

Starent Networks, Corp.
Form 3
June 05, 2007

FORM 3 UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

OMB APPROVAL

OMB Number: 3235-0104
Expires: January 31, 2005
Estimated average burden hours per response... 0.5

INITIAL STATEMENT OF BENEFICIAL OWNERSHIP OF SECURITIES

Filed pursuant to Section 16(a) of the Securities Exchange Act of 1934,
Section 17(a) of the Public Utility Holding Company Act of 1935 or Section
30(h) of the Investment Company Act of 1940

(Print or Type Responses)

1. Name and Address of Reporting Person *		2. Date of Event Requiring Statement	3. Issuer Name and Ticker or Trading Symbol	
Â Sirota Gennady H		(Month/Day/Year)	Starent Networks, Corp. [STAR]	
(Last)	(First)	(Middle)	4. Relationship of Reporting Person(s) to Issuer	5. If Amendment, Date Original Filed(Month/Day/Year)
		06/05/2007		
C/O STARENT NETWORKS, CORP.,Â 30 INTERNATIONAL PLACE			(Check all applicable)	
(Street)			<input type="checkbox"/> Director	<input type="checkbox"/> 10% Owner
			<input checked="" type="checkbox"/> Officer	<input type="checkbox"/> Other
			(give title below)	(specify below)
			VP of Product Management	
TEWKSBURY,Â MAÂ 01876			6. Individual or Joint/Group Filing(Check Applicable Line)	
(City)	(State)	(Zip)	<input checked="" type="checkbox"/> Form filed by One Reporting Person	
			<input type="checkbox"/> Form filed by More than One Reporting Person	

Table I - Non-Derivative Securities Beneficially Owned

1. Title of Security (Instr. 4)	2. Amount of Securities Beneficially Owned (Instr. 4)	3. Ownership Form: Direct (D) or Indirect (I) (Instr. 5)	4. Nature of Indirect Beneficial Ownership (Instr. 5)
Common Stock	255,833	D	Â
Common Stock	233,333	I	See Footnote ⁽¹⁾

Reminder: Report on a separate line for each class of securities beneficially owned directly or indirectly. SEC 1473 (7-02)

Persons who respond to the collection of information contained in this form are not required to respond unless the form displays a currently valid OMB control number.

Table II - Derivative Securities Beneficially Owned (e.g., puts, calls, warrants, options, convertible securities)

1. Title of Derivative Security (Instr. 4)	2. Date Exercisable and Expiration Date (Month/Day/Year)	3. Title and Amount of Securities Underlying Derivative Security	4. Conversion or Exercise	5. Ownership Form of	6. Nature of Indirect Beneficial Ownership (Instr. 5)
--	--	--	---------------------------	----------------------	---

Edgar Filing: Starent Networks, Corp. - Form 3

	Date Exercisable	Expiration Date	(Instr. 4) Title	Amount or Number of Shares	Price of Derivative Security	Derivative Security: Direct (D) or Indirect (I) (Instr. 5)	
Stock Option (Right to Buy)	Â (2)	01/23/2013	Common Stock	7,500	\$ 0.3	D	Â
Stock Option (Right to Buy)	Â (3)	07/26/2015	Common Stock	180,000	\$ 1.65	D	Â
Stock Option (Right to Buy)	Â (4)	09/29/2016	Common Stock	49,999	\$ 1.65	D	Â
Stock Option (Right to Buy)	Â (5)	04/13/2017	Common Stock	19,999	\$ 8.25	D	Â

Reporting Owners

Reporting Owner Name / Address	Relationships			
	Director	10% Owner	Officer	Other
Sirota Gennady H C/O STARENT NETWORKS, CORP. 30 INTERNATIONAL PLACE TEWKSBURY, MA 01876	Â	Â	Â VP of Product Management	Â

Signatures

/s/ Gennady H. Sirota 06/05/2007

**Signature of Reporting Person Date

Explanation of Responses:

- * If the form is filed by more than one reporting person, see Instruction 5(b)(v).
- ** Intentional misstatements or omissions of facts constitute Federal Criminal Violations. See 18 U.S.C. 1001 and 15 U.S.C. 78ff(a).
- (1) Represents securities held by The Gennady H. Sirota Grantor Retained Annuity Trust-2007. Mr. Sirota disclaims beneficial ownership of the shares held by the trust except to the extent of his pecuniary interest therein, if any.
- (2) 12.5% of the option vests on each of 1/23/04, 1/23/05, 7/23/05, 1/23/06, 7/23/06, 1/23/07, 7/23/07 and 7/23/08.
- (3) The option vests 25% on 1/1/06 and the remainder vests in 12 equal quarterly installments beginning on 4/1/06.
- (4) The option vests 25% on 9/29/07 and the remainder vests in 12 equal quarterly installments beginning on 12/29/07.
- (5) The option vests 20% on 1/1/08 and the remainder vests in 16 equal quarterly installments beginning on 4/1/08.

Note: File three copies of this Form, one of which must be manually signed. If space is insufficient, See Instruction 6 for procedure. Potential persons who are to respond to the collection of information contained in this form are not required to respond unless the form displays a currently valid OMB number.

ing-bottom:2px;">10.67%

2,225,591

9.25

%

2,526,347

10.50

%

2,406,044

10.00

%

Tier 1 capital (to risk-weighted assets)

Company

2,293,016

9.52

%

1,745,659

7.25

%

2,046,635

8.50

%

N/A

N/A

Bank

2,151,338

8.94

Explanation of Responses:

%

1,744,382

7.25

%

2,045,138

8.50

%

1,924,835

8.00

%

Tier 1 capital (to average assets)(1)

Company

2,293,016

9.15

%

1,002,494

4.00

%

1,002,494

4.00

%

N/A

N/A

Bank

Explanation of Responses:

2,151,338

8.59
%

1,002,144

4.00
%

1,002,144

4.00
%

1,252,680

5.00
%

(1) The Tier 1 capital ratio (to average assets) is not impacted by the Basel III Capital Rules; however, it should be noted that the Federal Reserve Board and the FDIC may require the Company and the Bank, respectively, to maintain a Tier 1 capital ratio (to average assets) above the required minimum.

Our mortgage finance loan volumes can increase significantly at month end, causing a meaningful difference between ending balance and average balance for any period. At September 30, 2018, our total mortgage finance loans were \$5.5 billion compared to the average for the three months ended September 30, 2018 of \$5.4 billion. As CET1, Tier 1 and total capital ratios are calculated using quarter-end risk-weighted assets and our mortgage finance loans are 100% risk-weighted (excluding MCA mortgage loans held for sale, which receive lower risk weights), the quarter-end fluctuation in these balances can significantly impact our reported ratios. Due to the actual risk profile and liquidity of this asset class, we manage capital allocated to mortgage finance loans based on changing trends in average balances and do not believe that the quarter-end balance is representative of risk characteristics that would justify higher allocations. However, we continue to monitor our capital allocation to confirm that all capital levels remain above well-capitalized levels.

Dividends that may be paid by subsidiary banks are routinely restricted by various regulatory authorities. The amount that can be paid in any calendar year without prior approval of the Bank's regulatory agencies cannot exceed the lesser of the net profits (as defined) for that year plus the net profits for the preceding two calendar years, or retained earnings. The Basel III Capital

25

Table of Contents

Rules further limit the amount of dividends that may be paid by our Bank. No dividends were declared or paid on our common stock during the nine months ended September 30, 2018 or 2017.

(9) STOCK-BASED COMPENSATION

We have long-term incentive plans under which stock-based compensation awards are granted to employees and directors by the board of directors, or its designated committee. Grants are subject to vesting requirements and may include, among other things, nonqualified stock options, stock appreciation rights ("SARs"), restricted stock units ("RSUs"), restricted stock and performance units, or any combination thereof. There are 2,550,000 total shares authorized for grant under the plans.

The table below summarizes our stock-based compensation expense for the three and nine months ended September 30, 2018 and 2017 (in thousands):

	Three months ended September 30, 2018		Nine months ended September 30, 2017	
Stock-settled awards:				
SARs	\$ 19	\$ 64	\$ 112	\$ 210
RSUs	2,261	2,184	6,235	5,491
Restricted stock	12	8	36	16
Cash-settled performance units	2,144	3,811	9,250	9,304
Total	\$ 4,436	\$ 6,067	\$ 15,633	\$ 15,021

(in thousands)	September 30, 2018
Unrecognized compensation expense related to unvested stock-settled awards	\$ 17,487
Weighted average period over which expense is expected to be recognized, in years	2.8

(10) INCOME TAXES

The Tax Cuts and Jobs Act (the "Tax Act") enacted in December 2017 reduced the federal corporate income tax rate from 35% to 21% effective January 1, 2018. As a result of the Tax Act, we re-measured certain deferred tax assets and liabilities based on the rates at which they are expected to reverse in the future, which is generally 21%. However, we are still analyzing certain aspects of the Tax Act and refining our calculations, which could potentially affect the measurement of these balances or potentially give rise to new deferred tax amounts. The provisional amount recorded in 2017 related to the re-measurement of our deferred tax asset was \$17.6 million, and no further adjustments were made during the nine months ended September 30, 2018.

The reconciliation of our total effective income tax rate to the U.S. federal statutory tax rate for the nine months ended September 30, 2018 and 2017 is as follows:

	Nine months ended September 30, 2018		2017	
U.S. statutory rate	21 %	35 %		
State taxes	1 %	1 %		
Non-deductible expenses	1 %	— %		
Non-taxable income	(1)%	(1)%		
Other	(1)%	(1)%		
Effective tax rate	21 %	34 %		

(11) FAIR VALUE DISCLOSURES

Edgar Filing: Starent Networks, Corp. - Form 3

We determine the fair market values of our assets and liabilities measured at fair value on a recurring and nonrecurring basis using the fair value hierarchy as prescribed in ASC 820, Fair Value Measurements and Disclosures. The standard describes three levels of inputs that may be used to measure fair value as provided below.

26

Table of Contents

Quoted prices in active markets for identical assets or liabilities. This category includes the assets and Level 1 liabilities related to our non-qualified deferred compensation plan where values are based on quoted market prices for identical equity securities in an active market.

Observable inputs other than Level 1 prices, such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable Level 2 market data for substantially the full term of the assets or liabilities. Level 2 assets include agency mortgage-backed debt securities and Community Reinvestment Act funds. This category also includes certain loans held for sale and derivative assets and liabilities where values are obtained from independent pricing services using observable market data.

Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities. Level 3 assets and liabilities include financial instruments whose value is determined using pricing models, discounted cash flow methodologies or similar techniques, as well as instruments for which the determination of fair values requires significant management judgment or Level 3 estimation. This category includes tax-exempt asset-backed securities for which fair value is determined using a price-based model and certain loans held for sale for which fair values are determined using third party pricing models. This category also includes impaired loans and OREO where collateral values have been based on third party appraisals; however, comparative sales data typically used in appraisals may be unavailable or more subjective in certain markets due to lack of market activity.

Assets and liabilities measured at fair value at September 30, 2018 and December 31, 2017 are as follows (in thousands):

	Fair Value Measurements Using	
	Level 1	Level 2 Level 3
September 30, 2018		
Available-for-sale debt securities:(1)		
Residential mortgage-backed securities	\$ -	\$ 7,709
Tax-exempt asset-backed securities	—	93,369
Equity securities(1)(2)	9,468	850
Loans held for sale (3)	—	1,630,017
Loans held for investment(4)(6)	—	19,823
OREO(5)(6)	—	79
Derivative assets(7)	—	35,781
Derivative liabilities(7)	—	27,381
Non-qualified deferred compensation plan liabilities (8)	10,467	—
December 31, 2017		
Available-for-sale debt securities:(1)		
Residential mortgage-backed securities	\$ -	\$ 10,945
Equity securities(1)(2)	5,470	106
Loans held for sale(3)	—	1,007,695
Loans held for investment(4)(6)	—	21,216
OREO(5)(6)	—	11,742
Derivative assets(7)	—	16,719
Derivative liabilities(7)	—	17,377
Non-qualified deferred compensation plan liabilities (8)	5,587	—

(1)

Explanation of Responses:

Edgar Filing: Starent Networks, Corp. - Form 3

Securities are measured at fair value on a recurring basis, generally monthly, except for tax-exempt asset-backed securities which are measured quarterly.

- (2) Equity securities consist of Community Reinvestment Act funds and investments related to our non-qualified deferred compensation plan.
- (3) Loans held for sale, excluding SBA loans which are carried at lower of cost or market, are measured at fair value on a recurring basis, generally monthly.

27

Table of Contents

- (4) Includes impaired loans that have been measured for impairment at the fair value of the loan's collateral.
- (5) OREO is transferred from loans to OREO at fair value less selling costs.
- (6) Loans held for investment and OREO are measured on a nonrecurring basis, generally annually or more often as warranted by market and economic conditions.
- (7) Derivative assets and liabilities are measured at fair value on a recurring basis, generally quarterly.
- Non-qualified deferred compensation plan liabilities represent the fair value of the obligation to the employee,
- (8) which corresponds to the fair value of the invested assets, and are measured at fair value on a recurring basis, generally monthly.

Level 3 Valuations

Financial instruments are considered Level 3 when their values are determined using pricing models, discounted cash flow methodologies or similar techniques and at least one significant model assumption or input is unobservable.

Level 3 financial instruments include those for which the determination of fair value requires significant management judgment or estimation. Currently, we measure the fair value of tax-exempt asset-backed securities using a price-based model and certain loans held for sale using third party pricing models on a recurring basis, and measure certain collateral dependent impaired loans and OREO on a nonrecurring basis as described below.

Level 3 Fair Value Rollforward

The following table presents a reconciliation for the three and nine months ended September 30, 2018 of the level 3 fair value category measured at fair value on a recurring basis using Level 3 inputs (in thousands):

	Balance at Beginning of Period	Purchases / Additions	Sales / Reductions	Net Realized/Unrealized Gains (Losses)		Balance at End of Period
				Realized	Unrealized	
Three months ended September 30, 2018						
Tax-exempt asset-backed securities(1)	\$ —	\$ 95,521	\$ —	\$ —	\$ (2,152)	\$ 93,369
Loans held for sale(2)	\$ 27,929	\$ 901	\$ (6,948)	\$ (134)	\$ 165	\$ 21,913
Nine months ended September 30, 2018						
Tax-exempt asset-backed securities	\$ —	\$ 95,521	\$ —	\$ —	\$ (2,152)	\$ 93,369
Loans held for sale	\$ —	\$ 38,430	\$ (14,936)	\$ (66)	\$ (1,515)	\$ 21,913

(1) Changes in fair value of available-for-sale debt securities are recorded in accumulated other comprehensive income.

(2) Recorded in other non-interest income.

Tax-exempt asset-backed securities

The fair value of tax-exempt asset-backed securities is based on a price-based model, which utilizes Level 3, or unobservable, inputs. The fair value of these securities is generally based upon quoted prices of the underlying assets, which are used to calculate a weighted-average value. Other considerations include credit deterioration of underlying bonds, the probability of the sponsor exercising their call option and liquidity risks due to the instrument not being actively traded. At September 30, 2018, the fair value of these securities was calculated using a weighted-average price of 97.7%.

Loans held for sale

The fair value of loans held for sale using Level 3 inputs include loans that cannot be sold through normal sale channels and thus require significant management judgment or estimation when determining the fair value. The fair value of such loans is generally based upon quoted prices of comparable loans with a liquidity discount applied. At September 30, 2018, the fair value of these loans was calculated using a weighted-average discounted price of 93.5%.

Table of Contents

Loans held for investment

At September 30, 2018 and December 31, 2017, certain impaired loans held for investment were reported at fair value through a specific allocation of the allowance for loan losses based upon the fair value of the underlying collateral. The \$19.8 million fair value of loans held for investment at September 30, 2018 reported above includes impaired loans held for investment with a carrying value of \$28.0 million that were reduced by specific allowance allocations totaling \$8.2 million based on collateral valuations utilizing Level 3 inputs. The \$21.2 million fair value of loans held for investment at December 31, 2017 reported above includes impaired loans with a carrying value of \$32.2 million that were reduced by specific valuation allowance allocations totaling \$11.0 million based on collateral valuations utilizing Level 3 inputs. Fair values were based on third party appraisals, which are Level 3 inputs.

OREO

Certain foreclosed assets, upon initial recognition, are recorded at fair value less estimated selling costs. At September 30, 2018 and December 31, 2017, OREO had a carrying value of \$79,000 and \$11.7 million, respectively, with no valuation allowance at September 30, 2018 or December 31, 2017. The fair value of OREO was computed based on third party appraisals, which are Level 3 inputs.

Fair Value of Financial Instruments

GAAP requires disclosure of fair value information about financial instruments, whether or not recognized on the balance sheet, for which it is practical to estimate that value. In cases where quoted market prices are not available, fair values are based on estimates using present value or other valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. This disclosure does not and is not intended to represent the fair value of the Company.

A summary of the carrying amounts and estimated fair values of financial instruments is as follows (in thousands):

	September 30, 2018		December 31, 2017	
	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
Financial assets:				
Level 1 inputs:				
Cash and cash equivalents	\$2,785,051	\$2,785,051	\$2,905,591	\$2,905,591
Investment securities	9,461	9,461	5,460	5,460
Level 2 inputs:				
Investment securities	14,559	14,559	18,051	18,051
Loans held for sale	1,630,017	1,630,017	1,011,004	1,011,004
Derivative assets	35,781	35,781	16,719	16,719
Level 3 inputs:				
Investment securities	93,369	93,369	—	—
Loans held for sale	21,913	21,913	—	—
Loans held for investment, net	21,857,019	21,843,389	20,489,757	20,480,802
Financial liabilities:				
Level 2 inputs:				
Federal funds purchased	475,842	475,842	359,338	359,338
Customer repurchase agreements	10,976	10,976	5,702	5,702
Other borrowings	3,200,000	3,200,000	2,800,000	2,800,000
Subordinated notes	281,677	282,247	281,406	285,485
Derivative liabilities	27,381	27,381	17,377	17,377
Level 3 inputs:				
Deposits	20,385,637	20,386,435	19,123,180	19,124,121
Trust preferred subordinated debentures	113,406	113,406	113,406	113,406

Table of Contents

The following methods and assumptions were used by the Company in estimating its fair value disclosures for financial instruments:

Investment Securities

Within the investment securities portfolio, we hold equity securities related to our non-qualified deferred compensation plan that are valued using quoted market prices for identical equity securities in an active market, and are classified as Level 1 assets in the fair value hierarchy. The fair value of the remaining equity securities and residential mortgage-backed securities in our investment portfolio are based on prices obtained from independent pricing services that are based on quoted market prices for the same or similar securities, and are characterized as Level 2 assets in the fair value hierarchy. We have obtained documentation from our primary pricing service regarding their processes and controls applicable to pricing investment securities, and on a quarterly basis we independently verify the prices that we receive from the service provider using two additional independent pricing sources. We also hold tax-exempt asset-backed securities that are valued using a price-based model, which utilizes Level 3 inputs, and are classified as Level 3 assets in the fair value hierarchy.

Loans Held for Sale

Fair value for loans held for sale is derived from quoted market prices for similar loans, in which case they are characterized as Level 2 assets in the fair value hierarchy, or is derived from third party pricing models, in which case they are characterized as Level 3 assets in the fair value hierarchy.

Derivatives

The estimated fair value of interest rate swaps and caps is obtained from independent pricing services based on quoted market prices for similar derivative contracts and these financial instruments are characterized as Level 2 assets and liabilities in the fair value hierarchy. On a quarterly basis, we independently verify the fair value using an additional independent pricing source. Any significant differences are investigated and resolved. Foreign currency forward contracts are valued based upon quoted market prices obtained from independent pricing services for similar derivative contracts. As such, these financial instruments are characterized as Level 2 assets and liabilities in the fair value hierarchy. The derivative instruments related to the loans held for sale portfolio include loan purchase commitments and forward sales commitments. Loan purchase commitments are valued based upon the fair value of the underlying mortgage loans to be purchased, which is based on observable market data for similar loans. Forward sales commitments are valued based upon quoted market prices from brokers. As such, these loan purchase commitments and forward sales commitments are characterized as Level 2 assets or liabilities in the fair value hierarchy.

(12) DERIVATIVE FINANCIAL INSTRUMENTS

The fair value of derivative positions outstanding is included in accrued interest receivable and other assets and other liabilities in the accompanying consolidated balance sheets on a net basis when a right of offset exists, based on transactions with a single counterparty that are subject to a legally enforceable master netting agreement.

