SP Bancorp, Inc.
Form 10-K
February 28, 2014
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

x **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the fiscal ended December 31, 2013.

OR

¨ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the transition period from ______ to ______.

Commission file number: 001-34933

SP BANCORP, INC.

(Exact name of registrant as specified in its charter)

Maryland	**27-3347359**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification Number)**
5224 West Plano Parkway, Plano, Texas	**75093**
(Address of principal executive offices)	**(Zip Code)**

Registrant s telephone number, including area code: (972) 931-5311

Securities registered pursuant to Section 12(b) of the Act:

Common Stock, par value $0.01 per share	**The NASDAQ Stock Market LLC**
(Title of each class)	(Name of each exchange on which registered)

Securities registered pursuant to Section 12(g) of the Act:

None

Indicate by check mark if the Registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. YES ¨ NO x

Indicate by check mark if the Registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. YES ¨ NO x

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

Indicate by check mark whether the Registrant has submitted electronically and posted on its corporate website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the Registrant was required to submit and post such files). YES x NO ¨

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§229.405 of this chapter) is not contained herein, and will not be contained, to the best of Registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. ¨

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

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

Indicate by check mark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Act). YES ¨ NO x

The aggregate market value of the voting and non-voting common equity held by non-affiliates of the Registrant, computed by reference to the last sale price on June 30, 2013, as reported by the Nasdaq Stock Market, was approximately $28.6 million.

As of February 27, 2014, there were issued and outstanding 1,602,563 shares of the Registrant s Common Stock.

DOCUMENTS INCORPORATED BY REFERENCE:

The information required by Part III of this Annual Report on Form 10-K, to the extent not set forth herein, is incorporated by reference from the Registrant s Definitive Proxy Statement relating to the 2013 Annual Meeting of Stockholders, and any adjournment or postponement thereof, to be filed with the Securities and Exchange Commission within 120 days after the end of the fiscal year to which this Annual Report on Form 10-K relates.

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PART I

ITEM 1. Business
SP Bancorp, Inc.

SP Bancorp, Inc., a Maryland corporation (the Company) is a bank holding company and the parent of SharePlus Bank, a Texas chartered state bank (the Bank). The Company is regulated by the Board of Governors of the Federal Reserve System (the Federal Reserve). In December 2013, the Bank received approval from the Texas Department of Banking (the Department) to convert its charter to a Texas state bank charter and became a member of the Federal Reserve and the Company became a bank holding company. With these changes, the Department and the Federal Reserve are the primary regulators of the Bank and the Company is regulated by the Federal Reserve as a bank holding company. The Bank is subject to examination by the Federal Deposit Insurance Corporation (the FDIC). When using the terms we, us, our, or the Company, are referring to SP Bancorp and the Bank on a consolidated basis.

As of December 31, 2013, we had $304.0 million of total assets, $220.1 million of loans, net, including loans held for sale, $261.3 million of deposits and $32.8 million of total stockholders equity on a consolidated basis.

All information presented in this Annual Report on Form 10-K (this Annual Report) that relates to a period prior to the completion of our initial public offering on October 29, 2010, including the consolidated financial data presented as of and for the years ended December 31, 2009 and earlier, refers to the Bank.

Our executive offices are located at 5224 W. Plano Parkway, Plano, Texas 75093. Our telephone number at this address is (972) 931-5311. Our website address is www.shareplus.com. A copy of this Annual Report is available on our website. Information on our website is not incorporated into this Annual Report and should not be considered part of this Annual Report.

SharePlus Bank

The Bank is a Texas chartered bank headquartered in Plano, Texas. The Bank was originally chartered in 1958 as a federal credit union serving the employees and family members of Frito-Lay, Inc. Over the years and through a series of mergers, the credit union also grew to serve the employees and family members of YUM! Brands, Inc., A&W Restaurants, Inc., KFC Corporation, Long John Silver s, Inc., Pizza Hut, Inc., Taco Bell Corporation, and various PepsiCo divisions, as well as dozens of other companies that provided banking services to their employees. Throughout this Annual Report these companies are sometimes referred to as our former sponsor companies.

The Bank operates as a full-service commercial bank, providing services that include the acceptance of checking and savings deposits, the origination of one- to four-family residential mortgage, mortgage warehouse, commercial real estate, commercial business, home equity, automobile and personal loans. In addition to the Bank s home office in Plano, Texas, the Bank has three branches as of December 31, 2013: one located near downtown Dallas, Texas; one located near the Bank s headquarters in Plano, Texas; and one located in Louisville, Kentucky. In June 2013, the Bank closed its Irvine, California branch, and in March 2013, the Bank closed one of its branches located in Louisville, Kentucky, but an agency office remains there.

Our business consists primarily of taking deposits from the general public and investing those deposits, together with funds generated from operations and borrowings, in mortgage loans secured by residential real estate, home equity loans and lines of credit, commercial real estate loans, consumer loans (consisting primarily of automobile loans) and commercial business loans. At December 31, 2013, $190.8 million, or 86.2% of our total loan portfolio was comprised of residential and commercial real estate loans. We also offer brokerage services for the purchase and sale of non-deposit investment and insurance products through a third-party brokerage arrangement.

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The majority of our residential and commercial real estate loans are originated through our Texas branch network and are collateralized by properties within this market area. Additionally, we are a preferred lender through various employee loan programs and executive relocation loan programs for certain of our former sponsor companies. As a result of these programs a portion of our residential real estate loan portfolio is collateralized by properties outside of our Texas market area.

We also invest in investment securities, primarily consisting of government sponsored mortgage-backed securities and collateralized mortgage obligations guaranteed by Fannie Mae and Freddie Mac, and to a lesser extent, municipal obligations, small business administration obligations and agency bonds.

We offer a variety of deposit accounts, including noninterest-bearing and interest-bearing demand accounts, savings accounts, money market accounts and certificates of deposit.

Forward Looking Statements

This Annual Report contains forward-looking statements, which can be identified by the use of words such as estimate, project, believe, intend, anticipate, plan, seek, expect, may and words of similar meaning. These forward-looking statements include, but are not limited to:

- statements of our goals, intentions and expectations;
- statements regarding our business plans, prospects, growth and operating strategies;
- statements regarding the asset quality of our loan and investment portfolios; and
- estimates of our risks and future costs and benefits.

These forward-looking statements are based on our current beliefs and expectations and are inherently subject to significant business, economic and competitive uncertainties and contingencies, many of which are beyond our control. In addition, these forward-looking statements are subject to assumptions with respect to future business strategies and decisions that are subject to change. We are under no duty to and do not take any obligation to update any forward-looking statements after the date of this Annual Report, except as may be required by applicable law.

The following factors, among others, could cause actual results to differ materially from the anticipated results or other expectations expressed in the forward-looking statements:

- general economic conditions, either nationally or in our market areas, that are worse than expected;
- competition among depository and other financial institutions;
- changes in the interest rate environment that reduce our margins or reduce the fair value of financial instruments;
- adverse changes in the securities markets;
- changes in laws or government regulations or policies affecting financial institutions, including changes in regulatory fees and capital requirements;

our ability to enter new markets successfully and capitalize on growth opportunities;

our ability to successfully integrate acquired entities, if any;

changes in consumer spending, borrowing and savings habits;

changes in accounting policies and practices, as may be adopted by the bank regulatory agencies, the Financial Accounting Standards Board (the FASB), the Securities and Exchange Commission (the SEC) and the Public Company Accounting Oversight Board;

changes in federal, state and local tax rates;

our ability to attract and retain key personnel;

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- changes in our organization, compensation and benefit plans;
- changes in our financial condition or results of operations that reduce capital; and
- changes in the financial condition or future prospects of issuers of securities that we own.

Because of these and a wide variety of other uncertainties, our future results may be materially different from the results indicated by these forward-looking statements. See Risk Factors for additional risks and uncertainties that may affect our business.

Market Areas

Our primary market area consists of the communities located in the Dallas-Fort Worth-Arlington metropolitan statistical area, which includes the cities of Plano and Dallas and Collin County and Dallas County. This region is also known as the Dallas-Fort Worth Metroplex or the DFW Metroplex and encompasses 12 counties in North Texas. The city of Plano is a suburb north of Dallas and is one of the largest cities in Texas.

Plano is the corporate headquarters for some of the country s largest and most recognized companies with the following companies having their headquarters (or major regional offices) in Plano: Capital One Auto Finance, Dr. Pepper Snapple Group (formerly Cadbury Schweppes Americas Beverages), Cinemark Theatres, Frito Lay, J.C. Penney, Dell Perot Systems and Rent-A-Center. The total area of the DFW Metroplex contains 9,286 square miles. Its size makes it larger than the area of Rhode Island and Connecticut combined.

In addition to serving the DFW Metroplex, we also serve retail customers (primarily employees of our former sponsor companies) through one branch office and one agency office located in Louisville, Kentucky. Louisville is the largest city in the state of Kentucky and is home to the University of Louisville and many major corporations and organizations.

Competition

We face intense competition in our market areas, both in making loans and attracting deposits. We compete with commercial banks, savings institutions, mortgage brokerage firms, credit unions, finance companies, mutual funds, insurance companies and investment banking firms. Many of our competitors have greater name recognition and market presence and offer certain services that we do not or cannot provide. Our deposit sources are primarily concentrated in the communities surrounding our banking offices, located in the Dallas-Fort Worth Metroplex and surrounding communities in North Texas.

Lending Activities

Our principal lending activities include the origination of mortgage loans secured by residential and commercial real estate, home equity loans, including lines of credit and home improvement loans, consumer loans (consisting primarily of automobile loans) and commercial business loans.

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Loan Portfolio Composition. The table below sets forth the composition of our loan portfolio, including loans held for sale, by type of loan, at the dates indicated.

	As of December 31,									
	2013		2012		2011		2010		2009	
	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent
	(Dollars in thousands)									
Mortgage loans:										
One-to-four-family residential	$ 121,222	54.74%	$ 129,891	56.16%	$ 142,956	65.35%	$ 143,929	73.38%	$ 125,418	72.96%
Mortgage warehouse	31,550	14.25	33,094	14.30	12,541	5.73				
Home Equity [1]	8,942	4.04	8,564	3.70	9,612	4.40	10,112	5.15	8,996	5.23
Commercial real estate	38,055	17.18	41,489	17.94	38,348	17.53	29,303	14.94	22,615	13.16
Consumer Loans:										
Automobile and other vehicles	2,821	1.27	3,451	1.49	5,321	2.43	7,195	3.67	9,892	5.75
Signature [2]	1,213	0.55	1,341	0.58	1,711	0.78	1,806	0.92	2,072	1.21
Other [3]	714	0.32	968	0.42	1,286	0.59	1,334	0.68	1,536	0.89
Commercial business loans	16,932	7.65	12,505	5.41	6,986	3.19	2,473	1.26	1,369	0.80
Total loans	$ 221,449	100.00%	$ 231,303	100.00%	$ 218,761	100.00%	$ 196,152	100.00%	$ 171,898	100.00%
Other items:										
Premiums on mortgage pools [4]	55		66		71		106		51	
Deferred loan origination costs, net	691		629		494		532		458	
Allowance for loan losses	(2,069)		(2,420)		(1,754)		(2,136)		(940)	
Total loans, net	$ 220,126		$ 229,578		$ 217,572		$ 194,654		$ 171,467	

(1) Includes home equity loans, home equity lines of credit and home improvement loans.
(2) Signature loans are unsecured.
(3) Includes loans on recreational vehicles, boats, certificates of deposit and other securities and other secured loans.
(4) Represents the premium over par value paid for purchased loans. The premium is amortized on a monthly basis as an adjustment to yield.

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Loan Portfolio Maturities and Yields. The table below sets forth the scheduled repayments of our loan portfolio at December 31, 2013. Demand loans, loans having no stated repayment schedule or maturity, and overdraft loans are reported as being due in one year or less.

	One-to-four family residential		Mortgage warehouse		Home equity	
	Amount	Weighted Average Rate	Amount	Weighted Average Rate	Amount	Weighted Average Rate
			(Dollars in thousands)			
Due during the years ending December 31,						
2014	$ 2	7.33%	$ 31,550	5.37%	$ 12	6.98%
2015	863	4.64%		%	90	6.65%
2016	273	6.91%		%	37	7.46%
2017 - 2018	1,483	6.41%		%	176	7.19%
2019 - 2023	1,311	7.23%		%	1,379	6.63%
2024 - 2028	7,249	4.66%		%	1,720	6.69%
2029 and beyond	110,041	4.40%		%	5,528	4.33%
Total loans	$ 121,222	4.48%	$ 31,550	5.37%	$ 8,942	5.23%

	Commercial real estate		Automobile and other vehicles		Signature	
	Amount	Weighted Average Rate	Amount	Weighted Average Rate	Amount	Weighted Average Rate
			(Dollars in thousands)			
Due during the years ending December 31,						
2014	$ 5,863	5.94%	$ 132	5.93%	$ 34	4.71%
2015	2,430	5.54%	501	5.16%	90	11.82%
2016	4,843	4.78%	699	5.10%	122	11.81%
2017 - 2018	12,123	4.95%	1,248	4.39%	78	11.30%
2019 - 2023	12,635	4.95%	241	3.49%	29	9.45%
2024 - 2028		%		%	3	14.00%
2029 and beyond	161	6.50%		%	857	10.77%
Total loans	$ 38,055	5.13%	$ 2,821	4.70%	$ 1,213	10.79%

	Other		Commercial business loans		Total	
	Amount	Weighted Average Rate	Amount	Weighted Average Rate	Amount	Weighted Average Rate
			(Dollars in thousands)			
Due during the years ending December 31,						
2014	$ 161	3.69%	$ 5,574	5.45%	$ 43,328	5.46%
2015	137	4.57%	2,182	4.77%	6,293	5.21%
2016	89	5.05%	1,866	5.10%	7,929	5.08%
2017 - 2018	98	4.84%	5,597	6.08%	20,803	5.37%
2019 - 2023	157	6.77%	1,713	6.30%	17,465	5.39%
2024 - 2028		%		%	8,972	5.05%

2029 and beyond	72	5.75%		%	116,659	4.45%
Total loans	$ 714	5.07%	$ 16,932	5.62%	$ 221,449	4.88%

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The table below sets forth fixed- and adjustable-rate loans at December 31, 2013 contractually due after December 31, 2014:

	Fixed	Adjustable (in thousands)	Total
Mortgage loans:			
One- to four-family residential	$ 37,094	$ 84,126	$ 121,220
Mortgage warehouse			
Home equity	2,857	6,074	8,931
Commercial real estate	19,527	12,666	32,193
Consumer Loans:			
Automobile and other vehicles	2,690		2,690
Signature	964	215	1,179
Other	553		553
Commercial business loans	7,095	4,263	11,358
Total loans	$ 70,780	$ 107,344	$ 178,124

One- to Four-Family Residential Mortgage and Mortgage Warehouse Loans. At December 31, 2013, $152.8 million, or 69.0% of our total loan portfolio, consisted of one- to four-family residential mortgage and mortgage warehouse loans. We offer residential mortgage loans that conform to Fannie Mae and Freddie Mac underwriting standards (conforming loans) as well as non-conforming loans. We generally underwrite our one- to four-family residential mortgage loans based on the applicant s employment and credit history and the appraised value of the subject property. Our loans have fixed-rates and adjustable-rates, with maturities of up to 30 years. At December 31, 2013, fixed-rate one- to four-family residential mortgage loans, including mortgage warehouse loans, totaled $60.9 million and adjustable-rate one- to four-family residential mortgage loans totaled $91.9 million.

We offer fixed-rate conventional mortgage loans with terms of up to 30 years that are fully amortizing with monthly loan payments, and adjustable-rate mortgage loans that generally provide an initial fixed interest rate for three, five, seven or ten years and amortize over a period up to 30 years. We do not offer discounted or teaser rates on our adjustable-rate mortgage loans.

Our one- to four-family residential mortgage loans are generally conforming loans, underwritten according to Fannie Mae, Freddie Mac, Federal Housing Administration (FHA) and Department of Veterans Affairs (VA) guidelines. We generally originate both fixed- and adjustable-rate mortgage loans in amounts up to the maximum conforming loan limits as established by the Federal Housing Finance Agency, which is currently $417,000 for single-family homes. However, it is not uncommon for single-family houses in parts of our Collin County and Dallas County market area to have market prices well in excess of this amount. At December 31, 2013, we had 51 one- to four-family residential mortgage and mortgage warehouse loans that had principal balances in excess of $750,000. At that date, our average one- to four-family residential mortgage and mortgage warehouse loan had a principal balance of $250,035. We also originate loans above the lending limit for conforming loans, which we refer to as jumbo loans. We typically originate adjustable-rate jumbo loans with an initial fixed-rate period of three, five, seven or ten years and which then adjust annually. Additionally, we occasionally originate fixed-rate jumbo loans with terms of up to 30 years. At December 31, 2013, our largest one- to four-family residential mortgage loan had an outstanding balance of $2.9 million, was secured by a single family residence in Dallas, Texas, and was performing in accordance with its terms.

We also originate first-lien mortgage loans with loan-to-value ratios in excess of 80%, provided that, with limited exceptions, the borrower obtains private mortgage insurance. We generally do not originate loans with a loan-to-value ratio in excess of 90% without private mortgage insurance or government guarantees. On occasion, we have originated first-lien mortgage loans with a loan-to-value of 80% with a second-lien loan for an additional 10% loan-to-value with no private mortgage insurance.

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We actively monitor our interest rate risk position to determine the desirable level of investment in fixed-rate mortgages. Generally, we retain in our portfolio fixed-rate one- to four-family residential mortgage loans with terms of less than 15 years and sell into the secondary mortgage market most of our long-term, fixed-rate one- to four-family residential mortgage loans with terms of 15 years or more. Such loans are sold on a servicing-released basis without recourse but with early-payment default provisions (generally, if one of the first three or four payments becomes 90 days or more past-due, depending on the investor). No loans were required to be repurchased during 2012 or 2013. We generally retain in our portfolio a small percentage of these long-term, fixed-rate loans if we determine that doing so is warranted due to the customer relationship.

We currently offer several types of adjustable-rate mortgage loans secured by residential properties with interest rates that are fixed for an initial period ranging from three to ten years. We offer adjustable-rate mortgage loans that are fully amortizing. After the initial fixed period, the interest rate on adjustable-rate mortgage loans is generally reset every year based upon a contractual spread or margin above the average yield on the London Interbank Offered Rate, adjusted to a constant maturity of one year, as published weekly by the Federal Reserve, subject to periodic and lifetime limitations on interest rate changes. Generally, the initial change in interest rates on our adjustable-rate mortgage loans cannot exceed two percentage points, subsequent interest rate changes cannot exceed two percentage points and total interest rate changes cannot exceed six percentage points over the life of the loan.

Adjustable-rate mortgage loans generally present different credit risks than fixed-rate mortgage loans, primarily because the underlying debt service payments of the borrowers increase as interest rates rise, thereby increasing the potential for default and higher rates of delinquency. At the same time, the marketability of the underlying collateral may be adversely affected by higher interest rates. Since changes in the interest rates on adjustable-rate mortgages may be limited by an initial fixed-rate period or by the contractual limits on periodic interest rate adjustments, adjustable-rate loans may not adjust as quickly to increases in interest rates as our interest-bearing liabilities.

We do not offer or purchase loans that provide for negative amortization of principal, such as Option ARM loans, where the borrower can pay less than the interest owed on the loan, resulting in an increased principal balance during the life of the loan.

We require title insurance on all of our one- to four-family residential mortgage loans that exceed $100,000, and we also require that borrowers maintain fire and extended coverage casualty insurance (and, if appropriate, flood insurance) in an amount at least equal to the lesser of the loan balance or the replacement cost of the improvements. We do not conduct environmental testing on residential mortgage loans unless specific concerns for hazards are identified by the appraiser used in connection with the origination of the loan.

Mortgage Warehouse. Mortgage warehouse loans are funded based on agreements with mortgage lenders pursuant to which we purchase legal ownership interests in the individual loans such lenders originate. These loans are typically paid off within 30 days of being funded when the loan is sold into the secondary market. Mortgage warehouse loans are underwritten consistently with established programs for permanent financing with investors, who have met the Bank s underwriting criteria. At December 31, 2013, our mortgage warehouse loan portfolio totaled $31.6 million.

Home Equity Loans and Lines of Credit. In addition to traditional one- to four-family residential mortgage loans, we offer home equity loans and home equity lines of credit that are secured by the borrower s primary residence. Our home equity loans are primarily originated with fixed rates of interest with terms of up to 15 years. Home equity loans and lines of credit are generally underwritten using the same criteria that we use to underwrite one- to four-family residential mortgage loans. Home equity loans are typically underwritten with a loan-to-value ratio of 80% when combined with the principal balance of the existing mortgage loan.

Home equity lines of credit are generally originated as revolving lines with adjustable-rates of interest. At December 31, 2013, the outstanding balance of revolving home equity lines of credit totaled $6.0 million, or 2.7% of our total loan portfolio, and the outstanding balance of term home equity loans totaled $2.9 million, or 1.3% of our total loan portfolio.

Home equity loans secured by second mortgages have greater risk than residential mortgage loans secured by first mortgages. We face the risk that the collateral will be insufficient to compensate us for loan losses and costs of foreclosure. When customers default on their loans, we attempt to foreclose on the property and resell the property as soon as possible to minimize foreclosure and carrying costs. However, the value of the collateral may not be sufficient to compensate us for the amount of the unpaid loan and we may be unsuccessful in recovering the remaining balance from those customers. Particularly with respect to our home equity loans, decreases in real estate values could adversely affect the value of property used as collateral for our loans.

Commercial Real Estate Loans. We originate commercial real estate loans secured primarily by office buildings, retail centers, owner-occupied offices, condominiums, developed lots and land. Loans secured by commercial real estate totaled $38.1 million, or 17.2% of our total loan portfolio, at December 31, 2013, and consisted of 52 loans outstanding with an average loan balance of approximately $0.7 million. Virtually all of the commercial real estate loans that we originate are secured by properties located in Texas. We do not actively pursue commercial lending opportunities in the Louisville market area, but will consider commercial business loan requests from existing customers.

Our commercial real estate loans are generally written for terms of up to five years with a 20 year amortization schedule. The rates are generally tied to the prime interest rate as reported in *The Wall Street Journal* and generally have a specified floor. In addition, we offer fixed rate products that typically do not exceed five years. Many of our commercial real estate loans are not fully amortizing and therefore require a balloon payment at maturity. We also originate fully amortizing commercial real estate loans. A portion of our commercial real estate loans are provided to borrowers following the completion of their real estate construction projects for which we provided the construction financing.

In underwriting commercial real estate loans, we generally lend up to 80% of the property s appraised value and up to 65% of the property s appraised value if the property is unimproved land. We base our decisions to lend on the economic viability of the property and the creditworthiness of the borrower. In evaluating a proposed commercial real estate loan, we emphasize the ratio of the property s projected net cash flow to the loan s debt service requirement (generally requiring a minimum ratio of 125%), computed after deduction for a vacancy factor and property expenses we deem appropriate. Personal guarantees are typically obtained from commercial borrowers. We require title insurance insuring the priority of our lien, fire and extended coverage casualty insurance, and, if appropriate, flood insurance, in order to protect our security interest in the underlying property.

Commercial real estate loans generally carry higher interest rates and have shorter terms than one- to four-family residential mortgage loans. Commercial real estate loans, however, entail significant additional credit risks compared to one- to four-family residential mortgage loans, as they typically involve larger loan balances concentrated with single borrowers or groups of related borrowers. In addition, the payment of loans secured by income-producing properties typically depends on the successful operation of the related real estate project and thus may be subject to a greater extent to adverse conditions in the real estate market and in the general economy.

At December 31, 2013, our largest commercial real estate loan had an outstanding commitment of $4.6 million and an outstanding balance of $1.4 million. These funds were used by the borrower to refinance existing debt and to provide for improvements to the underlying property. This loan was performing in accordance with its terms at December 31, 2013.

