

Board of Governors of the Federal Reserve System



Annual Report of Holding Companies—FR Y-6

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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.

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.

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.

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

December 31, 2017

Month / Day / Year

n/a

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

Reporter's Name, Street, and Mailing Address

I, Tim Gilles

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.

Texas Heritage Bancshares, Inc.

Legal Title of Holding Company

P O Box 340

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

Hondo TX 78861

City State Zip Code

1112 18th Street

Physical Location (if different from mailing address)

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.

Person to whom questions about this report should be directed:

Olen Thompson CFO

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

Signature of Holding Company Director and Official

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

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 304899
 C.I. _____

Is confidential treatment requested for any portion of this report submission? =No =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."

FORM FR-Y6

Texas Heritage Bancshares, Inc.

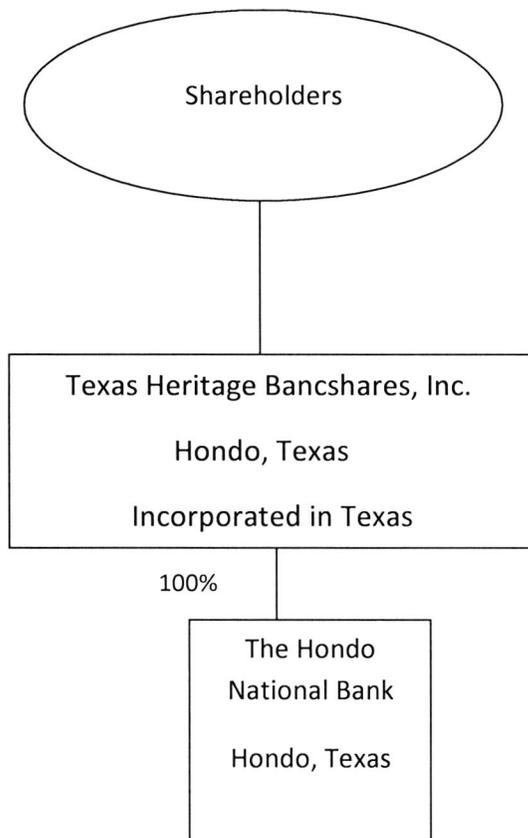
Hondo, Texas

Fiscal Year Ending December 31, 2017

Report Item

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

Texas Heritage Bancshares, Inc.
and Affiliated Companies
Hondo, Texas
Fiscal Year Ending December 31, 2017



- No entity in the organization has a LEI.

**FORM FR Y-6
DECEMBER 31, 2017
Report Item 4: Directors Officers**

| 1 | 2 | 3 - a | 3 - b | 3 - c | 4 - a | 4 - b | 4 - c |
|--|--------------------------|---------------------|--|------------------------------------|-------|-------|--------------------------------|
| Joe Hargrove Uvalde, TX, USA | Auction Owner Rancher | Director | Director- Hondo National Bank | President-Southwest L/S Auction | 26% | 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 |
| Tim Gilles 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% |
| Olen Thompson Hondo, TX USA | Banker | Secretary | EVP/CFO- Hondo National Bank | N/A | 0% | None | N/A |

THBS = Texas Heritage Bancshares, Inc.

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

CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 31, 2017 AND 2016

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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, 2017 and 2016, 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 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, which 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 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 the entity's preparation and fair presentation of the consolidated financial statements, the design and effectiveness of the entity's internal control. Accordingly, the audit includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient to support 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, 2017 and 2016 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 9, 2018

TEXAS HERITAGE BANCSHARES, INC. AND SUBSIDIARY

CONSOLIDATED BALANCE SHEETS

| December 31, | 2017 | 2016 |
|---|-----------------------|-----------------------|
| ASSETS | | |
| Cash and Cash Equivalents | | |
| Cash and due from banks | \$ 13,933,520 | \$ 7,862,282 |
| Federal funds sold | <u>5,125,000</u> | <u>-</u> |
| Total cash and cash equivalents | 19,058,520 | 7,862,282 |
| Time deposits | - | 248,000 |
| Securities available-for-sale, at estimated market value | 66,779,167 | 79,238,448 |
| Securities held-to-maturity, at cost | <u>3,713,282</u> | <u>4,657,864</u> |
| Loans, net | 151,736,948 | 142,631,781 |
| Loans held-for-sale | 200,000 | - |
| Premises and equipment, net | 3,735,976 | 3,571,430 |
| Accrued interest receivable | 1,344,603 | 1,378,866 |
| Other real estate owned, net | - | 301,858 |
| Cash surrender value of life insurance | 6,043,740 | 700,519 |
| Goodwill | 120,416 | 120,416 |
| Other assets | <u>1,345,595</u> | <u>1,404,045</u> |
| Total assets | <u>\$ 254,078,247</u> | <u>\$ 242,115,509</u> |
| LIABILITIES AND SHAREHOLDERS' EQUITY | | |
| Deposits: | | |
| Non-interest bearing | \$ 63,410,027 | \$ 53,7 |
| Interest bearing | <u>166,084,410</u> | <u>163</u> |
| Total deposits | 229,494,437 | 217 |
| Accrued interest payable | 40,156 | |
| Borrowings | - | |
| Other liabilities | <u>454,966</u> | |
| Total liabilities | <u>229,989,559</u> | |
| Shareholders' Equity | | |
| Common stock, par value \$1 per share: authorized 2,000,000 shares; issued and outstanding 783,000 shares in 2017 and 2016 | 783,000 | |
| Additional paid-in capital | 3,005 | |
| Retained earnings | 20,740 | |
| Accumulated other comprehensive income (loss) | (2,000) | |
| Total shareholders' equity | <u>20,740</u> | |
| Total liabilities and shareholders' equity | <u>\$ 254,078,247</u> | |

See notes to the consolidated financial statements

TEXAS HERITAGE BANCSHARES, INC. AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF INCOME

| Years Ended December 31, | 2017 | 2016 |
|--|---------------------|---------------------|
| INTEREST INCOME | | |
| Loans, including fees | \$ 8,002,131 | \$ 6,966,079 |
| Investment securities: | | |
| Taxable | 466,339 | 704,653 |
| Tax-exempt | 1,203,315 | 1,301,083 |
| Federal funds sold | 30,438 | 74,577 |
| Other | 79,819 | 6,146 |
| Total interest income | <u>9,782,042</u> | <u>9,052,538</u> |
| INTEREST EXPENSE | | |
| Deposits | 999,541 | 880,472 |
| Borrowings | 23,653 | 51,239 |
| Total interest expense | <u>1,023,194</u> | <u>931,711</u> |
| NET INTEREST INCOME | 8,758,848 | 8,120,827 |
| PROVISION FOR LOAN LOSSES | 200,000 | 240,000 |
| NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES | 8,558,848 | 7,880,827 |
| NON-INTEREST INCOME | | |
| Service charges on deposit accounts | 343,266 | 329,535 |
| Gain on sale of securities | 49,466 | 157,587 |
| Gain on sale of assets | - | 44,229 |
| Other | 659,824 | 538,127 |
| Total non-interest income | <u>1,052,556</u> | <u>1,069,478</u> |
| NON-INTEREST EXPENSE | | |
| Salaries, wages and benefits | 3,322,400 | 3,174,169 |
| Occupancy and equipment | 779,647 | 774,532 |
| Loss and write down on sale of other real estate | 42,983 | 11,337 |
| Other | 2,066,502 | 2,003,227 |
| Total non-interest expense | <u>6,211,532</u> | <u>5,963,265</u> |
| INCOME BEFORE INCOME TAXES | 3,399,872 | 2,987,040 |
| INCOME TAX EXPENSE | 3,251 | 1,800 |
| NET INCOME | \$ 3,396,621 | \$ 2,985,240 |

See notes to the consolidated financial statements.

TEXAS HERITAGE BANCSHARES, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

| Years Ended December 31, | 2017 | 2016 |
|--|---------------------|---------------------|
| NET INCOME | \$ 3,396,621 | \$ 2,985,240 |
| OTHER ITEMS OF COMPREHENSIVE INCOME | | |
| Adjustment for gain on sale of available-for-sale securities | (49,466) | (157,587) |
| Unrealized holding gain (loss) arising during period | <u>320,722</u> | <u>(1,326,198)</u> |
| Total other items of comprehensive income | <u>271,256</u> | <u>(1,483,785)</u> |
| Comprehensive income | <u>\$ 3,667,877</u> | <u>\$ 1,501,455</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, 2017 and 2016

| | Common Stock | Additional Paid-In Capital | Retained Earnings | Accumulated Other Comprehensive Income (Loss) | Total Shareholders' Equity |
|------------------------------------|-------------------|----------------------------------|----------------------|--|----------------------------------|
| Balance at January 1, 2016 | \$ 783,000 | \$ 3,005,020 | \$ 17,036,740 | \$ 772,456 | \$ 21,597,216 |
| Net income | - | - | 2,985,240 | - | 2,985,240 |
| Change in other comprehensive loss | - | - | - | (1,483,785) | (1,483,785) |
| Distributions to shareholders | - | - | (1,213,650) | - | (1,213,650) |
| Balance at December 31, 2016 | 783,000 | 3,005,020 | 18,808,330 | (711,329) | 21,885,021 |
| Net income | - | - | 3,396,621 | - | 3,396,621 |
| Change in other comprehensive loss | - | - | - | 271,256 | 271,256 |
| Distributions to shareholders | - | - | (1,464,210) | - | (1,464,210) |
| Balance at December 31, 2017 | <u>\$ 783,000</u> | <u>\$ 3,005,020</u> | <u>\$ 20,740,741</u> | <u>\$ (440,073)</u> | <u>\$ 24,088,688</u> |

See notes to the consolidated financial statements.