We enter into interest rate derivative positions that are not designated as hedging instruments. These derivative positions relate to transactions in which we enter into an interest rate swap, cap and/or floor with a customer while at the same time entering into an offsetting interest rate swap, cap and/or floor with another financial institution. In connection with each swap transaction, we agree to pay interest to the customer on a notional amount at a variable interest rate and receive interest from the customer on a similar notional amount at a fixed interest rate. At the same time, we agree to pay another financial institution the same fixed interest rate on the same notional amount and receive the same variable interest rate on the same notional amount. The transaction allows our customer to effectively convert a variable rate loan to a fixed rate. Because we act as an intermediary for our customer, changes in the fair value of the underlying derivative contracts substantially offset each other and do not have a material impact on our results of operations.

We also enter into foreign currency forward contracts that are not designated as hedging instruments. These derivative instruments relate to transactions in which we enter into a contract with a customer to buy or sell a foreign currency at a future date for a specified price while at the same time entering into an offsetting contract with a financial institution to buy or sell the same currency at the same future date for a specified price. These transactions allow our customers to manage their exposure to foreign currency exchange rate fluctuations. Because we act as an intermediary for our

customer, changes in the fair value of the underlying derivative instruments substantially offset each other and do not have a material impact on our results of operations.

We also enter into loan purchase commitment contracts with mortgage originators to purchase residential mortgage loans at a future date, as well as forward sales commitment contracts to sell residential mortgage loans at a future date as part of our MCA program. The objective of these transactions is to mitigate our exposure to interest rate risk associated with the purchase of

30

Table of Contents

mortgage loans held for sale. Any changes in fair value are recorded in other non-interest expense in the consolidated statements of income and other comprehensive income.

The notional amounts and estimated fair values of interest rate derivative positions outstanding at September 30, 2018 and December 31, 2017 are presented in the following tables (in thousands):

	September 30, 2018			December 31, 2017		
	Estimated Fair Value			Estimated Fair Value		
	Notional Amount	Asset Derivative	Liability Derivative	Notional Amount	Asset Derivative	Liability Derivative
Non-hedging interest rate derivatives:						
Financial institution counterparties:						
Commercial loan/lease interest rate swaps	\$ 1,593,483	\$ 21,796	\$ 4,691	\$ 1,393,764	\$ 4,736	\$ 15,482
Commercial loan/lease interest rate caps	567,490	2,525	17	242,700	421	7
Foreign currency forward contracts	50,975	2,441	—	2,466	4	69
Customer counterparties:						
Commercial loan/lease interest rate swaps	1,593,483	4,691	21,796	1,393,764	15,482	4,736
Commercial loan/lease interest rate caps	567,490	17	2,525	242,700	7	421
Foreign currency forward contracts	50,975	—	2,441	2,466	69	4
Economic hedging interest rate derivatives:						
Loan purchase commitments	308,933	1,104	81	253,815	635	190
Forward sales commitments	1,851,500	7,441	64	1,086,224	—	1,103
Gross derivatives		40,015	31,615		21,354	22,012
Offsetting derivative assets/liabilities		(4,234)	(4,234)		(4,635)	(4,635)
Net derivatives included in the consolidated balance sheets		\$ 35,781	\$ 27,381		\$ 16,719	\$ 17,377

The weighted average received and paid interest rates for interest rate swaps outstanding at September 30, 2018 and December 31, 2017 were as follows:

	September 30, 2018	September 30, 2018	December 31, 2017	December 31, 2017
	Weighted Average Interest Rate Received	Weighted Average Interest Rate Paid	Weighted Average Interest Rate Received	Weighted Average Interest Rate Paid
Non-hedging interest rate swaps	3.92%	4.17%	3.59%	4.34%

The weighted average strike rate for outstanding interest rate caps was 3.17% at September 30, 2018 and 2.40% at December 31, 2017.

Our credit exposure on derivative instruments is limited to the net favorable value and interest payments by each counterparty. In some cases collateral may be required from the counterparties involved if the net value of the derivative instruments exceeds a nominal amount. Our credit exposure associated with these instruments, net of any collateral pledged, was approximately \$20.9 million at September 30, 2018 and approximately \$16.7 million at December 31, 2017. Collateral levels are monitored and adjusted on a regular basis for changes in interest rate swap and cap values, as well as for changes in the value of forward sales commitments. At September 30, 2018, we had pledged to counterparties \$740,000 in cash collateral for these derivatives, all of which was included in interest-bearing deposits in other banks, and counterparties had pledged to us \$17.9 million in cash collateral included in interest-bearing deposits. At December 31, 2017, we had pledged to counterparties \$15.2 million in cash collateral for these derivatives, of which \$14.0 million was included in interest-bearing deposits in other banks and \$1.2 million was included in accrued interest receivable and other assets.

We also enter into credit risk participation agreements with financial institution counterparties for interest rate swaps related to loans in which we are either a participant or a lead bank. The risk participation agreements entered into by us as a participant

31

Table of Contents

bank provide credit protection to the financial institution counterparty should the borrower fail to perform on its interest rate derivative contract with that financial institution. We are party to 14 risk participation agreements where we are a participant bank having a notional amount of \$133.1 million at September 30, 2018, compared to 15 risk participation agreements having a notional amount of \$157.1 million at December 31, 2017. The maximum estimated exposure to these agreements, assuming 100% default by all obligors, was approximately \$120,000 at September 30, 2018 and \$221,000 at December 31, 2017. The fair value of these exposures was insignificant to the consolidated financial statements at both September 30, 2018 and December 31, 2017. Risk participation agreements entered into by us as the lead bank provide credit protection to us should the borrower fail to perform on its interest rate derivative contract with us. We are party to 10 risk participation agreements where we are the lead bank having a notional amount of \$122.4 million at September 30, 2018, compared to 10 agreements having a notional amount of \$86.3 million at December 31, 2017.

(13) NEW ACCOUNTING PRONOUNCEMENTS

ASU 2018-15 "Intangibles - Goodwill and Other - Internal-Use Software (Subtopic 350-40 - Customer's Accounting for Implementation Costs Incurred in a Cloud Computing Arrangement That Is a Service Contract)" ("ASU 2018-15") aligns the requirements for capitalizing implementation costs incurred in a hosting arrangement that is a service contract with the requirements for capitalizing implementation costs incurred to develop or obtain internal-use software (and hosting arrangements that include an internal-use software license). ASU 2018-15 will be effective for us on January 1, 2020 and is not expected to have an impact on our consolidated financial statements as we currently apply this guidance in practice.

ASU 2018-13 "Fair Value Measurement (Topic 820) - Changes to the Disclosure Requirements for Fair Value Measurement" ("ASU 2018-13") removes the requirement to disclose the amount of and reasons for transfers between Level 1 and Level 2 fair value measurement methodologies, the policy for timing of transfers between levels and the valuation processes for Level 3 fair value measurements. It also adds a requirement to disclose changes in unrealized gains and losses for the period included in other comprehensive income for recurring Level 3 fair value measurements held at the end of the reporting period and the range and weighted average of significant unobservable inputs used to develop Level 3 measurements. For certain unobservable inputs, entities may disclose other quantitative information in lieu of the weighted average if the other quantitative information would be a more reasonable and rational method to reflect the distribution of unobservable inputs used to develop Level 3 fair value measurements. ASU 2018-13 will be effective for us on January 1, 2020. We are evaluating the impact adoption will have on our disclosures.

ASU 2016-13 "Financial Instruments - Credit Losses (Topic 326)" ("ASU 2016-13") requires an entity to utilize a new impairment model known as the current expected credit loss ("CECL") model to estimate its lifetime "expected credit loss" and record an allowance that, when deducted from the amortized cost basis of the financial asset, presents the net amount expected to be collected on the financial asset. The CECL model is expected to result in more timely recognition of credit losses. ASU 2016-13 also requires new disclosures for financial assets measured at amortized cost, loans and available-for-sale debt securities. Entities will apply the standard's provisions as a cumulative-effect adjustment to retained earnings as of the beginning of the first reporting period in which the guidance is adopted. ASU 2016-13 will be effective for us on January 1, 2020. We are evaluating the impact adoption of ASU 2016-13 will have on our consolidated financial statements and disclosures. While we are currently unable to reasonably estimate the impact of adopting ASU 2016-13, we expect that the impact of adoption could be significantly influenced by the composition, characteristics and quality of our loan portfolio as well as the prevailing economic conditions and forecasts as of the adoption date. As part of our evaluation process, we have established a steering committee and working group that includes individuals from various functional areas to assess processes, portfolio segmentation, systems requirements and needed resources to implement this new accounting standard.

ASU 2016-02 "Leases (Topic 842)" ("ASU 2016-02") requires that lessees and lessors recognize lease assets and lease liabilities on the balance sheet and disclose key information about leasing arrangements. ASU 2016-02 will be effective for us on January 1, 2019. ASU 2016-02 provides for a modified retrospective transition approach requiring lessees to recognize and measure leases on the balance sheet at the beginning of either the earliest period presented or as of the beginning of the period of adoption with the option to elect certain practical expedients. We are electing to apply ASU 2016-02 as of the beginning of the period of adoption (January 1, 2019) and will not restate comparative

periods. We also expect to elect certain optional practical expedients. We have implemented a third party software solution to assist with the accounting under the new standard. Our operating leases relate primarily to office space and bank branches. Based on our current lease portfolio, we anticipate recognizing a lease liability and related right-of-use asset on our balance sheet, with an immaterial impact on our income statement compared to the current lease accounting model. However, the ultimate impact of the standard will depend on the company's lease portfolio as of the adoption date.

