage Bancshares, Incorporated (the "Company"), will be held at 5:00 p.m., local time, on Tuesday, March 16, 2021, in the lobby of The Hondo National Bank, 1112 18th Street, Hondo, Texas 78861, for the following purposes:

1. To consider and act upon the election of nine (9) directors to serve until the next Annual Meeting of Shareholders of the Company and until their successors are elected and qualified;
2. To transact such other business as may properly come before the meeting and any adjournment or postponement thereof.

You are urged to mark, sign, date, and promptly return your Proxy in the enclosed envelope so that your shares may be voted in accordance with your wishes and in order that the presence of a quorum may be assured. The prompt return of your signed Proxy, regardless of the number of shares you hold, will aid the Company in reducing the expense of additional proxy solicitation. The giving of such Proxy does not affect your right to vote in person if you attend the meeting. Any Proxy given pursuant to this solicitation may be revoked by the person giving it at any time before it is voted at the meeting. Proxies may be revoked by delivering to Julia Kraemer, Secretary to the Board of Directors of the Company, 1112 18th Street, Hondo, Texas 78861, a written notice of revocation bearing a later date than the Proxy, by duly executing and delivering to the Secretary of the Board of Directors a subsequently dated Proxy relating to the same shares or by attending the Meeting and voting in person (although attendance at the meeting will not in and of itself constitute revocation of a Proxy).

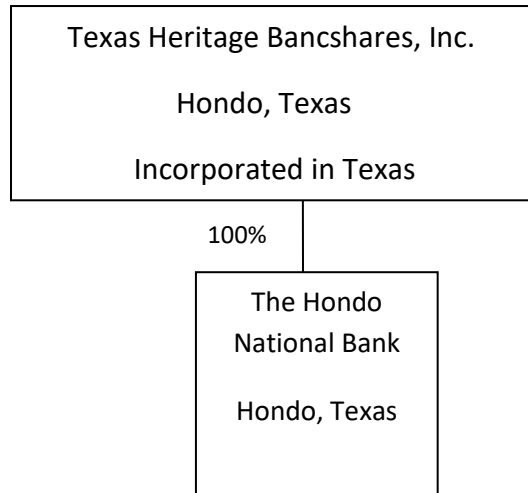
Only those shareholders of record at the close of business on March 1, 2021, will be entitled to notice of and to vote at the meeting and any adjournment or postponement thereof.

By Order of the Board of Directors



Olen Thompson
President

Texas Heritage Bancshares, Inc.
and Affiliated Companies
Hondo, Texas
Fiscal Year Ending December 31, 2020



- No entity in the organization has a LEI.

Results: A list of branches for your depository institution: **HONDO NATIONAL BANK, THE (ID_RSSD: 77253)**
 This depository institution is held by **TEXAS HERITAGE BANCSHARES, INC. (3048991)** of **HONDO, TX**
 The data are as of **12/31/2020**. Data reflects information that was received and processed through **01/05/2021**.

Reconciliation and Verification Steps

1. In the **Data Action** column of each branch row, enter one or more of the actions specified below
2. If required, enter the date in the **Effective Date** column

Actions

- OK:** If the branch information is correct, enter 'OK' in the **Data Action** column.
- Change:** If the branch information is incorrect or incomplete, revise the data, enter 'Change' in the **Data Action** column and the date when this information first became valid in the **Effective Date** column.
- Close:** If a branch listed was sold or closed, enter 'Close' in the **Data Action** column and the sale or closure date in the **Effective Date** column.
- Delete:** If a branch listed was never owned by this depository institution, enter 'Delete' in the **Data Action** column.
- Add:** If a reportable branch is missing, insert a row, add the branch data, and enter 'Add' in the **Data Action** column and the opening or acquisition date in the **Effective Date** column.

If printing this list, you may need to adjust your page setup in MS Excel. Try using landscape orientation, page scaling, and/or legal sized paper.

Submission Procedure

When you are finished, send a saved copy to your FRB contact. See the detailed instructions on this site for more information.
 If you are e-mailing this to your FRB contact, put your institution name, city and state in the subject line of the e-mail.