TEXAS HERITAGE BANCSHARES, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF CASH FLOWS

| Years Ended December 31, | 2017 | 2016 |
|---|---------------------|-------------------|
| OPERATING ACTIVITIES | | |
| Net income | \$ 3,396,621 | \$ 2,985,240 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Gain on sale of securities | (49,466) | (157,587) |
| Net amortization of investment premiums | 742,431 | 647,394 |
| Depreciation and amortization | 338,979 | 324,936 |
| Provision for loan losses | 200,000 | 240,000 |
| Gain on sale of assets | - | (44,229) |
| Loss and write down on sale of other real estate | 42,983 | 11,337 |
| Earnings on cash surrender value of life insurance | (93,221) | (20,423) |
| Net change in: | | |
| Accrued interest receivable | 34,263 | 83,074 |
| Accrued interest payable | 1,178 | (2,412) |
| Other assets and other liabilities | 96,942 | (60,015) |
| Loans held-for-sale | (200,000) | 6,674,513 |
| Net cash provided by operating activities | <u>4,510,710</u> | <u>10,681,828</u> |
| INVESTING ACTIVITIES | | |
| Activity in securities available-for-sale: | | |
| Sales proceeds from investment securities | 5,034,252 | 4,913,448 |
| Maturities, prepayments and calls | 148,862,204 | 192,631,619 |
| Purchases | (141,825,890) | (201,584,834) |
| Activity in securities held-to-maturity: | | |
| Maturities, prepayments and calls | 911,588 | 17,693,5 |
| Net redemption of time deposits | 248,000 | 498 |
| Net change in loans | (9,316,205) | (22,01) |
| Purchase of bank owned life insurance | (5,250,000) | |
| Purchase of bank premises and equipment | (503,525) | |
| Proceeds from sale of bank premises and equipment | - | |
| Improvements on other real estate owned | (733) | |
| Proceeds from the sale of other real estate owned | 268,636 | |
| Net cash used by investing activities | <u>(1,571,673)</u> | <u>-</u> |
| FINANCING ACTIVITIES | | |
| Net change in deposits | 11,938,021 | |
| Proceeds from borrowings | - | |
| Payments on borrowings | (2,216,610) | |
| Distributions paid to shareholders | (1,464,210) | |
| Net cash provided (used) by financing activities | <u>8,257,201</u> | |
| INCREASE IN CASH AND CASH EQUIVALENTS | 11,196 | |
| CASH AND CASH EQUIVALENTS AT BEGINNING OF YEAR | <u>7,86</u> | |
| CASH AND CASH EQUIVALENTS AT END OF YEAR | <u>\$ 19</u> | |
| SUPPLEMENTAL CASH DISCLOSURES | | |
| Loan foreclosures | \$ | |
| Deferred gain on other real estate owned | \$ | |
| Cash paid for taxes | - | |
| Cash paid for interest | - | |

See notes to the consolidated financial statements

TEXAS HERITAGE BANCSHARES, INC. AND SUBSIDIARY

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2017 and 2016

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 and Bandera 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 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 and Bandera 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, 2017, 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, 2017, the maximum credit risk exposure is **\$5,157,053**. 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, including equity securities with readily determinable fair values, are classified as “available-for-sale” and recorded at fair value, with unrealized gains and losses reported from earnings and reported in other comprehensive income.

TEXAS HERITAGE BANCSHARES, INC. AND SUBSIDIARY

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2017 and 2016

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 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 pay-off generally are reported at their outstanding unpaid principal balances adjusted for discounts, fees, and the allowance for loan losses.

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

Fees and costs associated with originating loans are recognized as income in the period in which fees are received and costs are incurred. Under the cost of funds method, such net fees or costs generally are deferred and recorded as a contra-asset to the related loans with an adjustment of yield. Management believes that not deferring such fees and costs over the life of the related loans does not materially affect the earnings of the Company.

TEXAS HERITAGE BANCSHARES, INC. AND SUBSIDIARY

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2017 and 2016

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Troubled Debt Restructured Loans – A troubled debt restructured loan is a loan which the Company, for reasons related to a borrower's financial difficulties, grants a concession to the borrower that the Company would not otherwise consider. The loan terms which have been modified or restructured due to a borrower's financial difficulty, include but are not limited to a reduction in the stated interest rate; an extension of the maturity at an interest rate below current market; a reduction in the face amount of the debt; a reduction in the accrued interest; or re-aging, extensions, deferrals, renewals and rewrites. A troubled debt restructured loan would generally be considered impaired in the year of modification and will be assessed periodically for continued impairment.

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 Bank'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. Gains and losses recognized on sales of mortgage loans are included in earnings.

Advertising – Advertising costs are expensed as incurred.

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

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

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

TEXAS HERITAGE BANCSHARES, INC. AND SUBSIDIARY

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2017 and 2016

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

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.

Foreclosed Assets – 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 for 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. An 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.

Restricted Investments – Restricted investments include various stocks and their carrying value is determined by the ultimate recoverability of par value, rather than by recognizing their fair market value. Federal Reserve Bank stock had a carrying value of \$188,650 as of December 31, 2017 and 2016, respectively. Federal Home Loan Bank stock had a carrying value of \$922,200 and \$914,000 as of December 31, 2017 and 2016, respectively. The Independent Bankers Capital Fund stock had a carrying value of \$124,654 as of December 31, 2017 and 2016. All are carried in other assets.

Income Taxes – The Company and its principal subsidiary, Hondo Bancshares, Inc., file a consolidated corporate federal income tax return. The Company elected to be treated as a corporation under the Internal Revenue Code, effective January 1, 2016. The Company's income, deductions, losses, and credits flow directly to the consolidated return. The Company does pay franchise taxes which are considered state income taxes on the consolidated statement of income.

U.S. generally accepted accounting principles require the Company to recognize uncertain tax positions taken by the Company and recognize a tax liability for an uncertain tax position that more likely than not would not be sustained upon audit by the Internal Revenue Service. The Company's management has evaluated the Company's uncertain tax positions and has concluded that as of December 31, 2017, there are no uncertain tax positions expected to be taken that would require recognition in the consolidated financial statements.

TEXAS HERITAGE BANCSHARES, INC. AND SUBSIDIARY

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2017 and 2016

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

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 2014.

2. INVESTMENT SECURITIES

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

| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Estimated Market Value |
|----------------------------------|----------------------|------------------------------|-------------------------------|------------------------------|
| December 31, 2017 | | | | |
| Mortgage-backed securities | \$ 15,385,353 | \$ 9,608 | \$ 110,763 | \$ 15,284,198 |
| State and political subdivisions | <u>51,833,887</u> | <u>117,924</u> | <u>456,842</u> | <u>51,494,969</u> |
| Total | <u>\$ 67,219,240</u> | <u>\$ 127,532</u> | <u>\$ 567,605</u> | <u>\$ 66,779,167</u> |
| December 31, 2016 | | | | |
| Mortgage-backed securities | \$ 24,492,760 | \$ 39,611 | \$ 250,166 | \$ 24,282,205 |
| State and political subdivisions | <u>55,457,017</u> | <u>161,521</u> | <u>662,295</u> | <u>54,956,243</u> |
| Total | <u>\$ 79,949,777</u> | <u>\$ 201,132</u> | <u>\$ 912,461</u> | <u>\$ 79,238,448</u> |

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

| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Estimated Market Value |
|----------------------------------|---------------------|------------------------------|-------------------------------|------------------------------|
| December 31, 2017 | | | | |
| Mortgage-backed securities | \$ 2,572,282 | \$ - | \$ 41,038 | \$ 2,531,244 |
| State and political subdivisions | <u>1,141,000</u> | <u>-</u> | <u>-</u> | <u>1,141,000</u> |
| Total | <u>\$ 3,713,282</u> | <u>\$ -</u> | <u>\$ 41,038</u> | <u>\$ 3,672,244</u> |
| December 31, 2016 | | | | |
| Mortgage-backed securities | \$ 3,381,864 | \$ - | \$ 38,259 | \$ 3,343,605 |
| State and political subdivisions | <u>1,276,000</u> | <u>-</u> | <u>856</u> | <u>1,275,144</u> |
| Total | <u>\$ 4,657,864</u> | <u>\$ -</u> | <u>\$ 39,115</u> | <u>\$ 4,618,749</u> |

TEXAS HERITAGE BANCSHARES, INC. AND SUBSIDIARY

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2017 and 2016

2. INVESTMENT SECURITIES (continued)

The amortized cost and estimated market value of securities at December 31, 2017, by contractual maturities, are shown below. Expected maturities will differ from contractual maturities because borrowers may 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 | \$ 4,658,233 | \$ 4,645,582 |
| Due in one to five years | 17,739,155 | 17,648,368 |
| Due in five to ten years | 27,631,760 | 27,455,326 |
| Due in over ten years or more | 1,804,739 | 1,745,693 |
| | <u>51,833,887</u> | <u>51,494,969</u> |
| Mortgage-backed securities | 15,385,353 | 15,284,198 |
| Total | <u>\$ 67,219,240</u> | <u>\$ 66,779,167</u> |

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

| | Amortized Cost | Estimated Market Value |
|----------------------------|---------------------|------------------------------|
| Due in one year or less | \$ 93,000 | \$ 93,000 |
| Due in one to five years | 371,000 | 371,000 |
| Due in five to ten years | 327,000 | 327,000 |
| Due in ten years or more | 350,000 | 350,000 |
| | <u>1,141,000</u> | <u>1,141,000</u> |
| Mortgage-backed securities | 2,572,282 | 2,531,244 |
| Total | <u>\$ 3,713,282</u> | <u>\$ 3,672,244</u> |

Investment securities were pledged to secure public deposits and for other purposes as required or permitted by law with a carrying value of \$19,646,549 and \$22,044,840 at December 31, 2017 and 2016, respectively.

| | 2017 | 2016 |
|--|--------------|--------------|
| Sale proceeds from sale of available-for-sale securities | \$ 5,034,252 | \$ 4,913,448 |
| Gross gains on sale of available-for-sale securities | \$ 49,466 | \$ 157,587 |
| Gross losses on sale of available-for-sale securities | \$ - | \$ - |

TEXAS HERITAGE BANCSHARES, INC. AND SUBSIDIARY

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2017 and 2016

2. INVESTMENT SECURITIES (continued)

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, 2017 and 2016.