Consumer Loans. We offer a variety of secured consumer loans, including new and used automobile loans, recreational vehicle loans and loans secured by certificates of deposits and other collateral, including marketable securities. We also offer unsecured consumer loans. We offer our consumer loans primarily to customers in our

market area surrounding our Plano headquarters as well as our market area surrounding our Louisville offices. Most of our consumer loans are secured by automobiles. At December 31, 2013, our consumer loan portfolio totaled $4.7 million, or 2.1% of our total loan portfolio, of which $2.8 million were automobile loans. All of our automobile loans are direct; we do not make indirect automobile loans through dealers.

Our secured consumer loans totaled $3.5 million, or 1.6% of our total loan portfolio at December 31, 2013, and consisted principally of auto loans. Additional secured consumer loans included recreational vehicle, motorcycle and boat loans. At December 31, 2013, our unsecured consumer loans totaled $1.2 million, or 0.6% of our total loan portfolio. These loans have either a fixed rate of interest for a maximum term of 60 months, or are revolving lines of credit with an adjustable-rate of interest tied to the prime interest rate as reported in *The Wall Street Journal*. At December 31, 2013, unfunded commitments on our unsecured lines of credit totaled $1.1 million.

Consumer loans generally have shorter terms to maturity, which reduces our exposure to changes in interest rates. In addition, management believes that offering consumer loan products helps to expand and create stronger ties to our existing customer base by increasing the number of customer relationships and providing cross-marketing opportunities.

Consumer and other loans generally have greater risk compared to longer-term loans secured by improved, owner-occupied real estate, particularly consumer loans that are secured by rapidly depreciable assets, such as automobiles. In these cases, any repossessed collateral for a defaulted loan may not provide an adequate source of repayment of the outstanding loan balance. As a result, consumer loan collections are dependent on the borrower s continuing financial stability and thus are more likely to be adversely affected by job loss, divorce, illness or personal bankruptcy, among other factors.

Commercial Business Loans. We typically make various types of secured commercial business loans to customers in our Texas market areas for the purpose of acquiring equipment and for other general business purposes, including inventory and accounts receivable financing. The terms of these loans generally range from one year to a maximum of five years. The loans are either negotiated on a fixed-rate basis or carry adjustable interest rates indexed to the prime interest rate as reported in *The Wall Street Journal* and generally subject to specified minimum rates. At December 31, 2013, we had 58 commercial business loans outstanding with an aggregate balance of $16.9 million, or 7.7% of our total loans. At December 31, 2013, the average commercial business loan balance was approximately $0.3 million.

Loan Originations, Purchases, Sales, Participations and Servicing. Lending activities are conducted primarily by our loan personnel operating at our main and branch office locations. Loans that we originate in each of our market areas are underwritten pursuant to our standard policies and procedures. In addition, our one- to four-family residential mortgage loans generally incorporate Fannie Mae, Freddie Mac, FHA and/or VA underwriting guidelines. We originate both adjustable-rate and fixed-rate loans. Our ability to originate fixed- or adjustable-rate loans is dependent upon the relative customer demand for such loans, which is affected by current market interest rates as well as anticipated future market interest rates. Our loan origination and sales activity may be adversely affected by a rising interest rate environment that typically results in decreased loan demand. Most of our commercial real estate and commercial loans are generated by our internal business development efforts and referrals from professional contacts. Most of our originations of one- to four-family residential mortgage loans, consumer loans and home equity loans are generated by existing customers, referrals from real estate brokers, residential home builders, walk-in business and from our internet website, and with respect to our Texas market area, a small network of mortgage brokers.

Additionally, we participate with several of the former credit union s sponsor companies as a preferred lender in employee loan programs and loan programs for executives who are being relocated throughout the United States through their employment with these companies. As a result of these programs a portion of our residential real estate loan portfolio is collateralized by properties outside of our Texas market area. Although our participation in these programs can result in our originating loans in locations that are not one of our market areas, we underwrite these loans with the same standards as our in-market loans.

We decide whether to retain the loans that we originate or sell loans in the secondary market after evaluating current and projected market interest rates, our interest rate risk objectives, our liquidity needs and other factors. We sold $58.2 million of one- to four-family residential mortgage loans (primarily fixed-rate loans, with terms of 15 years or longer and occasionally a conforming adjustable-rate loan) during the year ended December 31, 2013. We had $1.8 million in loans held for sale at December 31, 2013. We generally sell our residential mortgage loans on a servicing-released basis.

Loan Approval Procedures and Authority. Our lending activities follow written, non-discriminatory underwriting standards and loan origination procedures established by our board of directors. The loan approval process is intended to assess the borrower s ability to repay the loan and the value of the collateral that will secure the loan. To assess the borrower s ability to repay, we review the borrower s employment and credit history and information on the historical and projected income and expenses of the borrower. We will also evaluate a guarantor when a guarantee is provided as part of the loan.

The Bank s policies and loan approval limits are established by the Bank s board of directors. Our Senior Vice President of Commercial Lending may approve secured commercial loans up to $100,000 and unsecured commercial loans up to $25,000. Similarly, our Senior Vice President of Retail Lending has authority to approve secured consumer loans up to $125,000, unsecured consumer loans up to $20,000 and mortgage loans to be sold on the secondary market up to $417,000 (or other super-conforming limits as applicable) on an un-aggregated basis. The mortgage loan underwriter has the authority to approve loans to be sold on the secondary-market on an un-aggregated basis up to $417,000 and second lien real estate secured loans for the purpose of purchase, home equity, and home improvements to be held in the loan portfolio up to $100,000. Consumer lending managers have authority to approve secured consumer loans up to $100,000 and unsecured consumer loans up to $10,000.

Aggregate lending relationships in amounts up to $750,000 for residential mortgage loans and in amounts up to $250,000 for commercial loans may be approved by our President and Chief Executive Officer. All commercial loans that result in aggregate indebtedness of $500,000 or more must be approved or ratified by a majority of the Bank s Officers Loan Committee, consisting of our President and Chief Executive Officer, Chief Credit Officer, Senior Vice President of Retail Lending, Senior Vice President of Commercial Lending and Senior Vice President Mortgage Warehouse Lending. Commercial and residential relationships of $1.0 million or more are approved by the Credit Policy Committee consisting of four outside directors and our President and Chief Executive Officer. Approved mortgage loans in excess of $417,000 and all commercial loans are reported to the board of directors upon approval at the next regularly scheduled board meeting.

We generally require appraisals of all real property securing loans from a rotating list of independent, licensed, third-party appraisers. All appraisers are approved by the Bank s board of directors annually.

Subsequent to year end, the Bank amended its commercial lending policy to increase the approval limits of the CEO and Chief Credit Officer to $1.0 million each for secured credits, and the limit for Officer s Loan committee to $1.3 million for secured credits. The Bank intends to make similar changes to its consumer lending policy in the first quarter 2014.

Non-performing and Problem Assets

With respect to our residential mortgage loans and consumer loans, collection calls typically begin between the 10th and 15th day of delinquency. By the time a loan is 30 days past due, there will have been two to three delinquency notices sent as well as a minimum of two personal phone contact attempts from the assigned employee and/or an automated calling system. During each personal phone contact, the borrower is required to provide updated information and is counseled on the terms of the loan and the importance of making payments on or before the due date. If a loan becomes 60 days delinquent, repossessions typically commence, while foreclosures typically begin after the 90th day of delinquency. A summary report of all loans 30 days or more past due is provided monthly to our board of directors.

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With respect to our commercial real estate and commercial business lending, collection efforts are carried out directly by our commercial loan officers. Commercial loan officers review past due accounts weekly and contact delinquent borrowers immediately. Past due notices are typically sent to commercial real estate customers and commercial business customers when 15 days or more past due.

The accrual of interest on loans is discontinued when future payments are not reasonably assured or the loan is 90 days delinquent, unless the credit is well secured and in the process of collection. Loans are placed on nonaccrual status or charged-off at an earlier date if collection of principal or interest is considered doubtful.

All interest accrued but not collected for loans, including troubled debt restructurings that are placed on nonaccrual status or charged off is offset against interest income. The interest on these loans is accounted for on the cash-basis or cost-recovery method, until qualifying for return to accrual. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured.

Non-Performing Assets. The table below sets forth the amounts and categories of our non-performing assets at the dates indicated.

	As of December 31,				
	2013 Amount	2012 Amount	2011 Amount	2010 Amount	2009 Amount
	(Dollars in thousands)				
Non-accrual loans:					
Mortgage loans:					
One-to-four-family residential	$ 1,950	$ 3,324	$ 207	$ 1,704[2]	$ 421
Mortgage warehouse					
Home Equity	22			101	
Commercial real estate	1,163	4,675[1]		2,498[3]	1,270
Consumer Loans:					
Automobile and other vehicles	8	15		20	7
Signature					13
Other					
Commercial business loans				125	
Total non-accrual loans	3,143	8,014	207	4,448	1,711
Other real estate owned and repossessed assets:					
Mortgage loans:					
One-to-four-family residential	81				
Mortgage warehouse					
Home Equity					
Commercial real estate		1,477	1,824		
Consumer Loans:					
Automobile and other vehicles					
Signature					
Other					
Commercial business loans					
Total other real estate owned and repossessed assets	81	1,477	1,824		
Total non-performing assets	$ 3,224	$ 9,491	$ 2,031	$ 4,448	$ 1,711
Loans delinquent 90 days or greater and still accruing:	$	$	$	$	$
Troubled debt restructurings, not included in non-accrual loans:	$ 756	$ 10	$ 6,819	$ 997	$ 1,717
Ratios:					
Non-performing loans to total loans	1.42%	3.46%	0.09%	2.27%	1.00%
Non-performing assets to total assets	1.06%	3.29%	0.74%	1.86%	0.82%

(1) Includes one loan totaling $1.7 million that was sold during the first quarter of 2013.

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(2) Includes two loans with outstanding balances totaling $399,000 that were foreclosed during the first quarter of 2011.
(3) Includes one loan totaling $2.0 million that was foreclosed during the first quarter of 2011.

For the year ended December 31, 2013, gross interest income that would have been recorded had our non-accruing loans been current in accordance with their original terms was $0.2 million. Interest income recognized on such loans for the year ended December 31, 2013 was $19,000.

At December 31, 2013, our non-accrual loans totaled $3.1 million. The non-accrual loans consisted of nine one- to four-family residential loans, one commercial real estate loans, one home equity loan and two consumer loans.

At December 31, 2013, we had a total of 11 loans that were not classified as non-accrual, 90 days past due or troubled debt restructurings, but for which we had known information leading management to have serious concerns about the ability of the borrowers under such loans to comply with present loan repayment terms, which could result in such loans being classified as non-accrual, 90 days past due or troubled debt restructurings.

Nine of these loans, with an aggregate balance of $0.7 million are collateralized by one- to four-family residential mortgages of borrowers who have, on occasion, been late with scheduled payments. One of these loans is a commercial loan totaling $0.1 million that has occasionally been past due and there is one home equity line of credit totaling less than $50,000. This loan is secured by all equipment and intangible assets of the borrower.

Troubled Debt Restructurings. Troubled debt restructurings are defined under Accounting Standards Codification (ASC) 310-40 Troubled Debt Restructurings by Creditors to include loans for which either a portion of interest or principal has been forgiven, or for loans modified at interest rates or on terms materially less favorable than current market rates and terms. We periodically modify loans to extend the term or make other concessions to maximize our ultimate collection of the loan. We generally do not forgive principal or interest on loans or modify the interest rates on loans to rates that are below market rates. At December 31, 2013, we had $1.5 million of troubled debt restructurings comprised of four residential loans totaling $1.5 million and two consumer loans totaling $7,000. Of this $1.5 million in troubled debt restructurings, one loan totaling $0.2 million was past due over 90 days and was in the process of foreclosure and one loan totaling $0.8 million was past due between 30-89 days.

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Delinquent Loans. The table below sets forth certain information with respect to our loan portfolio delinquencies at the dates indicated:

	Loans Delinquent For					
	30-89 Days		90 Days and Over		Total	
	Number	Amount	Number	Amount	Number	Amount
	(Dollars in thousands)					
At December 31, 2013						
Mortgage loans:						
One-to-four-family residential	8	$ 1,062	4	$ 1,329	12	$ 2,391
Mortgage warehouse						
Home equity						
Commercial real estate						
Consumer Loans:						
Automobile and other vehicles	1	13			1	13
Signature	1	1			1	1
Other						
Commercial business loans	1	139			1	139
Total loans	11	$ 1,215	4	$ 1,329	15	$ 2,544
At December 31, 2012						
Mortgage loans:						
One-to-four-family residential	16	$ 2,818	1	$ 321	17	$ 3,139
Mortgage warehouse						
Home equity						
Commercial real estate						
Consumer Loans:						
Automobile and other vehicles	1	12			1	12
Signature						
Other	2	6			2	6
Commercial business loans						
Total loans	19	$ 2,836	1	$ 321	20	$ 3,157
At December 31, 2011						
Mortgage loans:						
One-to-four-family residential	15	$ 2,618	2	$ 207	17	$ 2,825
Mortgage warehouse						
Home equity	2	27			2	27
Commercial real estate						
Consumer Loans:						
Automobile and other vehicles	2	17			2	17
Signature						
Other						
Commercial business loans						
Total loans	19	$ 2,662	2	$ 207	21	$ 2,869
At December 31, 2010						
Mortgage loans:						
One-to-four-family residential	16	$ 1,984	11	$ 1,704	27	$ 3,688
Mortgage warehouse						
Home equity	3	51	3	101	6	152
Commercial real estate	2	1,844	2	2,498	4	4,342
Consumer Loans:						
Automobile and other vehicles	8	46	3	20	11	66
Signature	5	6			5	6
Other						
Commercial business loans			1	125	1	125

Total loans	34	$ 3,931	20	$ 4,448	54	$ 8,379
At December 31, 2009						
Mortgage loans:						
One-to-four-family residential	12	$ 1,616	10	$ 421	22	$ 2,037
Mortgage warehouse						
Home equity	1	34			1	34
Commercial real estate						
Consumer Loans:						
Automobile and other vehicles	10	66	1	7	11	73
Signature	3	10	1	13	4	23
Other						
Commercial business loans						
Total loans	26	$ 1,726	12	$ 441	38	$ 2,167

Total delinquent loans decreased to $2.5 million at December 31, 2013 from $3.2 million at December 31, 2012. The net decrease in delinquent loans was due primarily to a decline in delinquent one- to four-family residential mortgage loans.

Other Real Estate Owned and Repossessed Assets. Real estate acquired by us as a result of foreclosure or by deed in lieu of foreclosure is classified as other real estate owned (OREO). When property is acquired it is recorded at fair value at the date of foreclosure, establishing a new cost basis. Estimated fair value generally represents the sale price a buyer would be willing to pay on the basis of current market conditions, including normal terms from other financial institutions, less the estimated costs to sell the property. Holding costs and declines in estimated fair value result in charges to expense after acquisition. In addition, we periodically repossess certain collateral, including automobiles and other titled vehicles, called repossessed assets. At December 31, 2013, we had $81,000 in OREO and other repossessed assets, consisting entirely of acquired one- to four-family real estate.

Classification of Assets. Our policies, consistent with regulatory guidelines, provide for the classification of loans and other assets that are considered to be of lesser quality as substandard, doubtful, or loss assets. An asset is considered substandard if it is inadequately protected by the current net worth and paying capacity of the obligor or of the collateral pledged, if any. Substandard assets include those assets characterized by the distinct possibility that we will sustain some loss if the deficiencies are not corrected. Assets classified as doubtful have all of the weaknesses inherent in those classified substandard with the added characteristic that the weaknesses present make collection or liquidation in full, on the basis of currently existing facts, conditions and values, highly questionable and improbable. Assets (or portions of assets) classified as loss are those considered uncollectible and of such little value that their continuance as assets is not warranted. Assets that do not expose us to risk sufficient to warrant classification in one of the aforementioned categories, but which possess potential weaknesses that deserve our close attention, are required to be designated as special mention. As of December 31, 2013, we had $0.3 million of assets designated as special mention.

When we classify assets as either substandard, nonaccrual or doubtful, we allocate a portion of the related general loss allowances to such assets as we deem prudent. The allowance for loan losses is the amount estimated by management as necessary to absorb credit losses incurred in the loan portfolio that are both probable and reasonably estimable at the balance sheet date. When we classify a problem asset as doubtful, we charge the asset off. For other classified assets, we provide an allocated allowance for that portion of the asset that is considered uncollectible. Our determination as to the classification of our assets and the amount of our loss allowances are subject to review by our principal regulator, the Department, which can require that we establish additional loss allowances. We regularly review our asset portfolio to determine whether any assets require classification in accordance with applicable regulations. On the basis of our review of our assets at December 31, 2013, substandard assets consisted of loans of $4.4 million, with an allocated reserve of $571,000 and OREO of $81,000. There were no doubtful or loss assets at December 31, 2013.

As of December 31, 2013, our largest substandard asset was a $1.2 million commercial real estate loan secured by a retail property. Although currently performing as agreed, the loan was classified as substandard due to the property s current condition.

Allowance for Loan Losses

Analysis and Determination of the Allowance for Loan Losses. Our allowance for loan losses is the amount considered necessary to reflect probable incurred losses in our loan portfolio. We evaluate the need to establish allowances against losses on loans on a quarterly basis. When additional allowances are necessary, a provision for loan losses is charged to earnings.

Our methodology for assessing the appropriateness of the allowance for loan losses consists of two key elements: (1) allocated allowances for impaired loans and (2) a general valuation allowance for non-impaired loans. Although we determine the amount of each element of the allowance separately, the entire allowance for loan losses is available for the entire portfolio.

Allocated Allowances for Impaired Loans. When a loan is determined to be impaired, loss is measured by determining the present value of expected future cash flows or, for collateral-dependent loans, the fair value of the collateral adjusted for market conditions and selling expenses. Factors used to identify a problem loan include: (1) the strength of the customer s personal or business cash flows; (2) the availability of other sources of repayment; (3) the amount due or past due; (4) the type and value of collateral; (5) the strength of our collateral position; (6) the estimated cost to sell the collateral; and (7) the borrower s effort to cure the delinquency. In addition, for loans secured by real estate, we consider the extent of any past due and unpaid property taxes applicable to the property serving as collateral on the mortgage.

General Valuation Allowance on Non-impaired Loans. We establish a general allowance for non-impaired loans to recognize probable incurred losses associated with lending activities. This general valuation allowance is determined by segregating the loans by loan category and assigning allowance percentages based on our historical loss experience for the last three years, adjusted for qualitative factors that could impact the allowance for loan losses. These factors include changes in experience of lending staff, lending policies and procedures; changes in collection, charge-off and recovery practices; changes in the nature and volume of the loan portfolio; changes in the volume and severity of nonperforming loans; the existence and effect of any concentrations of credit and changes in the level of such concentrations; and changes in current, national and local economic and business conditions. The applied loss factors are re-evaluated quarterly to ensure their relevance in the current real estate environment.

In addition, as an integral part of their examination process, the Department and the Federal Reserve will periodically review our allowance for loan losses. Such agency may require that we recognize additions to the allowance based on its judgments of information available to it at the time of its examination.

The allowance for loan losses decreased $351,000, or 14.5%, to $2.1 million at December 31, 2013 from $2.4 million at December 31, 2012. The decrease was primarily attributable to a lower level of nonperforming loans in 2013 as well as improvements in the economy, which are factored into our allowance for loss methodology. In addition, the allowance for loan losses to total loans receivable, including loans held for sale, decreased to 0.93% at December 31, 2013 as compared to 1.05% at December 31, 2012. The allowance for loan losses as a percentage of nonperforming loans increased to 65.83% at December 31, 2013 from 30.20% at December 31, 2012.

Non-performing loans decreased to $3.1 million at December 31, 2013 from $8.0 million at December 31, 2012. Non-accrual loans consisted of nine one- to four family residential mortgage loans totaling $2.0 million with $112,000 in allocated allowances, one commercial real estate loan totaling $1.2 million with $434,000 in allocated allowances, one home equity loan totaling $22,000 with $22,000 in allocated reserve and two consumer loans totaling $7,600 with an allocated allowance of $3,000. The commercial real estate loan was current at December 31, 2013. Impaired loans with an allowance for loan losses were $1.6 million at December 31, 2013. Impaired loans without an allocated allowance for loan losses were $2.3 million at December 31, 2013.

Appraisals are performed by a rotating list of independent, certified appraisers to obtain fair values on non-homogenous loans secured by real estate. The appraisals are generally obtained when market conditions change, annually for criticized loans, and at the time a loan becomes impaired.

We periodically evaluate the carrying value of loans and the allowance is adjusted accordingly. While we use the best information available to make evaluations, future adjustments to the allowance may be necessary if conditions differ substantially from the information used in making the evaluations.

There were no changes in our non-accrual policy during the years ended December 31, 2013 or 2012.

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The table below sets forth activity in our allowance for loan losses as of the dates and for the years indicated:

	As of December 31,				
	2013 Amount	2012 Amount	2011 Amount	2010 Amount	2009 Amount
	(Dollars in thousands)				
Balance at beginning of year	$ 2,420	$ 1,754	$ 2,136	$ 940	$ 480
Charge offs:					
Mortgage loans:					
One-to-four-family residential	82	297	497	252	57
Mortgage warehouse					
Home Equity		28	63		
Commercial real estate	504		697		
Consumer Loans:					
Automobile and other vehicles			4	13	116
Signature		5	53	44	38
Other	14	41		15	34
Commercial business loans			444		
Total charge offs	600	371	1,758	324	245
Recoveries:					
Mortgage loans:					
One-to-four-family residential	1	2		41	
Mortgage warehouse					
Home Equity	8	4			
Commercial real estate					
Consumer Loans:					
Automobile and other vehicles	1	1	7	17	6
Signature	1	5	10	3	12
Other	11	7		2	
Commercial business loans			1		
Total recoveries	22	19	18	63	18
Net charge-offs	(578)	(352)	(1,740)	(261)	(227)
Provision for loan losses	227	1,018	1,358	1,457	687
Balance at end of year	$ 2,069	$ 2,420	$ 1,754	$ 2,136	$ 940
Ratios:					
Net charge-offs to average loans outstanding	0.26%	0.16%	0.87%	0.15%	0.14%
Allowance for loan losses to non-performing loans at end of year	65.83%	30.20%	847.34%	48.02%	54.94%
Allowance for loan losses to total loans at end of year	0.93%	1.05%	0.80%	1.09%	0.55%

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Allocation of Allowance for Loan Losses. The table below sets forth the allowance for loan losses allocated by loan category, the total loan balances by category (including loans held for sale), and the percent of loans in each category to total loans at the dates indicated. The allowance for loan losses allocated to each category is not necessarily indicative of future losses in any particular category and does not restrict the use of the allowance to absorb losses in other categories.

	As of December 31,					
	2013		2012		2011	
	Allowance for Loan Losses	Percent of Loans in Each Category to Total Loans	Allowance for Loan Losses	Percent of Loans in Each Category to Total Loans	Allowance for Loan Losses	Percent of Loans in Each Category to Total Loans
	(Dollars in thousands)					
Mortgage loans:						
One-to-four-family residential	$ 325	54.7%	$ 731	56.2%	$ 778	65.4%
Mortgage warehouse		14.2		14.3		5.7
Home Equity	78	4.0	83	3.7	133	4.4
Commercial real estate	1,142	17.2	1,215	17.9	624	17.5
Consumer Loans:						
Automobile and other vehicles	30	1.3	30	1.5	32	2.4
Signature	9	0.6	18	0.6	54	0.8
Other	6	0.3	17	0.4	3	0.6
Commercial business loans	479	7.7	326	5.4	130	3.2
Total loans	$ 2,069	100.0%	$ 2,420	100.0%	$ 1,754	100.0%

	As of December 31,			
	2010		2009	
	Allowance for Loan Losses	Percent of Loans in Each Category to Total Loans	Allowance for Loan Losses	Percent of Loans in Each Category to Total Loans
	(Dollars in thousands)			
Mortgage loans:				
One-to-four-family residential	$ 736	73.4%	$ 455	73.0%
Mortgage warehouse				
Home Equity	60	5.1	33	5.2
Commercial real estate	1,081	14.9	293	13.1
Consumer Loans:				
Automobile and other vehicles	85	3.7	107	5.8
Signature	27	0.9	23	1.2
Other	16	0.7	17	0.9
Commercial business loans	131	1.3	12	0.8
Total loans	$ 2,136	100.0%	$ 940	100.0%

Investments

The Bank s Asset/Liability Management Committee (ALCO Committee), consisting of two non-employee directors, our President and Chief Executive Officer, our Chief Financial Officer, the Chief Credit Officer, the Chief Accounting Officer and the Controller, has primary responsibility for establishing our investment policy and overseeing its implementation, subject to oversight by our entire board of directors. Authority to make investments under approved guidelines is delegated to the Investment Committee, comprised of our President and Chief

Executive Officer and our Chief Financial Officer. Investment transactions are reported to the ALCO Committee at its next meeting.