Note:
 To satisfy the **FR Y-10 reporting requirements**, you must also submit FR Y-10 Domestic Branch Schedules for each branch with a **Data Action** of **Change, Close, Delete, or Add**.
 The FR Y-10 report may be submitted in a hardcopy format or via the FR Y-10 Online application - <https://y10online.federalreserve.gov>

* FDIC UNINUM, Office Number, and ID_RSSD columns are for reference only. Verification of these values is not required

Data Action	Effective Date	Branch Service Type	Branch ID_RSSD*	Popular Name	Street Address	City	State	Zip Code	County	Country	FDIC UNINUM*	Office Number*	Head Office	Head Office ID_RSSD*	Comments
OK		Full Service (Head Office)	77253	HONDO NATIONAL BANK, THE	1112 18TH STREET	HONDO	TX	78861-1833	MEDINA	UNITED STATES	Not Required	Not Required	HONDO NATIONAL BANK, THE	77253	
OK		Full Service	2995623	BANDERA BRANCH	355 STATE HIGHWAY 16 SOUTH	BANDERA	TX	78003	BANDERA	UNITED STATES	Not Required	Not Required	HONDO NATIONAL BANK, THE	77253	
OK		Full Service	5373370	BLANCO BRANCH	401 MAIN STREET	BLANCO	TX	78606	BLANCO	UNITED STATES	Not Required	Not Required	HONDO NATIONAL BANK, THE	77253	
OK		Full Service	3590155	LEAKEY BRANCH	410 SOUTH HIGHWAY 83	LEAKEY	TX	78873	REAL	UNITED STATES	Not Required	Not Required	HONDO NATIONAL BANK, THE	77253	
OK		Full Service	363264	UVALDE BRANCH	727 E MAIN ST	UVALDE	TX	78801-5718	UVALDE	UNITED STATES	Not Required	Not Required	HONDO NATIONAL BANK, THE	77253	

FORM FR Y-6
DECEMBER 31, 2020
Report Item 4: Directors Officers

1	2	3 - a	3 - b	3 - c	4 - a	4 - b	4 - c
Stephen Horton Sabinal, TX, USA	Certified Public Accountant	Director	Director- Hondo National Bank	Coleman & Horton, CPA	27%	None	N/A
Joe Hargrove Uvalde, TX, USA	Auction Owner Rancher	Director	Director- Hondo National Bank	President-Southwest L/S Auction	18%	None	Southwest L/S Auction; 100%
Mike Miller Hondo, TX, USA	Real Estate Developer	Director	Director- Hondo National Bank	N/A	3%	None	N/A
James Barden Hondo, TX, USA	Investments/Rancher	Director/Chairman	Director- Hondo National Bank	N/A	3%	None	N/A
Olen Thompson Hondo, TX, USA	Banker- HNB	Director/ President	Director/ President- Hondo National Bank	N/A	0%	None	N/A
Reagan Houston San Antonio, TX, USA	Investments/Rancher	Director	Director- Hondo National Bank	N/A	8%	None	N/A
David McGuffin Hondo, TX, USA	Investments	Director	Director/Chairman- Hondo National Bank	N/A	3%	None	N/A
Robert Peden Hondo, TX, USA	Pharmacist	Director	Director- Hondo National Bank	N/A	0%	None	N/A
Fred Yanta Devine, TX, USA	Farmer	Director	Director- Hondo National Bank	N/A	3%	None	N/A
Justin Speer Uvalde, TX USA	Farmer/ Rancher	Director	Director- Hondo National Bank	Owner- Speer Ag	0%	None	Speer Ag; 50%
Julia Kraemer Hondo, TX USA	Banker- HNB	Secretary	VP/HR Officer- Hondo National Bank	N/A	0%	None	N/A

THBS = Texas Heritage Bancshares, Inc.

Texas Heritage Bancshares, Inc.

Fiscal Year Ending December 31, 2020

Report Item 3: Shareholders (1)(a)(b)(c) and (2)(a)(b)(c)			Fiscal Year Ending December 31, 2020		
Current Shareholders with ownership, control or holdings of 5% or more with power to vote as of fiscal year ending 12/31/20			Shareholders not listed in 3(1)(a) through 3(1)(c) that had ownership, control or holdings of 5% or more with power to vote during the fiscal ending 12/31/20		
(1)(a) Name (City, State, Country)	(1)(b) Country of Citizenship or Incorporation	(1)(c) Number and Percentage of Each Class of Voting Securities	(2)(a) Name (City, State, Country)	(2)(b) Country of Citiz or Incorporation	(2)(c) Number and Percentage of Each Class of Voting Securities
Joe Hargrove Uvalde, TX, USA	USA	137,623 18%-Common Stock	Arthur Ilse Hondo, TX, USA	USA	40,996 5%- Common Stock
Reagan Houston San Antonio, TX, USA	USA	60,000 8%-Common Stock	David Jones Hondo, TX, USA	USA	101,667 13%-Common Stock
Two Bar Trust Stephen Horton, Trustee Sabinal, TX, USA	USA	212,000 27%-Common Stock			

FORM FR-Y6

Texas Heritage Bancshares, Inc.

Hondo, Texas

Fiscal Year Ending December 31, 2020

Report Item

1. A. Texas Heritage Bancshares, Inc. is not required to prepare form 10 K with the SEC.