Available-for-sale

| | Less than 12 months | | 12 months or more | | Total | |
|---------------------------------------|----------------------|-------------------|----------------------|-------------------|----------------------|-------------------|
| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| December 31, 2017 | | | | | | |
| Mortgage-backed securities (10) | \$ 9,249,929 | \$ 53,096 | \$ 3,546,762 | \$ 57,667 | \$ 12,796,691 | \$ 110,763 |
| State and political subdivision (136) | <u>22,464,327</u> | <u>165,937</u> | <u>12,204,434</u> | <u>290,905</u> | <u>34,668,761</u> | <u>456,842</u> |
| Total | <u>\$ 31,714,256</u> | <u>\$ 219,033</u> | <u>\$ 15,751,196</u> | <u>\$ 348,572</u> | <u>\$ 47,465,452</u> | <u>\$ 567,605</u> |
| December 31, 2016 | | | | | | |
| Mortgage-backed securities (8) | \$ 18,186,307 | \$ 250,166 | \$ - | \$ - | \$ 18,186,307 | \$ 250,166 |
| State and political subdivision (143) | <u>32,972,534</u> | <u>607,007</u> | <u>3,619,998</u> | <u>55,288</u> | <u>36,592,532</u> | <u>662,295</u> |
| Total debt securities | <u>\$ 51,158,841</u> | <u>\$ 857,173</u> | <u>\$ 3,619,998</u> | <u>\$ 55,288</u> | <u>\$ 54,778,839</u> | <u>\$ 912,461</u> |

Held-to-maturity

| | Less than 12 months | | 12 months or more | | Total | |
|-------------------------------------|---------------------|-------------------|---------------------|-------------------|---------------------|-------------------|
| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| December 31, 2017 | | | | | | |
| Mortgage-backed securities (2) | \$ - | \$ - | \$ 2,531,244 | \$ 41,038 | \$ 2,531,244 | \$ 41,038 |
| State and political subdivision (0) | <u>-</u> | <u>-</u> | <u>-</u> | <u>-</u> | <u>-</u> | <u>-</u> |
| Total | <u>\$ -</u> | <u>\$ -</u> | <u>\$ 2,531,244</u> | <u>\$ 41,038</u> | <u>\$ 2,531,244</u> | <u>\$ 41,038</u> |
| December 31, 2016 | | | | | | |
| Mortgage-backed securities (2) | \$ 3,343,605 | \$ 38,259 | \$ - | \$ - | \$ 3,343,605 | \$ 38,259 |
| State and political subdivision (1) | <u>59,144</u> | <u>856</u> | <u>-</u> | <u>-</u> | <u>59,144</u> | <u>856</u> |
| Total | <u>\$ 3,402,749</u> | <u>\$ 39,115</u> | <u>\$ -</u> | <u>\$ -</u> | <u>\$ 3,402,749</u> | <u>\$ 39,115</u> |

TEXAS HERITAGE BANCSHARES, INC. AND SUBSIDIARY

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2017 and 2016

2. INVESTMENT SECURITIES (continued)

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, 2017, the outstanding premium related to investments in a loss position are as follows:

| | <u>Premium</u> |
|----------------------------------|----------------|
| Mortgage-backed securities | \$ 310,796 |
| State and political subdivisions | \$ 1,117,744 |

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, 2017.

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, 2017, no investment securities were other-than-temporarily impaired.

3. LOANS AND ALLOWANCE FOR LOAN LOSSES

Loans consisted of the following at December 31, 2017 and 2016:

| | <u>2017</u> | <u>2016</u> |
|---------------------------------|-----------------------|-----------------------|
| Commercial | \$ 26,562,136 | \$ 26,131,892 |
| Real estate | 92,418,097 | 87,173,887 |
| Agriculture | 25,312,465 | 21,024,626 |
| Consumer and other | 8,834,867 | 9,554,341 |
| Total loans | <u>153,127,565</u> | <u>143,884,746</u> |
| Less: Allowance for loan losses | <u>(1,390,617)</u> | <u>(1,252,965)</u> |
| Total net | <u>\$ 151,736,948</u> | <u>\$ 142,631,781</u> |

TEXAS HERITAGE BANCSHARES, INC. AND SUBSIDIARY

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2017 and 2016

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (continued)

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. 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.

TEXAS HERITAGE BANCSHARES, INC. AND SUBSIDIARY

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2017 and 2016

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (continued)

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.

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 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.

TEXAS HERITAGE BANCSHARES, INC. AND SUBSIDIARY

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2017 and 2016

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (continued)

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>2017</u> | <u>2016</u> |
|---|---------------------|---------------------|
| Principal outstanding, beginning of year | \$ 5,828,050 | \$ 4,953,819 |
| Loan balance guaranteed by outside borrower | (305,437) | (221,276) |
| New loans made in current year | 3,870,519 | 3,143,800 |
| Repayments | <u>(4,032,076)</u> | <u>(2,048,293)</u> |
| Principal outstanding, end of year | <u>\$ 5,361,056</u> | <u>\$ 5,828,050</u> |

An age analysis of past due loans, segregated by class of loans, as of December 31, 2017 and 2016, were as follows:

| | <u>30-59 Days Past Due</u> | <u>60-89 Days Past Due</u> | <u>Greater Than 90 Days</u> | <u>Total Past Due</u> | <u>Current</u> | <u>Total Loans</u> | <u>Recorded Investment > 90 Days and Still Accruing</u> |
|--------------------------|--------------------------------|--------------------------------|-------------------------------------|---------------------------|-----------------------|------------------------|--|
| December 31, 2017 | | | | | | | |
| Commercial | \$ - | \$ - | \$ - | \$ - | \$ 26,562,136 | \$ 26,562,136 | \$ - |
| Real estate | 161,259 | 184,044 | - | 345,303 | 92,072,794 | 92,418,097 | - |
| Agriculture | - | - | - | - | 25,312,465 | 25,312,465 | - |
| Consumer and other | <u>117,820</u> | <u>3,330</u> | - | <u>121,150</u> | <u>8,713,717</u> | <u>8,834,867</u> | - |
| Total | <u>\$ 279,079</u> | <u>\$ 187,374</u> | <u>\$ -</u> | <u>\$ 466,453</u> | <u>\$ 152,661,112</u> | <u>\$ 153,127,565</u> | <u>\$ -</u> |
| December 31, 2016 | | | | | | | |
| Commercial | \$ - | \$ - | \$ - | \$ - | \$ 26,131,892 | \$ 26,131,892 | \$ - |
| Real estate | 1,383,630 | 212,956 | 9,692 | 1,606,278 | 85,567,609 | 87,173,887 | 9,692 |
| Agriculture | - | - | - | - | 21,024,626 | 21,024,626 | - |
| Consumer and other | <u>93,109</u> | <u>19,911</u> | - | <u>113,020</u> | <u>9,441,321</u> | <u>9,554,341</u> | - |
| Total | <u>\$ 1,476,739</u> | <u>\$ 232,867</u> | <u>\$ 9,692</u> | <u>\$ 1,719,298</u> | <u>\$ 142,165,448</u> | <u>\$ 143,884,746</u> | <u>\$ 9,692</u> |

TEXAS HERITAGE BANCSHARES, INC. AND SUBSIDIARY

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2017 and 2016

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (continued)

Impaired loans, segregated by class of loans, as of December 31, 2017 and 2016, are set forth in the following table.

| | Recorded Investment | Unpaid Principal Balance | Related Allowance | Average Recorded Investment | Interest Income Recognized |
|----------------------------|------------------------|--------------------------------|----------------------|-----------------------------------|----------------------------------|
| December 31, 2017 | | | | | |
| With no related allowance: | | | | | |
| Commercial | \$ - | \$ - | \$ - | \$ - | \$ - |
| Real estate | - | - | - | - | - |
| Agriculture | - | - | - | - | - |
| Consumer and other | - | - | - | - | - |
| With a related allowance: | | | | | |
| Commercial | \$ - | \$ - | \$ - | \$ 24,605 | \$ - |
| Real estate | - | - | - | - | - |
| Agriculture | - | - | - | - | - |
| Consumer and other | - | - | - | - | - |
| Total: | | | | | |
| Commercial | \$ - | \$ - | \$ - | \$ 24,605 | \$ - |
| Real estate | - | - | - | - | - |
| Agriculture | - | - | - | - | - |
| Consumer and other | - | - | - | - | - |
| Total | <u>\$ -</u> | <u>\$ -</u> | <u>\$ -</u> | <u>\$ 24,605</u> | <u>\$ -</u> |
| December 31, 2016 | | | | | |
| With no related allowance: | | | | | |
| Commercial | \$ - | \$ - | \$ - | \$ - | \$ - |
| Real estate | - | - | - | - | - |
| Agriculture | - | - | - | - | - |
| Consumer and other | - | - | - | - | - |
| With a related allowance: | | | | | |
| Commercial | \$ 49,209 | \$ 49,209 | \$ 49,209 | \$ 24,605 | \$ - |
| Real estate | - | - | - | 10,477 | - |
| Agriculture | - | - | - | - | - |
| Consumer and other | - | - | - | - | - |
| Total: | | | | | |
| Commercial | \$ 49,209 | \$ 49,209 | \$ 49,209 | \$ 24,605 | \$ - |
| Real estate | - | - | - | 10,477 | - |
| Agriculture | - | - | - | - | - |
| Consumer and other | - | - | - | - | - |
| Total | <u>\$ 49,209</u> | <u>\$ 49,209</u> | <u>\$ 49,209</u> | <u>\$ 35,082</u> | <u>\$ -</u> |

TEXAS HERITAGE BANCSHARES, INC. AND SUBSIDIARY

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2017 and 2016

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (continued)

There was no effect of not recognizing interest income on nonaccrual loans in accordance with the original terms during the years ended December 31, 2017 and 2016.

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 – These grade loans 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 – These grade loans represent a completely acceptable asset and have no identifiable present or significant potential risk of 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 – These grade loans 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 – These grade loans 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, 2017 and 2016

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 – These grade loans 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, 2017 | | | | | |
| <i>Credit Risk Profile by</i> | | | | | |
| <i>Internally Assigned Grade</i> | | | | | |
| Grade: | | | | | |
| Pass/Pass Watch | \$ 26,523,744 | \$ 91,062,146 | \$ 23,950,239 | \$ 8,834,867 | \$ 150,370,996 |
| Special mention | - | 933,261 | - | - | 933,261 |
| Substandard | 38,392 | 422,690 | 1,362,226 | - | 1,823,308 |
| Doubtful | - | - | - | - | - |
| Loss | - | - | - | - | - |
| | <u>\$ 26,562,136</u> | <u>\$ 92,418,097</u> | <u>\$ 25,312,465</u> | <u>\$ 8,834,867</u> | <u>\$ 153,127,565</u> |
| Total | | | | | |
| <i>Credit Risk Profile Based on</i> | | | | | |
| <i>Payment Activity</i> | | | | | |
| Performing | \$ 26,562,136 | \$ 92,072,794 | \$ 25,312,465 | \$ 8,713,717 | \$ 152,661,112 |
| Nonperforming | - | 345,303 | - | 121,150 | 466,453 |
| | <u>\$ 26,562,136</u> | <u>\$ 92,418,097</u> | <u>\$ 25,312,465</u> | <u>\$ 8,834,867</u> | <u>\$ 153,127,565</u> |
| Total | | | | | |

TEXAS HERITAGE BANCSHARES, INC. AND SUBSIDIARY

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2017 and 2016

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, 2016 | | | | | |
| <i>Credit Risk Profile by Internally Assigned Grade</i> | | | | | |
| Grade: | | | | | |
| Pass/Pass Watch | \$ 25,638,229 | \$ 87,047,310 | \$ 18,897,752 | \$ 9,548,737 | \$ 141,132,028 |
| Special mention | 409,209 | - | 291,337 | - | 700,546 |
| Substandard | 84,454 | 126,577 | 1,835,537 | 5,604 | 2,052,172 |
| Doubtful | - | - | - | - | - |
| Loss | - | - | - | - | - |
| Total | <u>\$ 26,131,892</u> | <u>\$ 87,173,887</u> | <u>\$ 21,024,626</u> | <u>\$ 9,554,341</u> | <u>\$ 143,884,746</u> |
| <i>Credit Risk Profile Based on Payment Activity</i> | | | | | |
| Performing | \$ 26,131,892 | \$ 85,567,609 | \$ 21,024,626 | \$ 9,441,321 | \$ 142,165,448 |
| Nonperforming | - | 1,606,278 | - | 113,020 | 1,719,298 |
| Total | <u>\$ 26,131,892</u> | <u>\$ 87,173,887</u> | <u>\$ 21,024,626</u> | <u>\$ 9,554,341</u> | <u>\$ 143,884,746</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, 2017 and 2016

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.