Table of Contents

QUARTERLY FINANCIAL SUMMARIES – UNAUDITED
 Consolidated Daily Average Balances, Average Yields and Rates
 (In thousands)

	For the three months ended September 30, 2018			For the three months ended September 30, 2017		
	Average Balance	Revenue/ Expense	Yield/ Rate	Average Balance	Revenue/ Expense	Yield/ Rate
Assets						
Investment securities – taxable	\$24,221	\$191	3.14 %	\$86,087	\$340	1.57 %
Investment securities – non-taxable(2)	91,298	1,228	5.33 %	—	—	— %
Federal funds sold and securities purchased under resale agreements	203,972	1,018	1.98 %	205,938	642	1.24 %
Interest-bearing deposits in other banks	1,697,787	8,386	1.96 %	2,383,060	7,544	1.26 %
Loans held for sale	1,484,459	17,272	4.62 %	1,009,703	9,882	3.88 %
Loans held for investment, mortgage finance	5,443,829	49,715	3.62 %	4,847,530	42,294	3.46 %
Loans held for investment(1)(2)	16,331,622	225,604	5.48 %	14,427,980	178,839	4.92 %
Less reserve for loan losses	179,227	—	—	172,774	—	—
Loans held for investment, net	21,596,224	275,319	5.06 %	19,102,736	221,133	4.59 %
Total earning assets	25,097,961	303,414	4.80 %	22,787,524	239,541	4.17 %
Cash and other assets	877,954			713,778		
Total assets	\$25,975,915			\$23,501,302		
Liabilities and Stockholders' Equity						
Transaction deposits	\$3,253,310	\$13,642	1.66 %	\$2,145,324	\$4,359	0.81 %
Savings deposits	7,820,742	29,930	1.52 %	7,618,843	17,152	0.89 %
Time deposits	1,778,831	8,462	1.89 %	496,076	924	0.74 %
Total interest-bearing deposits	12,852,883	52,034	1.61 %	10,260,243	22,435	0.87 %
Other borrowings	2,275,640	12,117	2.11 %	1,821,837	5,726	1.25 %
Subordinated notes	281,619	4,191	5.90 %	281,256	4,191	5.91 %
Trust preferred subordinated debentures	113,406	1,237	4.33 %	113,406	930	3.25 %
Total interest-bearing liabilities	15,523,548	69,579	1.78 %	12,476,742	33,282	1.06 %
Demand deposits	7,940,503			8,764,263		
Other liabilities	116,302			116,998		
Stockholders' equity	2,395,562			2,143,299		
Total liabilities and stockholders' equity	\$25,975,915			\$23,501,302		
Net interest income(2)		\$233,835			\$206,259	
Net interest margin			3.70 %			3.59 %
Net interest spread			3.02 %			3.11 %
Loan spread(3)			3.93 %			4.02 %

(1) The loan averages include non-accrual loans and are stated net of unearned income.

(2) Taxable equivalent rates used where applicable.

(3) Yield on loans, net of reserves, less funding cost including all deposits and borrowed funds.

Table of Contents

	For the nine months ended September 30, 2018			For the nine months ended September 30, 2017		
	Average Balance	Revenue/ Expense	Yield/ Rate	Average Balance	Revenue/ Expense	Yield/ Rate
Assets						
Investment securities – taxable	\$24,198	\$590	3.26 %	\$61,212	\$851	1.86 %
Investment securities – non-taxable(2)	30,767	1,228	5.33 %	74	3	4.85 %
Federal funds sold and securities purchased under resale agreements	210,531	2,808	1.78 %	218,777	1,606	0.98 %
Interest-bearing deposits in other banks	1,830,849	23,607	1.72 %	2,645,145	19,935	1.01 %
Loans held for sale	1,397,121	46,833	4.48 %	973,016	27,652	3.80 %
Loans held for investment, mortgage finance	4,818,342	134,133	3.72 %	3,811,298	98,798	3.47 %
Loans held for investment(1)(2)	15,883,407	637,692	5.37 %	13,714,390	485,226	4.73 %
Less reserve for loan losses	184,216	—	—	171,029	—	—
Loans held for investment, net	20,517,533	771,825	5.03 %	17,354,659	584,024	4.50 %
Total earning assets	24,010,999	846,891	4.72 %	21,252,883	634,071	3.99 %
Cash and other assets	828,147			651,270		
Total assets	\$24,839,146			\$21,904,153		
Liabilities and Stockholders' Equity						
Transaction deposits	\$2,980,386	\$32,587	1.46 %	\$2,054,701	\$9,445	0.61 %
Savings deposits	7,862,053	77,342	1.32 %	7,189,274	40,575	0.75 %
Time deposits	1,092,975	13,414	1.64 %	460,046	2,241	0.65 %
Total interest-bearing deposits	11,935,414	123,343	1.38 %	9,704,021	52,261	0.72 %
Other borrowings	2,039,010	28,915	1.90 %	1,539,208	11,626	1.01 %
Subordinated notes	281,528	12,573	5.97 %	281,167	12,573	5.98 %
Trust preferred subordinated debentures	113,406	3,457	4.08 %	113,406	2,641	3.11 %
Total interest-bearing liabilities	14,369,358	168,288	1.57 %	11,637,802	79,101	0.91 %
Demand deposits	8,034,509			8,062,792		
Other liabilities	109,044			112,505		
Stockholders' equity	2,326,235			2,091,054		
Total liabilities and stockholders' equity	\$24,839,146			\$21,904,153		
Net interest income(2)		\$678,603			\$554,970	
Net interest margin			3.78 %			3.49 %
Net interest spread			3.15 %			3.08 %
Loan spread(3)			4.07 %			4.02 %

(1) The loan averages include non-accrual loans and are stated net of unearned income.

(2) Taxable equivalent rates used where applicable.

(3) Yield on loans, net of reserves, less funding cost including all deposits and borrowed funds.

Table of Contents

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

Forward-Looking Statements

Certain statements and financial analysis contained in this report that are not historical facts are forward-looking statements made pursuant to the safe harbor provisions of federal securities laws. Forward-looking statements may also be contained in our future filings with SEC, in press releases and in oral and written statements made by us or with our approval that are not statements of historical fact. These forward-looking statements are based on our beliefs, assumptions and expectations of our future performance taking into account all information currently available to us. Words such as "believes," "expects," "estimates," "anticipates," "plans," "goals," "objectives," "expects," "intends," "seeks," "targeted," "continue," "remain," "will," "should," "may" and other similar expressions are intended to identify forward-looking statements but are not the exclusive means of identifying such statements.

Forward-looking statements may include, among other things, statements about the credit quality of our loan portfolio, economic conditions, including the continued impact on our customers from volatility in oil and gas prices, expectations regarding rates of default or loan losses, volatility in the mortgage industry, our business strategies and our expectations about future financial performance, future growth and earnings, the appropriateness of our allowance for loan losses and provision for credit losses, the impact of increased regulatory requirements on our business, increased competition, interest rate risk, new lines of business, new product or service offerings and new technologies. Forward-looking statements are subject to various risks and uncertainties, which change over time, are based on management's expectations and assumptions at the time the statements are made and are not guarantees of future results. Important factors that could cause actual results to differ materially from the forward-looking statements include, but are not limited to, the following:

- Deterioration of the credit quality of our loan portfolio or declines in the value of collateral related to external factors such as commodity prices, real estate values or interest rates, increased default rates and loan losses or adverse changes in the industry concentrations of our loan portfolio.

- Changing economic conditions or other developments adversely affecting our commercial, entrepreneurial and professional customers.

- Changes in the value of commercial and residential real estate securing our loans or in the demand for credit to support the purchase and ownership of such assets.

- Adverse economic conditions and other factors affecting our middle market customers and their ability to continue to meet their loan obligations.

- Unanticipated effects from the Tax Act may limit its benefits or adversely impact our business, which could include decreased demand for borrowing by our middle market customers or increased price competition that offsets the benefits of decreased federal income tax expense.

- The failure to correctly assess and model the assumptions supporting our allowance for loan losses, causing it to become inadequate in the event of deteriorations in loan quality and increases in charge-offs.

- Changes in the U.S. economy in general or the Texas economy specifically resulting in deterioration of credit quality, increases in non-performing assets or charge-offs or reduced demand for credit or other financial services we offer, including the effects from declines in the level of drilling and production related to the continued volatility in oil and gas prices.

- Adverse changes in economic or market conditions, in Texas, the United States or internationally, that could affect the credit quality of our loan portfolio or our operating performance.

- Unexpected market conditions or regulatory changes that could cause access to capital market transactions and other sources of funding to become more difficult to obtain on terms and conditions that are acceptable to us.

- The inadequacy of our available funds to meet our deposit, debt and other obligations as they become due, or our failure to maintain our capital ratios as a result of adverse changes in our operating performance or financial condition, or changes in applicable regulations or regulator interpretation of regulations impacting our business or the characterization or risk weight of our assets.

- The failure to effectively balance our funding sources with cash demands by depositors and borrowers.

-

The failure to manage information systems risk or to prevent cyber-attacks against us, our customers or our third party vendors, or to manage risks from disruptions or security breaches affecting us, our customers or our third party vendors.

35

Table of Contents

The failure to effectively manage our interest rate risk resulting from unexpectedly large or sudden changes in interest rates or rate or maturity imbalances in our assets and liabilities, and potential adverse effects to our borrowers including their inability to repay loans with increased interest rates.

Legislative and regulatory changes imposing further restrictions and costs on our business, a failure to remain well capitalized or well managed status or regulatory enforcement actions against us, and uncertainty related to future implementation and enforcement of regulatory requirements resulting from the current political environment.

The failure to successfully execute our business strategy, which may include expanding into new markets, developing and launching new lines of business or new products and services within the expected timeframes and budgets or to successfully manage the risks related to the development and implementation of these new businesses, products or services.

• The failure to attract and retain key personnel or the loss of key individuals or groups of employees.

• Increased or more effective competition from banks and other financial service providers in our markets.

• Structural changes in the markets for origination, sale and servicing of residential mortgages.

Uncertainty in the pricing of mortgage loans that we purchase, and later sell or securitize, as well as competition for the MSRMs related to these loans and related interest rate risk or price risk resulting from retaining MSRMs, and the potential effects of higher interest rates on our MCA loan volumes.

• Material failures of our accounting estimates and risk management processes based on management judgment, or the supporting analytical and forecasting models.

• Failure of our risk management strategies and procedures, including failure or circumvention of our controls.

• Credit risk resulting from our exposure to counterparties.

• An increase in the incidence or severity of fraud, illegal payments, security breaches and other illegal acts impacting our Bank and our customers.

• The failure to maintain adequate regulatory capital to support our business.

• Unavailability of funds obtained from borrowing or capital transactions or from our Bank to fund our obligations.

• Incurrence of material costs and liabilities associated with legal and regulatory proceedings and related matters with respect to the financial services industry, including those directly involving us or our Bank.

• Environmental liability associated with properties related to our lending activities.

• Severe weather, natural disasters, acts of war or terrorism and other external events.