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The investment policy is reviewed at least annually by the full board of directors. This policy dictates that investment decisions be made based on minimizing exposure to credit risk, liquidity requirements, potential returns and consistency with our interest rate risk management strategy.

Our current investment policy permits us to invest in any legally permissible investment security, including mortgage-backed securities, including pass-through securities, insured and guaranteed by Fannie Mae, Freddie Mac and Ginnie Mae as well as collateralized mortgage obligations (CMOs) issued or backed by securities issued by government entities or government-sponsored enterprises and private issuers, as well as investment grade bank-qualified municipal securities and investment grade corporate debt securities.

Our current investment policy does not permit speculative trading, repurchase agreements or reverse repurchase agreements, short sales, options, mortgage derivative products and other financial derivative products or purchases of high-risk mortgage securities. As a bank, the Bank is generally not permitted to invest in equity securities, although this general restriction does not apply to SP Bancorp, which may acquire up to 5% of voting securities of any company without regulatory approval.

We designate a security as held to maturity, available-for-sale, or trading, depending on our ability to sell the security and our intent. Securities available for sale are reported at fair value, while securities held to maturity are reported at amortized cost. We do not maintain a trading portfolio.

Mortgage-Backed Securities. We invest in mortgage-backed securities insured or guaranteed by Fannie Mae, Freddie Mac or Ginnie Mae. We invest in mortgage-backed securities to achieve positive interest rate spreads with minimal administrative expense, and to lower our credit risk as a result of the guarantees provided by Freddie Mac, Fannie Mae or Ginnie Mae.

Mortgage-backed securities are created by pooling mortgages and issuing a security with an interest rate that is less than the interest rate on the underlying mortgages. Mortgage-backed securities typically represent a participation interest in a pool of single-family or multi-family mortgages, although we invest primarily in mortgage-backed securities backed by one- to four-family residential mortgages. The issuers of such securities pool and resell the participation interests in the form of securities to investors such as the Bank. Some securities pools are guaranteed as to payment of principal and interest to investors. Mortgage-backed securities generally yield less than the loans underlying such securities because of the cost of payment guarantees and credit enhancements. However, mortgage-backed securities are more liquid than individual mortgage loans since generally there is an active trading market for such securities. In addition, mortgage-backed securities may be used to collateralize our specific liabilities and obligations. Finally, mortgage-backed securities are assigned lower risk weightings for purposes of calculating our risk-based capital ratio.

Investments in mortgage-backed securities involve a risk that actual payments will be greater or less than the prepayment rate estimated at the time of purchase, which may require adjustments to the amortization of any premium or acceleration of any discount relating to such interests, thereby affecting the net yield on our securities. We periodically review current prepayment trends to determine whether prepayment estimates require modification that could cause amortization or accretion adjustments.

CMOs. CMOs are debt securities issued by a special-purpose entity that aggregates pools of mortgages and mortgage-backed securities and creates different classes of securities with varying maturities and amortization schedules, as well as a residual interest, with each class possessing different risk characteristics. The cash flows from the underlying collateral are generally divided into tranches or classes that have descending priorities with respect to the distribution of principal and interest cash flows, while cash flows on pass-through mortgage-backed securities are distributed pro rata to all security holders.

All of the mortgage-backed securities and CMOs owned by the Bank are guaranteed by the U.S. Government or agencies thereof or by government sponsored enterprises.

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Municipal Obligations. We invest in state, county and school district municipal bonds through both general obligation and revenue bonds, with maturities of up to 20 years. Our policy allows us to purchase such securities after the credit-worthiness of the issuer is established. No more than 15% of our capital can be invested in obligations of any one municipality or other state or local government.

Asset-Backed Securities. Asset-backed securities are securities in which the value and income payments are derived from and securitized by specified pools of underlying assets. All of the asset-backed securities owned by the Bank are substantially guaranteed by the U.S. Government.

Investment Securities Portfolio Maturities and Yields. The table below sets forth the composition, maturities and yields the securities portfolio at December 31, 2013. At such date, all of our securities were held as available-for-sale. Maturities are based on the final contractual payment dates, and do not reflect the impact of prepayments or early redemptions that may occur. Municipal securities yields have not been adjusted to a tax-equivalent basis.

December 31, 2013	More than Five Years Through Ten Years	More than Ten Years	Total
Securities available for sale:			
Municipal securities			
Amortized cost	$	$ 9,775	$ 9,775
Fair market value		9,365	9,365
Weighted average yield		2.96%	2.96%
Collateralized mortgage obligations guaranteed by FNMA and FHLMC			
Amortized cost	856	3,566	4,422
Fair market value	858	3,555	4,413
Weighted average yield	0.02%	2.88%	2.32%
Mortgage-backed securities guaranteed by FNMA, GMNA and FHLMC			
Amortized cost		11,578	11,578
Fair market value		11,462	11,462
Weighted average yield		1.95%	1.95%
Asset-backed securities substantially guaranteed by the United States Government			
Amortized cost	3,032		3,032
Fair market value	3,014		3,014
Weighted average yield	0.96%		0.96%
Agency securities			
Amortized cost	1,006		1,006
Fair market value	991		991
Weighted average yield	2.55%		2.55%
Total available for sale securities			
Amortized cost	$ 4,894	$ 24,919	$ 29,813
Fair market value	$ 4,863	$ 24,382	$ 29,245

Sources of Funds

General. Deposits traditionally have been our primary source of funds for our lending and investment activities. We also borrow, primarily from the Federal Home Loan Bank of Dallas, to supplement cash flow needs, to lengthen the maturities of liabilities for interest rate risk management purposes and to manage our cost of funds. Our additional sources of funds are the proceeds of loan sales, scheduled loan payments, maturing investments, loan prepayments, Federal Home Loan Bank of Dallas advances, retained earnings and income on other earning assets.

Deposits. We generate deposits primarily from the areas in which our branch offices are located**.** We rely on our competitive pricing, convenient locations and customer service to attract and retain deposits. We offer a variety of deposit accounts with a range of interest rates and terms. Our deposit accounts consist of savings accounts, demand deposit accounts, money market accounts and certificates of deposit. At December 31, 2013, we had $202,000 in brokered deposits. All of our brokered deposits are managed through the Promontory Interfinancial Network, LLC (the Promontory Network). The Promontory Network offers the Certificate of Deposit Account Registry Service (CDARS) for certificates of deposit, and the Insured Cash Sweep (ICS) for money market accounts. When a customer makes a deposit and requests the full protection of FDIC insurance, but where such deposit exceeds applicable limits, we use CDARS or ICS to place the funds into certificates of deposit or money market accounts issued by banks in the network so that the full amount of the deposit is insured by the Federal Deposit Insurance Corporation (the FDIC). The Promontory Network matching system allows network members to exchange funds for a fee. This exchange occurs on a dollar-for-dollar basis, so that the equivalent of the original deposit comes back to us.

Interest rates, maturity terms, service fees and withdrawal penalties are established on a periodic basis. Deposit rates and terms are based primarily on current operating strategies and market interest rates, liquidity requirements, interest rates paid by competitors and our deposit growth goals.

At December 31, 2013, we had a total of $100.7 million in certificates of deposit, of which $47.3 million had remaining maturities of one year or less. Based on historical experience and our current pricing strategy, we believe we will retain a large portion of these accounts upon maturity.

The table below sets forth the distribution of our average total deposit accounts, by account type, for the years indicated:

	For the Years Ended December 31,								
	2013			2012			2011		
	Balance	Percent	Weighted Average Rate	Balance	Percent	Weighted Average Rate	Balance	Percent	Weighted Average Rate
	(Dollars in thousands)								
Deposit type:									
Non-interest bearing demand	$ 29,219	11.18%	%	$ 21,726	9.54%	%	$ 9,737	4.66%	%
Interest-bearing demand	55,803	21.36	0.12	53,555	23.51	0.13	56,653	27.09	0.17
Money market	39,068	14.95	0.18	39,049	17.14	0.21	41,262	19.73	0.33
Savings	36,536	13.98	0.05	36,851	16.17	0.11	33,343	15.94	0.22
Certificates of deposit	100,660	38.53	1.17	76,646	33.64	1.23	68,152	32.58	1.52
Total	$ 261,286	100.00%	0.56%	$ 227,827	100.00%	0.55%	$ 209,147	100.00%	0.64%

As of December 31, 2013, the aggregate amount of outstanding certificates of deposit, including our individual retirement accounts, in amounts greater than or equal to $100,000 was approximately $100.7 million. The table below sets forth the maturity of those certificates as of December 31, 2013 (in thousands):

Three months or less	$ 6,212
Over three months through six months	14,346
Over six months through one year	26,739
Over one year through three years	39,979
Over three years	13,384
Total	$ 100,660

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The table below sets forth certificates of deposit classified by interest rate at the dates indicated:

	As of December 31,		
	2013	2012	2011
		(in thousands)	
Less than 2%	$ 91,601	$ 69,828	$ 58,913
2.00% - 2.99%	7,759	9,004	11,336
3.00% - 3.99%	1,300	1,870	2,239
4.00% - 4.99%		37	110
Total	$ 100,660	$ 80,739	$ 72,598

The table below sets forth, by interest rate ranges, information concerning our certificates of deposit:

	As of December 31, 2013 Period to Maturity					
	Less Than or Equal to One Year	More Than One Year to Two Years	More Than Two Years to Three Years	More Than Three Years	Total	Percent of Total
			(in thousands)			
Less than 1%	$ 26,853	$ 16,044	$ 3,703	$ 880	$ 47,480	47.17%
1.00% - 1.99%	18,210	7,110	6,916	11,885	44,121	43.83
2.00% - 2.99%	1,033	804	5,303	619	7,759	7.71
3.00% - 3.99%	1,200	100			1,300	1.29
Total	$ 47,296	$ 24,058	$ 15,922	$ 13,384	$ 100,660	100.00%

Borrowings. Our borrowings primarily consist of advances from the Federal Home Loan Bank of Dallas. At December 31, 2013, we had available credit under the Federal Home Loan Bank advance program of $81.8 million. The table below sets forth information concerning balances and interest rates on our borrowings as of the dates and for the years indicated:

	As of and For the Years Ended December 31,		
	2013	2012	2011
		(Dollars in thousands)	
Balance at end of year	$ 7,368	$ 20,316	$ 25,978
Average balance during year	$ 10,475	$ 23,546	$ 20,711
Maximum outstanding at any month end	$ 29,656	$ 34,503	$ 41,979
Weighted average interest rate at end of year	1.16%	0.40%	1.16%
Average interest rate during year	1.60%	1.27%	2.16%

Subsidiary Activities

The Bank is the wholly owned subsidiary of SP Bancorp. The Bank has no subsidiaries.

SUPERVISION AND REGULATION

General

The Bank was supervised and examined by the Office of the Comptroller of the Currency (the OCC) until the effective date of its conversion to a Texas state chartered bank that is a member of the Federal Reserve System after the close of business on December 23, 2013 (the Effective

Date). After the Effective Date, the Bank is

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supervised and examined by the Texas Department of Banking (the Department) and the Board of Governors of the Federal Reserve System (the Federal Reserve) and is subject to examination by the Federal Deposit Insurance Corporation (the FDIC). Deposits at the Bank continue to be insured by the FDIC.

This regulation and supervision establishes a comprehensive framework of activities in which an institution may engage and is intended primarily for the protection of the FDIC s deposit insurance funds and depositors, and not for the protection of stockholders. Under this system of federal regulation, financial institutions are periodically examined to ensure that they satisfy applicable standards with respect to their capital adequacy, assets, management, earnings, liquidity and sensitivity to market interest rates. The Bank also is a member of and owns stock in the Federal Home Loan Bank of Dallas, which is one of the twelve regional banks in the Federal Home Loan Bank System. The Bank also is regulated by the Consumer Financial Protection Bureau (the CFPB), which publishes regulations implementing the various consumer financial protection laws. Until the Effective Date, the OCC examined the Bank and after the Effective Date the Department and the Federal Reserve examine the Bank and prepare reports based on their examination of the Bank for the consideration of its board of directors concerning any operating deficiencies. The Bank s relationship with its depositors and borrowers also is regulated to a great extent by federal law and state law, especially in matters concerning the ownership of deposit accounts and the form and content of the Bank s loan documents.

As a savings and loan holding company, SP Bancorp was required to file certain reports with, was subject to examination by, and otherwise must comply with the rules and regulations of the Federal Reserve. On the Effective Date, SP Bancorp became a registered bank holding company that is subject to inspection, supervision, examination and reporting requirements imposed by the Federal Reserve under the Federal Bank Holding Company Act. SP Bancorp is also subject to federal securities laws and SEC rules and regulations.

Certain of the regulatory requirements that are applicable to the Bank and SP Bancorp are described below. This description of statutes, regulations and policies is not intended to be a complete description of such statutes, regulations and policies or their effects on the Bank and SP Bancorp, and is qualified in its entirety by reference to the actual statutes, regulations and policies. Such statutes, regulations and policies are continually under review by Congress and state legislatures and federal and state regulatory agencies. A change in statutes, regulations or regulatory policies applicable to SP Bancorp or the Bank could have a material effect on the business, financial condition and results of operations of SP Bancorp.

New Federal Legislation

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act) has significantly changed the current bank regulatory structure and affected the lending, investment, trading and operating activities of financial institutions and their holding companies. The Dodd-Frank Act eliminated the Office of Thrift Supervision on July 21, 2011, the former primary federal regulator of both the Bank and SP Bancorp. The Dodd-Frank Act also authorized the Federal Reserve to supervise and regulate all savings and loan holding companies like SP Bancorp until the Effective Date, in addition to bank holding companies which it regulates. As a result, the Federal Reserve regulations applicable to bank holding companies, including holding company capital requirements, applied to savings and loan holding companies like SP Bancorp, unless an exemption exists. These capital requirements are substantially similar to the capital requirements currently applicable to the Bank as described in Federal Banking Regulation-Capital Requirements. The Dodd-Frank Act also requires the Federal Reserve to set minimum capital levels for bank holding companies and savings and loan holding companies that are as stringent as those required for the insured depository institution subsidiaries, and the components of Tier 1 capital are restricted to capital instruments that are currently considered to be Tier 1 capital for insured depository institutions. Bank holding companies with assets of less than $500 million are exempt from these capital requirements. Accordingly, after the Effective Date, SP Bancorp is subject to this small bank holding company exemption.

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Under the Dodd-Frank Act, the proceeds of trust preferred securities are excluded from Tier 1 capital unless such securities were issued prior to May 19, 2010 by bank or savings and loan holding companies with less than $15 billion of assets. The legislation also establishes a floor for capital of insured depository institutions that cannot be lower than the standards in effect today, and directs the federal banking regulators to implement new leverage and capital requirements that take into account off-balance sheet activities and other risks, including risks relating to securitized products and derivatives.

The Dodd-Frank Act also created the CFPB with broad powers to regulate, supervise and enforce specified consumer protection laws. The CFPB has broad rulemaking authority for a wide range of consumer protection laws that apply to all banks such as the Bank, including the authority to prohibit unfair, deceptive or abusive acts and practices. The CFPB has examination and enforcement authority over all banks and savings institutions with more than $10 billion in assets. Banks and savings institutions with $10 billion or less in assets will be examined by their applicable bank regulators. The new legislation also weakens the federal preemption available for national banks and federal savings associations, and gives state attorneys general the ability to enforce applicable federal consumer protection laws.

In December 2013, a provision of the Dodd-Frank Act known as the Volcker Rule was finalized by the federal banking agencies. The Volcker Rule prohibits banks and their affiliates from engaging in proprietary trading and prohibits investment in hedge funds and private equity funds.

The legislation also broadens the base for FDIC insurance assessments. Assessments will now be based on the average consolidated total assets less tangible equity capital of a financial institution. The Dodd-Frank Act also permanently increased the maximum amount of deposit insurance for banks, savings institutions and credit unions to $250,000 per depositor, retroactive to January 1, 2008. The Dodd-Frank Act also established that non-interest bearing transaction accounts had unlimited deposit insurance through December 31, 2012 and Congress did not extend this temporary program. Lastly, the Dodd-Frank Act will increase stockholder influence over boards of directors by requiring companies to give stockholders a non-binding vote on executive compensation and so-called golden parachute payments. The legislation also directs federal regulators, including, the Federal Reserve, to promulgate rules applicable to financial institutions and their holding companies with more than $1 billion in assets prohibiting excessive compensation paid to financial institution officers, directors and employees, regardless of whether the company is publicly traded or not. The Dodd-Frank Act provided for originators of certain securitized loans to retain a percentage of the risk for transferred loans, directed the Federal Reserve to regulate pricing of certain debit card interchange fees and contained a number of reforms related to mortgage origination.

The Dodd-Frank Act contained a number of reforms related to mortgage origination and servicing. In January 2013, the CFPB published a series of very detailed and complex final rules that will impact mortgage origination and servicing once they become effective, generally in January 2014 unless noted below. Had these final rules not been published, many of the statutory requirements in Title XIV of the Dodd-Frank Act would have become effective on January 21, 2013 without any implementing regulations.

The final rules concerning mortgage origination and servicing address the following topics:

Ability to Repay. This final rule implements the Dodd-Frank Act provisions requiring that for residential mortgages, creditors must make a reasonable and good faith determination based on verified and documented information that the consumer has a reasonable ability to repay the loan according to its terms. The final rule also establishes a presumption of compliance with the ability to repay determination for a certain category of mortgages called qualified mortgages meeting a series of detailed requirements. The final rule also provides a rebuttable presumption for higher-priced mortgage loans.

High-Cost Mortgage. This final rule strengthens consumer protections for high-cost mortgages (generally bans balloon payments and prepayment penalties, subject to exceptions and bans or limits certain fees and practices) and requires consumers to receive information about homeownership counseling prior to taking out a high-cost mortgage.

Appraisals for High-Risk Mortgages. The final rule permits a creditor to extend a higher-priced (subprime) mortgage loan only if the following conditions are met (subject to exceptions): (i) the creditor obtains a written appraisal; (ii) the appraisal is performed by a certified or licensed appraiser; and (iii) the appraiser conducts a physical property visit of the interior of the property. The rule also requires that during the application process, the applicant receives a notice regarding the appraisal process and their right to receive a free copy of the appraisal.

Copies of Appraisals. This final rule amends Regulation B, which implements the Equal Credit Opportunity Act. It requires a creditor to provide a free copy of appraisal or valuation reports prepared in connection with any closed-end loan secured by a first lien on a dwelling. The final rule requires notice to applicants of the right to receive copies of any appraisal or valuation reports and creditors must send copies of the reports whether or not the loan transaction is consummated. Creditors must provide the copies of the appraisal or evaluation reports for free, however, the creditors may charge reasonable fees for the cost of the appraisal or valuation unless applicable law provides otherwise.

Escrow Requirements. This final rule implements Dodd-Frank Act changes that generally extend the required duration of an escrow account on certain higher-priced mortgage loans from a minimum of one year to a minimum of five years, subject to certain exemptions for loans made by certain creditors that operate predominantly in rural or underserved areas, as long as certain other criteria are met. This final rule was effective on June 1, 2013.

Servicing. Two final rules were published to implement laws to protect consumers from detrimental actions by mortgage servicers and to provide consumers with better tools and information when dealing with mortgage servicers. One final rule amends Regulation Z, which implements the Truth in Lending Act and a second final rule amends Regulation X, which implements the Real Estate Settlement Procedures Act. The rules cover nine major topics implementing the Dodd-Frank Act provisions related to mortgage servicing. The final rules include a number of exemptions and other adjustments for small servicers, defined as servicers that service 5,000 or fewer mortgage loans and service only mortgage loans that they or an affiliate originated or own.

Mortgage Loan Originator Compensation. This final rule implements Dodd-Frank Act requirements, as well as revises and clarifies existing regulations and commentary on loan originator compensation. The rule also prohibits, among other things: (i) certain arbitration agreements; (ii) financing certain credit insurance in connection with a mortgage loan; (iii) compensation based on a term of a transaction or a proxy for a term of a transaction; and (iv) dual compensation from a consumer and another person in connection with the transaction. The final rule also imposes a duty on individual loan officers, mortgage brokers and creditors to be qualified and, when applicable, registered or licensed to the extent required under applicable State and Federal law.

Many of the provisions of the Dodd-Frank Act have delayed effective dates and the legislation requires various federal agencies to promulgate numerous and extensive implementing regulations over the next several years and many deadlines have been missed. Although the substance and scope of these regulations cannot be completely determined at this time, it is expected that the legislation and implementing regulations will increase our operating and compliance costs.

Federal Banking Regulation

Business Activities. A Texas state chartered bank derives its lending and investment powers from the Texas Finance Code, as amended, and the regulations of the Department. Under these laws and regulations, the Bank may invest in mortgage loans secured by residential and commercial real estate, commercial business and consumer loans, certain types of debt securities and certain other assets, subject to applicable limits.

Capital Requirements. Federal Reserve regulations require state member banks to meet three minimum capital standards: a 1.5% tangible capital ratio, a 4% leverage ratio (3% for banks receiving the highest rating on the CAMELS rating system), and an 8% risk-based capital ratio.

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The risk-based capital standard for banks requires the maintenance of Tier 1 (core) and total capital (which is defined as core capital and supplementary capital) to risk-weighted assets of at least 4% and 8%, respectively. In determining the amount of risk-weighted assets, all assets, including certain off-balance sheet assets, are multiplied by a risk-weight factor of 0% to 200%, assigned by the Federal Reserve, based on the risks believed inherent in the type of asset. Core capital is defined as common stockholders equity (including retained earnings), certain noncumulative perpetual preferred stock and related surplus and minority interests in equity accounts of consolidated subsidiaries, less intangibles other than certain mortgage servicing rights and credit card relationships. The components of supplementary capital include cumulative preferred stock, long-term perpetual preferred stock, mandatory convertible securities, subordinated debt and intermediate preferred stock, the allowance for loan and lease losses limited to a maximum of 1.25% of risk-weighted assets and up to 45% of net unrealized gains on available-for-sale equity securities with readily determinable fair market values. Overall, the amount of supplementary capital included as part of total capital cannot exceed 100% of core capital. Additionally, a bank that retains credit risk in connection with an asset sale may be required to maintain additional regulatory capital because of the purchaser s recourse against the bank. In assessing an institution s capital adequacy, the Department and Federal Reserve take into consideration not only these numeric factors but qualitative factors as well, and has the authority to establish higher capital requirements for individual banks where necessary.

At December 31, 2013, the Bank s capital exceeded all applicable requirements.

In December 2010, the Basel Committee on Banking Supervision (the Basel Committee) released revised final frameworks for the regulation of capital and liquidity of internationally active banking organizations. These new frameworks are generally referred to as Basel III . On July 2, 2013, the Federal Reserve, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency released three final rules that substantially amend the regulatory risk-based capital rules applicable to the Company and the Bank. The final rules implement the Basel III regulatory capital reforms and changes required by the Dodd-Frank Act. The Company and the Bank will begin transitioning to the new final rule on January 1, 2015 when the new minimum capital requirements are effective, however, the new capital conservation buffer and certain deductions from common equity Tier 1 capital phase in over a time period from 2015 through 2019.