TEXAS HERITAGE BANCSHARES, INC. AND SUBSIDIARY

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2017 and 2016

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (continued)

Furthermore, consumer loan accounts are charged-off automatically based on regulatory requirements. The following table details activity in the allowance for loan losses by portfolio segment for the years ended December 31, 2017 and 2016. 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, 2017 | | | | | | |
| Beginning balance | \$ 335,507 | \$ 394,761 | \$ 392,366 | \$ 130,331 | \$ - | \$ 1,252,965 |
| Charge-offs | (37,560) | - | - | (80,696) | - | (118,256) |
| Recoveries | 9,920 | - | - | 45,988 | - | 55,908 |
| Provision | (42,017) | 80,727 | 17,613 | 38,545 | 105,132 | 200,000 |
| Ending balance | <u>\$ 265,850</u> | <u>\$ 475,488</u> | <u>\$ 409,979</u> | <u>\$ 134,168</u> | <u>\$ 105,132</u> | <u>\$ 1,390,617</u> |
| Ending balance allocated to loans individually evaluated for impairment | \$ 35,394 | \$ 30,053 | \$ 96,854 | \$ - | \$ - | \$ 162,301 |
| Ending balance allocated to loans collectively evaluated for impairment | <u>230,456</u> | <u>445,435</u> | <u>313,125</u> | <u>134,168</u> | <u>105,132</u> | <u>1,228,316</u> |
| Total ALLL at December 31, 2017 | <u>\$ 265,850</u> | <u>\$ 475,488</u> | <u>\$ 409,979</u> | <u>\$ 134,168</u> | <u>\$ 105,132</u> | <u>\$ 1,390,617</u> |
| December 31, 2016 | | | | | | |
| Beginning balance | \$ 269,903 | \$ 271,947 | \$ 405,638 | \$ 132,973 | \$ - | \$ 1,080,461 |
| Charge-offs | (15,857) | - | (33,301) | (52,784) | - | (101,942) |
| Recoveries | - | - | 13,029 | 21,417 | - | 34,446 |
| Provision | 81,461 | 122,814 | 7,000 | 28,725 | - | 240,000 |
| Ending balance | <u>\$ 335,507</u> | <u>\$ 394,761</u> | <u>\$ 392,366</u> | <u>\$ 130,331</u> | <u>\$ -</u> | <u>\$ 1,252,965</u> |
| Ending balance allocated to loans individually evaluated for impairment | \$ 49,209 | \$ - | \$ - | \$ - | \$ - | \$ 49,209 |
| Ending balance allocated to loans collectively evaluated for impairment | <u>286,298</u> | <u>394,761</u> | <u>392,366</u> | <u>130,331</u> | <u>-</u> | <u>1,203,756</u> |
| Total ALLL at December 31, 2016 | <u>\$ 335,507</u> | <u>\$ 394,761</u> | <u>\$ 392,366</u> | <u>\$ 130,331</u> | <u>\$ -</u> | <u>\$ 1,252,965</u> |

TEXAS HERITAGE BANCSHARES, INC. AND SUBSIDIARY

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2017 and 2016

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (continued)

The Company's recorded investment in loans as of December 31, 2017 and 2016 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, 2017 | | | | | |
| Ending balance of loans individually evaluated for impairment | \$ 38,392 | \$ 1,355,951 | \$ 1,362,226 | \$ - | \$ 2,756,569 |
| Ending balance of loans collectively evaluated for impairment | <u>26,523,744</u> | <u>91,062,146</u> | <u>23,950,239</u> | <u>8,834,867</u> | <u>150,370,996</u> |
| Ending balance | <u>\$ 26,562,136</u> | <u>\$ 92,418,097</u> | <u>\$ 25,312,465</u> | <u>\$ 8,834,867</u> | <u>\$ 153,127,565</u> |
| December 31, 2016 | | | | | |
| Ending balance of loans individually evaluated for impairment | \$ 493,663 | \$ 126,577 | \$ 2,126,874 | \$ 5,604 | \$ 2,752,718 |
| Ending balance of loans collectively evaluated for impairment | <u>25,638,229</u> | <u>87,047,310</u> | <u>18,897,752</u> | <u>9,548,737</u> | <u>141,132,028</u> |
| Ending balance | <u>\$ 26,131,892</u> | <u>\$ 87,173,887</u> | <u>\$ 21,024,626</u> | <u>\$ 9,554,341</u> | <u>\$ 143,884,746</u> |

4. PREMISES AND EQUIPMENT

Premises and equipment consisted of the following at December 31, 2017 and 2016:

| | <u>2017</u> | <u>2016</u> |
|--------------------------------|---------------------|---------------------|
| Land | \$ 871,764 | \$ 816,764 |
| Buildings and improvements | 3,726,894 | 3,430,655 |
| Furniture and equipment | <u>2,350,519</u> | <u>2,198,233</u> |
| | <u>6,949,177</u> | <u>6,445,652</u> |
| Less: Accumulated depreciation | <u>(3,213,201)</u> | <u>(2,874,222)</u> |
| Total | <u>\$ 3,735,976</u> | <u>\$ 3,571,430</u> |
| Depreciation expense | \$ 338,979 | \$ 324,936 |
| Proceeds on sale of assets | \$ - | \$ 78,000 |
| Gross gain (loss) | \$ - | \$ 44,229 |

TEXAS HERITAGE BANCSHARES, INC. AND SUBSIDIARY

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2017 and 2016

5. OTHER REAL ESTATE

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

| | <u>2017</u> | <u>2016</u> |
|------------------------------|------------------|-------------------|
| Balance at beginning of year | \$ 301,858 | \$ 333,476 |
| Foreclosures | 11,038 | 111,497 |
| Additions to property | 733 | 4,345 |
| Writedown of value | (25,091) | - |
| Sales | <u>(288,538)</u> | <u>(147,460)</u> |
| Balance at end of year | <u>\$ -</u> | <u>\$ 301,858</u> |

In 2017, the Company sold property with a reserves allowance of \$25,091, for \$268,636, which resulted in a loss of \$19,902. In 2016, the Company sold property for \$134,190, which resulted in a loss of \$13,270. Deferred gains from previous years' sales of \$2,010 and \$1,933 were recognized in 2017 and 2016, respectively. Since February 2015, some property held in other real estate is leased to third parties on a month-to-month basis resulting in rental income of \$41,084 and \$37,354 in 2017 and 2016, respectively. This property was sold in 2017.

6. DEPOSITS

Deposits consisted of the following at December 31, 2017 and 2016:

| | <u>2017</u> | <u>2016</u> |
|-------------------------|-----------------------|-----------------------|
| Non-interest bearing: | | |
| Demand accounts | <u>\$ 63,410,027</u> | <u>\$ 53,743,732</u> |
| Interest bearing: | | |
| NOW accounts | 42,470,594 | 46,254,154 |
| Money market accounts | 49,636,538 | 49,509,049 |
| Savings accounts | 12,990,711 | 11,801,246 |
| Certificates of deposit | <u>60,986,567</u> | <u>56,248,235</u> |
| | <u>166,084,410</u> | <u>163,812,684</u> |
| Total | <u>\$ 229,494,437</u> | <u>\$ 217,556,416</u> |

TEXAS HERITAGE BANCSHARES, INC. AND SUBSIDIARY

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2017 and 2016

6. DEPOSITS (continued)

At December 31, 2017, the schedule of maturities of certificates of deposits were as follows:

| | |
|-------|----------------------|
| 2018 | \$ 46,816,553 |
| 2019 | 12,016,182 |
| 2020 | 823,234 |
| 2021 | 66,046 |
| 2022 | <u>1,264,552</u> |
| Total | <u>\$ 60,986,567</u> |

| | <u>2017</u> | <u>2016</u> |
|---|---------------|---------------|
| Paid interest on deposits | \$ 998,363 | \$ 882,884 |
| Related party deposits (executive officers and directors) | \$ 13,265,592 | \$ 12,142,386 |
| Certificates greater than \$250,000 or more | \$ 20,810,000 | \$ 15,583,000 |

7. OTHER BORROWINGS

The Company has an available line of credit at the Federal Home Loan Bank for a maximum of \$61.3 million as of December 31, 2017. The advances are secured by specific mortgage loans of the Company. The amount of loans pledged as collateral under the agreements approximates \$61.3 million at December 31, 2017. As of December 31, 2017 and 2016, 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 and with TIB for \$2,000,000. As of December 31, 2017 and 2016, the Company had federal funds purchased balance outstanding of \$0 and \$1,525,000, respectively.

In November 2013, the Company borrowed \$2,600,000 from the Leroy C. Jones Irrevocable Trust at an interest rate of 4.50%. Principal and interest of \$48,271 is due monthly until maturity, November 2018. As of December 31, 2017, the Company has paid all outstanding balances. As of December 31, 2016, the Company had an outstanding balance with Leroy C. Jones Irrevocable Trust of \$691,610.

| | <u>2017</u> | <u>2016</u> |
|-----------------------------|-------------|-------------|
| Interest paid on borrowings | \$ 23,653 | \$ 51,239 |

TEXAS HERITAGE BANCSHARES, INC. AND SUBSIDIARY

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2017 and 2016

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>2017</u> | <u>2016</u> |
|------------------------|-------------|-------------|
| Matching contributions | \$ 57,382 | \$ 56,840 |

9. DEFERRED COMPENSATION PLANS

Deferred Compensation Plans in Payment Stage

Effective November 1, 2000, the Company started a deferred compensation plan for the former Chairman of the Board/President, which is funded by an insurance policy with the Company named as beneficiary. The Company expensed the deferred fees and the amount owed to the former Chairman of the Board/President was recorded in a liability account. In June 2009, the Chairman of the Board/President retired and deferred compensation payout commenced. The deferred compensation liability for this plan totaled **\$81,263** and \$130,090 for December 31, 2017 and 2016, respectively.

Minimum future compensation obligations related to the deferred compensation liability was as follows:

| | |
|-------|------------------|
| 2018 | \$ 53,078 |
| 2019 | <u>28,185</u> |
| Total | <u>\$ 81,263</u> |

Deferred Compensation Plans for Future Benefit

Effective July 1, 2017, the Company started a salary continuation plan for three of the Bank’s key management, which is funded by insurance policies with the Company named as beneficiary. The Bank will payout deferred salary upon retirement of members of key management. The deferred compensation liability related to this plan for December 31, 2017 was **\$61,073** and is included in other liabilities.