Actual outcomes and results may differ materially from what is expressed in our forward-looking statements and from our historical financial results due to the factors discussed elsewhere in this report or disclosed in our other SEC filings. Forward-looking statements included herein speak only as of the date hereof and should not be relied upon as representing our expectations or beliefs as of any date subsequent to the date of this report. Except as required by law, we undertake no obligation to revise any forward-looking statements contained in this report, whether as a result of new information, future events or otherwise. The factors discussed herein are not intended to be a complete summary of all risks and uncertainties that may affect our businesses. For a more detailed discussion of these and other factors that may affect our business, see "Risk Factors" in the 2017 Form 10-K and other filings we have made with the SEC. Though we strive to monitor and mitigate risk, we cannot anticipate all potential economic, operational and financial developments that may adversely impact our operations and our financial results. Forward-looking statements should not be viewed as predictions and should not be the primary basis upon which investors evaluate an investment in our securities.

Overview of Our Business Operations

We commenced our banking operations in December 1998. An important aspect of our growth strategy has been our ability to service and manage effectively a large number of loans and deposit accounts in multiple markets in Texas, as well as several lines of business serving a regional or national clientele of commercial borrowers. Accordingly, we have created an operations infrastructure sufficient to support our lending and banking operations that we continue to build out as needed to serve a larger customer base and specialized industries.

The following discussion and analysis presents the significant factors affecting our financial condition as of September 30, 2018 and December 31, 2017 and results of operations for the three and nine month periods ended September 30, 2018 and

2017. This discussion should be read in conjunction with our consolidated financial statements and notes to the financial statements appearing in Part I, Item 1 of this report.

Results of Operations

Summary of Performance

We reported net income of \$85.6 million and net income available to common stockholders of \$83.1 million, or \$1.65 per diluted common share, for the third quarter of 2018 compared to net income of \$58.7 million and net income available to common stockholders of \$56.2 million, or \$1.12 per diluted common share, for the third quarter of 2017. Return on average common equity ("ROE") was 14.68% and return on average assets ("ROA") was 1.31% for the third quarter of 2018, compared to 11.20% and 0.99%, respectively, for the third quarter of 2017. The improved results for the quarter resulted primarily from an increase in net interest income, as well as a decrease in the provision for credit losses and decrease in income tax expense caused by a decrease in income tax rates as a result of the Tax Cuts and Jobs Act (the "Tax Act") which became effective on January 1, 2018, offset by an increase in non-interest expense. Net income and net income available to common stockholders for the nine months ended September 30, 2018 totaled \$228.9 million and \$221.6 million, respectively, or \$4.41 per diluted common share, compared to net income and net income available to common stockholders of \$152.3 million and \$145.0 million, respectively, or \$2.89 per diluted common share, for the same period in 2017. ROE was 13.62% and ROA was 1.23% for the nine months ended September 30, 2018 compared to 9.99% and 0.93%, respectively, for the same period in 2017. The improved results for the first nine months of 2018 resulted primarily from an increase in net interest income and a decrease in income tax expense caused by a decline in income tax rates as a result of the Tax Act, offset by increases in the provision for credit losses and non-interest expense.

Details of the changes in the various components of net income are discussed below.

Net Interest Income

Net interest income was \$232.2 million for the third quarter of 2018, compared to \$204.4 million for the third quarter of 2017. The increase was due to an increase in average earning assets of \$2.3 billion as compared to the third quarter of 2017, as well as the effect of increases in interest rates on loan yields. The increase in average earning assets included a \$474.8 million increase in average loans held for sale, a \$2.5 billion increase in average net loans held for investment and a \$29.4 million increase in average investment securities, offset by a \$687.2 million decrease in average liquidity assets. For the quarter ended September 30, 2018, average net loans held for investment, liquidity assets and loans held for sale represented approximately 86%, 8% and 6%, respectively, of average earning assets compared to approximately 85%, 11% and 4% for the same quarter of 2017.

Average interest-bearing liabilities for the quarter ended September 30, 2018 increased \$3.0 billion from the third quarter of 2017, which included a \$2.6 billion increase in average interest-bearing deposits and a \$453.8 million increase in other borrowings. Average demand deposits were \$7.9 billion for the quarter ended September 30, 2018, compared to \$8.8 billion for the same period of 2017. The average cost of total deposits and borrowed funds increased to 1.10% for the third quarter of 2018 compared to 0.54% for the same period of 2017. The cost of interest-bearing liabilities increased from 1.06% for the quarter ended September 30, 2017 to 1.78% for the same period of 2018. The decrease in demand deposits and the increases in deposit and funding costs reflect the impact of the rising interest rate environment and the shift to interest-bearing deposits.

Net interest income was \$674.2 million for the nine months ended September 30, 2018, compared to \$550.7 million for the same period of 2017. The increase was due to an increase in average earning assets of \$2.8 billion as compared to the nine months ended September 30, 2017, as well as the effect of increases in interest rates on loan yields. The increase in average earning assets included a \$424.1 million increase in average loans held for sale and a \$3.2 billion increase in average net loans held for investment, offset by a \$6.3 million decrease in average securities and an \$822.5 million decrease in average liquidity assets. For the nine months ended September 30, 2018, average net loans held for investment, liquidity assets and loans held for sale represented approximately 85%, 9% and 6%, respectively, of average earning assets compared to approximately 82%, 13% and 5% for the same period of 2017.

Edgar Filing: Starent Networks, Corp. - Form 3

Average interest-bearing liabilities for the nine months ended September 30, 2018 increased \$2.7 billion from the same period of 2017, which included a \$2.2 billion increase in average interest-bearing deposits and a \$499.8 million increase in other borrowings. Average demand deposits decreased from \$8.1 billion for the nine months ended September 30, 2017 to \$8.0 billion for the nine months ended September 30, 2018. The average cost of total deposits and borrowed funds increased to 0.92% for the nine months ended September 30, 2018 compared to 0.44% for the same period of 2017. The cost of interest-bearing liabilities increased from 0.91% for the nine months ended September 30, 2017 to 1.57% for the same period of 2018.

37

Table of Contents

The decrease in demand deposits and the increases in deposit and funding costs reflect the impact of the rising interest rate environment and the shift to interest-bearing deposits.

The following table (in thousands) presents changes in taxable-equivalent net interest income between the three and nine month periods ended September 30, 2018 and 2017 and identifies the changes due to differences in the average volume of earning assets and interest-bearing liabilities and changes due to differences in the average interest rate on those assets and liabilities.

	Three months ended			Nine months ended		
	September 30, 2018/2017			September 30, 2018/2017		
	Net	Change Due To(1)	Yield/Rate(2)	Net	Change Due To(1)	Yield/Rate(2)
	Change	Volume		Change	Volume	
Interest income:						
Investment securities	\$1,079	\$116	\$ 963	\$964	\$(121)	\$ 1,085
Loans held for sale	7,390	4,643	2,747	19,181	12,281	6,900
Loans held for investment, mortgage finance loans	7,421	5,200	2,221	35,335	26,026	9,309
Loans held for investment	46,765	23,607	23,158	152,466	76,387	76,079
Federal funds sold and securities purchased under resale agreements	376	(6)	382	1,202	(54)	1,256
Interest-bearing deposits in other banks	842	(2,176)	3,018	3,672	(6,116)	9,788
Total	63,873	31,384	32,489	212,820	108,403	104,417
Interest expense:						
Transaction deposits	9,283	2,262	7,021	23,142	4,387	18,755
Savings deposits	12,778	453	12,325	36,767	3,503	33,264
Time deposits	7,538	2,393	5,145	11,173	3,317	7,856
Other borrowings	6,391	1,430	4,961	17,289	3,728	13,561
Long-term debt	307	5	302	816	15	801
Total	36,297	6,543	29,754	89,187	14,950	74,237
Net interest income	\$27,576	\$24,841	\$ 2,735	\$123,633	\$93,453	\$ 30,180

(1) Yield/rate and volume variances are allocated to yield/rate.

(2) Taxable equivalent rates are used where applicable.

Net interest margin, which is defined as the ratio of net interest income to average earning assets, was 3.70% for the third quarter of 2018 compared to 3.59% for the third quarter of 2017. The year-over-year increase was due primarily to the increase in total average loans, improved asset composition and the effect of increases in interest rates on loan yields attributable to our asset-sensitive balance sheet. The yield on total loans held for investment increased to 5.06% for the third quarter of 2018 compared to 4.59% for the third quarter of 2017 and the yield on earning assets increased to 4.80% for the third quarter of 2018 compared to 4.17% for the third quarter of 2017. Funding costs, including demand deposits and borrowed funds, increased to 1.10% for the third quarter of 2018 compared to 0.54% for the third quarter of 2017. The spread on total earning assets, net of the cost of deposits and borrowed funds, was 3.70% for the third quarter of 2018 compared to 3.63% for the third quarter of 2017. The increase resulted primarily from increases in interest rates and increases in the higher yielding loan components of earning assets. Total funding costs, including all deposits, long-term debt and stockholders' equity, increased to 1.07% for the third quarter of 2018 compared to 0.56% for the third quarter of 2017.

Table of Contents

Non-interest Income

The components of non-interest income were as follows (in thousands):

	Three months		Nine months	
	ended September 30,		ended September 30,	
	2018	2017	2018	2017
Service charges on deposit accounts	\$3,477	\$3,211	\$9,619	\$9,323
Wealth management and trust fee income	2,065	1,627	5,996	4,386
Bank owned life insurance (BOLI) income	643	615	1,959	1,562
Brokered loan fees	6,141	6,152	17,124	17,639
Servicing income	4,987	4,486	15,446	10,387
Swap fees	1,355	647	4,269	3,404
Other	6,850	2,265	8,331	8,181
Total non-interest income	\$25,518	\$19,003	\$62,744	\$54,882

Non-interest income increased \$6.5 million during the three months ended September 30, 2018 compared to the same period of 2017. This increase was primarily due to a \$4.6 million increase in other non-interest income attributable to an increase in gain on sale of MCA loans, as well as a \$2.0 million gain on sale of OREO during the three months ended September 30, 2018 resulting from the sale of our largest OREO property.

Non-interest income increased \$7.9 million during the nine months ended September 30, 2018 compared to the same period of 2017. This increase was primarily due to a \$5.1 million increase in servicing income attributable to an increase in MSRs as well as a \$1.6 million increase in wealth management and trust fee income due to an increase in assets under management.

While management expects continued growth in certain components of non-interest income, the future rate of growth could be affected by increased competition from nationwide and regional financial institutions among other factors. In order to achieve growth in non-interest income, management from time to time evaluates new products, new lines of business and the expansion of existing lines of business. Any new product introduction or new market entry could place additional demands on capital and managerial resources.