Transition Schedule for New Ratios and Capital Definitions

Year (as of January 1)	**2015**	**2016**	**2017**	**2018**	**2019**
Minimum common equity tier 1 capital ratio	4.5%	4.5%	4.5%	4.5%	4.5%
Common equity tier 1 capital conservation buffer	N/A	0.625%	1.25%	1.875%	2.5%
Minimum common equity tier 1 capital ratio plus capital conservation buffer	4.5%	5.125%	5.75%	6.375%	7.0%
Phase-in of most deductions from common equity tier 1 (including 10 percent & 15 percent common equity tier 1 threshold deduction items that are over the limits) [1]	40%	60%	80%	100%	100%
Minimum tier 1 capital ratio	6.0%	6.0%	6.0%	6.0%	6.0%
Minimum tier 1 capital ratio plus capital conversation buffer	N/A	6.625%	7.25%	7.875%	8.5%
Minimum total capital ratio	8.0%	8.0%	8.0%	8.0%	8.0%
Minimum total capital ratio plus conservation buffer	N/A	8.625%	9.25%	9.875%	10.5%

N/A means not applicable.

[1] Deductions from common equity tier 1 capital include goodwill and other intangibles, deferred tax assets that arise from net operating loss and tax credit carryforwards (above certain levels), gains-on-sale in connection with a securitization, any defined benefit pension fund net asset (for banking organizations that are not insured depository institutions), investments in a banking organization s own capital instruments, mortgage servicing assets (above certain levels) and investments in the capital of unconsolidated financial institutions (above certain levels).

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The new final Basel III rules take important steps toward improving the quality and increasing the quantity of capital for all banking organizations as well as setting higher standards for large, internationally active banking organizations. The regulatory agencies believe that the new rules will result in capital requirements that better reflect banking organizations risk profiles, thereby improving the overall resilience of the banking system. The regulatory agencies have carefully considered the potential impacts on all banking organizations, including community banking organizations such as the Company and the Bank, and sought to minimize the potential burden of these changes where consistent with applicable law and the agencies goals of establishing a robust and comprehensive capital framework.

The new final Basel III rules treatment of one- to four-family residential mortgage exposures remains the same as under current general risk-based capital rules. This includes a 50 percent risk weight for prudently underwritten first lien mortgage loans that are not past due, reported as nonaccrual, or restructured, and a 100 percent risk weight for all other residential mortgages. Also in the new rules, non-advanced approaches banking organizations, such as the Company and the Bank, are given a one-time option to filter certain Accumulated Other Comprehensive Income (AOCI) components, comparable to the treatment under the current general risk-based capital rule. The AOCI opt-out election must be made on the institution s first regulatory filing after January 1, 2015.

The new final Basel III rules also make certain major changes from the current general risk-based capital rules, including, but not limited to:

Implementing higher minimum capital requirements, including a new common equity tier 1 capital requirement, and establishes criteria that instruments must meet in order to be considered common equity tier 1 capital, additional tier 1 capital or tier 2 capital. The new minimum capital to risk-weighted assets requirements are a common equity tier 1 capital ratio of 4.5 percent and a tier 1 capital ratio of 6.0 percent (an increase from 4.0 percent), and a total capital ratio that remains at 8.0 percent. The minimum leverage ratio (tier 1 capital to total assets) is 4.0 percent. The new rules maintain the general structure of the current prompt corrective action framework (described below) while incorporating these increased minimum requirements starting January 1, 2015.

Changing the definition of capital by incorporating stricter eligibility criteria for regulatory capital instruments that would disallow the including of instruments such as trust preferred securities in tier 1 capital going forward, and new constraints on the inclusion of minority interests, mortgage-servicing rights, deferred tax assets, and other certain investments in the capital of unconsolidated financial institutions. In addition, the new rules require that most regulatory capital deductions be made from common equity tier 1 capital.

The Dodd-Frank Act prohibits references to, and reliance on, external credit ratings in the banking regulations and directs the agencies to use alternative standards of creditworthiness. The new rules replace the ratings-based approach with a simplified supervisory formula approach in order to determine the appropriate risk-weights of securitization exposures. Alternatively, banking organizations may use the existing gross-up approach to assign securitization exposures to a risk weight category or choose to assign such exposures a 1,250 percent risk weight.

Mortgage servicing assets and deferred tax assets are subject to stricter individual and aggregate limitations as a percentage of common equity tier 1 capital than those applicable under the current general risk-based capital rules.

Increasing the risk-weights for past-due loans, certain commercial real estate loans, and some equity exposures, and makes selected other changes in risk-weights and credit conversion factors.

In order to avoid limitations on capital distributions, including dividend payments and certain discretionary bonus payments to executive officers, a banking organization must hold a capital conservation buffer composed of common equity tier 1 capital above its minimum risk-based capital requirements. This buffer will help to ensure that banking organizations conserve capital when it is

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most needed, allowing them to better weather periods of economic stress. The buffer is measured relative to risk-weighted assets. Phase-in of the capital conservation buffer requirements will begin on January 1, 2016.

The following table summarizes how much a banking organization can pay out in the form of distributions or discretionary bonus payments in a quarter based on its capital conservation buffer. A banking organization with a buffer greater than 2.5 percent would not be subject to limits on capital distributions or discretionary bonus payments; however, a banking organization with a buffer of less than 2.5 percent would be subject to increasingly stringent limitations as the buffer approaches zero:

Payout Restrictions and Capital Conservation Buffer

Capital Conservation Buffer (as a percentage of risk-weighted assets)	**Maximum Payout** (as a percentage of eligible retained income)
Greater than 2.5 percent	No payout limitation applies
Less than or equal to 2.5 percent and greater than 1.875 percent	60 percent
Less than or equal to 1.875 percent and greater than 1.25 percent	40 percent
Less than or equal to 1.25 percent and greater than 0.625 percent	20 percent
Less than or equal to 0.625 percent	0 percent

The new rules also prohibit a banking organization from making distributions or discretionary bonus payments during any quarter if its eligible retained income is negative in that quarter and its capital conservation buffer ratio was less than 2.5 percent at the beginning of the quarter. The eligible retained income of a banking organization is defined as its net income for the four calendar quarters preceding the current calendar quarter, based on the organization s quarterly regulatory reports, net of any distributions and associated tax effects not already reflected in net income. When the new rules are fully phased-in in 2019, the minimum capital requirements plus the capital conservation buffer will exceed the prompt corrective action well-capitalized thresholds.

On January 6, 2013, the Group of Governors and Heads of Supervision, the oversight body of the Basel Committee, met and unanimously endorsed a 4 year delay in the Basel Committee s rules establishing a liquidity coverage ratio (LCR). Under the revised liquidity requirements, banks would be required to meet 60 percent of the LCR obligations by 2015, and the full rule would be phased in annually through 2019. At this time, it is unclear how these provisions will be implemented in the United States and what impact these delays in the effective dates will have on the capital proposals. Management is watching these rules closely for its potential impact on the impact on SP Bancorp s and the Bank s business.

Loans-to-One Borrower. Generally, a state-chartered, member bank may not make a loan or extend credit to a single or related group of borrowers in excess of 25% of the bank s Tier 1 capital. An additional amount may be loaned, subject to applicable limits and compliance with Department regulations. As of December 31, 2013, the Bank s largest lending relationship with a single or related group of borrowers totaled $4.6 million, which represented 14.9% of Tier 1 capital. Therefore, the Bank was in compliance with the loans-to-one borrower limitations.

Qualified Thrift Lender Test. As a federal savings bank, the Bank was required to satisfy the qualified thrift lender (QTL) test. Under the QTL test, the Bank must maintain at least 65% of its portfolio assets in qualified thrift investments (primarily residential mortgages and related investments, including mortgage-backed securities) in at least nine months of the most recent 12-month period. Portfolio assets generally means total assets of a savings bank, less the sum of specified liquid assets up to 20% of total assets, goodwill and other intangible assets, and the value of property used in the conduct of the savings bank s business.

The Bank also may satisfy the QTL test by qualifying as a domestic building and loan association as defined in the Internal Revenue Code.

A savings institution that fails the qualified thrift lender test must operate under specified restrictions. The Dodd-Frank Act made noncompliance with the QTL test also subject to agency enforcement action for a violation of law. At the Effective Date of December 23, 2013, the Bank satisfied the QTL test. After the Effective Date, the Bank is no longer subject to the QTL test because it is a Texas-chartered state member bank.

Capital Distributions. Federal Reserve and Department regulations govern capital distributions by a state-chartered, member bank, which include cash dividends, stock repurchases and other transactions charged to the bank s capital account. A bank must file an application for approval of a capital distribution if:

- the total capital distributions for the applicable calendar year exceed the sum of the bank s net income for that year to date plus the bank s retained net income for the preceding two years, less any required transfers to surplus;
- the bank would not be at least adequately capitalized following the distribution;
- the distribution would violate any applicable statute, regulation, agreement or Federal Reserve- or Department-imposed condition; or
- the bank is not eligible for expedited treatment of its filings.

Even if an application is not otherwise required, every bank that is a subsidiary of a holding company must still file a notice with the Federal Reserve and the Department at least 30 days before the board of directors declares a dividend or approves a capital distribution. Federal law also prohibits a state-chartered, member bank from paying dividends that would be greater than the bank s undivided profits.

The Federal Reserve and/or the Department may disapprove a notice or application if:

- the bank would be undercapitalized following the distribution;
- the proposed capital distribution raises safety and soundness concerns; or
- the capital distribution would violate a prohibition contained in any statute, regulation or agreement.

In addition, the Federal Deposit Insurance Act provides that an insured depository institution shall not make any capital distribution, if after making such distribution the institution would be undercapitalized. A bank may not make a capital distribution that would reduce its regulatory capital below the amount required for the liquidation account established in connection with its conversion to stock form. This restriction continues to apply to the Bank after the Effective Date.

Liquidity. A state member bank is required to maintain a sufficient amount of liquid assets to ensure its safe and sound operation.

Community Reinvestment Act and Fair Lending Laws. All banks have a responsibility under the Community Reinvestment Act and related regulations of the Federal Reserve to help meet the credit needs of their communities, including low- and moderate-income borrowers. In connection with its examination of a bank, the appropriate federal regulator is required to assess the bank s record of compliance with the Community Reinvestment Act. In addition, the Equal Credit Opportunity Act and the Fair Housing Act prohibit lenders from discriminating in their lending practices on the basis of characteristics specified in those statutes. A bank s failure to comply with the provisions of the Community Reinvestment Act could, at a minimum, result in denial of certain corporate applications such as branches or mergers, or in restrictions on its activities. The failure to comply with the Equal Credit Opportunity Act and the Fair Housing Act could result in enforcement actions by the Federal Reserve, as well as other federal regulatory agencies and the Department of Justice and can lead to a

lower rating under the Community Reinvestment Act. The Bank received an overall satisfactory Community Reinvestment Act rating in its most recent federal examination. The Community Reinvestment Act requires all FDIC-insured institutions to publicly disclose their rating.

Transactions with Related Parties. A bank s authority to engage in transactions with its affiliates is limited by Federal Reserve regulations and by Sections 23A and 23B of the Federal Reserve Act and its implementing Regulation W promulgated by the Federal Reserve. An affiliate is generally a person or company that controls, or is under common control with an insured depository institution such as the Bank, and, therefore, SP Bancorp is an affiliate of the Bank. In general, transactions between an insured depository institution and its affiliates are subject to certain quantitative and collateral requirements. In addition, until the Effective Date, OCC regulations prohibited the Bank from lending to any of its affiliates that are engaged in activities that are not permissible for bank holding companies and from purchasing the securities of any affiliate, other than a subsidiary. Finally, transactions with affiliates must be consistent with safe and sound banking practices, not involve low-quality assets and be on terms that are as favorable to the institution as comparable transactions with non-affiliates. The Federal Reserve requires banks to maintain detailed records of all transactions with affiliates.

The Bank s authority to extend credit to its directors, executive officers and 10% stockholders, as well as to entities controlled by such persons, is currently governed by the requirements of Sections 22(g) and 22(h) of the Federal Reserve Act and Regulation O of the Federal Reserve. Among other things, these provisions require that extensions of credit to insiders:

(i) be made on terms that are substantially the same as, and follow credit underwriting procedures that are not less stringent than, those prevailing for comparable transactions with unaffiliated persons and that do not involve more than the normal risk of repayment or present other unfavorable features; and

(ii) not exceed certain limitations on the amount of credit extended to such persons, individually and in the aggregate, which limits are based, in part, on the amount of the Bank s capital.

In addition, extensions of credit in excess of certain limits must be approved in advance by members of the Bank s board of directors who do not have an interest in the transaction.

Enforcement. The Federal Reserve has primary Federal enforcement responsibility over state member banks and the Department has separate authority under Texas law to bring enforcement actions against all institution-affiliated parties, including directors, officers, stockholders, attorneys, appraisers and accountants who knowingly or recklessly participate in wrongful action likely to have an adverse effect on a bank. Formal enforcement actions by the Federal Reserve or the Department may range from the issuance of a capital directive or cease and desist order, to removal of officers and/or directors of the institution, and the appointment of a receiver or conservator. Civil penalties cover a wide range of violations and actions, and range up to $37,500 per day, unless a finding of reckless disregard is made, in which case penalties may be as high as $1.425 million per day. The FDIC also has the authority to terminate deposit insurance or to recommend to the Federal Reserve that an enforcement action be taken with respect to a particular financial institution. If action is not taken by the Federal Reserve, the FDIC has authority to take action under specified circumstances.

Standards for Safety and Soundness. Federal law requires each federal banking agency to prescribe certain standards for all insured depository institutions. These standards relate to, among other things, internal controls, information systems and audit systems, loan documentation, credit underwriting, interest rate risk exposure, asset growth, compensation, and other operational and managerial standards as the agency deems appropriate. Interagency guidelines set forth the safety and soundness standards that the federal banking agencies use to identify and address problems at insured depository institutions before capital becomes impaired. If the appropriate federal banking agency determines that an institution fails to meet any standard prescribed by the guidelines, the agency may require the institution to submit to the agency an acceptable plan to achieve compliance with the standard. If an institution fails to meet these standards, the appropriate federal banking

agency may require the institution to implement an acceptable compliance plan. Failure to implement such a plan can result in further enforcement action, including the issuance of a cease and desist order or the imposition of civil money penalties.

Prompt Corrective Action Regulations. Under prompt corrective action regulations, the Federal Reserve is authorized and, under certain circumstances, required to take supervisory actions against undercapitalized state member banks. For this purpose, a bank is placed in one of the following five categories based on the savings bank s capital:

- well-capitalized (at least 5% leverage capital, 6% Tier 1 risk-based capital and 10% total risk-based capital);
- adequately capitalized (at least 4% leverage capital, 4% Tier 1 risk-based capital and 8% total risk-based capital);
- undercapitalized (less than 3% leverage capital, 4% Tier 1 risk-based capital and 8% total risk-based capital);
- significantly undercapitalized (less than 3% leverage capital, 3% Tier 1 risk-based capital and 6% total risk-based capital); and
- critically undercapitalized (less than 2% tangible capital).

Generally, the Federal Reserve is required to appoint a receiver or conservator for a state member bank that is critically undercapitalized within specific time frames. The regulations also provide that a capital restoration plan must be filed with the Federal Reserve within 45 days of the date a state member bank receives notice that it is undercapitalized, significantly undercapitalized or critically undercapitalized. Any holding company of a state member bank that is required to submit a capital restoration plan must guarantee the lesser of an amount equal to 5% of the bank s assets at the time it was notified or deemed to be undercapitalized by the Federal Reserve, or the amount necessary to restore the bank to adequately capitalized status. This guarantee remains in place until the Federal Reserve notifies the bank that it has maintained adequately capitalized status for each of four consecutive calendar quarters, and the Federal Reserve has the authority to require payment and collect payment under the guarantee. Failure by a holding company to provide the required guarantee will result in certain operating restrictions on the state member bank, such as restrictions on the ability to declare and pay dividends, pay executive compensation and management fees, and increase assets or expand operations. The Federal Reserve may also take any one of a number of discretionary supervisory actions against undercapitalized state member banks, including the issuance of a capital directive and the replacement of senior executive officers and directors.

At December 31, 2013, the Bank met the criteria for being considered well-capitalized.

Insurance of Deposit Accounts. The Dodd-Frank Act permanently increased the maximum amount of deposit insurance for banks, savings institutions and credit unions to $250,000 per depositor, retroactive to January 1, 2008. Also, under the Dodd-Frank Act, noninterest-bearing checking accounts had unlimited deposit insurance through December 31, 2012; however, Congress did not extended this temporary program.

On November 12, 2009, the FDIC approved a final rule requiring insured depository institutions to prepay, on December 31, 2009, their estimated quarterly risk-based assessments for the fourth quarter of 2009, and for all of 2010, 2011, and 2012. Estimated assessments for the fourth quarter of 2009 and for all of 2010 were based upon the assessment rate in effect on September 30, 2009, with three basis points added for the 2011 and 2012 assessment rates. In addition, a 5% annual growth in the assessment base was assumed. Prepaid assessments are to be applied against the actual quarterly assessments until exhausted, and may not be applied to any special assessments that may occur in the future. Any unused prepayments will be returned to the institution on June 30, 2013. On June 30, 2013, the FDIC returned $144,980 to the Bank.

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Effective April 1, 2011, the FDIC implemented a requirement of the Dodd-Frank Act to revise its assessment system to base it on each institution s total assets less tangible capital of each institution instead of deposits. The FDIC also revised its assessment schedule so that it ranges from 2.5 basis points for the least risky institutions to 45 basis points for the riskiest.

All FDIC-insured institutions are required to pay a pro rata portion of the interest due on obligations issued by the Financing Corporation (FICO) for anticipated payments, issuance costs and custodial fees on bonds issued by the FICO in the 1980s to recapitalize the Federal Savings and Loan Insurance Corporation. The bonds issued by the FICO are due to mature in 2017 through 2019. For the quarter ended December 31, 2011, the annualized FICO assessment was equal to 1.00 cent for each $100 in domestic deposits maintained at an institution. Assessments related to the FICO bond obligations were not subject to the December 31, 2009 prepayment. Our expense for the assessment of deposit insurance and the FICO payments was $214,000 and $235,000 for 2013 and 2012, respectively.

Insurance of deposits may be terminated by the FDIC upon a finding that the institution has engaged in unsafe or unsound practices, is in an unsafe or unsound condition to continue operations or has violated any applicable law, regulation, rule, order or regulatory condition imposed in writing. We do not know of any practice, condition or violation that might lead to termination of deposit insurance.

Prohibitions Against Tying Arrangements. State member banks are prohibited, subject to some exceptions, from extending credit to or offering any other service, or fixing or varying the consideration for such extension of credit or service, on the condition that the customer obtain some additional service from the institution or its affiliates or not obtain services of a competitor of the institution.

Federal Home Loan Bank System. The Bank is a member of the Federal Home Loan Bank System, which consists of 12 regional Federal Home Loan Banks. The Federal Home Loan Bank System provides a central credit facility primarily for member institutions as well as other entities involved in home mortgage lending. As a member of the Federal Home Loan Bank of Dallas, the Bank is required to acquire and hold shares of capital stock in the Federal Home Loan Bank. As of December 31, 2013, the Bank was in compliance with this requirement.

Other Regulations

Interest and other charges collected or contracted for by the Bank are subject to state usury laws and federal laws concerning interest rates. The Bank s operations are also subject to federal laws applicable to credit transactions, such as the:

- Truth-In-Lending Act, governing disclosures of credit terms to consumer borrowers;
- Home Mortgage Disclosure Act, requiring financial institutions to provide information to enable the public and public officials to determine whether a financial institution is fulfilling its obligation to help meet the housing needs of the community it serves;
- Equal Credit Opportunity Act, prohibiting discrimination on the basis of race, creed or other prohibited factors in extending credit;
- Fair Credit Reporting Act, governing the use and provision of information to credit reporting agencies;
- Fair Debt Collection Practices Act, governing the manner in which consumer debts may be collected by collection agencies;
- Truth in Savings Act; and
- rules and regulations of the various federal agencies charged with the responsibility of implementing such federal laws.

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The operations of the Bank also are subject to the:

- Right to Financial Privacy Act, which imposes a duty to maintain confidentiality of consumer financial records and prescribes procedures for complying with administrative subpoenas of financial records;
- Electronic Funds Transfer Act and Regulation E promulgated thereunder, which govern automatic deposits to and withdrawals from deposit accounts and customers rights and liabilities arising from the use of automated teller machines and other electronic banking services;
- Check Clearing for the 21st Century Act (also known as Check 21), which gives substitute checks, such as digital check images and copies made from that image, the same legal standing as the original paper check;
- The USA PATRIOT Act, which requires banks to, among other things, establish broadened anti-money laundering compliance programs, and due diligence policies and controls to ensure the detection and reporting of money laundering. Such required compliance programs are intended to supplement existing compliance requirements that also apply to financial institutions under the Bank Secrecy Act and the Office of Foreign Assets Control regulations; and
- The Gramm-Leach-Bliley Act, which places limitations on the sharing of consumer financial information by financial institutions with unaffiliated third parties. Specifically, the Gramm-Leach-Bliley Act requires all financial institutions offering financial products or services to consumers and retail customers to provide such consumers and customers with the financial institution s privacy policy and provide such consumers and customers the opportunity to opt out of the sharing of certain personal financial information with unaffiliated third parties.

Holding Company Regulation

General. SP Bancorp was a non-diversified savings and loan holding company within the meaning of the Home Owners Loan Act until the Effective Date. After the Effective Date, SP Bancorp is a registered bank holding company under the Federal Bank Holding Company Act (the BHC Act). As such, SP Bancorp is registered with the Federal Reserve and is subject to Federal Reserve regulations, examinations and reporting requirements. In addition, the Federal Reserve has enforcement authority over SP Bancorp. Among other things, this authority permits the Federal Reserve to restrict or prohibit activities that are determined to be a serious risk to the financial soundness, safety or stability of any bank subsidiary of the bank holding company.

Permissible Activities. Under present law, the business activities of SP Bancorp are generally limited to activities permissible under Section 4(c)(8) of the BHC Act, including banking, managing or controlling banks and other activities that the Federal Reserve has determined to be so closely related to banking as to be a proper incident thereto, subject to the prior approval of the Federal Reserve, and certain additional activities authorized by Federal Reserve regulations.

The BHC Act, the Bank Merger Act and the Texas Finance Code and other federal and state statutes regulate acquisitions of commercial banks. The BHC Act requires the prior approval of the Federal Reserve for the direct or indirect acquisition by a bank holding company of more than 5.0% of the voting shares of a commercial bank or its parent holding company. Under the Bank Merger Act, the prior approval of the Federal Reserve or other appropriate bank regulatory authority is required for a member bank to merge with another bank or purchase the assets or assume the deposits of another bank. In reviewing applications seeking approval of merger and acquisition transactions, the bank regulatory authorities will consider, among other things, the competitive effect and public benefits of the transactions, the capital position of the combined organization, the risks to the stability of the U.S. banking or financial system, the applicant s performance record under the Community Reinvestment Act and fair housing laws and the effectiveness of the subject organizations in combating money laundering activities.

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Capital. The Dodd-Frank Act requires the Federal Reserve to promulgate consolidated capital requirements for depository institution holding companies that are no less stringent, both quantitatively and in terms of components of capital, than those applicable to depository institutions themselves. Instruments such as cumulative preferred stock and trust preferred securities will no longer be includable as Tier 1 capital, as is currently permitted for bank holding companies. Instruments issued prior to May 19, 2010 will be grandfathered for companies with consolidated assets of $15 billion or less. There is a five-year transition period (from the July 21, 2010 effective date of the Dodd-Frank Act) before the capital requirements will apply. The Federal Reserve has a long standing policy statement excluding bank holding companies under $500 million in consolidated assets from the capital rules. This policy exception was codified in the Dodd-Frank Act, however, the statute did not make a similar exception for savings and loan holding companies under $500 in consolidated assets. Accordingly, as a result of the Bank s charter conversion, on December 31, 2013, SP Bancorp is a registered bank holding company with under $500 million in consolidated assets that is not subject to a separate capital requirement at the holding company level.