In 2017, the Company has 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. As of December 31, 2017, no liability has been incurred.

The cash surrender value of the insurance policies for the Bank’s deferred compensation plans was **\$6,043,740** and \$700,519 as of December 31, 2017 and 2016, respectively. Interest is periodically credited to the account.

TEXAS HERITAGE BANCSHARES, INC. AND SUBSIDIARY

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2017 and 2016

10. EMPLOYMENT AGREEMENT

The Company entered into an employment agreement on June 1, 2011, which entitles the President of the Company to a base salary, incentive compensation and an automobile allowance. The employment agreement entitles the President to participate in all other fringe benefit plans maintained by the Company. Either party may terminate the employment agreement at any time with ninety days written notice. If the President is terminated by the Company without cause, the Company is required to pay a lump sum payment of \$172,000 and unpaid vacation time or for any other entitled benefits.

11. LEASES

The Company's leased space agreement is scheduled to end in 2018. Minimum future rental expense related to the leased space on the non-cancellable operating lease agreements totals \$3,950.

Rental expense was **\$7,900** and \$4,938 for 2017 and 2016, respectively. The Company did not receive any rental income for 2017 and 2016, which has been reflected as an offset to occupancy expense.

12. 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>2017</u> | <u>2016</u> |
|---------------------------|----------------------|---------------|
| Unfunded loan commitments | \$ 18,427,350 | \$ 26,187,267 |
| Standby letters of credit | \$ 482,054 | \$ 692,002 |

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.

TEXAS HERITAGE BANCSHARES, INC. AND SUBSIDIARY

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2017 and 2016

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

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.

13. REGULATORY MATTERS

Cash Reserve Requirements – The Bank is required to maintain average cash reserve balances with the Federal Reserve Bank or depository banks thereof.

| | <u>2017</u> | <u>2016</u> |
|--------------------------|-------------|-------------|
| Cash reserve requirement | \$ 790,000 | \$ 604,000 |

Capital Requirements – Banks are 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 Company 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 Company'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 Company 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.

Tier 1 capital includes Common Equity Tier 1 capital and additional Tier 1 capital as allowed by regulation. The Company did not have any additional Tier 1 capital beyond Common Equity Tier 1 as of December 31, 2017.

TEXAS HERITAGE BANCSHARES, INC. AND SUBSIDIARY

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2017 and 2016

13. REGULATORY MATTERS (continued)

Total capital includes Tier 1 capital and Tier 2 capital. Tier 2 capital for the Company 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.

When fully phased in on January 1, 2019, the Basel III Capital Rules will require the Company 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 as that buffer is phased in, effectively resulting in a minimum ratio of Common Equity Tier 1 capital to risk-weighted assets of at least 7.0% upon full implementation), (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 as that buffer is phased in, effectively resulting in a minimum Tier 1 capital ratio of 8.5% upon full implementation), (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 as that buffer is phased in, effectively resulting in a minimum total capital ratio of 10.5% upon full implementation) and (iv) a minimum leverage ratio of 4.0%, calculated as the ratio of Tier 1 capital to average quarterly assets.

The implementation of the capital conservation buffer began on January 1, 2016 at the 0.625% level and is being phased in over a four-year period (increasing by that amount on each subsequent January 1, until it reaches 2.5% on January 1, 2019). The Basel III Capital Rules also provide for a "countercyclical capital buffer" that is applicable to only certain covered institutions and does not have any current applicability to the Company.

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 (or below the combined capital conservation buffer and countercyclical capital buffer, when the latter is applied) will face constraints on dividends, equity repurchases and compensation based on the amount of the shortfall.

The following table presents actual and required capital ratios as of December 31, 2017 for the Company under the Basel III Capital Rules. The minimum required capital amounts presented include the minimum required capital levels as of December 31, 2017 based on the phase-in provisions of the Basel III Capital Rules and the minimum required capital levels as of January 1, 2019 when the Basel III Capital Rules have been fully phased-in. 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.

TEXAS HERITAGE BANCSHARES, INC. AND SUBSIDIARY

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2017 and 2016

13. REGULATORY MATTERS (continued)

| | Actual | | Minimum Capital Required Basel III Phase-In Schedule | | Minimum Capital Required Basel III Fully Phase-In Schedule | | Required to be Considered Well Capitalized | |
|---|---------------|--------|--|--------|--|--------|--|--------|
| | Amount | Ratio | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| As of December 31, 2017 | | | | | | | | |
| Common Equity Tier I Capital (to Risk-Weighted Assets) | \$ 24,408,278 | 14.13% | \$ 9,932,597 | 5.750% | \$ 12,091,857 | 7.00% | \$ 11,228,153 | 6.50% |
| Tier I Capital (to Risk-Weighted Assets) | \$ 24,408,278 | 14.13% | \$ 12,523,710 | 7.250% | \$ 14,682,970 | 8.50% | \$ 13,819,266 | 8.00% |
| Total Capital (to Risk-Weighted Assets) | \$ 25,902,867 | 15.00% | \$ 15,973,435 | 9.250% | \$ 18,132,007 | 10.50% | \$ 17,268,578 | 10.00% |
| Tier I Capital (to Average Assets) | \$ 24,408,278 | 9.62% | \$ 10,148,972 | 4.000% | \$ 10,148,972 | 4.00% | \$ 12,686,215 | 5.00% |
| As of December 31, 2016 | | | | | | | | |
| Common Equity Tier I Capital (to Risk-Weighted Assets) | \$ 23,167,477 | 14.57% | \$ 8,149,164 | 5.125% | \$ 11,130,565 | 7.00% | \$ 10,335,525 | 6.50% |
| Tier I Capital (to Risk-Weighted Assets) | \$ 23,167,477 | 14.57% | \$ 10,534,285 | 6.625% | \$ 13,515,687 | 8.50% | \$ 12,720,646 | 8.00% |
| Total Capital (to Risk-Weighted Assets) | \$ 24,420,442 | 15.36% | \$ 13,712,651 | 8.625% | \$ 16,693,662 | 10.50% | \$ 15,898,725 | 10.00% |
| Tier I Capital (to Average Assets) | \$ 23,167,477 | 9.48% | \$ 9,775,307 | 4.000% | \$ 9,775,307 | 4.00% | \$ 12,219,133 | 5.00% |

As of December 31, 2017, capital levels at the Company exceed all capital adequacy requirements under the Basel III Capital Rules on a fully phased-in basis. Based on the ratios presented above, capital levels as of December 31, 2017 at the Company exceed the minimum levels necessary to be considered “well capitalized.”

The Company 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 Company fails to meet the minimum capital requirements, which could have a direct material effect on our financial statements. Management believes, as of December 31, 2017, that the Company meets all capital adequacy requirements to which it is subject.

14. 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, 2017 that the Bank could declare, without the approval of the Comptroller of the Currency, were approximately **\$3,850,000**. Actual dividends available to be distributed are also subject to the Bank maintaining required regulatory capital ratios.

TEXAS HERITAGE BANCSHARES, INC. AND SUBSIDIARY

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2017 and 2016

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.

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.

TEXAS HERITAGE BANCSHARES, INC. AND SUBSIDIARY

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2017 and 2016

15. FAIR VALUE DISCLOSURES (continued)

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. 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.

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 prepayments 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.

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, 2017 | | | | |
| Mortgage-backed securities | \$ - | \$ 15,284,198 | \$ - | \$ 15,284,198 |
| State and political subdivisions | - | 51,494,969 | - | 51,494,969 |
| December 31, 2016 | | | | |
| Mortgage-backed securities | \$ - | \$ 24,282,205 | \$ - | \$ 24,282,205 |
| State and political subdivisions | - | 54,956,243 | - | 54,956,243 |

TEXAS HERITAGE BANCSHARES, INC. AND SUBSIDIARY

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2017 and 2016

15. FAIR VALUE DISCLOSURES (continued)

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, 2017 | | | | |
| Impaired loans | \$ - | \$ - | \$ - | \$ - |
| December 31, 2016 | | | | |
| Impaired loans | \$ - | \$ - | \$ - | \$ - |

During the years ended December 31, 2017 and 2016, 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>2017</u> | <u>2016</u> |
|--|-------------|-------------|
| Carrying value of impaired loans | \$ - | \$ 49,209 |
| Specific valuation allowance allocations | - | (49,209) |
| Fair value of impaired loans | <u>\$ -</u> | <u>\$ -</u> |

Non-Financial Assets and Non-Financial Liabilities

Certain non-financial assets and non-financial liabilities measured at fair value on a non-recurring basis include the following:

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, 2017 and 2016.

TEXAS HERITAGE BANCSHARES, INC. AND SUBSIDIARY

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2017 and 2016

15. FAIR VALUE DISCLOSURES (continued)

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, 2017 | | | | |
| Other real estate | \$ - | \$ - | \$ - | \$ - |
| December 31, 2016 | | | | |
| Other real estate | \$ - | \$ - | \$ 301,858 | \$ 301,858 |

Fair Value of Financial Instruments

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

The estimated fair value amounts of financial instruments have been determined by the Company using available market information and appropriate valuation methodologies. However, considerable judgment is required to interpret data to develop the estimates of fair value. Accordingly, the estimates presented herein are not necessarily indicative of the amounts the Company could realize in a current market exchange. The use of different market assumptions and/or estimation methodologies may have a material effect on the estimated fair value amounts. In addition, reasonable comparability between financial institutions may not be likely due to the wide range of permitted valuation techniques and numerous estimates that must be made given the absence of active secondary markets for many of the financial instruments. This lack of uniform valuation methodologies also introduces a greater degree of subjectivity to these estimated fair values.

TEXAS HERITAGE BANCSHARES, INC. AND SUBSIDIARY

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2017 and 2016

15. FAIR VALUE DISCLOSURES (continued)

The estimated fair values and carrying values of all financial instruments under current authoritative guidance at December 31 were as follows:

| | 2017 | | 2016 | |
|-------------------------------|---------------------|----------------------------|---------------------|----------------------------|
| | Carrying Amounts | Estimated Fair Value | Carrying Amounts | Estimated Fair Value |
| Financial Assets: | | | | |
| <i>Level 2 Inputs:</i> | | | | |
| Cash and cash equivalents | \$ 19,058,520 | \$ 19,058,520 | \$ 7,862,282 | \$ 7,862,282 |
| Time deposits | - | - | 248,000 | 248,000 |
| Securities available-for-sale | 66,779,167 | 66,779,167 | 79,238,448 | 79,238,448 |
| Securities held-to-maturity | 3,713,282 | 3,672,244 | 4,657,864 | 4,618,749 |
| Accrued interest receivable | 1,344,603 | 1,344,603 | 1,378,866 | 1,378,866 |
| Cash value of life insurance | 6,043,740 | 6,043,740 | 700,519 | 700,519 |
| <i>Level 3 Inputs:</i> | | | | |
| Loans, net | \$ 151,736,948 | \$ 150,967,000 | \$ 142,631,781 | \$ 143,508,000 |
| Loans held-for-sale | 200,000 | 205,898 | - | - |
| Financial Liabilities: | | | | |
| <i>Level 2 Inputs:</i> | | | | |
| Deposits | \$ 229,494,437 | \$ 229,703,000 | \$ 217,556,416 | \$ 218,006,000 |
| Accrued interest payable | 40,156 | 40,156 | 38,978 | 38,978 |
| Borrowings | - | - | 2,216,610 | 2,216,610 |

The following methods and assumptions were used by the Company in estimating the fair value of the above classes of financial instruments.