Non-interest Expense

The components of non-interest expense were as follows (in thousands):

	Three months ended		Nine months ended	
	September 30,		September 30,	
	2018	2017	2018	2017
Salaries and employee benefits	\$77,327	\$67,882	\$222,268	\$194,039
Net occupancy expense	8,362	6,436	22,952	19,062
Marketing	10,214	7,242	29,127	18,349
Legal and professional	10,764	6,395	29,948	20,975
Communications and technology	7,435	6,002	21,211	24,414
FDIC insurance assessment	6,524	6,203	18,884	16,800
Servicing related expenses	4,207	3,897	12,379	8,329
Allowance and other carrying costs for OREO	(1,864)	105	467	315
Other(1)	13,174	10,668	37,998	30,455
Total non-interest expense	\$136,143	\$114,830	\$395,234	\$332,738

Other expense includes such items as courier expenses, regulatory assessments other than FDIC insurance, due (1) from bank charges and other general operating expenses, none of which account for 1% or more of total interest income and non-interest income.

Non-interest expense for the third quarter of 2018 increased \$21.3 million, or 19%, to \$136.1 million from \$114.8 million in the third quarter of 2017. The increase is primarily due to increases in salaries and employee benefits, net occupancy, marketing, legal and professional, communications and technology and other non-interest expenses, all of which were attributable to general business growth. Offsetting these increases was a \$2.0 million decrease in allowance and other carrying

Table of Contents

costs for OREO expense related to the above-mentioned sale of OREO. As a result of the sale, we reversed a \$2.0 million valuation allowance that was recorded on the property during the first quarter of 2018.

Non-interest expense for the nine months ended September 30, 2018 increased \$62.5 million, or 19%, to \$395.2 million from \$332.7 million for the nine months ended September 30, 2017. The increase is primarily due to increases in salaries and employee benefits, net occupancy expense, marketing, legal and professional, FDIC insurance assessment and other non-interest expenses, all of which were attributable to general business growth. Servicing related expenses for the nine months ended September 30, 2018 increased \$4.1 million compared to the nine months ended September 30, 2017 primarily due to an increase in MSR's, which are being amortized. Offsetting these increases was a \$3.2 million decrease in communications and technology expense primarily related to a technology write-off taken in the second quarter of 2017.

Analysis of Financial Condition

Loans Held for Investment

Loans were as follows as of the dates indicated (in thousands):

	September 30, 2018	December 31, 2017
Commercial	\$10,116,945	\$9,189,811
Mortgage finance	5,477,787	5,308,160
Construction	2,263,463	2,166,208
Real estate	3,924,682	3,794,577
Consumer	51,692	48,684
Leases	319,411	264,903
Gross loans held for investment	22,153,980	20,772,343
Deferred income (net of direct origination costs)	(106,655)	(97,931)
Allowance for loan losses	(190,306)	(184,655)
Total loans held for investment, net	\$21,857,019	\$20,489,757

Our business plan focuses primarily on lending to middle market businesses and successful professionals and entrepreneurs, and as such, commercial, real estate and construction loans have comprised a majority of our loan portfolio. Consumer loans generally have represented 1% or less of the portfolio. Mortgage finance loans relate to our mortgage warehouse lending operations in which we purchase mortgage loan ownership interests that are typically sold within 10 to 20 days. Volumes fluctuate based on the level of market demand for the product and the number of days between purchase and sale of the loans, as well as overall market interest rates and tend to peak at the end of each month.

We originate a substantial majority of all loans held for investment, excluding mortgage finance loans. We also participate in syndicated loan relationships, both as a participant and as an agent. As of September 30, 2018, we had \$2.1 billion in syndicated loans, \$502.3 million of which we administer as agent. All syndicated loans, whether we act as agent or participant, are underwritten to the same standards as all other loans we originate. As of September 30, 2018, \$35.0 million of our syndicated loans were on non-accrual.

Portfolio Geographic Concentration

More than 50% of our loan exposure is outside of Texas and more than 50% of our deposits are sourced outside of Texas. However, as of September 30, 2018, a majority of our loans held for investment, excluding our mortgage finance loans and other national lines of business, were to businesses with headquarters and operations in Texas. This geographic concentration subjects the loan portfolio to the general economic conditions within this area. We also make loans to these customers that are secured by assets located outside of Texas. The risks created by this concentration have been considered by management in the determination of the appropriateness of the allowance for loan losses.

Table of Contents

Summary of Loan Loss Experience

The provision for credit losses, which includes a provision for losses on unfunded commitments, is a charge to earnings to maintain the allowance for loan losses at a level consistent with management's assessment of the collectability of the loan portfolio in light of current economic conditions and market trends. We recorded a provision for credit losses of \$13.0 million during the third quarter of 2018 compared to \$20.0 million in the third quarter of 2017. The decrease in provision recorded during the third quarter of 2018 compared to the same period in 2017 was primarily related to improvements in the composition of our classified loan portfolios, including energy loans. The allowance for credit losses, including the allowance for losses on unfunded commitments reported on the consolidated balance sheet in other liabilities, totaled \$200.6 million at September 30, 2018, \$193.7 million at December 31, 2017 and \$192.7 million at September 30, 2017. The combined allowance as a percentage of loans held for investment excluding mortgage finance loans decreased to 1.21% at September 30, 2018 from 1.26% at December 31, 2017 and 1.30% at September 30, 2017 as a result of strong loan growth and overall positive trends in the credit quality of our portfolio.

The allowance for credit losses results from consistent application of our loan loss reserve methodology. At September 30, 2018, we believe the allowance is appropriate and has been derived from consistent application of our methodology. Should any of the factors considered by management in evaluating the appropriateness of the allowance for loan losses change, our estimate of inherent losses in the portfolio could also change, which would affect the level of future provisions for loan losses.

Table of Contents

Activity in the allowance for loan losses is presented in the following table (in thousands, except percentage and multiple data):

	Nine months ended September 30, 2018	Year ended December 31, 2017	Nine months ended September 30, 2017	
Allowance for loan losses:				
Beginning balance	\$184,655	\$168,126	\$168,126	
Loans charged-off:				
Commercial	45,273	34,145	32,146	
Construction	—	59	59	
Real estate	—	290	290	
Consumer	767	180	180	
Leases	319	—	—	
Total charge-offs	46,359	34,674	32,675	
Recoveries:				
Commercial	1,069	4,593	3,574	
Construction	—	104	104	
Real estate	43	75	74	
Consumer	78	70	56	
Leases	32	10	9	
Total recoveries	1,222	4,852	3,817	
Net charge-offs	45,137	29,822	28,858	
Provision for loan losses	50,788	46,351	43,661	
Ending balance	\$190,306	\$184,655	\$182,929	
Allowance for off-balance sheet credit losses:				
Beginning balance	\$9,071	\$11,422	\$11,422	
Provision for off-balance sheet credit losses	1,212	(2,351)	(1,661)	
Ending balance	\$10,283	\$9,071	\$9,761	
Total allowance for credit losses	\$200,589	\$193,726	\$192,690	
Total provision for credit losses	\$52,000	\$44,000	\$42,000	
Allowance for loan losses to LHI	0.86	% 0.89	% 0.89	%
Allowance for loan losses to LHI excluding mortgage finance loans(2)	1.15	% 1.20	% 1.23	%
Net charge-offs to average LHI(1)	0.29	% 0.16	% 0.22	%
Net charge-offs to average LHI excluding mortgage finance loans(1)(2)	0.38	% 0.21	% 0.28	%
Total provision for credit losses to average LHI(1)	0.34	% 0.24	% 0.32	%
Total provision for credit losses to average LHI excluding mortgage finance loans(1)(2)	0.44	% 0.31	% 0.41	%
Recoveries to total charge-offs	2.64	% 13.99	% 11.68	%
Allowance for off-balance sheet credit losses to off-balance sheet credit commitments	0.13	% 0.13	% 0.14	%
Total allowance for credit losses to LHI	0.91	% 0.94	% 0.94	%
Total allowance for credit losses to LHI excluding mortgage finance loans(2)	1.21	% 1.26	% 1.30	%
Allowance for loan losses to non-accrual loans	1.8x	1.8x	1.5x	

(1) Interim period ratios are annualized.

(2) The indicated ratios are presented with and excluding the mortgage finance loans because the risk profile of our mortgage finance loans is different than our other loans held for investment. No provision for credit losses is

allocated to these loans based on the internal risk grade assigned.

Table of Contents

Non-performing Assets

Non-performing assets include non-accrual loans and leases and repossessed assets. The table below summarizes our non-accrual loans by type and by type of property securing the credit and OREO (in thousands):

	September 30, 2018	December 31, 2017	September 30, 2017
Non-accrual loans:(1)			
Commercial			
Oil and gas properties	\$ 31,235	\$ 64,192	\$ 80,142
Assets of the borrowers	41,067	7,571	9,841
Inventory	30,182	24,399	23,121
Other	2,473	3,569	3,283
Total commercial	104,957	99,731	116,387
Real estate			
Commercial property	1,015	1,096	1,123
Unimproved land and/or developed residential lots	—	—	—
Single family residences	1,263	—	—
Other	237	617	695
Total real estate	2,515	1,713	1,818
Consumer	60	—	—
Leases	—	—	—
Total non-accrual loans	107,532	101,444	118,205
Repossessed assets:			
OREO	79	11,742	18,131
Other repossessed assets	—	—	—
Total non-performing assets	\$ 107,611	\$ 113,186	\$ 136,336
Loans held for investment past due 90 days and accruing(2)	\$ 11,295	\$ 8,429	\$ 8,892
Loans held for sale past due 90 days and accruing(3)	\$ 25,238	\$ 19,737	\$ —

(1) As of September 30, 2018, December 31, 2017 and September 30, 2017, non-accrual loans included \$22.5 million, \$18.8 million and \$12.0 million, respectively, in loans that met the criteria for restructured.

(2) At September 30, 2018, December 31, 2017 and September 30, 2017, loans past due 90 days and still accruing include premium finance loans of \$8.2 million, \$5.5 million and \$8.4 million, respectively.

(3) Includes loans guaranteed by U.S. government agencies that were repurchased out of Ginnie Mae securities. Loans are recorded as loans held for sale and carried at fair value on the balance sheet. Interest on these past due loans accrues at the debenture rate guaranteed by the U.S. government. Also includes loans that, pursuant to Ginnie Mae servicing guidelines, we have the unilateral right, but not the obligation, to repurchase if defined delinquent loan criteria are met and therefore must record as loans held for sale on our balance sheet regardless of whether the repurchase option has been exercised.