Dividends. The Federal Reserve has issued policy guidance regarding the payment of dividends by bank holding companies that it made applicable to savings and loan holding companies as well. In general, the Federal Reserve s policies provide that dividends should be paid only out of current earnings and only if the prospective rate of earnings retention by the holding company appears consistent with the organization s capital needs, asset quality and overall financial condition. Federal Reserve guidance provides for prior regulatory review of capital distributions in certain circumstances such as where the company s net income for the past four quarters, net of dividends previously paid over that period, is insufficient to fully fund the dividend or the company s overall rate of earnings retention is inconsistent with the company s capital needs and overall financial condition. The ability of a holding company to pay dividends may be restricted if a subsidiary bank becomes undercapitalized. These regulatory policies could affect the ability of SP Bancorp to pay dividends or otherwise engage in capital distributions.

Source of Strength. The Dodd-Frank Act extended the source of strength doctrine to all holding companies, including savings and loan holding companies. The Dodd-Frank Act requires regulatory agencies to issue regulations requiring that all bank and savings and loan holding companies serve as a source of financial and managerial strength to their subsidiary depository institutions by providing capital, liquidity and other support in times of financial stress; however, no such proposals have yet been published.

Federal Securities Laws

Our common stock is registered with the SEC under the Securities Exchange Act of 1934, as amended (the Exchange Act). We are subject to the information, proxy solicitation, insider trading restrictions and other requirements under the Exchange Act.

Sarbanes-Oxley Act of 2002

The Sarbanes-Oxley Act of 2002 addresses, among other issues, corporate governance, auditing and accounting, executive compensation, and enhanced and timely disclosure of corporate information. As directed by the Sarbanes-Oxley Act, our Chief Executive Officer and Chief Financial Officer are required to certify that our quarterly and annual reports do not contain any untrue statement of a material fact. The rules adopted by the SEC under the Sarbanes-Oxley Act have several requirements, including having these officers certify that: they are responsible for establishing, maintaining and regularly evaluating the effectiveness of our internal control over financial reporting; they have made certain disclosures to our auditors and the audit committee of the board of directors about our internal control over financial reporting; and they have included information in our quarterly and annual reports about their evaluation and whether there have been changes in our internal control over financial reporting or in other factors that could materially affect internal control over financial reporting. As a smaller reporting company, our independent registered public accounting firm will not be required to render an attestation report as it relates to internal control over financial reporting.

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TAXATION

Federal Taxation

General. SP Bancorp and the Bank are subject to federal income taxation in the same general manner as other corporations, with some exceptions discussed below. The following discussion of federal taxation is intended only to summarize material federal income tax matters and is not a comprehensive description of the tax rules applicable to SP Bancorp and the Bank.

Method of Accounting. For federal income tax purposes, the Bank currently reports its income and expenses on the accrual method of accounting and uses a tax year ending December 31st for filing its consolidated federal income tax returns.

Minimum Tax. The Internal Revenue Code of 1986, as amended, imposes an alternative minimum tax at a rate of 20% on a base of regular taxable income plus certain tax preferences, referred to as alternative minimum taxable income. The alternative minimum tax is payable to the extent alternative minimum taxable income is in excess of an exemption amount. Net operating losses can, in general, offset no more than 90% of alternative minimum taxable income. Certain payments of alternative minimum tax may be used as credits against regular tax liabilities in future years. At December 31, 2013, the Bank had no minimum tax credit carryforward.

Net Operating Loss Carryovers. Generally, a financial institution may carry back net operating losses to the preceding two taxable years and forward to the succeeding 20 taxable years. At December 31, 2013, the Bank had no net operating loss carryforward for federal income tax purposes.

Corporate Dividends. We may exclude from our income 100% of dividends received from the Bank as a member of the same affiliated group of corporations.

Audit of Tax Returns. The Bank s federal income tax returns have not been audited in the most recent five-year period.

State Taxation

In 2006, the State of Texas enacted legislation replacing its franchise tax with a margin tax effective with tax reports filed on or after January 1, 2008. The Texas margin tax is computed by applying the applicable tax rate (1% for most entities) to the margin. Margin equals the lesser of three calculations: total revenue minus cost of goods sold; total revenue minus compensation; or total revenue times 70%. Lending institutions may deduct interest expense as cost of goods sold. Our calculation in 2013 was total revenue minus compensation.

Personnel

As of December 31, 2013, we had 65 full-time employees and 4 part-time employees. Our employees are not represented by any collective bargaining group. Management believes that we have a good working relationship with our employees.

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ITEM 1A. Risk Factors

There are numerous and varied risks, known and unknown, that may prevent us from achieving our goals. You should carefully consider the risks described below and the other information included in this Annual Report, including the consolidated financial statements and related notes thereto. If any of the following risks, or any other risks not described below, actually occur, it is likely that our business, financial condition, and/or operating results could be materially adversely affected. In such case, the trading price and market value of our common stock could decline and you may lose part or all of your investment in our common stock. The risks and uncertainties described below include forward-looking statements and our actual results may differ from those discussed in these forward-looking statements.

Risks Related to Our Business

The credit quality of our loans could decline.

Although we regularly review credit exposure related to particular customers, industry sectors and product lines, default risk may arise from circumstances that are difficult to predict or detect. In such circumstances, we could experience an increase in our provision for loan loss, non-performing assets, troubled debt restructurings and delinquent loans any of which could have a material adverse effect on our financial condition and results of our operation.

Specifically, mortgage lending, including one-to four-family residential mortgage loans, home equity loans, lines of credit and commercial real estate loans, is generally sensitive to regional and local economic conditions that may significantly affect the ability of borrowers to meet their loan payment obligations, making loss levels difficult to predict. Historically, declines in residential real estate values resulting from downturns in local housing markets has reduced the value of the real estate collateral securing many of our loans and has increased the risk that we would incur losses if borrowers default on their loans. Declines in the volume of real estate sales and sales prices, coupled with increases in unemployment, may result in higher loan delinquencies or problem assets.

Our loan portfolio also contains adjustable rate loans. Borrowers with adjustable rate loans are exposed to increased monthly payments when the related interest rate adjusts upward under the terms of the loan from the initial fixed to the rate computed in accordance with the applicable index and margin. Any rise in prevailing market interest rates may result in increased payments for borrowers who have adjustable rate loans, increasing the possibility of default. Borrowers seeking to avoid these increased monthly payments by refinancing their loans may no longer be able to find available replacement loans at comparably lower interest rates. In addition, a decline in real estate prices may leave borrowers with insufficient equity in the collateral to permit them to refinance or the inability to sell the collateral for an amount equal to or greater than the unpaid principal balance of their loans.

These potential negative events, which may have a greater impact on our earnings and capital than on the earnings and capital of other financial institutions due to our product mix, may cause us to incur losses, which would adversely affect our capital and liquidity and damage our financial condition and business operations.

One- to four-family residential real estate loans comprise a large portion of our loan portfolio and are sensitive to regional and local economic conditions and other factors that impact the ability of borrowers to meet their loan payment obligations.

We originate fixed and adjustable rate loans secured by one- to four-family residential real estate. This type of real estate lending is generally sensitive to regional and local economic conditions that significantly impact the ability of borrowers to meet their loan payment obligations, making loss levels difficult to predict. Declines in residential real estate values as a result of downturns in DFW Metroplex housing markets may reduce the value of the real estate collateral securing these types of loans and increased the risk of losses if borrowers default on

their loans. Residential loans with high combined loan-to-value ratios generally will be more sensitive to declining property values than those with lower combined loan-to-value ratios and therefore may experience a higher incidence of default and severity of losses. In addition, if the borrowers sell their homes, the borrowers may be unable to repay their loans in full from the sale proceeds. As a result, these loans may experience higher rates of delinquencies, defaults and losses, which could in turn adversely affect our financial condition and results of operations.

Our exposure to credit and regulatory risk is increased by our commercial real estate and commercial business lending.

At December 31, 2013, our portfolio of commercial real estate loans totaled $38.1 million, or 17.2% of our total loans, and our portfolio of commercial business loans totaled $16.9 million, or 7.7% of our total loans. Commercial real estate loans and commercial business loans generally have a greater risk of loss than owner-occupied one- to four-family residential real estate loans. Repayment of commercial real estate and commercial business loans generally depends, in large part, on sufficient income from the property or the borrower s business to cover operating expenses and debt service. These types of loans typically involve larger loan balances to single borrowers or groups of related borrowers compared to one- to four-family residential real estate loans. Changes in economic conditions that are beyond the control of the borrower and lender may affect the value of the security for the loan, the future cash flow of the affected property or business.

Under our new commercial bank charter, we intend to emphasize business lending and marketing our products and services to small and medium-sized businesses. These small and medium-sized businesses generally have fewer financial resources in terms of capital or borrowing capacity than larger entities. These firms are generally more vulnerable to economic downturns, whether large and sudden downturns or more moderate downturns that are more prolonged, and may not have the capital needed to compete against their larger, more capitalized competitors. Additionally, the continued success of these firms is frequently contingent on a small group of owners or senior management, and the death, disability or resignation of one or more such individuals could also have a material effect on the business and its ability to repay its loan obligations. If general economic conditions negatively affect these businesses, our results of operations and financial condition may be adversely affected.

If our allowance for loan losses is not sufficient to cover actual loan losses, our earnings will decrease.

We make various assumptions and judgments about the collectability of our loan portfolio, including the creditworthiness of our borrowers and the value of the real estate and other assets serving as collateral for the repayment of many of our loans. In determining the amount of the allowance for loan losses, we review our loans and our loss and delinquency experience, and we evaluate economic conditions. If our assumptions are incorrect, our allowance for loan losses may not be sufficient to cover probable incurred losses in our loan portfolio, requiring us to make additions to our allowance for loan losses. While our allowance for loan losses was 0.93% of total loans, including loans held for sale, at December 31, 2013, material additions to our allowance could materially decrease our net income.

In addition, bank regulators periodically review our allowance for loan losses and may require us to increase our allowance for loan losses or recognize further loan charge-offs. Any increase in our allowance for loan losses or loan charge-offs as required by these regulatory authorities may have a material adverse effect on our financial condition and results of operations.

Future changes in interest rates could reduce our profits.

Our ability to make a profit depends largely on our net interest income, which could be negatively affected by changes in interest rates. Net interest income is the difference between:

- the interest income we earn on our interest-earning assets, such as loans and securities; and
- the interest expense we incur on our interest-bearing liabilities, such as deposits and borrowings.

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As a result of our historical focus on one- to four-family residential real estate loans, the interest rates on our loans are generally fixed for a longer period of time than the interest rates on our deposits. Additionally, many of our investment securities have lengthy maturities with fixed interest rates. Like many banks, our focus on deposit accounts as a source of funds, which have either no stated maturity or shorter contractual maturities than mortgage loans, results in our liabilities having a shorter average duration than our assets. For example, as of December 31, 2013, 56.7% of our loans had maturities of 10 years or longer, while 47.0% of our certificates of deposit had maturities of one year or less. Although we actively monitor our interest rate risk position by, among other practices, retaining one- to four-family residential mortgage loans with terms of less than 15 years and adjustable rate residential mortgage loans which typically reprice between three and seven years, and selling into the secondary mortgage market most of our long-term fixed rate one- to four-family residential mortgage loans with terms of 15 years or more, this imbalance can create significant earnings volatility because market interest rates change over time. In a period of rising interest rates, the interest we earn on our assets, such as loans and investments, may not increase as rapidly as the interest we pay on our liabilities, such as deposits. In a period of declining interest rates, the interest income we earn on our assets may decrease more rapidly than the interest expense we incur on our liabilities, as borrowers prepay mortgage loans and mortgage-backed securities and callable investment securities are called or prepaid, thereby requiring us to reinvest these cash flows at lower interest rates.

In addition, changes in interest rates can affect the average lives of loans and mortgage-backed and related securities. A reduction in interest rates generally results in increased prepayments of loans and mortgage-backed and related securities, as borrowers refinance their debt in order to reduce their borrowing costs. This creates reinvestment risk, which is the risk that we may not be able to reinvest prepayments at rates that are comparable to the rates we earned on the prepaid loans or securities. Conversely, increases in interest rates may decrease loan demand and/or make it more difficult for borrowers to repay adjustable-rate loans.

Changes in interest rates also affect the current fair value of our interest-earning securities portfolio. Generally, the value of securities moves inversely with changes in interest rates. At December 31, 2013, the fair value of our available for sale securities portfolio, consisting of mortgage-backed securities, CMOs, municipal obligations, agency securities and asset-backed securities totaled $29.2 million. Net unrealized losses on these securities totaled approximately $568,000 at December 31, 2013.

We measure our interest rate risk and potential change in our net portfolio value through the use of the FTN Financial Sendero Asset/Liability Management Analysis system (the FTN Model). The FTN Model uses a discounted cash flow analysis and an option-based pricing approach to measure the interest rate sensitivity of net portfolio value. Net portfolio value is the discounted present value of expected cash flows from assets, liabilities, and off-balance sheet contracts. At December 31, 2013, in the event of a 200 basis point increase in interest rates, we would experience an 8.28% decrease in net portfolio value. In the event of a 100 basis point decrease in interest rates, we would experience a 9.75% decrease in net portfolio value. See Item 7 Management s Discussion and Analysis of Financial Condition and Results of Operations Management of Market Risk Net Portfolio Value.

Negative developments in the financial industry and the domestic and international credit markets may adversely affect our operations and results.

Negative developments in the global credit and securitization markets during the past several years resulted in a global recession and significant uncertainty in the financial markets. As a result, loan portfolio quality deteriorated at many financial institutions, reflecting in part, the weakened U.S. economy and rising unemployment. In addition, the values of real estate collateral supporting many commercial loans and home mortgages declined and may not fully recover in the near future. Bank and depository institution holding company stock prices were negatively affected, as did the ability of banks and depository institution holding companies to raise capital or borrow in the debt markets.

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The potential exists for additional federal or state laws and regulations regarding lending and funding practices and liquidity standards, and bank regulatory agencies are expected to continue to be active in responding to concerns and trends identified in examinations, including the expected issuance of many formal enforcement orders. Actions taken to date, as well as potential actions, may not have the beneficial effects that are intended. In addition, new laws, regulations, and other regulatory changes could increase our FDIC insurance premiums, may also increase our costs of regulatory compliance and of doing business, and may otherwise adversely affect our operations. New laws and regulations such as Dodd-Frank, and other regulatory changes, along with negative developments in the financial services industry and the domestic and international credit markets, may significantly affect our ongoing operations, costs and profitability. Further, declines in the stock market in general, or for stock of financial institutions and their holding companies, may affect our stock performance.

A return of recessionary conditions could result in increases in our level of non-performing loans and/or reduce demand for our products and services, which could have an adverse effect on our results of operations.

The ongoing debate in Congress regarding the federal budget deficit, and concerns over the United States credit rating (which was downgraded by Standard & Poor s), the European sovereign debt crisis, the overall weakness in the economy and continued high unemployment in the United States, among other economic indicators, have contributed to increased volatility in the capital markets and diminished expectations for the economy.

A return of recessionary conditions and/or continued negative developments in the domestic and international credit markets may significantly affect the markets in which we do business, the value of our loans and investments, and our ongoing operations, costs and profitability. Further declines in real estate values and sales volumes and continued high unemployment levels may result in higher than expected loan delinquencies and a decline in demand for our products and services. These negative events may cause us to incur losses and may adversely affect our capital, liquidity, and financial condition.

Furthermore, the Federal Reserve Board, in an attempt to help the overall economy, has, among other things, kept interest rates low through its targeted federal funds rate and the purchase of mortgage-backed securities. If the Federal Reserve Board increases the federal funds rate, overall interest rates will likely rise, which may negatively impact the ongoing recovery of the housing markets and the U.S. economy. In addition, deflationary pressures, while possibly lowering our operating costs, could have a significant negative effect on our borrowers, especially our business borrowers, and the values of underlying collateral securing loans, which could negatively affect our financial performance. See Future changes in interest rates could reduce our profits.

If economic conditions deteriorate in the state of Texas, the value of our collateral and borrowers ability to repay loans may decline.

The majority of our loans are located in the state of Texas. Our financial results may be adversely affected by changes in prevailing economic conditions, including decreases in real estate values, changes in interest rates which may cause a decrease in interest rate spreads, adverse employment conditions, the monetary and fiscal policies of the federal government and other significant external events. Decreases in real estate values in the state of Texas could adversely affect the value of property used as collateral for many of our loans. As a result, the market value of the real estate underlying such loans may not, at any given time, be sufficient to satisfy the outstanding principal amount of the loans. In the event that we are required to foreclose on a property securing a loan, we may not recover funds in an amount equal to the remaining loan balance. Consequently, we would sustain loan losses and potentially incur a higher provision for loan loss expense, which would have an adverse impact on our earnings. In addition, adverse changes in the Texas economy may have a negative effect on the ability of borrowers to make timely repayments of their loans, which would also have an adverse impact on earnings.

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Strong competition within our market areas may limit our growth and profitability.

Competition in the banking and financial services industry is intense. In our market areas, we compete with commercial banks, savings institutions, mortgage brokerage firms, credit unions, finance companies, mutual funds, insurance companies and brokerage and investment banking firms operating locally and elsewhere. Many of our competitors have greater name recognition and market presence that benefit them in attracting business, and offer certain services that we do not or cannot provide. In addition, larger competitors may be able to price loans and deposits more aggressively than we do, which could affect our ability to grow and remain profitable on a long-term basis. Larger competitors may also be able to achieve economies of scale and, as a result, may offer a broader range of products and services as well as better pricing for those products and services than we can.

Moreover, advances in technology and other changes have lowered barriers to entry and made it possible for non-banks to offer products and services traditionally provided by banks. For example, consumers can maintain funds that would have historically been held as bank deposits in brokerage accounts or mutual funds. Consumers can also complete transactions such as paying bills and/or transferring funds directly without the assistance of banks. The process of eliminating banks as intermediaries, known as disintermediation, could result in the loss of customer deposits and the related income generated from those deposits. Further, our smaller competitors may have fewer regulatory constraints and may have lower cost structures.

Our profitability depends upon our continued ability to successfully compete in our market areas. If we must raise interest rates paid on deposits or lower interest rates charged on our loans in order to remain competitive, our net interest margin and profitability could be adversely affected.

Liquidity risk could impair our ability to fund operations and jeopardize our financial condition.

Liquidity is essential to our business. We rely on a number of different sources in order to meet our potential liquidity demands. Our primary sources of liquidity are increases in deposit accounts, cash flows from loan payments and our securities portfolio. Borrowings also provide us with a source of funds to meet liquidity demands. For example, we have entered into borrowing agreements with the Federal Home Loan Bank of Dallas pursuant to which we had the ability to borrow up to $89.4 million at December 31, 2013. An inability to raise funds through deposits, borrowings, the sale of loans and other sources could have a material adverse effect on our liquidity. Our access to funding sources in amounts adequate to finance our activities or on terms which are acceptable to us could be impaired by factors that affect us specifically, or the financial services industry or economy in general. Factors that could detrimentally impact our access to liquidity sources include adverse regulatory action against us or a decrease in the level of our business activity as a result of a downturn in the markets in which our loans are concentrated. Our ability to borrow could also be impaired by factors that are not specific to us, such as a disruption in the financial markets or negative views and expectations about the prospects for the financial services industry in light of the recent turmoil faced by banking organizations or deterioration in credit markets.

Protecting our business from identity theft and the theft of other customer data increases our cost of operations. To the extent that we, or our third party providers, are unable to prevent the loss of customer information, our operations may become disrupted and our net income may be adversely affected.

We must protect our computer systems and network from physical break-ins, security breaches, and other disruptive problems caused by the Internet or other users. Moreover, third party providers, such as payment processing centers, must also take similar actions to protect customer information. We rely on encryption and authentication technology to provide the security and authentication necessary to effect secure transmissions of confidential information, as do our third party providers. However, security measures implemented by us or our third party providers may not prevent cyber-fraud. Advances in computer capabilities, new discoveries in the field of cryptography, or other developments could result in a compromise or breach of the algorithms we and our third-party service providers use to protect customer transaction data. If any compromise of our security or the security of our third party providers were to occur, it could have a material adverse effect on our business, financial condition, and results of operations.

Our business is reliant on outside vendors.

Our business is dependent on the use of outside service providers that support our day-to-day operations including data processing and electronic communications. Our operations are exposed to risk that a service provider may not perform in accordance with established performance standards required in our agreements for any number of reasons including equipment or network failure, a change in their senior management, their financial condition, their product line or mix and how they support existing customers, or a simple change in their strategic focus. While we have comprehensive policies and procedures in place to mitigate risk at various phases of service provider management from selection, to performance monitoring and renewals, the failure of a service provider to perform in accordance with contractual agreements could be disruptive to our business, which could have a material adverse effect on our financial conditions and results of our operations.

We operate in a highly regulated environment and may be adversely affected by changes in laws and regulations.

We are subject to extensive regulation, supervision, and examination by the Texas Department of Banking, the Federal Reserve Board, the FDIC and other regulatory bodies. Such regulators govern the activities in which we may engage, primarily for the protection of depositors, consumers and investors. These regulatory authorities have extensive discretion in connection with their supervisory and enforcement activities, including the imposition of restrictions on the operations of a bank, the classification of assets by a bank, and the adequacy of a bank s allowance for loan losses. Any change in such regulation and oversight, whether in the form of regulatory policy, regulations, or legislation, could have a material impact on our results of operations. Because our business is highly regulated, the laws, rules, and applicable regulations are subject to regular modification and change. There can be no assurance that proposed laws, rules, and regulations, or any other laws, rules, or regulations, will not be adopted in the future, which could make compliance more difficult or expensive or otherwise adversely affect our business, financial condition, or prospects.

Financial reform legislation recently enacted by Congress will result in new laws and regulations that are expected to increase our costs of operations.

Congress enacted the Dodd-Frank Act in 2010. This new law significantly changed the bank regulatory structure and affected the lending, deposit, investment, trading and operating activities of financial institutions and their holding companies. The Dodd-Frank Act requires various federal agencies to adopt a broad range of new implementing rules and regulations, and to prepare numerous studies and reports for Congress. The federal agencies are given significant discretion in drafting the implementing rules and regulations, and consequently, many of the details and much of the impact of the Dodd-Frank Act may not be known for many months or years.

Effective one year after the date of enactment was a provision of the Dodd-Frank Act that eliminates the federal prohibitions on paying interest on demand deposits, thus allowing businesses to have interest bearing checking accounts. Depending on competitive responses, this significant change to existing law could have an adverse effect on our interest expense.

The Dodd-Frank Act also broadens the base for FDIC insurance assessments. Assessments are now based on the average consolidated total assets less tangible equity capital of a financial institution. The Dodd-Frank Act also permanently increases the maximum amount of deposit insurance for banks, savings institutions and credit unions to $250,000 per depositor, retroactive to January 1, 2008, and non-interest bearing transaction accounts had unlimited deposit insurance through December 31, 2012, however, Congress did not extend this temporary program.

The Dodd-Frank Act requires publicly traded companies to give stockholders a non-binding vote on executive compensation and so-called golden parachute payments. The legislation also directs the Federal Reserve Board to promulgate rules prohibiting excessive compensation paid to holding company executives, regardless of whether the company is publicly traded or not.

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The Dodd-Frank Act created the CFPB with broad powers to supervise and enforce consumer protection laws. The CFPB has broad rule-making authority for a wide range of consumer protection laws that apply to all banks and savings institutions, including the authority to prohibit unfair, deceptive or abusive acts and practices. The CFPB has examination and enforcement authority over all banks and savings institutions with more than $10 billion in assets. Banks and savings institutions with $10 billion or less in assets will continue to be examined for compliance by their applicable bank regulators. The Dodd-Frank Act also weakens the federal preemption rules that have been applicable for national banks and federal savings associations, and gives state attorneys general the ability to enforce federal consumer protection laws.

In December 2013, a provision of the Dodd-Frank Act known as the Volcker Rule was finalized by the federal banking agencies. The Volcker Rule prohibits banks and their affiliates from engaging in proprietary trading and prohibits investment in hedge funds and private equity funds. We currently do not believe any of our investments are considered prohibited investments. In the event this conclusion changes, we may be required to sell certain assets as prices that may result in realize losses on sale.