Cash and Cash Equivalents, Time Deposits, Accrued Interest Receivable and Accrued Interest Payable – The carrying amounts approximate fair value due to the relatively short period of time between the origination of these instruments and their expected realization.

Securities Held-to-Maturity – Fair value estimates are based on quoted market prices, if available. If a quoted market price is not available, fair value is estimated using quoted market prices for similar instruments.

Cash Surrender Value of Life Insurance – The carrying amount of bank-owned life insurance is based on information received from the insurance carriers indicating the financial performance of the policies and the amount the Company would receive should the policies be surrendered.

TEXAS HERITAGE BANCSHARES, INC. AND SUBSIDIARY

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2017 and 2016

15. FAIR VALUE DISCLOSURES (continued)

Loans, Net – Fair values are estimated by stratifying the loan portfolio into groups of loans with similar financial characteristics. Loans are segregated by type such as real estate, commercial, consumer, and other loans with each category further segmented into fixed and adjustable rate interest terms.

For mortgage loans, the Company uses the secondary market rates in effect for loans that have similar characteristics. The fair value of other fixed rate loans is calculated by discounting scheduled cash flows through the anticipated maturities adjusted for prepayment estimates. Adjustable interest rate loans are assumed to approximate fair value because they generally reprice within the short term.

Fair values are adjusted for credit risk based on assessment of risk identified with specific loans, and risk adjustments on the remaining portfolio based on credit loss experience. Assumptions regarding credit risk are judgmentally determined using specific borrower information, internal credit quality analysis, and historical information on segmented loan categories for non-specific borrowers.

Loan Held-For-Sale – The fair is based on sales data received from the sale of the loan in subsequent month.

Deposits – The fair value of deposits with no stated maturity, such as checking, now and money market, is equal to the amount payable on demand. The fair value of time certificates of deposit is based on the discounted value of contractual cash flows. The discount rate is estimated using the rates currently offered for deposits of similar maturities.

Borrowings – The fair value of the Company's borrowings are estimated using discounted cash flow analysis based on the interest rate that would be effective December 31, 2017, if the borrowings repriced according to their stated terms.

Off-Balance-Sheet Instruments – Fair values for off-balance-sheet, credit-related financial instruments are based on fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the counterparties' credit standing. The fair value of these financial instruments is considered insignificant. Additionally, these financial instruments have no carrying value.

16. LITIGATION

The Company is party to litigation arising in the normal course of business. Management, after consultation with legal counsel, believes that the liabilities, if any, arising from such litigation and claims will not be material to the Company's financial position.

TEXAS HERITAGE BANCSHARES, INC. AND SUBSIDIARY

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2017 and 2016

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.

The Company's directors approved a dividend payment totaling \$783,000 to shareholders as of record date, January 1, 2018. The dividend was paid January 24, 2018.

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, 2019. 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, 2020 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. We expect 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. We expect the adoption will result in a material increase to the allowance for loan losses balance. At this time, the impact is being evaluated.

ASU 2014-09, "Revenue from Contracts with Customers (Topic 606)." In May 2014, the FASB amended existing guidance related to revenue from contracts with customers. This amendment supersedes and replaces nearly all existing revenue recognition guidance, including industry-specific guidance, establishes a new control-based revenue recognition model, changes the basis for deciding when revenue is recognized over time or at a point in time, provides new and more detailed guidance on specific topics and expands and improves disclosures about revenue.

TEXAS HERITAGE BANCSHARES, INC. AND SUBSIDIARY

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2017 and 2016

18. RECENTLY ISSUED AUTHORITATIVE GUIDANCE (continued)

In addition, this amendment specifies the accounting for some costs to obtain or fulfill a contract with a customer. The amendments will be effective for annual periods beginning after December 15, 2018 and are expected to have a significant impact on the Company's consolidated financial statements. We are finalizing our assessment and have identified the revenue line items within the scope of this new guidance. We do not expect the new standard to result in a material change for revenue because the majority of the Company's financial instruments are not within the scope of Topic 606. The Company is evaluating revenue streams within Other Noninterest Income including service charges on deposit accounts and income from fiduciary activities.

ASU 2016-01, "Financial Instruments – Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities." In January 2016, the FASB amended existing guidance that requires equity investments (except those accounted for under the equity method of accounting, or those that result in consolidation of the investee) to be measured at fair value with changes in fair value recognized in net income. It requires public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes. It requires separate presentation of financial assets and financial liabilities by measurement category and form of financial asset (i.e., securities or loans and receivables). It eliminates the requirement for public business entities to disclose the method(s) and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured at amortized cost. The amendments will be effective for fiscal years beginning after December 15, 2018 and are not expected to have a significant impact on the Company's consolidated financial statements.

ASU 2016-15, "Statement of Cash Flows (Topic 230) - Classification of Certain Cash Receipts and Cash Payments." In August 2016, the FASB issued this ASU that provides guidance related to certain cash flow issues in order to reduce the current and potential future diversity in practice. The amendments will be effective for fiscal years beginning after December 15, 2018 and are not expected to have a significant impact on the Company's consolidated financial statements.

ASU 2017-04, "Intangibles – Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment". In January 2017, the FASB 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 will be effective for annual periods beginning after December 15, 2021 and 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, 2017

| | Texas Heritage Bancshares, Inc. | Hondo National Bank | Eliminations | Consolidated Balance |
|---|------------------------------------|---------------------------|------------------------|-------------------------|
| ASSETS | | | | |
| Cash and Cash Equivalents | | | | |
| Cash and due from banks | \$ 67 | \$ 13,933,520 | \$ (67) | \$ 13,933,520 |
| Federal funds sold | - | 5,125,000 | - | 5,125,000 |
| Total cash and cash equivalents | <u>67</u> | <u>19,058,520</u> | <u>(67)</u> | <u>19,058,520</u> |
| Securities available-for-sale, at estimated market value | - | 66,779,167 | - | 66,779,167 |
| Securities held-to-maturity, at cost | - | 3,713,282 | - | 3,713,282 |
| Loans, net | - | 151,736,948 | - | 151,736,948 |
| Loans held-for-sale | - | 200,000 | - | 200,000 |
| Investment in subsidiary | 24,088,621 | - | (24,088,621) | - |
| Premises and equipment, net | - | 3,735,976 | - | 3,735,976 |
| Accrued interest receivable | - | 1,344,603 | - | 1,344,603 |
| Cash surrender value of life insurance | - | 6,043,740 | - | 6,043,740 |
| Goodwill | - | 120,416 | - | 120,416 |
| Other assets | - | 1,345,595 | - | 1,345,595 |
| Total assets | <u>\$ 24,088,688</u> | <u>\$ 254,078,247</u> | <u>\$ (24,088,688)</u> | <u>\$ 254,078,247</u> |
| LIABILITIES AND SHAREHOLDERS' EQUITY | | | | |
| Deposits: | | | | |
| Non-interest bearing | \$ - | \$ 63,410,094 | \$ (67) | \$ 63,410,027 |
| Interest bearing | - | 166,084,410 | - | 166,084,410 |
| Total deposits | - | 229,494,504 | (67) | 229,494,437 |
| Accrued interest payable | - | 40,156 | - | 40,156 |
| Other liabilities | - | 454,966 | - | 454,966 |
| Total liabilities | <u>-</u> | <u>229,989,626</u> | <u>(67)</u> | <u>229,989,559</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 |
| Retained earnings | 20,740,741 | 18,242,177 | (18,242,177) | 20,740,741 |
| Accumulated other comprehensive income (loss) | (440,073) | (440,073) | 440,073 | (440,073) |
| Total shareholders' equity | <u>24,088,688</u> | <u>24,088,621</u> | <u>(24,088,621)</u> | <u>24,088,688</u> |
| Total liabilities and shareholders' equity | <u>\$ 24,088,688</u> | <u>\$ 254,078,247</u> | <u>\$ (24,088,688)</u> | <u>\$ 254,078,247</u> |

See report of independent auditors.