Potential problem loans consist of loans that are performing in accordance with contractual terms but for which we have concerns about the borrower's ability to comply with repayment terms because of the borrower's potential financial difficulties. We monitor these loans closely and review their performance on a regular basis. At September 30, 2018, we had \$39.3 million in loans of this type, compared to \$49.1 million at December 31, 2017, which were not included in either non-accrual or 90 days past due categories.

Table of Contents

Loans Held for Sale

Through our MCA program, we commit to purchase residential mortgage loans from independent correspondent lenders and deliver those loans into the secondary market via whole loan sales to independent third parties or in securitization transactions to Ginnie Mae and GSEs such as Fannie Mae and Freddie Mac. For additional information on our loans held for sale portfolio, see Note 6 - Certain Transfers of Financial Assets in the accompanying notes to the consolidated financial statements included elsewhere in this report.

44

Table of Contents

Liquidity and Capital Resources

In general terms, liquidity is a measurement of our ability to meet our cash needs. Our objective in managing our liquidity is to maintain our ability to meet loan commitments, purchase investment securities or repay deposits and other liabilities in accordance with their terms, without an adverse impact on our current or future earnings. Our liquidity strategy is guided by policies, formulated and monitored by our senior management and our Balance Sheet Management Committee ("BSMC"), which take into account the demonstrated marketability of assets, the sources and stability of our funding and the level of unfunded commitments. We regularly evaluate all of our various funding sources with an emphasis on accessibility, stability, reliability and cost effectiveness. For the year ended December 31, 2017 and for the nine months ended September 30, 2018 our principal source of funding has been our customer deposits, supplemented by our short-term and long-term borrowings, primarily from Federal funds purchased and Federal Home Loan Bank ("FHLB") borrowings, which are generally used to fund mortgage finance assets.

Liquidity assets were \$2.6 billion at September 30, 2018, and continue to be significant as a result of deposit growth and increases in borrowing capacity related to our mortgage finance loans. The following table summarizes the composition of liquidity assets (in thousands):

	September 30, 2018	December 31, 2017	September 30, 2017
Federal funds sold and securities purchased under resale agreements	\$ 30,000	\$ 30,000	\$ 25,000
Interest-bearing deposits in other banks	2,585,570	2,697,581	2,332,537
Total liquidity assets	\$2,615,570	\$2,727,581	\$2,357,537

Total liquidity assets as a percent of:

Total loans held for investment, excluding mortgage finance loans	15.8	% 17.8	% 15.9	%
Total loans held for investment	11.9	% 13.2	% 11.5	%
Total earning assets	10.0	% 11.2	% 10.0	%
Total deposits	12.8	% 14.3	% 12.4	%

Our liquidity needs to support growth in loans held for investment have been fulfilled primarily through growth in our core customer deposits. Our goal is to obtain as much of our funding for loans held for investment and other earning assets as possible from deposits of these core customers. These deposits are generated principally through development of long-term relationships with customers, with a significant focus on treasury management products. In addition to deposits from our core customers, we also have access to deposits through brokered customer relationships. For regulatory purposes, these relationship brokered deposits are categorized as brokered deposits; however, since these deposits arise from a customer relationship, which involves extensive treasury services, we consider these deposits to be core deposits for our reporting purposes.

Table of Contents

We also have access to incremental deposits through brokered retail certificates of deposit, or CDs. These traditional brokered deposits are generally of short maturities, 30 to 90 days, and are used to fund temporary differences in the growth in loan balances, including growth in loans held for sale or other specific categories of loans as compared to customer deposits. The following table summarizes our period-end and average year-to-date core customer deposits, relationship brokered deposits and traditional brokered deposits (in millions):

	September 30, 2018	December 31, 2017	September 30, 2017	
Deposits from core customers	\$ 17,044.4	\$ 17,100.8	\$ 17,259.2	
Deposits from core customers as a percent of total deposits	83.6	% 89.4	% 90.5	%
Relationship brokered deposits	\$ 1,813.0	\$ 2,022.4	\$ 1,822.1	
Relationship brokered deposits as a percent of total deposits	8.9	% 10.6	% 9.5	%
Traditional brokered deposits	\$ 1,528.2	\$—	\$—	
Traditional brokered deposits as a percent of total deposits	7.5	% —	% —	%
Average deposits from core customers(1)	\$ 17,477.8	\$ 16,806.9	\$ 16,239.7	
Average deposits from core customers as a percent of total quarterly average deposits(1)	87.5	% 91.1	% 91.4	%
Average relationship brokered deposits(1)	\$ 1,878.6	\$ 1,647.0	\$ 1,527.1	
Average relationship brokered deposits as a percent of total quarterly average deposits(1)	9.4	% 8.9	% 8.6	%
Average traditional brokered deposits(1)	\$ 613.5	\$—	\$—	
Average traditional brokered deposits as a percent of total quarterly average deposits(1)	3.1	% —	% —	%

(1) Annual averages presented for December 31, 2017.

We have access to sources of traditional brokered deposits that we estimate to be \$4.0 billion. Based on our internal guidelines, we have chosen to limit our use of these sources to a lesser amount. Customer deposits (total deposits, including relationship brokered deposits, minus brokered CDs) at September 30, 2018 decreased by \$265.8 million from December 31, 2017 and decreased \$223.9 million from September 30, 2017.

We have short-term borrowing sources available to supplement deposits and meet our funding needs. Such borrowings are generally used to fund our mortgage finance assets, due to their liquidity, short duration and interest spreads available. These borrowing sources include Federal funds purchased from our downstream correspondent bank relationships (which consist of banks that are smaller than our bank) and from our upstream correspondent bank relationships (which consist of banks that are larger than our bank), customer repurchase agreements, and advances from the FHLB and the Federal Reserve. The following table summarizes our short-term borrowings as of September 30, 2018 (in thousands):

Federal funds purchased	\$475,842
Repurchase agreements	10,976
FHLB borrowings	3,200,000
Line of credit	—
Total short-term borrowings	\$3,686,818
Maximum short-term borrowings outstanding at any month-end during 2018	\$4,520,849

The following table summarizes our other borrowing capacities in excess of balances outstanding at September 30, 2018 (in thousands):

FHLB borrowing capacity relating to loans	\$4,922,080
FHLB borrowing capacity relating to investment securities	761
Total FHLB borrowing capacity	\$4,922,841
Unused Federal funds lines available from commercial banks	\$722,000

Table of Contents

The following table summarizes our long-term borrowings as of September 30, 2018 (in thousands):

Subordinated notes	\$281,677
Trust preferred subordinated debentures	113,406
Total long-term borrowings	\$395,083

We have an unsecured, revolving, non-amortizing line of credit with maximum availability of \$130.0 million with a maturity date of December 18, 2018. The loan proceeds may be used for general corporate purposes including funding regulatory capital infusions into the Bank. The loan agreement contains customary financial covenants and restrictions. As of September 30, 2018 and December 31, 2017, there were no borrowings outstanding.

Our equity capital, including \$150 million in preferred stock, averaged \$2.3 billion for the nine months ended September 30, 2018, as compared to \$2.1 billion for the same period in 2017. We have not paid any cash dividends on our common stock since we commenced operations and have no plans to do so in the foreseeable future.

As of September 30, 2018, our capital ratios were above the levels required to be well capitalized. We believe that our earnings, periodic capital raising transactions and the addition of loan and deposit relationships will allow us to continue to grow organically.

Table of Contents

Commitments and Contractual Obligations

The following table presents significant fixed and determinable contractual payment obligations to third parties by payment date. Payments for borrowings do not include interest. Payments related to leases are based on actual payments specified in the underlying contracts. As of September 30, 2018, our significant fixed and determinable contractual obligations to third parties, excluding interest, were as follows (in thousands):

	Within One Year	After One but Within Three Years	After Three but Within Five Years	After Five Years	Total
Deposits without a stated maturity	\$ 18,381,151	\$ —	\$ —	\$—	\$ 18,381,151
Time deposits	1,983,370	20,311	355	450	2,004,486
Federal funds purchased and customer repurchase agreements	486,818	—	—	—	486,818
FHLB borrowings	3,200,000	—	—	—	3,200,000
Operating lease obligations(1)	16,798	33,115	30,203	32,280	112,396
Subordinated notes	—	—	—	281,677	281,677
Trust preferred subordinated debentures	—	—	—	113,406	113,406
Total contractual obligations	\$ 24,068,137	\$ 53,426	\$ 30,558	\$ 427,813	\$ 24,579,934

(1) Non-balance sheet item.

Critical Accounting Policies

SEC guidance requires disclosure of “critical accounting policies.” The SEC defines “critical accounting policies” as those that are most important to the presentation of a company’s financial condition and results, and require management’s most difficult, subjective or complex judgments, often as a result of the need to make estimates about the effect of matters that are inherently uncertain.

We follow financial accounting and reporting policies that are in accordance with accounting principles generally accepted in the United States. The more significant of these policies are summarized in Note 1 - Operations and Summary of Significant Accounting Policies in the accompanying notes to the consolidated financial statements included in the 2017 Form 10-K. Not all significant accounting policies require management to make difficult, subjective or complex judgments. However, the policy noted below could be deemed to meet the SEC’s definition of a critical accounting policy.

Allowance for Loan Losses

Management considers the policies related to the allowance for loan losses as the most critical to the financial statement presentation. The total allowance for loan losses includes activity related to allowances calculated in accordance with Accounting Standards Codification (“ASC”) 310, Receivables, and ASC 450, Contingencies. The allowance for loan losses is established through a provision for credit losses charged to current earnings. The amount maintained in the allowance reflects management’s continuing evaluation of the loan losses inherent in the loan portfolio. The allowance for loan losses is comprised of specific reserves assigned to certain classified loans and general reserves. Factors contributing to the determination of specific reserves include the creditworthiness of the borrower, and more specifically, changes in the expected future receipt of principal and interest payments and/or in the value of pledged collateral. A reserve is recorded when the carrying amount of the loan exceeds the discounted estimated cash flows using the loan’s initial effective interest rate or the fair value of the collateral for certain collateral-dependent loans. For purposes of determining the general allowance, the portfolio is segregated by product types in order to recognize differing risk profiles among categories, and then further segregated by credit grades. See “Summary of Loan Loss Experience” above and Note 4 – Loans Held for Investment and Allowance for Loan Losses in the accompanying notes to the consolidated financial statements included elsewhere in this report for further discussion of the risk factors considered by management in establishing the allowance for loan losses.