It is difficult to predict at this time what specific impact the Dodd-Frank Act and the yet-to-be-written implementing rules and regulations will have on community banks. However, it is expected that at a minimum they will increase our operating and compliance costs and could increase our interest expense.

New regulations could restrict our ability to originate and sell mortgage loans.

The Consumer Financial Protection Bureau has issued a rule designed to clarify for lenders how they can avoid monetary damages under the Dodd-Frank Act, which would hold lenders accountable for ensuring a borrower s ability to repay a mortgage. Loans that meet this qualified mortgage definition will be presumed to have complied with the new ability-to-repay standard. Under the Consumer Financial Protection Bureau s rule, a qualified mortgage loan must not contain certain specified features, including:

- excessive upfront points and fees (those exceeding 3% of the total loan amount, less bona fide discount points for prime loans);
- interest-only payments;
- negative-amortization; and
- terms longer than 30 years.

Also, to qualify as a qualified mortgage, a borrower s total monthly debt-to-income ratio may not exceed 43%. Lenders must also verify and document the income and financial resources relied upon to qualify the borrower for the loan and underwrite the loan based on a fully amortizing payment schedule and maximum interest rate during the first five years, taking into account all applicable taxes, insurance and assessments. The Consumer Financial Protection Bureau s rule on qualified mortgages could limit our ability or desire to make certain types of loans or loans to certain borrowers, or could make it more expensive and time consuming to make these loans, which could limit our growth or profitability.

Our business may be subject to possible enforcement or other legal action for failure to comply with laws and regulations.

Failure to comply with laws, regulations, policies or supervisory guidance could result in enforcement and other legal actions by Federal or state authorities, including criminal and civil penalties, the loss of FDIC insurance, the revocation of a banking charter, other sanctions by regulatory agencies, civil money penalties and/or reputation damage. In this regard, government authorities, including the bank regulatory agencies, are pursuing aggressive enforcement actions with respect to compliance and other legal matters involving financial activities, which heightens the risks associated with actual and perceived compliance failures. Any of the foregoing could have a material adverse effect on our business, financial condition and results of operations.

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We will become subject to more stringent capital requirements.

The Dodd-Frank Act requires the federal banking agencies to establish minimum leverage and risk-based capital requirements for insured banks and their holding companies. The federal banking agencies issued a joint final rule, or the Final Capital Rule, that implements the Basel III capital standards and establishes the minimum capital levels required under the Dodd-Frank Act. We must comply with the Final Capital Rule by January 1, 2015. The Final Capital Rule establishes a minimum common equity Tier I capital ratio of 6.5% of risk-weighted assets for a well capitalized institution and increases the minimum Tier I capital ratio for a well capitalized institution from 6.0% to 8.0%. Additionally, the Final Capital Rule requires an institution to maintain a 2.5% common equity Tier I capital conservation buffer over the 6.5% minimum risk-based capital requirement to avoid restrictions on the ability to pay dividends, discretionary bonuses, and engage in share repurchases. The Final Capital Rule permanently grandfathers trust preferred securities issued before May 19, 2010, subject to a limit of 25% of Tier I capital. The Final Capital Rule increases the required capital for certain categories of assets, including high-volatility construction real estate loans and certain exposures related to securitizations; however, the Final Capital Rule retains the current capital treatment of residential mortgages. Under the Final Capital Rule, we may make a one-time, permanent election to continue to exclude accumulated other comprehensive income from capital. If we do not make this election, unrealized gains and losses will be included in the calculation of our regulatory capital. Implementation of these standards, or any other new regulations, may adversely affect our ability to pay dividends, or require us to reduce business levels or raise capital, including in ways that may adversely affect our results of operations or financial condition.

Our ability to attract and retain key employees may change.

Our success depends, in large part, on our ability to attract and retain key employees, competition for which can be intense. We may not be able to hire or retain these employees. The unexpected loss of a key employee could have a material adverse impact on our business as the skills, knowledge of our market and institution, and the years of experience of a departing key employee which are all difficult to quickly replace with qualified personnel. Furthermore, in 2011 federal regulators imposed limitations on incentive-based compensation for covered financial institutions which the regulators believe encourage inappropriate risk-taking, are deemed by a regulator to be excessive or may lead to material losses. We may be at a disadvantage offering compensation packages in competition with other banks and non-banks that are not subject to the rules.

The soundness of other financial institutions could adversely affect us.

The financial services industry is interrelated. As with all institutions, including commercial and savings banks, credit unions, broker-dealers, investment banks, and other such institutional clients, we routinely engage in financial transactions with other financial institutions including loan syndications and participations, trading and clearing transactions, deposit accounts, and many other routine transactions. We rely on other institutions ability to remain commercially viable, that they are being operated in safe and sound manner, and in accordance with all applicable laws and regulations applicable to the transactions in which we engage as well as the operation of their business as a whole. If our reliance is misplaced, or a default, failure or even rumors of such by one of more of those institutions occurs, it may lead to transaction-specific loss, default or credit risk for us, and could lead to further industry-wide liquidity problems, all of which can have a material adverse effect on our financial condition and results of operations.

We continually encounter technological change.

The financial services industry is continually undergoing rapid technological change with frequent introductions of new technology-driven products and services. The effective use of technology increases efficiency and enables financial institutions to better serve customers and to reduce costs. Our future success depends, in part, upon its ability to address the needs of its customers by using technology to provide products and services that will satisfy customer demands, as well as to create additional efficiencies in our operations. Many of our competitors have

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substantially greater resources to invest in technological improvements. We may not be able to effectively implement new technology-driven products and services or be successful in marketing these products and services to its customers. Failure to successfully keep pace with technological change affecting the financial services industry could have a material adverse impact on our business, financial condition and results of operations.

Natural disasters, severe weather events, worldwide hostilities, including terrorist attacks, and other external events may adversely affect the general economy, the financial services industry, the industries of our customers, and us in particular.

Natural disasters, severe weather events, including those prominent in our geographic footprint and those prominent in the geographic areas of our vendors and business partners, together with worldwide hostilities, including terrorist attacks, and other external events could have a significant impact on our ability to conduct our business. They could also affect the stability of our deposit base, our borrowers ability to repay loans, impair collateral, result in a loss of revenue or an increase in expenses. Although management has established disaster recovery and business continuity procedures and plans, the occurrence of any such event may adversely affect our business, which in turn could have a material adverse effect on our financial condition and results of our operations.

Changes in accounting standards, or our own accounting practices or policies, could materially impact our financial statements.

From time to time entities that set accounting standards change the financial accounting and reporting standards that govern the preparation of our financial statements. These changes can be both difficult to predict and involve judgment and discretion in their interpretation by us, and our independent accounting firms. The changes implemented by the entities in setting standards themselves could materially impact, potentially even retroactively, how we report our financial condition and results of our operations as could our interpretation of those changes.

New lines of business or new products and services may subject us to additional risks.

From time to time, we may implement new lines of business or offer new products and services within existing lines of business. There are substantial risks and uncertainties associated with these efforts, particularly in instances where the markets are not fully developed. In developing and marketing new lines of business and/or new products and services we may invest significant time and resources. Initial timetables for the introduction and development of new lines of business and/or new products or services may not be achieved and price and profitability targets may not prove feasible. External factors, such as compliance with regulations, competitive alternatives, and shifting market preferences, may also impact the successful implementation of a new line of business or a new product or service. Furthermore, any new line of business and/or new product or service could have a significant impact on the effectiveness of our system of internal controls. Failure to successfully manage these risks in the development and implementation of new lines of business or new products or services could have a material adverse effect on our business, financial condition and results of operations.

Our Warehouse Purchase Program balances can experience significant fluctuations.

We have a lending concentration in the Warehouse Purchase Program. Because Warehouse Purchase Program balances are contingent upon residential mortgage lending activity, changes in the residential real estate market nationwide and in our market areas can lead to fluctuations of balances in this product, materially impacting both interest and non-interest income. Factors that can impact Mortgage Warehouse balances include interest rates, home prices, home inventories, new housing starts, inclement weather, banking regulations, and intense industry competition. Additionally, Warehouse Purchase Program period-end balances are generally higher than the average balance during the period due to increased mortgage activity that occurs at the end of a month.

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We depend on the accuracy and completeness of information about customers and counterparties.

In deciding whether to extend credit or enter into other transactions, we may rely on information furnished by or on behalf of customers and counterparties, including financial statements, credit reports and other financial information. We may also rely on representations of those customers, counterparties or other third parties, such as independent auditors, as to the accuracy and completeness of that information. Reliance on inaccurate or misleading financial statements, credit reports or other financial information could have a material adverse impact on our business, financial condition and results of operations.

Acquisitions may disrupt our business and dilute shareholder value.

As part of our growth strategy, we regularly evaluate merger and acquisition opportunities and conduct due diligence activities related to possible transactions with other financial institutions and financial services companies. As a result of the recent increase in merger and acquisition activity involving small banks, negotiations may take place and future mergers or acquisitions involving cash, debt, or equity securities may occur at any time. We seek merger or acquisition partners that are culturally similar, have experienced management, and possess either significant market presence or have potential for improved profitability through financial management, economies of scale, or expanded services.

Acquiring other banks, business or branches involves potential adverse impact to our financial results and various other risks commonly associated with acquisitions, including, among other things:

- difficulty in estimating the value of the target company;
- payment of a premium over book and market values that may dilute our tangible book value and earnings per share in the short and long term;
- potential exposure to unknown or contingent liabilities of the target company, including, without limitation, liabilities for regulatory and compliance issues;
- exposure to potential asset quality issues of the target company;
- there may be volatility in reported income as goodwill impairment losses could occur irregularly and in varying amounts;
- difficulty and expense of integrating the operations and personnel of the target company;
- inability to realize the expected revenue increases, cost savings, increases in geographic or product presence, and / or other projected benefits;
- potential disruption to our business;
- potential diversion of our management s time and attention;
- the possible loss of key employees and customers of the target company; and

potential changes in banking or tax laws or regulations that may affect the target company.

Risks Related to Our Common Stock

Regulatory and corporate governance anti-takeover provisions may make it difficult for you to receive a change-in-control premium.

Provisions of federal banking laws, including regulatory approval requirements, could make it more difficult for a third party to acquire us, even if doing so would be perceived to be beneficial to our stockholders. These provisions effectively inhibit a non-negotiated merger or other business combination, which, in turn, could adversely affect the market price of our common stock. With certain limited exceptions, federal regulations make it difficult for any one person or company or a group of persons from, directly or indirectly, acquiring more than

10% (5% if the acquirer is a bank holding company) of any class of our voting stock or obtaining the ability to control in any manner the election of a majority of our directors or otherwise direct our management or policies without prior notice or application to and the approval of the appropriate federal regulator(s). Certain provisions of our corporate documents are also designed to make merger, tender offer or proxy contest more difficult, even if such events were perceived by many of our stockholders to be beneficial to their interests.

Our stock price can be volatile and its trading volume is generally less than other institutions.

Stock price volatility may make it more difficult for you to resell your common stock when you want and at prices you find attractive. Our stock price can fluctuate significantly in response to a variety of factors. The factors that may cause a fluctuation in our stock price, among those risk factors discussed elsewhere in this report, are:

- actual or anticipated variations in quarterly results of operations;
- recommendations by securities analysts;
- operating and stock price performance of other companies that investors deem comparable to us;
- news reports relating to trends, concerns and other issues in the financial services industry;
- perceptions in the marketplace regarding us and/or our competitors;
- new technology used, or serves offered, by competitors;
- significant acquisitions or business combinations, strategic partnerships, joint ventures or capital commitments by or involving us or our competitors;
- failure to integrate acquisitions or realize anticipated benefits from acquisitions;
- changes in governmental regulations; and
- geopolitical conditions such as acts or threats of terrorism or military conflicts.

Also, although our common stock is currently listed for trading on the Nasdaq Stock Market, the trading volume of our stock is less than that of other, larger financial services companies. Given the lower trading volume of our stock, significant sales of the stock, or the expectation of these sales, could cause the stock price to fall.

An investment in our common stock is not an insured deposit.

Our common stock is not a bank deposit and, therefore, is not insured against loss by the FDIC, any other deposit insurance fund or by any other public or private entity. Investment in our common stock is inherently risky for the reasons described in this Risk Factors section and elsewhere in this report and is subject to the same market forces that affect the price of common stock in any company. As a result, if you acquire our common stock, you could lose some or all of your investment.

We are subject to financial reporting and other requirements that place significant demands on our resources.

We are subject to reporting and other obligations under the Exchange Act, including the requirements of Section 404 of the Sarbanes-Oxley Act. Section 404 of the Sarbanes-Oxley Act requires us to conduct an annual management assessment of the effectiveness of our internal controls over financial reporting. These reporting and other obligations place significant demands on our management, administrative, operational, internal audit and accounting resources. Any failure to maintain effective internal controls could have a material adverse effect on our business, operating results and stock price. Moreover, effective internal control is necessary for us to provide reliable financial reports and prevent fraud. If we cannot provide reliable financial reports or prevent fraud, we may not be able to manage our business as effectively as we would if an effective control environment existed, and our business and reputation with investors may be harmed.

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There are inherent limitations in all control systems, and misstatements due to error or fraud may occur and not be detected.

The ongoing internal control provisions of Section 404 of the Sarbanes-Oxley Act require us to identify material weaknesses in internal control over financial reporting, which is a process to provide reasonable assurance regarding the reliability of financial reporting for external purposes in accordance with accounting principles generally accepted in the United States. Our management, including our chief executive officer and chief financial officer, do not expect that our internal controls and disclosure controls will prevent all errors and all fraud. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. In addition, the design of a control system must reflect the fact that there are resource constraints and the benefit of controls must be relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, in our company have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty and that breakdowns can occur because of simple errors or mistakes. Further, controls can be circumvented by individual acts of some persons, by collusion of two or more persons, or by management override of the controls. The design of any system of controls is also based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions. Over time, a control may be inadequate because of changes in conditions, such as growth of the company or increased transaction volume, or the degree of compliance with the policies or procedures may deteriorate. Because of inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected.

In addition, discovery and disclosure of a material weakness, by definition, could have a material adverse impact on our financial statements. Such an occurrence could discourage certain customers or suppliers from doing business with us, cause downgrades in our future debt ratings leading to higher borrowing costs and affect how our stock trades. This could in turn negatively affect our ability to access public debt or equity markets for capital.

ITEM 1B. Unresolved Staff Comments

Not applicable.

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ITEM 2. Properties

We operate from our main office in Plano, Texas. In addition to the Bank s home office in Plano, Texas, the Bank has three branches: one located near downtown Dallas, Texas; one located near the Bank s headquarters in Plano, Texas; and one located in Louisville, Kentucky. During June 2013, the Bank closed its Irvine, California branch, but an ATM remains in the location. During March 2013, the Bank closed one of its branches located in Louisville, Kentucky, but an agency office remains there.

The following table sets forth information with respect to our banking offices, including the expiration date of leases with respect to leased facilities.

Address	Leased or Owned	Year Acquired or Leased	Expires
Main Office: 5224 W. Plano Parkway Plano, Texas 75093	Owned	2002	N/A
Branch Offices: 2501 Oak Lawn Dallas, Texas 75219	Leased	2006	03/2017
7701 Legacy Drive Plano, Texas 75024	Leased	2004	12/2014
1900 Colonel Sanders Lane Louisville, Kentucky 40213	Leased	2005	05/2014
Agency Offices: 7100 Corporate Drive Plano, Texas 75024	Leased	2011	2/2014
5600 Headquarter Drive Plano, Texas 75024	Leased	2010	12/2014
5200 Commerce Crossings Louisville, Kentucky 40229	Leased	2005	5/2014

ITEM 3. Legal Proceedings

At December 31, 2013, we were not involved in any pending legal proceedings other than routine legal proceedings occurring in the ordinary course of business which, in the aggregate, involve amounts which management believes will not materially adversely affect our financial condition, our results of operations and our cash flows.

ITEM 4. Mine Safety Disclosures.

Not applicable.

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PART II

ITEM 5. Market for Registrant s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities

(a) ***Market, Holder and Dividend Information.*** Our common stock is traded on the Nasdaq Stock Market under the symbol SPBC. As of February 20, 2014, there were approximately 277 stockholders of record of our common stock. We believe the number of beneficial owners is greater than the number of record holders because beneficial owners of our common stock hold shares in nominee or street name for the benefit of individual investors.

The table below provides the high and low closing bid price information for our common stock for each quarterly period within the two most recent years as reported by the Nasdaq Capital Market.

		High	Low	Dividends
2013	Fourth Quarter	$ 20.45	$ 19.25	$
	Third Quarter	$ 20.98	$ 17.95	$
	Second Quarter	$ 19.40	$ 17.76	$
	First Quarter	$ 18.50	$ 15.61	$
2012	Fourth Quarter	$ 16.44	$ 13.60	$
	Third Quarter	$ 16.00	$ 12.75	$
	Second Quarter	$ 13.25	$ 11.83	$
	First Quarter	$ 12.65	$ 10.09	$

SP Bancorp does not currently pay cash dividends on its common stock. Dividend payments by SP Bancorp are dependent on dividends it receives from the Bank, because SP Bancorp has no source of income other than dividends from the Bank, earnings from the investment of proceeds from the sale of shares of common stock retained by SP Bancorp and interest payments with respect to SP Bancorp s loan to the Employee Stock Ownership Plan. See Item 1. Business Supervision and Regulation Federal Banking Regulation Capital Distributions.

Sales of Unregistered Securities. None.

(b) ***Use of Proceeds***. Not applicable

(c) ***Stock Repurchases.*** The table below sets for the details of shares repurchased during the fourth quarter of 2013:

	Total Number of Shares Purchased [(a)]	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publically Announced Plans or Programs	Maximum Number of Shares That May Yet Be Purchased Under the Plans or Programs
October 1, 2013 through October 31, 2013	15,000	19.59	15,000	11,137

(a) Share repurchases were made pursuant to a share repurchase program authorized by our board of directors on August 5, 2013. This program allowed for the repurchase up to 5% of the issued and outstanding shares, or 81,937 shares. At December 31, 2013, 70,800 shares had been repurchased pursuant to the program. During January 2014, the Company repurchased the remaining 11,137 shares allowable under the repurchase program.

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ITEM 6. Selected Financial Data

Smaller reporting companies are not required to provide the information required by this item.

Below are certain performance measures for the Company:

	December 31, 2013	December 31, 2012	December 31, 2011
Return on average assets	0.41%	0.53%	0.36%
Return on average equity	3.73%	4.57%	2.86%
Dividend payout ratio			
Average equity to average assets	11.11%	11.59%	12.44%

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ITEM 7. Management s Discussion and Analysis of Financial Condition and Results of Operations

Overview

SP Bancorp, Inc., a Maryland corporation (the Company) is a bank holding company and the parent of SharePlus Bank, a Texas chartered state bank (the Bank). The Company is regulated by the Board of Governors of the Federal Reserve System (the Federal Reserve). In December 2013, the Bank received approval from the Texas Department of Banking (the Department) to convert its charter to a Texas state bank charter and became a member of the Federal Reserve and the Company became a bank holding company. With these changes, the Department and the Federal Reserve are the primary regulators of the Bank and the Company is regulated by the Federal Reserve as a bank holding company. The Bank is subject to examination by the Federal Deposit Insurance Corporation (the FDIC). When using the terms we, us, our, or the Company, are referring to SP Bancorp and the Bank on a consolidated basis.

The Company has not engaged in any business to date other than owning the common stock of Bank. The Bank is a Texas state chartered bank that was originally chartered in 1958 as a federal credit union serving the employees and family members of Frito-Lay, Inc. and eventually grew to serve the employees and family members of YUM! Brands, Inc., A&W Restaurants, Inc., KFC Corporation, Long John Silver s, Inc., Pizza Hut, Inc., Taco Bell Corp., and various PepsiCo divisions, as well as various other companies that provided banking services to their employees.

Our business consists primarily of taking deposits and investing those deposits, together with funds generated from operations and borrowings, in mortgage loans secured by residential real estate, home equity loans and lines of credit, commercial real estate loans, consumer loans (consisting primarily of automobile loans) and commercial business loans.

Our results of operations depend mainly on our net interest income, which is the difference between the interest income we earn on our loan and investment portfolios and the interest expense we incur on our deposits and, to a lesser extent, our borrowings. Results of operations are also affected by service charges and other fees, provision for loan losses, gains on sales of securities and loans and other income. Our noninterest expense consists primarily of compensation and benefits, occupancy costs, equipment expense, data processing, ATM expense, professional and outside services, FDIC insurance assessments and marketing.

Our results of operations are also significantly affected by general economic and competitive conditions (such as changes in energy prices which have an impact on our Texas market area), as well as by changes in interest rates, government policies and actions of regulatory authorities. Future changes in applicable laws, regulations or government policies similarly may materially affect our financial condition and results of operations.

Total assets increased $15.9 million, or 5.5%, to $304.0 million at December 31, 2013 from $288.1 million at December 31, 2012. The increase was primarily the result of an increase in securities available for sale and cash and cash equivalents, which was funded by customer deposits.

Net income for the year ended December 31, 2013 was $1.2 million compared to net income of $1.5 million for the year ended December 31, 2012. Net interest income decreased $0.5 million to $9.7 million for the year ended December 31, 2013 from $10.2 million for the year ended December 31, 2012. Noninterest income decreased $1.0 million, provision for loan losses decreased $0.8 million, noninterest expense decreased $0.4 million and income tax expense decreased $17,000 and for the year ended December 31, 2013, as compared to the year ended December 31, 2012.

Business Strategy

Our primary objective is to remain a community-oriented financial institution dedicated to providing a full range of financial services to consumers and businesses in our primary market areas. We have increased our deposits and loan portfolio in and around our Texas branch office network through a more traditional community bank

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growth pattern. We intend to continue to provide the highest quality service and financial products to our customers and to increase our commercial real estate and commercial business lending, while maintaining our residential real estate lending through our Texas branch network.

Our strategy for accomplishing these goals and improving our profitability is as follows:

Diversify our loan portfolio by increasing our emphasis on commercial real estate and commercial business loans while continuing the origination of one- to four-family residential mortgage loans, including mortgage warehouse loans. Our strategy for increasing net income includes increasing our loan originations and diversifying our loan portfolio by transitioning from a predominantly consumer driven model to that of a more diversified financial institution. We intend to continue to emphasize the origination of one- to four-family residential mortgage loans and commercial real estate loans, which amounted to 69.0% and 17.2%, respectively, of our total loans at December 31, 2013, compared to 70.1% and 17.9%, respectively, of our total loans at December 31, 2012.

As we increase our emphasis on commercial real estate and commercial business loans, we anticipate that our commercial real estate and commercial business loan portfolio will increase both in absolute value as well as a percentage of our total loan portfolio. Commercial real estate loans generally are originated with higher interest rates compared to one- to four-family residential mortgage loans and, therefore, have a positive effect on our interest rate spread and net interest income. In addition, we intend to increase our commercial business loan portfolio. While the total dollar amount of our consumer loans is expected to remain relatively stable in the near term, it is expected that consumer loans will continue to decline as a percentage of our total loan portfolio.

Use conservative underwriting guidelines and aggressively monitor our loan portfolio to maintain asset quality. We introduce loan products only when we are confident that our staff has the necessary expertise to originate and administer such loans, and that sound underwriting and collection procedures are in place. Our goal is to continue to improve our asset quality through conservative underwriting standards and the diligence of our loan collection personnel. At December 31, 2013, our ratio of non-performing loans to total loans was 1.42%. At December 31, 2013, our ratio of allowance for loan losses to non-performing loans was 65.83% and our ratio of allowance for loan losses to total loans, including loans held for sale was 0.93%.

Emphasize lower cost core deposits to reduce the funding costs of our loan originations. We offer interest-bearing and noninterest-bearing demand accounts, money market accounts and savings accounts (collectively referred to as core deposits), which generally are lower-cost sources of funds than certificates of deposit, and are less sensitive to withdrawal when interest rates fluctuate. At December 31, 2013, 61.5% of our total deposits consisted of these lower cost core deposits. We believe the convenient locations of our branch network, and especially our facilities located within our former sponsor companies offices, provide us with a competitive advantage in accessing low-cost core deposits from our existing customers that use these branches. We intend to continue emphasizing our core deposits as a source of funds. With respect to our commercial customers, we generally request that commercial banking borrowers open checking accounts with us at the time they establish a borrowing relationship with us.