TEXAS HERITAGE BANCSHARES, INC. AND SUBSIDIARY

CONSOLIDATING STATEMENT OF INCOME

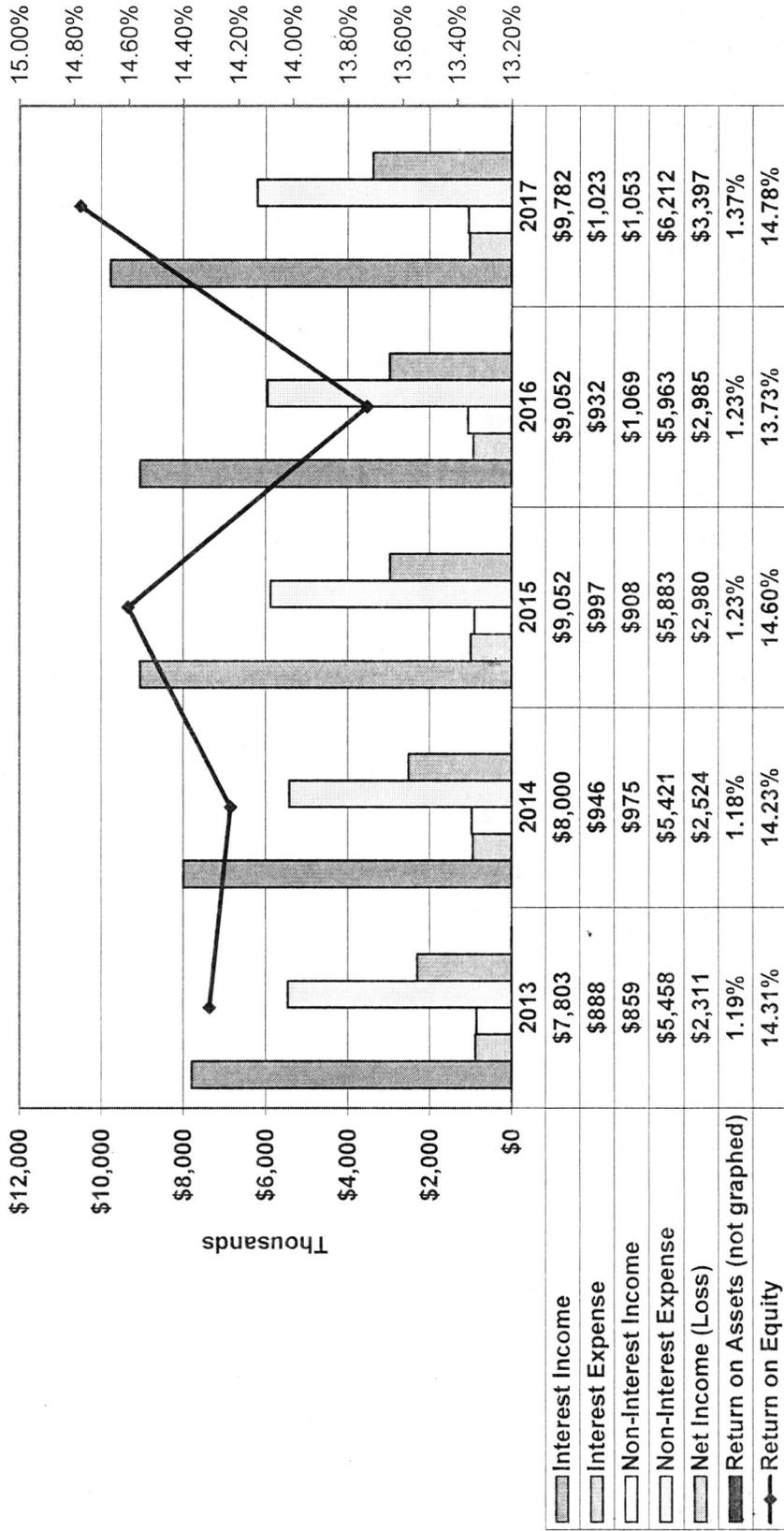
Year Ended December 31, 2017

| | Texas Heritage Banshares, Inc. | Hondo National Bank | Eliminations | Consolidated Balance |
|--|-----------------------------------|---------------------------|-----------------------|-------------------------|
| INTEREST INCOME | | | | |
| Loans, including fees | \$ - | 8,002,131 | \$ - | \$ 8,002,131 |
| Investment securities: | | | | |
| Taxable | - | 466,339 | - | 466,339 |
| Tax-exempt | - | 1,203,315 | - | 1,203,315 |
| Federal funds sold | - | 30,438 | - | 30,438 |
| Other | - | 79,819 | - | 79,819 |
| Total interest income | <u>-</u> | <u>9,782,042</u> | <u>-</u> | <u>9,782,042</u> |
| INTEREST EXPENSE | | | | |
| Deposits | - | 999,541 | - | 999,541 |
| Borrowings | 15,590 | 8,063 | - | 23,653 |
| Total interest expense | <u>15,590</u> | <u>1,007,604</u> | <u>-</u> | <u>1,023,194</u> |
| NET INTEREST INCOME | (15,590) | 8,774,438 | - | 8,758,848 |
| PROVISION FOR LOAN LOSSES | <u>-</u> | <u>200,000</u> | <u>-</u> | <u>200,000</u> |
| NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES | <u>(15,590)</u> | <u>8,574,438</u> | <u>-</u> | <u>8,558,848</u> |
| NON-INTEREST INCOME | | | | |
| Dividends from subsidiaries | 2,171,411 | - | (2,171,411) | - |
| Undistributed earnings of subsidiaries | 1,240,800 | - | (1,240,800) | - |
| Service charges on deposit accounts | - | 343,266 | - | 343,266 |
| Gain on sale of securities | - | 49,466 | - | 49,466 |
| Other | - | 659,824 | - | 659,824 |
| Total non-interest income | <u>3,412,211</u> | <u>1,052,556</u> | <u>(3,412,211)</u> | <u>1,052,556</u> |
| NON-INTEREST EXPENSE | | | | |
| Salaries, wages and benefits | - | 3,322,400 | - | 3,322,400 |
| Occupancy and equipment | - | 779,647 | - | 779,647 |
| Loss and write down on sale of other real estate | - | 42,983 | - | 42,983 |
| Other | - | 2,066,502 | - | 2,066,502 |
| Total non-interest expense | <u>-</u> | <u>6,211,532</u> | <u>-</u> | <u>6,211,532</u> |
| INCOME BEFORE INCOME TAXES | 3,396,621 | 3,415,462 | (3,412,211) | 3,399,872 |
| STATE INCOME TAX EXPENSE | <u>-</u> | <u>3,251</u> | <u>-</u> | <u>3,251</u> |
| NET INCOME | <u>\$ 3,396,621</u> | <u>\$ 3,412,211</u> | <u>\$ (3,412,211)</u> | <u>\$ 3,396,621</u> |

See report of independent auditors.

TEXAS HERITAGE BANCSHARES, INC.

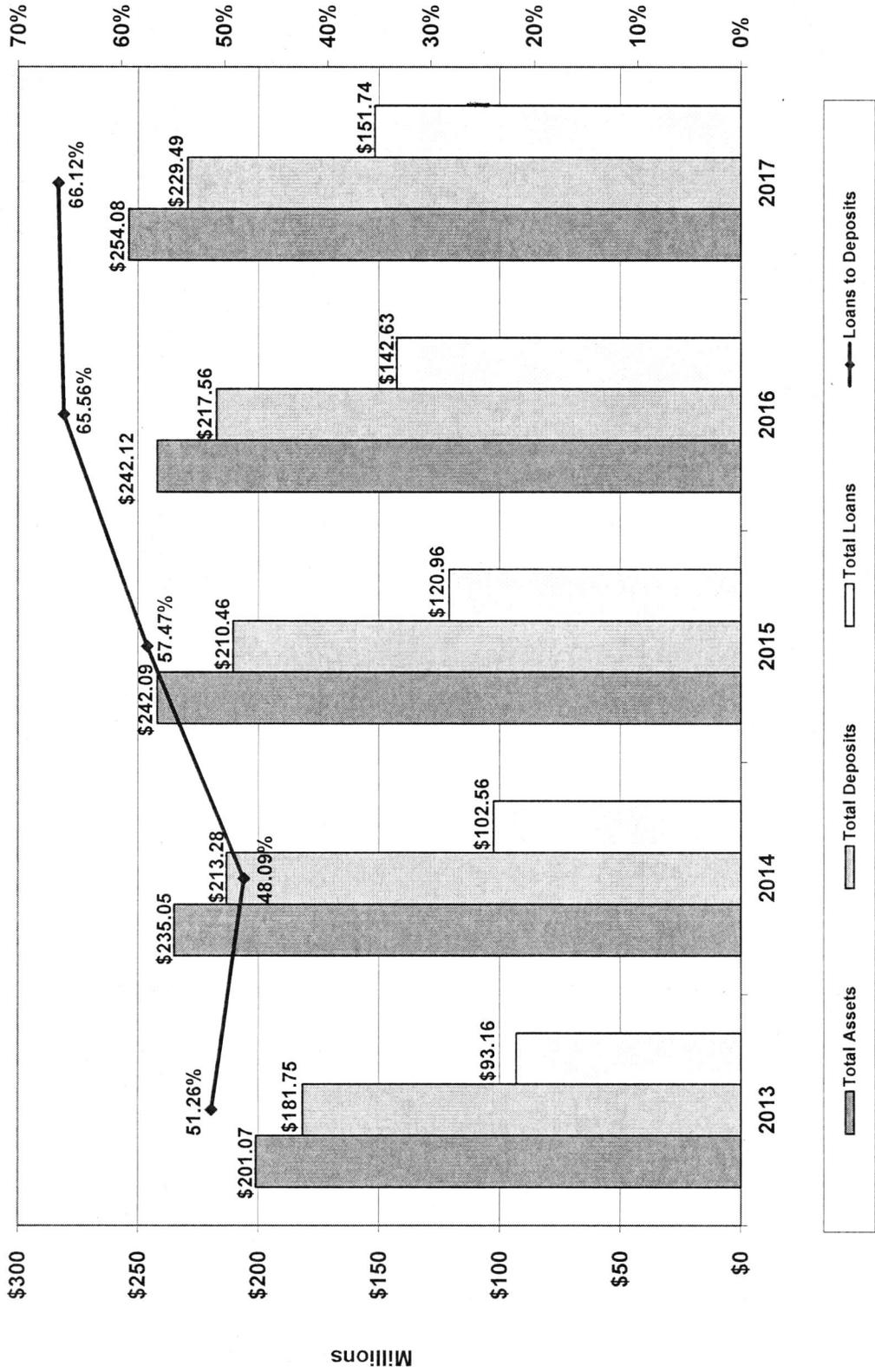
Financial Highlights



See report of independent auditors.

TEXAS HERITAGE BANCSHARES, INC.