Table of Contents**ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

Market risk is a broad term for the risk of economic loss due to adverse changes in the fair value of a financial instrument. These changes may be the result of various factors, including interest rates, foreign exchange rates, commodity prices, or equity prices. Additionally, the financial instruments subject to market risk can be classified either as held for trading purposes or held for other than trading.

We are subject to market risk primarily through the effect of changes in interest rates on our portfolio of assets held for purposes other than trading. Additionally, we have some market risk relative to commodity prices through our energy lending activities. Petroleum and natural gas commodity prices were suppressed throughout 2015 and 2016, but stabilized amidst continuing market uncertainty during 2017 and continuing into 2018. Declines in commodity prices negatively impacted our energy clients' ability to perform on their loan obligations, and further uncertainty and volatility could have a negative impact on our customers and our loan portfolio. Management does not currently expect the current decline in commodity prices to have a material adverse effect on our financial position. Foreign exchange rates, commodity prices and/or equity prices do not pose significant market risk to us.

The responsibility for managing market risk rests with the BSMC, which operates under policy guidelines established by our board of directors. The negative acceptable variation in net interest revenue due to a 200 basis point increase or decrease in interest rates is generally limited by these guidelines to plus or minus 10-15%. These guidelines also establish maximum levels for short-term borrowings, short-term assets and public and brokered deposits. They also establish minimum levels for liquidity, among other things. Oversight of our compliance with these guidelines is the ongoing responsibility of the BSMC, with exceptions reported to the Risk Management Committee, and to our board of directors if deemed necessary, on a quarterly basis. Additionally, the Credit Policy Committee ("CPC") specifically manages risk relative to commodity price market risks. The CPC establishes maximum portfolio concentration levels for energy loans as well as maximum advance rates for energy collateral.

Interest Rate Risk Management

Our interest rate sensitivity is illustrated in the following table. The table reflects rate-sensitive positions as of September 30, 2018, and is not necessarily indicative of positions on other dates. The balances of interest rate sensitive assets and liabilities are presented in the periods in which they next reprice to market rates or mature and are aggregated to show the interest rate sensitivity gap. The mismatch between repricings or maturities within a time period is commonly referred to as the "gap" for that period. A positive gap (asset sensitive), where interest-rate sensitive assets exceed interest rate sensitive liabilities, generally will result in the net interest margin increasing in a rising rate environment and decreasing in a falling rate environment. A negative gap (liability sensitive) will generally have the opposite results on the net interest margin. To reflect anticipated prepayments, certain asset and liability categories are shown in the table using estimated cash flows rather than contractual cash flows. The Company employs interest rate floors in certain variable rate loans to enhance the yield on those loans at times when market interest rates are extraordinarily low. The degree of asset sensitivity, spreads on loans and net interest margin may be reduced until rates increase by an amount sufficient to eliminate the effects of floors. The adverse effect of floors as market rates increase may also be offset by the positive gap, the extent to which rates on deposits and other funding sources lag increasing market rates and changes in composition of funding.

Table of Contents

Interest Rate Sensitivity Gap Analysis

September 30, 2018

(In thousands)

	0-3 mo Balance	4-12 mo Balance	1-3 yr Balance	3+ yr Balance	Total Balance
Assets:					
Interest-bearing deposits in other banks, federal funds sold and securities purchased under resale agreements	\$2,615,570	\$—	—	\$—	\$2,615,570
Investment securities(1)	11,644	16,728	34,402	54,615	117,389
Total variable loans	19,626,616	33,861	1,985	832	19,663,294
Total fixed loans	577,862	1,740,568	436,750	1,387,436	4,142,616
Total loans(2)	20,204,478	1,774,429	438,735	1,388,268	23,805,910
Total interest sensitive assets	\$22,831,692	\$1,791,157	\$473,137	\$1,442,883	\$26,538,869
Liabilities:					
Interest-bearing customer deposits	\$9,821,495	\$—	\$—	\$—	\$9,821,495
CDs & IRAs	849,125	1,134,245	20,311	805	2,004,486
Traditional brokered deposits	1,528,196	—	—	—	1,528,196
Total interest-bearing deposits	12,198,816	1,134,245	20,311	805	13,354,177
Repurchase agreements, Federal funds purchased, FHLB borrowings, line of credit	3,686,818	—	—	—	3,686,818
Subordinated notes	—	—	—	281,677	281,677
Trust preferred subordinated debentures	—	—	—	113,406	113,406
Total borrowings	3,686,818	—	—	395,083	4,081,901
Total interest sensitive liabilities	\$15,885,634	\$1,134,245	\$20,311	\$395,888	\$17,436,078
Gap	\$6,946,058	\$656,912	\$452,826	\$1,046,995	\$—
Cumulative Gap	6,946,058	7,602,970	8,055,796	9,102,791	9,102,791
Demand deposits					\$7,031,460
Stockholders' equity					2,426,442
Total					\$9,457,902

(1) Investment securities based on fair market value.

(2) Loans are stated at gross.

The table above sets forth the balances as of September 30, 2018 for interest-bearing assets, interest-bearing liabilities and the total of non-interest-bearing deposits and stockholders' equity. While a gap interest table is useful in analyzing interest rate sensitivity, an interest rate sensitivity simulation provides a better illustration of the sensitivity of earnings to changes in interest rates. Earnings are also affected by changing interest rates on the value of funding derived from demand deposits and stockholders' equity. We perform a sensitivity analysis to identify interest rate risk exposure on net interest income. We quantify and measure interest rate risk exposure using a model to dynamically simulate the effect of changes in net interest income relative to changes in interest rates and loan and deposit account balances over the next twelve months based on three interest rate scenarios. These are a "most likely" rate scenario and two "shock test" scenarios.

The "most likely" rate scenario is based on the consensus forecast of future interest rates published by independent sources. These forecasts incorporate future spot rates and relevant spreads of instruments that are actively traded in the open market. The Federal Reserve's Federal funds target affects short-term borrowing rates; the prime lending rate and LIBOR are the basis for most of our variable-rate loan pricing. The 10-year mortgage rate is also monitored because of its effect on prepayment speeds for mortgage-backed securities. We believe these are our primary interest rate

exposures. We are not currently using derivatives to manage our interest rate exposure.

50

Table of Contents

For modeling purposes, as of September 30, 2018, the “shock test” scenarios assume a sustained parallel 100 and 200 basis point increase in interest rates, as well as a 100 basis point decrease in rates. As of September 30, 2017, the scenarios assumed a sustained parallel 100 and 200 basis point increase in interest rates. As short-term rates remained low through 2017, we did not believe that analysis of an assumed decrease in interest rates would provide meaningful results.

Our interest rate risk exposure model incorporates assumptions regarding the level of interest rate or balance changes on indeterminable maturity deposits (demand deposits, interest-bearing transaction accounts and savings accounts) for a given level of market rate changes. Given the current environment of increasing short-term rates, deposit pricing can vary by product and customer. These assumptions have been developed through a combination of historical analysis and future expected pricing behavior. Changes in prepayment behavior of mortgage-backed securities, residential and commercial mortgage loans in each rate environment are captured using industry estimates of prepayment speeds for various coupon segments of the portfolio. The impact of planned growth and new business activities is factored into the simulation model. This modeling indicated interest rate sensitivity as follows (in thousands):

	Anticipated Impact Over the Next Twelve Months as Compared to Most Likely Scenario			Anticipated Impact Over the Next Twelve Months as Compared to Most Likely Scenario	
	100 bp Increase	200 bp Increase	100 bp Decrease	100 bp Increase	200 bp Increase
	September 30, 2018			September 30, 2017	
Change in net interest income	\$ 106,977	\$ 214,641	\$ (111,867)	\$ 114,593	\$ 231,113

The simulations used to manage market risk are based on numerous assumptions regarding the effect of changes in interest rates on the timing and extent of repricing characteristics, future cash flows and customer behavior. These assumptions are inherently uncertain and, as a result, the model cannot precisely estimate net interest income or precisely predict the impact of higher or lower interest rates on net interest income. Actual results may differ from simulated results due to timing, magnitude and frequency of interest rate changes as well as changes in market conditions and management strategies, among other factors.

Table of Contents

ITEM 4. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

Our management, with the supervision and participation of our Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the "Exchange Act")) as of the end of the period covered by this report. Based upon that evaluation, we have concluded that, as of the end of such period, our disclosure controls and procedures were effective in recording, processing, summarizing and reporting, on a timely basis, information required to be disclosed by us in the reports that we file or submit under the Exchange Act and were effective in ensuring that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is accumulated and communicated to the Company's management, including our Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

Changes in Internal Control over Financial Reporting

There were no changes in our internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) during the period covered by this report that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II—OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

We are subject to various claims and legal actions related to operating activities that arise in the ordinary course of business. Management does not currently expect the ultimate disposition of these matters to have a material adverse impact on our financial statements.

ITEM 1A. RISK FACTORS

There have been no material changes in the risk factors previously disclosed in the 2017 Form 10-K.

Table of Contents

ITEM 6. EXHIBITS

(a) Exhibits

- 31.1 Certification of Chief Executive Officer pursuant to Rule 13a-14(a) of the Exchange Act, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002, filed herewith.
- 31.2 Certification of Chief Financial Officer pursuant to Rule 13a-14(a) of the Exchange Act, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002, filed herewith.
- 32.1 Certification of Chief Executive Officer pursuant to Rule 13a-14(b) of the Exchange Act and 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, furnished herewith.
- 32.2 Certification of Chief Financial Officer pursuant to Rule 13a-14(b) of the Exchange Act and 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, furnished herewith.

- 101 The following materials from Texas Capital Bancshares, Inc.'s Quarterly Report on Form 10-Q for the quarter ended September 30, 2018, formatted in XBRL (eXtensible Business Reporting Language): (i) Consolidated Statements of Income, (ii) Consolidated Balance Sheets, (iii) Consolidated Statements of Cash Flows, and (iv) Notes to Consolidated Financial Statements

Table of Contents

SIGNATURES

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

TEXAS CAPITAL BANCSHARES, INC.

Date: October 17, 2018

/s/ Julie Anderson

Julie Anderson

Chief Financial Officer

(Duly authorized officer and principal financial officer)

54