Manage interest rate risk. Successfully managing interest rate risk is an integral part of our business strategy. Management and our board of directors evaluate the interest rate risk inherent in our assets and liabilities, and determine the level of risk that is appropriate and consistent with our capital levels, liquidity and performance objectives. In particular, during the current low interest rate environment, we have sought to minimize the risk of originating long-term, fixed rate loans by selling such loans in the secondary market, and in particular, selling substantially all of our qualifying one- to four- family fixed-rate residential mortgage loans with terms of 15 years or greater. In addition, a portion of our loan portfolio consists of commercial real estate loans and consumer loans which generally have shorter terms and provide higher yields than one- to four- family residential mortgage

loans. Finally, our mortgage warehouse lines of credit are secured by loans that typically stay on the line for 30 days or less. We also monitor the mix of our deposits, a majority of which have been lower cost core deposits. Our strategy is to continue managing interest rate risk in response to changes in the local and national economy and to increase our assets as we deploy the proceeds from the offering.

Follow a controlled growth strategy to minimize increases in our noninterest expense. We believe our infrastructure, personnel and fixed operating base can support a substantially larger institution, and we intend to implement such growth without significant increases in our noninterest expense with respect to the use of these branches and systems. Although we experienced increases in noninterest expense as a result of our becoming a public company, management has implemented operational strategies to minimize increases in noninterest expense, including using technology to limit facility and personnel costs, including enhanced ATM and website functionality, and implementing remote deposit capture at our commercial customers locations. We also intend to pursue future acquisitions of commercial banks, savings institutions, and other financial services companies, including branch offices of such companies, although we have no current arrangements or agreements with respect to any such acquisitions.

We believe following these strategies will allow us to offer our customers a broad range of financial products and services. Our goal is to provide full relationship banking to our customers. We plan to execute upon our business strategy, subject to changes necessitated by future market conditions and other factors.

Critical Accounting Policies

We consider accounting policies that require management to exercise significant judgment or discretion or make significant assumptions that have, or could have, a material impact on the carrying value of certain assets or on income, to be critical accounting policies. We consider the following to be our critical accounting policies.

Allowance for Loan Losses. We believe that the allowance for loan losses and related provision for loan losses are particularly susceptible to change in the near term, due to changes in credit quality which are evidenced by trends in charge-offs and in the volume and severity of past due loans. In addition, our loan mix is changing as we continue to increase our commercial lending. Commercial loans generally have greater credit risk than one- to four-family residential mortgage and consumer loans due to these loans being larger in amount and non-homogenous.

The allowance for loan losses is maintained at a level to cover probable incurred losses in the loan portfolio at the balance sheet date. Based on our estimate of the level of allowance for loan losses required, we record a provision for loan losses as a charge to earnings to maintain the allowance for loan losses at an appropriate level.

The estimate of our credit losses is applied to two general categories of loans:

- loans that we evaluate individually for impairment under Accounting Standards Codification (ASC) 310-10, Receivables; and
- groups of loans with similar risk characteristics that we evaluate collectively for impairment under ASC 450-20, Loss Contingencies.

The allowance for loan losses is evaluated on a regular basis by management and reflects its consideration of significant factors that affect the collectability of the loan portfolio. The factors used to evaluate the collectability of the loan portfolio include, but are not limited to, current economic conditions, our historical loss experience, the nature and volume of the loan portfolio, the financial strength of the borrower, and estimated value of any underlying collateral. This evaluation is inherently subjective as it requires estimates that are subject to significant revision as more information becomes available. Actual loan losses may be significantly more than the allowance for loan losses we have established which could have a material negative effect on our financial results. See also Business of the Bank Allowance for Loan Losses.

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Comparison of Financial Condition at December 31, 2013 and December 31, 2012

Summary of Selected Balance Sheet Data.

	As of December 31,		Increase/	
	2013	2012	(Decrease)	% Change
	(Dollars in thousands)			
Total assets	$ 304,009	$ 288,121	$ 15,888	5.51%
Total cash and cash equivalents	37,564	23,933	13,631	56.95
Securities available for sale, at fair value	29,245	15,713	13,532	86.12
Loans held for sale	1,846	7,290	(5,444)	(74.68)
Loans, net	218,280	222,288	(4,008)	(1.80)
Other real estate owned	81	1,477	(1,396)	(94.52)
Premises and equipment, net	4,053	4,249	(196)	(4.61)
Federal Reserve Bank stock, at cost	350		350	
Federal Home Loan Bank of Dallas stock, at cost	440	1,099	(659)	(59.96)
Bank-owned life insurance	7,681	7,439	242	3.25
Other assets [(1)]	4,469	4,633	(164)	(3.54)
Deposits	261,286	232,340	28,946	12.46
Borrowings	7,368	20,316	(12,948)	(63.73)
Stockholders equity	32,816	33,040	(224)	(0.68)

(1) Includes fixed annuity investment, accrued interest receivable, deferred tax assets and other assets.

Total assets increased $15.9 million to $304.0 million at December 31, 2013. The increase in total assets was driven by increases in customer deposits that were reinvested in cash and cash equivalents and in securities and used to reduce borrowings.

Net loans, including loans held for sale, decreased $9.5 million to $220.1 million at December 31, 2013. All loan categories except commercial business loans and home equity loans decreased during 2013. Commercial business loans and home equity loans increased during 2013 as a result of higher loan production from new and existing customers.

Other real estate owned (OREO) decreased $1.4 million to $81,000 at December 31, 2013 due to sales of previously foreclosed properties.

Deposits increased $28.9 million to $261.3 million at December 31, 2013. Deposit growth, driven mostly by certificates of deposits, increased as a result of inflows from new and existing customers. The increase was partially the result of a local advertising campaign designed to lengthen our CD maturities.

Advances from the Federal Home Loan Bank of Dallas (the FHLB) decreased $12.9 million to $7.4 million at December 31, 2013 due to increased deposits and the corresponding payoffs of advances.

The decline in stockholders equity was primarily due to the repurchase of 70,800 share of our common stock during 2013, partially offset by $1.2 million of net income for 2013.

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Comparison of Operating Results for the Years Ended December 31, 2013 and 2012

General. We recorded net income of $1.2 million for the year ended December 31, 2013 compared to net income of $1.5 million for the year ended December 31, 2012, a decrease of $0.3 million. The change in net income was due to a decrease in net interest income of $0.5 million and a decrease in noninterest income of $1.0 million, offset by a decrease in noninterest expense of $0.4 million and a decrease in the provision for loan losses of $0.8 million.

Summary of Net Interest Income.

	Years Ended December 31, 2013	2012	Increase/ (Decrease)	% Change
	(Dollars in thousands)			
Interest income:				
Interest and fees on loans	$ 10,768	$ 11,202	$ (434)	(3.87)%
Securities taxable	37	158	(121)	(76.58)
Securities nontaxable	133	104	29	27.88
Other interest earning assets	195	146	49	33.56
Total interest income	11,133	11,610	(477)	(4.11)
Interest expense:				
Savings deposits	19	41	(22)	(53.66)
Money market	67	81	(14)	(17.28)
Demand deposit accounts	70	69	1	1.45
Certificates of deposit	1,109	942	167	17.73
Total deposits	1,265	1,133	132	11.65
Borrowings	168	299	(131)	(43.81)
Total interest expense	1,433	1,432	1	0.07
Net interest income	$ 9,700	$ 10,178	$ (478)	(4.70)%

Summary of Average Yields, Average Rates and Average Balances.

Average Yields and Rates

	As of December 31, 2013	2012	Increase/ (Decrease) in basis points
Loans	4.81%	5.00%	(0.19)
Securities taxable	0.30%	1.08%	(0.78)
Securities nontaxable	2.94%	3.42%	(0.48)
Other interest earning assets including FHLB Stock	0.45%	0.55%	(0.10)
Total interest-earning assets	3.92%	4.32%	(0.40)
Savings deposits	0.05%	0.11%	(0.06)
Money market	0.18%	0.21%	(0.03)
Demand deposit accounts	0.12%	0.13%	(0.01)
Certificates of deposits	1.17%	1.23%	(0.06)
Total deposits	0.56%	0.55%	0.01
Borrowings	1.60%	1.27%	0.33
Total interest-bearing liabilities	0.60%	0.62%	(0.02)

Net interest rate spread	3.32%	3.70%	(0.38)
Net interest margin	3.42%	3.79%	(0.37)

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Average Balances

	Years Ended December 31, 2013	2012	Increase/ (Decrease)	% Change
	(Dollars in thousands)			
Loans	$ 224,051	$ 223,886	$ 165	0.07%
Securities - taxable	12,280	14,580	(2,300)	(15.78)
Securities - nontaxable	4,523	3,042	1,481	48.69
Other interest earning assets	43,135	27,111	16,024	59.11
Total interest earning assets	283,989	268,619	15,370	5.72
Savings deposits	38,275	36,851	1,424	3.86
Money market deposits	36,798	39,049	(2,251)	(5.76)
Demand deposit accounts	57,053	53,555	3,498	6.53
Certificates of deposit	94,481	76,646	17,835	23.27
Total deposits	226,607	206,101	20,506	9.95
Borrowings	10,475	23,546	(13,071)	(55.51)
Total interest bearing liabilities	237,082	229,647	7,435	3.24
Net interest-earning assets	$ 46,907	$ 38,972	$ 7,935	20.36

Interest Income. Interest income and fees on loans decreased for the year ended December 31, 2013 due to lower average yields on the Bank s loan portfolio.

Interest income on taxable and nontaxable securities decreased for the year ended December 31, 2013 due primarily to an increase in amortization associated with accelerated payments on certain taxable securities.

Interest income on other interest-earning assets increased for the year ended December 31, 2013 as a result of higher average balances, particularly interest earning deposits, partially offset by lower average rates earned on these assets.

Interest Expense. Interest expense was flat for the year ended December 31, 2013. While deposits grew, we have been able to reprice higher yielding deposits at lower rates having the effect of keeping interest expense flat. The increase in the average balance of our deposits resulted primarily from increases in the average balance of certificates of deposit and savings deposits.

Interest expense on borrowed funds, consisting almost entirely of Federal Home Loan Bank advances, decreased for the year ended December 31, 2013 due to a lower borrowing level.

Net Interest Income. Net interest income decreased for the year ended December 31, 2013 as the returns earned on our interest earning assets declined. While we experienced growth in deposits, which translated into growth in interest earnings assets, these funds were invested in lower earning assets. Our net interest rate spread decreased to 3.32% from 3.70% and our net interest margin decreased to 3.42% from 3.79%.

Provision for Loan Losses. We recorded a provision for loan losses of $227,000 for the year ended December 31, 2013 and a provision for loan losses of $1.0 million for the year ended December 31, 2012. The decrease in the provision for loan losses was primarily attributable to a lower amount of nonperforming loans in 2013 and improvements in the economy, which are factored into our allowance for loan loss methodology.

At December 31, 2013, nonperforming loans totaled $3.1 million, or 1.42% of total loans, including loans held for sale, as compared to $8.0 million, or 3.46% of total loans, including loans held for sale, at December 31, 2012. The allowance for loan losses to total loans, including loans held for sale, decreased to 0.93% at December 31, 2012 as compared to 1.05% at December 31, 2012.

Summary of Noninterest Income.

	Years Ended December 31, 2013	2012	Increase/ (Decrease)	% Change
	(Dollars in thousands)			
Noninterest income:				
Service charges	$ 1,071	$ 1,136	$ (65)	(5.72)%
Gain on sale of securities available for sale	98	683	(585)	(85.65)
Gain on sale of mortgage loans	1,448	2,093	(645)	(30.82)
Mortage warehouse fees	400	215	185	86.05
Increase in cash surrender of bank owned life insurance	242	246	(4)	(1.63)
Other	236	130	106	81.54
Total noninterest income	$ 3,495	$ 4,503	$ (1,008)	(22.39)%

Noninterest Income. Noninterest income decreased primarily due to lower gains on sale of mortgage loans, due to lower volumes, and lower gains from the sale of securities recognized during 2013. Gains on sale of securities are subject to interest rate fluctuations and we may be unable to generate such gains in the future. Our origination, sale and resulting gains on one- to four-family residential loans in the secondary market is dependent on customer demand and can be affected by current and anticipated market interest rates. Service charges decreased as a result of lower non-sufficient funds charges and other deposit fees driven by new regulations related to overdraft protection programs. Other noninterest income increased due to fees generated on investment sales and gains on disposals of OREO.

Summary of Noninterest Expense.

	Years Ended December 31, 2013	2012	Increase/ (Decrease)	% Change
	(Dollars in thousands)			
Noninterest expense:				
Compensation and benefits	$ 6,253	$ 6,121	$ 132	2.16%
Occupancy costs	994	1,004	(10)	(1.00)
Equipment expense	126	192	(66)	(34.38)
Data processing expense	697	588	109	18.54
ATM expense	385	333	52	15.62
Professional and outside services	1,442	1,552	(110)	(7.09)
Stationary and supplies	71	89	(18)	(20.22)
Marketing	205	209	(4)	(1.91)
FDIC insurance assessments	214	235	(21)	(8.94)
Provision for losses on other real estate owned	73	244	(171)	(70.08)
Operations from other real estate owned	33	98	(65)	(66.33)
Other expense	634	871	(237)	(27.21)
Total noninterest expense	$ 11,127	$ 11,536	$ (409)	(3.55)%

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Noninterest Expense. Noninterest expense decreased for the year ended December 31, 2013, primarily as a result of a provision for losses on OREO and a provision for loss on a fraudulent wire transfer transaction that were recognized in 2012 and not repeated in 2013. These decreases were partially offset by an increase in compensation and benefits.

Compensation and benefits expense increased due to higher salary levels, our addition of personnel in the Bank s commercial lending department and increased share-based compensation expense. Data processing expense increased due to one-time costs associated with new products as well as the on-going cost of these products. ATM expense increased following the deployment of new ATM equipment to branches that were closed and converted to limited service locations. Professional and outside services decreased due to lower consulting, tax and audit expenses. Equipment expense decreased as a result of cost cutting efforts by management to lower equipment maintenance costs. Operations from OREO decreased due to reductions in holding costs related to OREO during 2013. Other noninterest expense decreased as a result of a wire transfer fraud that occurred during 2012, resulting in $153,000 in expense, net of an insurance recovery, being recorded for 2012, which was not repeated in 2013.

Income Tax Expense. We recorded $596,000 of income tax expense for the year ended December 31, 2013, compared to $613,000 of income tax expense for the year ended December 31, 2012. Our effective tax rate was 32.4% for 2013, compared to 28.8% for 2012. The differences between the statutory rate of 34.0% and the effective tax rates were primarily attributable to permanent differences related to tax exempt income consisting of interest on municipal obligations and bank-owned life insurance income.

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Average Balances and Yields. The table below sets forth average balances, average yields and costs, and certain other information for the years indicated. Tax-equivalent yield adjustments have not been made for tax-exempt securities. All average balances are daily average balances. Non-accrual loans were included in the computation of average balances, but have been reflected in the table as loans carrying a zero yield. The yields set forth below include the effect of deferred fees, discounts and premiums that are amortized or accreted to interest income or expense.

	For the Years Ended December 31,								
	2013			2012			2011		
	Average Outstanding Balance	Interest	Yield/Rate	Average Outstanding Balance	Interest	Yield/Rate	Average Outstanding Balance	Interest	Yield/Rate
	(Dollars in thousands)								
Interest-earning assets:									
Loans	$ 224,051	$ 10,768	4.81%	$ 223,886	$ 11,202	5.00%	$ 200,935	$ 10,666	5.31%
Securities taxable	12,280	37	0.30	14,580	158	1.08	19,219	327	1.70
Securities nontaxable	4,523	133	2.94	3,042	104	3.42	5,797	205	3.54
Other interest-earning assets	42,418	192	0.45	25,768	141	0.55	19,454	102	0.52
FHLB of Dallas stock	717	3	0.42	1,343	5	0.37	1,155	4	0.35
Total interest-earning assets	283,989	11,133	3.92	268,619	11,610	4.32	246,560	11,304	4.58
Noninterest-earning assets	16,228			17,175			15,946		
Total assets	$ 300,217			$ 285,794			$ 262,506		
Interest-bearing liabilities:									
Savings deposits	38,275	19	0.05	36,851	41	0.11	33,343	69	0.21
Money market	36,798	67	0.18	39,049	81	0.21	41,262	138	0.33
Demand deposit accounts	57,053	70	0.12	53,555	69	0.13	56,653	95	0.17
Certificates of deposit	94,481	1,109	1.17	76,646	942	1.23	68,152	1,040	1.53
Total deposits	226,607	1,265	0.56	206,101	1,133	0.55	199,410	1,342	0.67
Borrowings	10,475	168	1.60	23,546	299	1.27	20,711	447	2.16
Total interest-bearing liabilities	237,082	1,433	0.60	229,647	1,432	0.62	220,121	1,789	0.81
Noninterest-bearing liabilities	29,781			23,012			9,737		
Total liabilities	266,863			252,659			229,858		
Equity	33,354			33,135			32,648		
Total liabilities and equity	$ 300,217			$ 285,794			$ 262,506		
Net interest income		$ 9,700			$ 10,178			$ 9,515	
Net interest rate spread (1)			3.32%			3.70%			3.77%
Net interest-earning assets (2)	$ 46,907			$ 38,972			$ 26,439		
Net interest margin (3)			3.42%			3.79%			3.86%
Average of interest-earning assets to interest-bearing liabilities			119.78%			116.97%			112.01%

(1) Net interest rate spread represents the difference between the yield on average interest-earning assets and the cost of average interest-bearing liabilities.
(2) Net interest-earning assets represent total interest-earning assets less total interest-bearing liabilities.
(3) Net interest margin represents net interest income divided by average total interest-earning assets.

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Rate/Volume Analysis

The table below sets forth the effects of changing rates and volumes on our net interest income for the fiscal years indicated. The rate column shows the effects attributable to changes in rate (changes in rate multiplied by prior volume). The volume column shows the effects attributable to changes in volume (changes in volume multiplied by prior rate). The total column represents the sum of the prior columns. For purposes of this table, changes attributable to both rate and volume, which cannot be segregated, have been allocated to the changes due to rate and the changes due to volume in proportion to the relationship of the absolute dollar amounts of change in each.

	For the Years Ended December 31,					
	2013 Compared to 2012			2012 Compared to 2011		
	Increase (Decrease) Due to		Total Increase	Increase (Decrease) Due to		Total Increase
	Volume	Rate	(Decrease)	Volume	Rate	(Decrease)
	(in thousands)					
Interest-earning assets:						
Loans	$ 8	$ (442)	$ (434)	$ 1,174	$ (638)	$ 536
Securities taxable	(22)	(99)	(121)	(68)	(101)	(169)
Securities nontaxable	45	(16)	29	(94)	(7)	(101)
Other interest-earning assets	79	(28)	51	34	5	39
FHLB of Dallas stock	(3)	1	(2)	1		1
Total interest-earning assets	107	(584)	(477)	1,047	(741)	306
Interest-bearing liabilities:						
Savings deposits	1	(23)	(22)	8	(36)	(28)
Money market	(4)	(10)	(14)	(7)	(50)	(57)
Demand deposit accounts	5	(4)	1	(5)	(21)	(26)
Certificates of deposit	212	(45)	167	118	(216)	(98)
Total deposits	214	(82)	132	114	(323)	(209)
Borrowings	(196)	65	(131)	55	(203)	(148)
Total interest-bearings liabilities	18	(17)	1	169	(526)	(357)
Change in net interest income	$ 89	$ (567)	$ (478)	$ 878	$ (215)	$ 663

Management of Market Risk

General. Because the majority of our assets and liabilities are sensitive to changes in interest rates, our most significant form of market risk is interest rate risk. We are vulnerable to increases in interest rates to the extent that our interest-bearing liabilities mature or reprice more quickly than our interest-earning assets. As a result, a principal part of our business strategy is to manage interest rate risk and limit the exposure of our net interest income to changes in market interest rates. Accordingly, our board of directors has established an Asset/Liability Management Committee that is responsible for evaluating the interest rate risk inherent in our assets and liabilities, determining the level of risk that is appropriate (given our business strategy, operating environment, capital, liquidity and performance objectives) and managing this risk consistent with the guidelines approved by the board of directors.

Our interest rate sensitivity is monitored through the use of a net interest income simulation model that generates estimates of the change in our net interest income and net portfolio value over a range of interest rate scenarios. The modeling assumes loan prepayment rates, reinvestment rates and deposit decay rates based on historical experience and current economic conditions.

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We have sought to manage our interest rate risk in order to control the exposure of our earnings and capital to changes in interest rates. As part of our ongoing asset-liability management, we currently use the following strategies to manage our interest rate risk:

(i) sell long-term, fixed-rate one- to four-family residential mortgage loans (terms of 15 years or more) that we originate;

(ii) lengthen the weighted average maturity of our liabilities through retail deposit pricing strategies and through longer-term wholesale funding sources such as fixed-rate advances from the Federal Home Loan Bank of Dallas;

(iii) invest in shorter- to medium-term securities;

(iv) originate commercial real estate loans, commercial loans and consumer loans, which tend to have shorter terms and higher interest rates than residential mortgage loans, and which generate customer relationships that can result in larger noninterest-bearing demand deposit accounts;

(v) originate mortgage warehouse lines of credit secured by loans that typically stay on the line for 30 days or less; and

(vi) maintain adequate levels of capital.

We have not engaged in hedging through the use of derivatives.

Net Portfolio Value. As part of our interest rate risk management we compute the amount by which the net present value of our cash flow from assets, liabilities and off-balance sheet items (NPV) would change in the event of a range of assumed changes in market interest rates. We measure our interest rate risk and potential change in our NPV through the use of the FTN Financial Sendero Asset/Liability Management Analysis system (the FTN Model). The FTN Model uses a discounted cash flow analysis and an option-based pricing approach to measure the interest rate sensitivity of net portfolio value. Historically, the FTN Model estimated the economic value of each type of asset, liability and off-balance sheet contract under the assumption that the United States Treasury yield curve increases or decreases instantaneously by 100 to 300 basis points in 100 basis point increments. However, given the current relatively low level of market interest rates, an NPV calculation for an interest rate decrease of greater than 100 basis points has not been prepared. A basis point equals one-hundredth of one percent, and 100 basis points equals one percent. An increase in interest rates from 3% to 4% would mean, for example, a 100 basis point increase in the Change in Interest Rates column below. FTN Financial provides us with the results of the FTN Model, which is based on information we provide to FTN Financial to estimate the sensitivity of our net portfolio value.

The table below sets forth, as of December 31, 2013, the calculation of the estimated changes in our NPV that would result from the designated immediate changes in the United States Treasury yield curve.

	As of December 31, 2013							
		Estimated Decrease in NPV		NPV as a Percentage of Present Value of Assets [3]		Net Interest Income		
Increase (Decrease) in Interest Rates (basis points) [1]	Estimated NPV [2]	Amount	Percent	NPV Ratio [4]	Increase (Decrease) (basis points)	Estimated Net Interest Income	Amount	Percent
	(Dollars in thousands)							
300	$ 31,997	$ (5,131)	(13.82)%	11.19%	(104)	$ 8,842	$ (646)	(6.81)%
200	34,053	(3,075)	(8.28)	11.66	(57)	9,076	(412)	(4.34)
100	35,723	(1,405)	(3.78)	12.00	(23)	9,273	(215)	(2.27)
	37,128			12.23		9,488		

(100)	33,508	(3,620)	(9.75)	10.96	(127)	9,345	(143)	(1.51)

(1) Assumes an instantaneous uniform change in interest rates at all maturities.
(2) NPV is the discounted present value of expected cash flows from assets, liabilities and off-balance sheet contracts.
(3) Present value of assets represents the discounted present value of incoming cash flows on interest-earning assets.
(4) NPV Ratio represents NPV divided by the present value of assets.