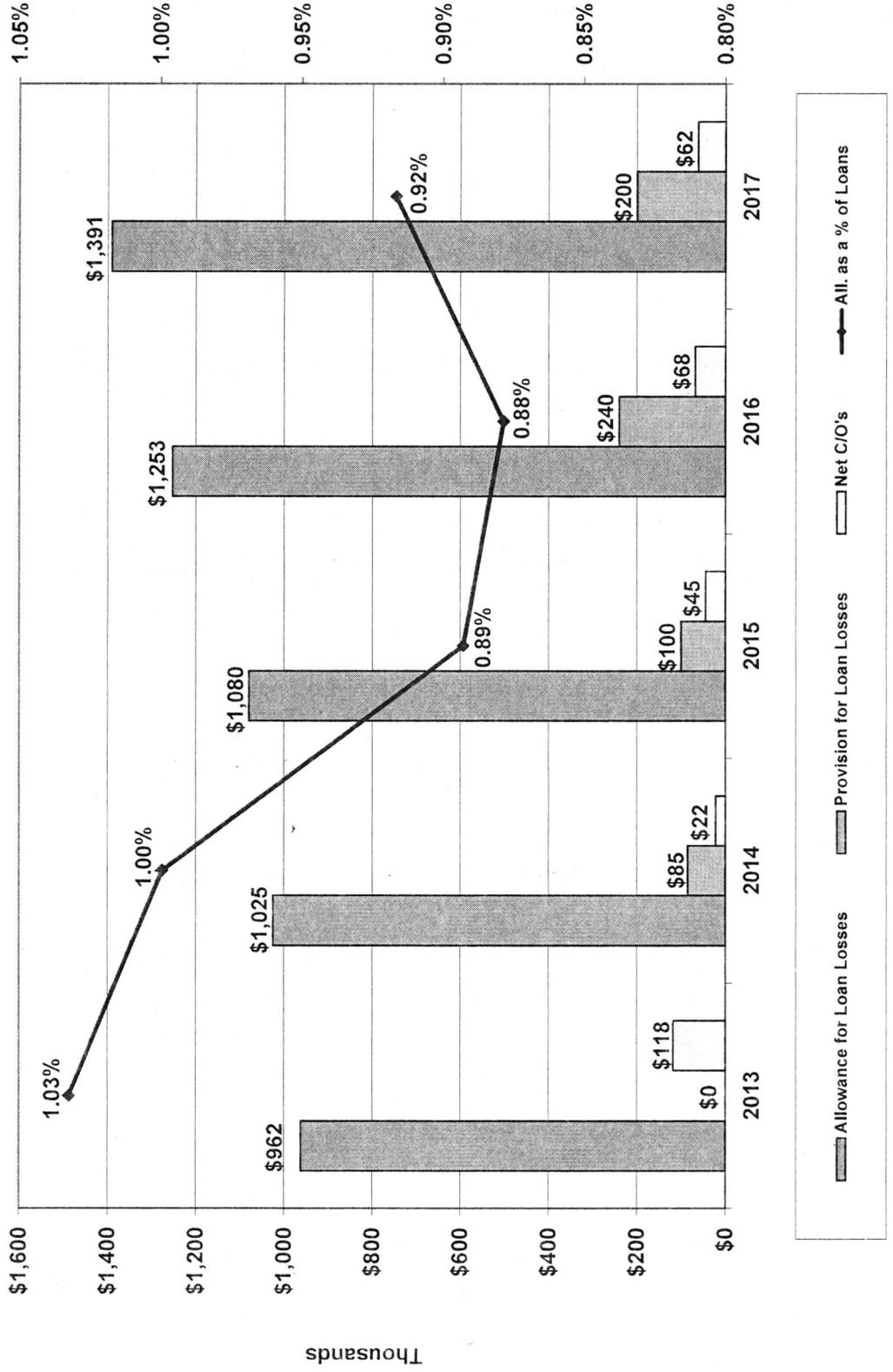
Loans and Deposits



See report of independent auditors.

TEXAS HERITAGE BANCSHARES, INC.

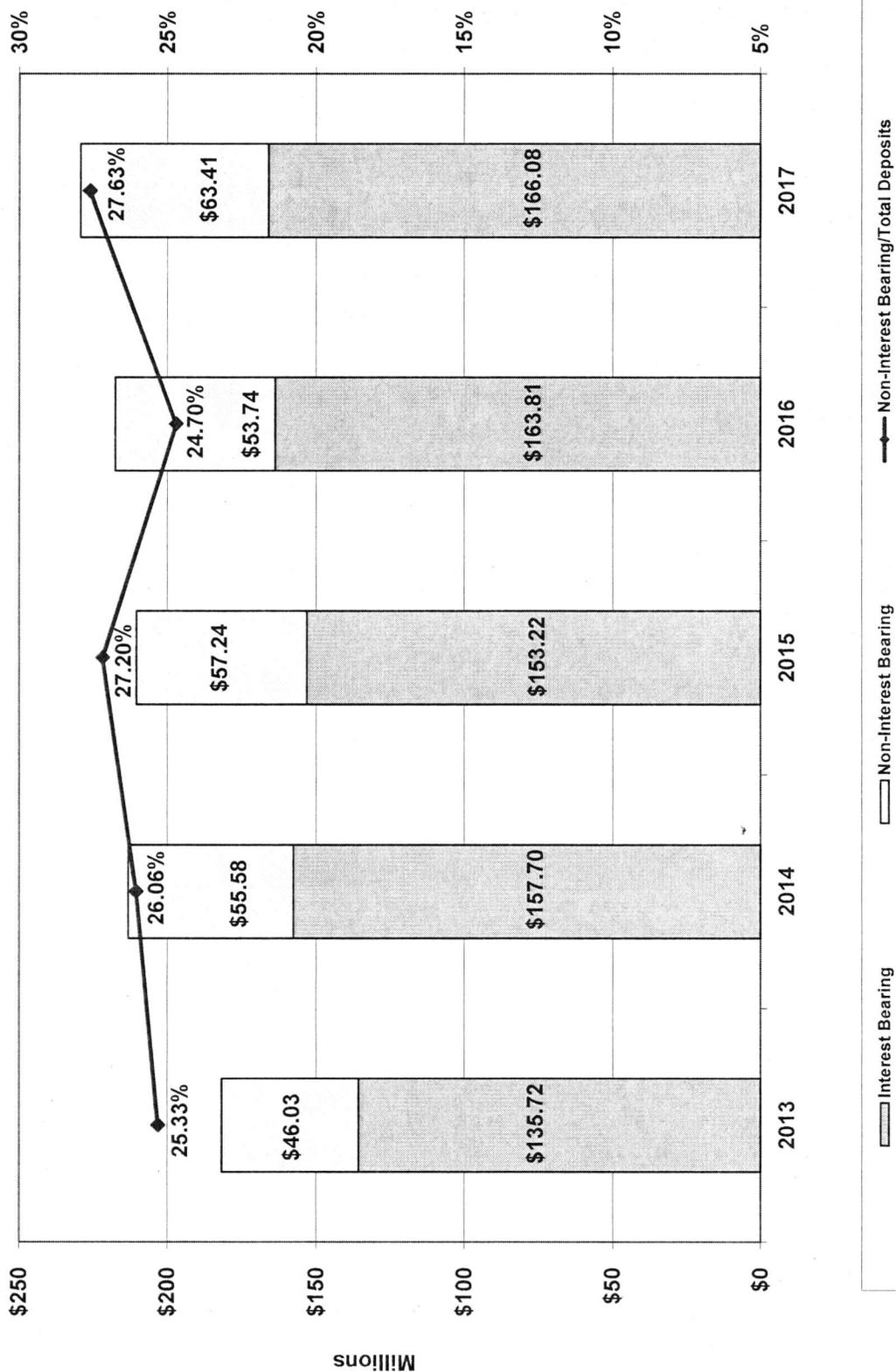
Allowance for Loan Losses



See report of independent auditors.

TEXAS HERITAGE BANCSHARES, INC.

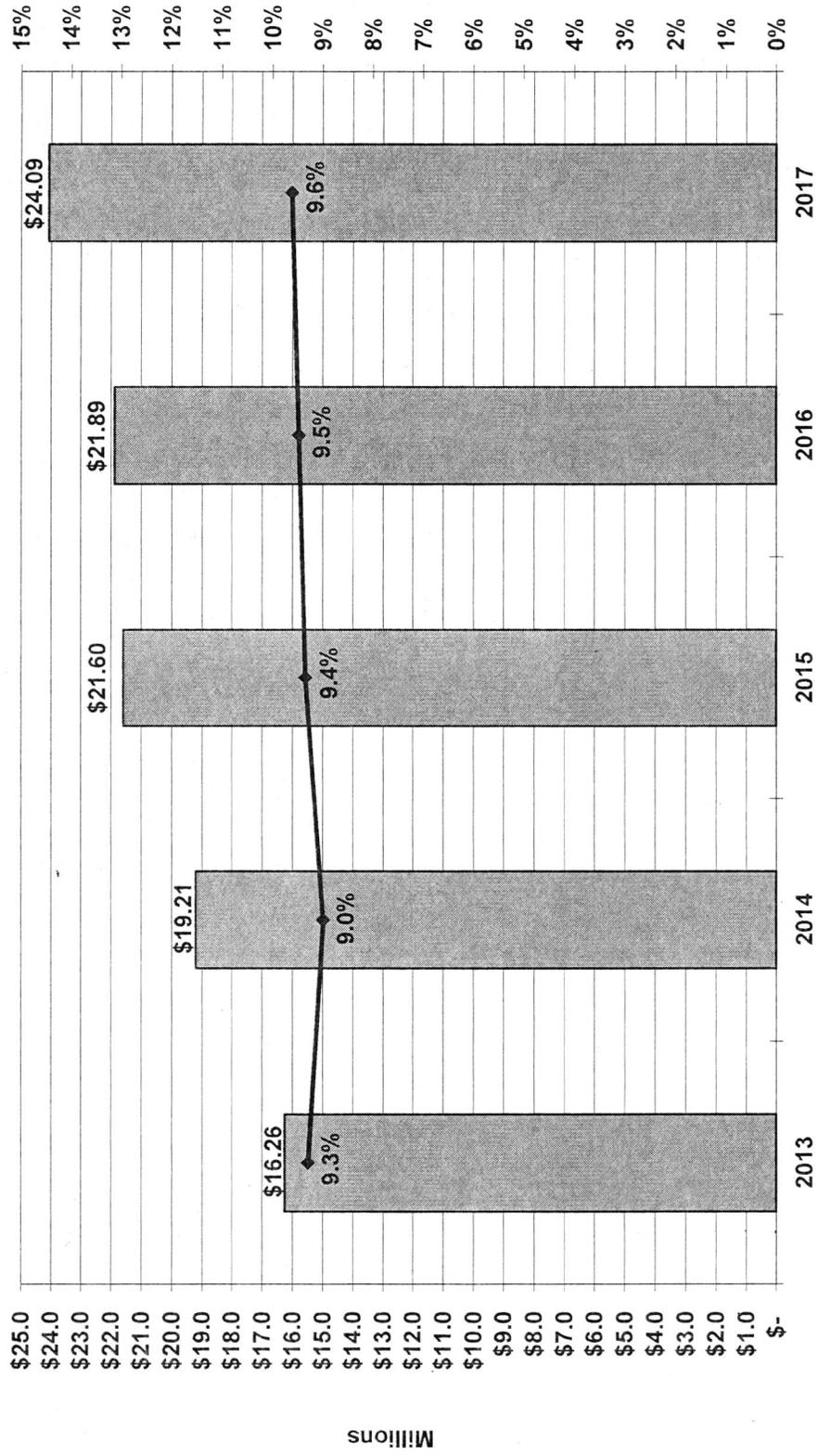
Deposits



See report of independent auditors.

TEXAS HERITAGE BANCSHARES, INC.

Total Equity and Leverage Ratio



Total Equity
 Leverage Ratio

See report of independent auditors.

Texas Heritage Bancshares, Inc.

March 20, 2018

Shareholder's Meeting
Texas Heritage Bancshares, Inc.

Dear Valued Shareholders,

The year 2017 was an exciting and profitable year for Texas Heritage Bancshares, Inc. and Hondo National Bank. HNB remains profitable and competitive in all the market areas we service.

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

Our dedicated staff has done an excellent job in serving our customer's needs and requests.

Please consider attending our Annual Shareholders Meeting to be held Tuesday, March 20th, 2018 at 5:00 p.m. in the Hondo National Bank lobby. 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, 2017.

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 20th. Remember, Shareholders continue to be the life blood of successful organizations. We appreciate and value each and every one of you as a Shareholder.

Sincerely,



Tim Gilles
President/CEO

**NOTICE OF ANNUAL MEETING OF SHAREHOLDERS
TO BE HELD ON MARCH 20, 2018**

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 20, 2018, 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 Olen Thompson, 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, 2018, 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



Tim Gilles
President