Computations of prospective effects of hypothetical interest rate changes are based on numerous assumptions, including relative levels of market interest rates, loan prepayments and deposit decay, and should not be relied upon as indicative of actual results. The FTN Model illustrates the change in the economic value of our assets and liabilities at December 31, 2013 assuming an immediate change in interest rates. The table above indicates that at December 31, 2013, in the event of a 200 basis point increase in interest rates, we would experience an 8.28% decrease in net portfolio value. In the event of a 100 basis point decrease in interest rates, we would experience a 9.75% decrease in net portfolio value.

Certain shortcomings are inherent in the methodologies used in determining interest rate risk through changes in net portfolio value. Modeling changes require making certain assumptions that may or may not reflect the manner in which actual yields and costs respond to changes in market interest rates. In this regard, the net portfolio value and net interest income information presented assume that the composition of our interest-sensitive assets and liabilities existing at the beginning of a period remains constant over the period being measured and assume that a particular change in interest rates is reflected uniformly across the yield curve regardless of the duration or repricing of specific assets and liabilities. Accordingly, although interest rate risk calculations provide an indication of our interest rate risk exposure at a particular point in time, such measurements are not intended to and do not provide a precise forecast of the effect of changes in market interest rates on our net interest income and will differ from actual results.

Liquidity and Capital Resources

Liquidity is the ability to meet current and future financial obligations of a short-term nature. Our primary sources of funds consist of deposit inflows, loan sales and repayments, advances from the Federal Home Loan Bank of Dallas, and maturities and sales of securities. While maturities and scheduled amortization of loans and securities are predictable sources of funds, deposit flows and mortgage prepayments are greatly influenced by general interest rates, economic conditions and competition. Our Asset/Liability Management Committee is responsible for establishing and monitoring our liquidity targets and strategies in order to ensure that sufficient liquidity exists for meeting the borrowing needs and deposit withdrawals of our customers as well as unanticipated contingencies. For the years ended December 31, 2013 and 2012, our liquidity ratio averaged 24.2% and 16.9%, respectively. We believe that we have enough sources of liquidity to satisfy our short- and long-term liquidity needs as of December 31, 2013 and during the next 12 months.

We regularly monitor and adjust our investments in liquid assets based upon our assessment of: (i) expected loan demand; (ii) expected deposit flows; (iii) yields available on interest-earning deposits and securities; and (iv) the objectives of our asset/liability management program. Excess liquid assets are invested generally in interest-earning deposits and short- and intermediate-term securities.

Our most liquid assets are cash and cash equivalents. The levels of these assets are affected by our operating, financing, lending and investing activities during any given period. At December 31, 2013, cash and cash equivalents totaled $37.6 million. Securities classified as available-for-sale, which may provide additional sources of liquidity, totaled $29.2 million at December 31, 2013.

Our cash flows are derived from operating activities, investing activities and financing activities as reported in our Consolidated Statements of Cash Flows in our consolidated financial statements.

At December 31, 2013, we had $42.3 million in loan commitments outstanding, including $30.5 million in unused lines of credit to borrowers. Certificates of deposit due within one year of December 31, 2013 totaled $47.3 million, or 18.1% of total deposits. If these deposits do not remain with us, we will be required to seek other sources of funds, including loan sales and Federal Home Loan Bank advances. Depending on market conditions, we may be required to pay higher rates in the future. We believe, however, that based on past experience, a significant portion of such deposits will remain with us. We also have the ability to attract and retain deposits by adjusting the interest rates offered.

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Our primary investing activity is originating loans. During the years ended December 31, 2013 and 2012, we originated $165.6 million and $176.0 million of loans, respectively. We purchased $26.0 million and $16.6 million of securities during the years December 31, 2013 and 2012, respectively.

Financing activities consist primarily of activity in deposit accounts and Federal Home Loan Bank advances. We had a net increase in total deposits of $28.9 million for the year ended December 31, 2013, and a net increase in total deposits of $20.4 million for the year ended December 31, 2012. Deposit flows are affected by the overall level of interest rates, the interest rates and products offered by us and our local competitors, and by other factors.

Liquidity management is both a daily and long-term function of business management. We have entered into borrowing agreements with the Federal Home Loan Bank of Dallas, which provide us with an additional source of funds to the extent that we require funds beyond what we generate through operations. Federal Home Loan Bank advances decreased $13.0 million, to $7.4 million at December 31, 2013. Historically, advances from the Federal Home Loan Bank have been used primarily to fund loan demand. At December 31, 2013, we had the ability to borrow up to $89.4 million from the Federal Home Loan Bank of Dallas.

The Bank is subject to various regulatory capital requirements, including a risk-based capital measure. The risk-based capital guidelines include both a definition of capital and a framework for calculating risk-weighted assets by assigning balance sheet assets and off-balance sheet items to broad risk categories. At December 31, 2013, the Bank exceeded all regulatory capital requirements. The Bank is considered well capitalized under regulatory guidelines. See Supervision and Regulation Federal Banking Regulation Capital Requirements and Note 14 Regulatory Matters of the notes to consolidated financial statements included in this Annual Report.

Off-Balance Sheet Arrangements and Aggregate Contractual Obligations

Commitments. As a financial services provider, we are routinely party to various financial instruments with off-balance-sheet risks, such as commitments to extend credit and unused lines of credit. While these contractual obligations represent our future cash requirements, a significant portion of commitments to extend credit may expire without being drawn upon. Such commitments are subject to the same credit policies and approval process accorded to loans we make. For additional information, see Note 8 Financial Instruments with Off-Balance Sheet Risk of the notes to consolidated financial statements included in this Annual Report.

Contractual Obligations. In the ordinary course of our operations, we enter into certain contractual obligations. Such obligations include operating leases for premises and equipment, agreements with respect to borrowed funds and deposit liabilities. The table below sets forth future minimum rental payments due under non-cancelable branch and equipment operating leases at December 31, 2013:

2014	$ 240
2015	268
2016	268
2017	249
2018	162
Thereafter	133
	$ 1,320

Recent Accounting Pronouncements

In February 2013, the Financial Accounting Standards Board issued an accounting standards update to finalize the reporting requirements for items reclassified out of accumulated other comprehensive income (AOCI). Items fully reclassified out of AOCI to net income must have the effect of the reclassification disclosed according to the respective income statement line item and must be disclosed either on the face of the financial

statements by income statement line item, or in the notes thereto. For public companies, the amendments in the update became effective for interim and annual periods beginning on or after December 15, 2012. The impact of this standard on the Company is to record a reclassification adjustment for gain on sale of securities available for sale, included in net income.

Impact of Inflation and Changing Prices

Our financial statements and related notes have been prepared in accordance with U.S. GAAP. U.S. GAAP generally requires the measurement of financial position and operating results in terms of historical dollars without consideration of changes in the relative purchasing power of money over time due to inflation. The impact of inflation is reflected in the increased cost of our operations. Unlike industrial companies, our assets and liabilities are primarily monetary in nature. As a result, changes in market interest rates have a greater impact on performance than the effects of inflation.

ITEM 7A. Quantitative and Qualitative Disclosures about Market Risk

Information required by this item is incorporated herein by reference to Item 7, Management s Discussion and Analysis of Financial Condition and Results of Operations above.

ITEM 8. Financial Statements and Supplementary Data

The Company s consolidated financial statements are presented in this Annual Report beginning at page F-1.

ITEM 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure

None.

ITEM 9A. Controls and Procedures

(a) An evaluation was performed under the supervision and with the participation of the Company s management, including the President and Chief Executive Officer and the Executive Vice President and Chief Financial Officer, of the effectiveness of the design and operation of the Company s disclosure controls and procedures (as defined in Rule 13a-15(e) promulgated under the Exchange Act as of December 31, 2013. Based on that evaluation, the Company s management, including the President and Chief Executive Officer and the Executive Vice President and Chief Financial Officer, concluded that the Company s disclosure controls and procedures were effective.

During the quarter ended December 31, 2013, there have been no changes in the Company s internal control over financial reporting that have materially affected, or are reasonably likely to materially affect, the Company s internal control over financial reporting.

(b) Management s annual report on internal control over financial reporting.

Management of the Company is responsible for establishing and maintaining adequate internal control over financial reporting.

The Company s internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with accounting principles generally accepted in the United States of America. The Company s internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the Company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with accounting principles generally accepted in the United States of America, and that receipts and expenditures of the Company are being made only in accordance with

authorizations of management and directors of the Company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the Company s assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Management, including the principal executive officer and principal financial officer, assessed the effectiveness of the Company s internal control over financial reporting as of December 31, 2013, based on the 1992 criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in Internal Control-Integrated Framework. Based on such assessment, management believes that, as of December 31, 2013, the Company s internal control over financial reporting is effective, based on those criteria.

This Annual Report does not include an attestation report of the Company s independent registered public accounting firm regarding internal control over financial reporting. Management s report was not subject to attestation by the Company s independent registered public accounting firm pursuant to provisions of the Dodd-Frank Act that permit the Company to provide only management s report in this annual report.

ITEM 9B. Other Information

None.

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PART III

ITEM 10. Directors, Executive Officers and Corporate Governance

Information concerning directors and executive officers of SP Bancorp, Inc. and certain board committee members is incorporated herein by reference by the Proxy Statement, specifically the section captioned Proposal I Election of Directors.

Code of Ethics

We have adopted a Code of Ethics and Business Conduct that is designed to promote the highest standards of ethical conduct by our directors, executive officers and employees. The Code of Ethics and Business Conduct requires that our directors, executive officers and employees avoid conflicts of interest, comply with all laws and other legal requirements, conduct business in an honest and ethical manner and otherwise act with integrity and in our best interest.

In addition, we have adopted a Code of Ethics for Senior Officers that is applicable to our senior financial officers, including our principal executive officer, principal financial officer, principal accounting officer and all officers performing similar functions.

A copy of our Code of Ethics of Business Conduct and Code of Ethics for Senior Officers is available on our website, www.shareplus.com. Information on our website is not incorporated into this Annual Report and should not be considered part of this Annual Report.

ITEM 11. Executive Compensation

Information concerning executive compensation is incorporated herein by reference from the Proxy Statement, specifically the section captioned Proposal I Election of Directors.

ITEM 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters

Information concerning security ownership of certain owners and management is incorporated herein by reference from the Proxy Statement, specifically the sections captioned Voting Securities and Principal Holders Thereof and Proposal I Election of Directors.

ITEM 13. Certain Relationships and Related Transactions and Director Independence

Information concerning relationships and transactions is incorporated herein by reference from the Proxy Statement, specifically the section captioned Transactions with Certain Related Persons.

ITEM 14. Principal Accountant Fees and Services

Information concerning principal accountant fees and services is incorporated herein by reference from the Proxy Statement, specifically the section captioned Proposal II Ratification of Appointment of Independent Registered Public Accounting Firm.

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PART IV

ITEM 15. Exhibits and Financial Statement Schedules

(a)(1) Financial Statements

The documents filed as a part of this Form 10-K are:

(A) Reports of Independent Registered Public Accounting Firms;

(B) Consolidated Balance Sheets - December 31, 2013 and 2012;

(C) Consolidated Statements of Income - years ended December 31, 2013 and 2012;

(D) Consolidated Statements of Comprehensive Income - years ended December, 31, 2013 and 2012;

(E) Consolidated Statements of Changes in Stockholders Equity - years ended December 31, 2013 and 2012;

(F) Consolidated Statements of Cash Flows - years ended December 31, 2013 and 2012; and

(G) Notes to Consolidated Financial Statements.

(a)(2) Financial Statement Schedules

All financial statement schedules have been omitted as the required information is inapplicable or has been included in the Notes to Consolidated Financial Statements.

(a)(3) Exhibits

3.1	Articles of Incorporation of SP Bancorp, Inc. (filed as an exhibit to the registration statement on Form S-1 (File No. 333-167967 dated July 2, 2010 and incorporated by reference herein).
3.2	Bylaws of SP Bancorp, Inc. (filed as an exhibit to the registration statement on Form S-1 (File No. 333-167967 dated July 2, 2010 and incorporated by reference herein).
4	Form of Common Stock Certificate of SP Bancorp, Inc. (filed as an exhibit to the registration statement on Form S-1 (File No. 333-167967 dated July 2, 2010 and incorporated by reference herein).
10.1+	SharePlus Federal Bank 2010 Annual Incentive Compensation Plan (filed as an exhibit to the registration statement on Form S-1 (File No. 333-167967 dated July 2, 2010 and incorporated by reference herein).

10.2+	SharePlus Federal Bank 2008 Nonqualified Deferred Compensation Plan (filed as an exhibit to the registration statement on Form S-1 (File No. 333-167967 dated July 2, 2010 and incorporated by reference herein).
10.3+	SharePlus Federal Bank Phantom Stock Plan (filed as an exhibit to the registration statement on Form S-1 (File No. 333-167967 dated July 2, 2010 and incorporated by reference herein).
10.4+	SP Bancorp, Inc. 2012 Equity Incentive Plan (filed as Annex A to the Definitive Proxy Statement on Schedule 14A filed on April 12, 2012 and incorporated by reference herein).
10.5+	SP Bancorp, Inc. 2012 Equity Incentive Plan Form of Restricted Stock Award (filed as an exhibit to the Quarterly Report on Form 10-Q for the quarter ended March 31, 2013 and incorporated herein by reference herein).

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10.6+	SP Bancorp, Inc. 2012 Equity Incentive Plan Form of Stock Option (filed as an exhibit to the Quarterly Report on Form 10-Q for the quarter ended March 31, 2013 and incorporated herein by reference herein).
10.7*+	Form of Non-Employee Director Change in Control Agreement
10.8*+	Form of Executive Change in Control Agreement
21*	List of Subsidiaries
23.1*	Consent of Crowe Horwath LLP
23.2*	Consent of McGladrey LLP
31.1*	Certification of Principal Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2*	Certification of Principal Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1*	Certification of Principal Executive Officer and Principal Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

101. INS	XBRL Instance Document
101. SCH	XBRL Taxonomy Extension Schema Document
101. CAL	XBRL Taxonomy Extension Calculation Linkbase Document
101. DEF	XBRL Taxonomy Extension Definition Linkbase Document
101. LAB	XBRL Taxonomy Extension Label Linkbase Document
101. PRE	XBRL Taxonomy Extension Presentation Linkbase Document

* Filed herewith

\+ Indicates a management contract or compensatory plan.

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Signatures

Pursuant to the requirements of Section 13 of the Securities Exchange Act of 1934, the Company has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

SP Bancorp, Inc.

Date: February 28, 2014

By: /s/ Jeffrey L. Weaver
Jeffrey L. Weaver
President and Chief Executive Officer
(Duly Authorized Representative)

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Registrant and in the capacities and on the dates indicated.

Signatures	Title	Date
/s/ Jeffrey L. Weaver	President, Chief Executive Officer and Director (Principal Executive Officer)	February 28, 2014
Jeffrey L. Weaver		
/s/ Suzanne C. Salls	Executive Vice President and Chief Financial Officer (Principal Financial and Accounting Officer)	February 28, 2014
Suzanne C. Salls		
/s/ Paul Zmigrosky	Chairman of the Board	February 28, 2014
Paul Zmigrosky		
/s/ Christopher Cozby	Director	February 28, 2014
Christopher Cozby		
/s/ Carl Forsythe	Director	February 28, 2014
Carl Forsythe		
/s/ P. Stan Keith	Director	February 28, 2014
P. Stan Keith		
/s/ David Rader	Director	February 28, 2014
David Rader		
/s/ Randall E. Sloan	Director	February 28, 2014
Randall E. Sloan		
/s/ David Stephens	Director	February 28, 2014

David Stephens		
/s/ Lora Villarreal	Director	February 28, 2014
Lora Villarreal		
/s/ Jeff Williams	Director	February 28, 2014
Jeff Williams		

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EXHIBIT INDEX

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\+ Indicates a management contract or compensatory plan.

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INDEX TO CONSOLIDATED FINANCIAL STATEMENTS OF SP BANCORP, INC. AND SUBSIDIARY

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Consolidated Statements of Income for the years ended December 31, 2013 and 2012	F-5
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Consolidated Statements of Changes in Stockholders Equity for the years ended December 31, 2013 and 2012	F-7
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Report of Independent Registered Public Accounting Firm

The Board of Directors, Audit Committee and Stockholders

SP Bancorp, Inc.

Plano, Texas

We have audited the accompanying consolidated balance sheet of SP Bancorp, Inc. (the Company) as of December 31, 2013, and the related consolidated statements of income, comprehensive income, changes in stockholders equity and cash flows for the year then ended. These consolidated financial statements are the responsibility of the Company s management. Our responsibility is to express an opinion on these consolidated financial statements based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform an audit of its internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company s internal control over financial reporting. Accordingly, we express no such opinion. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of SP Bancorp, Inc. as of December 31, 2013, and the results of its operations and its cash flows for the year then ended in conformity with U.S. generally accepted accounting principles.

/s/ Crowe Horwath LLP

Dallas, Texas

February 28, 2014

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Report of Independent Registered Public Accounting Firm

The Board of Directors, Audit Committee and Stockholders

SP Bancorp, Inc.

Plano, Texas

We have audited the accompanying consolidated balance sheet of SP Bancorp, Inc. (the Company) as of December 31, 2012, and the related consolidated statements of income, comprehensive income, changes in stockholders equity and cash flows for the year then ended. These consolidated financial statements are the responsibility of the Company s management. Our responsibility is to express an opinion on these consolidated financial statements based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform an audit of its internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company s internal control over financial reporting. Accordingly, we express no such opinion. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of SP Bancorp, Inc. as of December 31, 2012, and the results of their operations and their cash flows for the year then ended in conformity with U.S. generally accepted accounting principles.

/s/ McGladrey LLP

Dallas, Texas

March 6, 2013

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SP Bancorp, Inc.

Consolidated Balance Sheets

(In thousands, except share amounts)

	December 31, 2013	December 31, 2012
ASSETS		
Cash and due from banks	$ 27,094	$ 22,318
Federal funds sold	10,470	1,615
Total cash and cash equivalents	37,564	23,933
Securities available for sale (amortized cost of $29,813 and $15,658 at December 31, 2013 and December 31, 2012, respectively)	29,245	15,713
Fixed annuity investment	1,264	1,223
Loans held for sale	1,846	7,290
Loans, net of allowance for losses of $2,069 and $2,420 at December 31, 2013 and December 31, 2012, respectively	218,280	222,288
Accrued interest receivable	846	724
Other real estate owned	81	1,477
Premises and equipment, net	4,053	4,249
Federal Reserve Bank stock, at cost	350	
Federal Home Loan Bank stock, at cost	440	1,099
Bank-owned life insurance	7,681	7,439
Deferred income taxes, net	957	910
Other assets	1,402	1,776
Total assets	$ 304,009	$ 288,121
LIABILITIES AND STOCKHOLDERS EQUITY		
Deposits		
Noninterest-bearing	$ 29,219	$ 22,336
Interest-bearing	232,067	210,004
Total deposits	261,286	232,340
Borrowings	7,368	20,316
Accrued interest payable	10	9
Other liabilities	2,529	2,416
Total liabilities	271,193	255,081
Commitments and contingent liabilities		
Stockholders equity		
Preferred stock, $0.01 par value, 50,000,000 shares authorized, none issued or outstanding		
Common stock, $0.01 par value; 100,000,000 shares authorized, 1,613,700 shares issued and outstanding at December 31, 2013 and 1,668,750 shares issued and outstanding at December 31, 2012	16	16
Additional paid in capital	14,014	14,453
Unallocated Employee Stock Ownership Plan shares 119,348 shares at December 31, 2013 and 131,633 shares at December 31, 2012	(1,242)	(1,314)
Retained earnings substantially restricted	20,402	19,849
Accumulated other comprehensive (loss) income	(374)	36
Total stockholders equity	32,816	33,040

Total liabilities and stockholders equity	$ 304,009	$ 288,121

See accompanying Notes to Consolidated Financial Statements

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SP Bancorp, Inc.

Consolidated Statements of Income

(In thousands, expect per share amounts)

	Years Ended December 31, 2013	2012
Interest income:		
Interest and fees on loans	$ 10,768	$ 11,202
Securities taxable	37	158
Securities nontaxable	133	104
Other interest earning assets	195	146
Total interest income	11,133	11,610
Interest expense:		
Deposit accounts	1,265	1,133
Borrowings	168	299
Total interest expense	1,433	1,432
Net interest income	9,700	10,178
Provision for loan losses	227	1,018
Net interest income after provision for loan losses	9,473	9,160
Noninterest income:		
Service charges	1,071	1,136
Gain on sale of securities available for sale	98	683
Gain on sale of mortgage loans	1,448	2,093
Mortgage warehouse fees	400	215
Increase in cash surrender value of bank owned life insurance	242	246
Other	236	130
Total noninterest income	3,495	4,503
Noninterest expense:		
Compensation and benefits	6,253	6,121
Occupancy costs	994	1,004
Equipment expense	126	192
Data processing expense	697	588
ATM expense	385	333
Professional and outside services	1,442	1,552
Stationary and supplies	71	89
Marketing	205	209
FDIC insurance assessments	214	235
Provision for losses on other real estate owned	73	244
Operations from other real estate owned	33	98
Other expense	634	871
Total noninterest expense	11,127	11,536

Income before income tax expense	1,841	2,127
Income tax expense	596	613
Net income	$ 1,245	$ 1,514
Basic earnings per share	$ 0.81	$ 0.97
Diluted earnings per share	$ 0.81	$ 0.96

See accompanying Notes to Consolidated Financial Statements

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SP Bancorp, Inc.

Consolidated Statements of Comprehensive Income

(In thousands)

	Years Ended December 31, 2013	2012
Net income	$ 1,245	$ 1,514
Other comprehensive loss, before tax:		
Net unrealized (losses) gains on available for sale securities, arising during the year	(525)	415
Reclassification adjustment for gain on sale of securities available for sale, included in net income	(98)	(683)
Other comprehensive loss, before tax	(623)	(268)
Income tax benefit	(213)	(90)
Other comprehensive loss, net of tax	(410)	(178)
Comprehensive income	$ 835	$ 1,336

See accompanying Notes to Consolidated Financial Statements

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SP Bancorp, Inc.

Consolidated Statements of Changes in Stockholders Equity

(In thousands, except share amounts)

	Shares	Common Stock	Additional Paid-in Capital	Unallocated Employee Stock Ownership Plan Shares	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total Stockholders Equity
, 2012	1,725,000	$ 17	$ 15,278	$ (1,018)	$ 18,636	$ 214	$ 33,127
e					1,514		1,514
sive						(178)	(178)
Stock Plan hased rket				(373)			

f" valign="bottom">
350 (101) 249 (9,975) 1,452

on nts	(69,202)	5,550	(63,652)	(51,857)	5,904	(45,953)
fication t plan tion in net loss)	2,297	(482)	1,815	4,595	(965)	3,630
er ensive loss)	$(107,370)	$4,006	$(103,364)	$(307,401)	$24,155	$ (283,246)

(Dollars in thousands)	Three Months Ended June 30, 2017 Before Tax	Tax Effect	Net of Tax	Six Months Ended June 30, 2017 Before Tax	Tax Effect	Net of Tax
Unrealized appreciation (depreciation) ("URA(D)") on securities - temporary	$ (9,165)	$ 14,916	$ 5,751	$ 22,041	$ 6,534	$ 28,575
URA(D) on securities - OTTI	(994)	111	(883)	(5,495)	1,336	(4,159)
Reclassification of net realized losses (gains) included in net income (loss)	(11,067)	2,074	(8,993)	(17,775)	6,583	(11,192)
Foreign currency translation adjustments	38,560	(2,893)	35,667	52,373	(4,813)	47,560
Reclassification of benefit plan liability amortization included in net income (loss)	3,083	(1,079)	2,004	6,166	(2,158)	4,008
Total other comprehensive income (loss)	$ 20,417	$ 13,129	$ 33,546	$ 57,310	$ 7,482	$ 64,792

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The following table presents details of the amounts reclassified from AOCI for the periods indicated:

	Three Months Ended June 30,		Six Months Ended June 30,		
AOCI component	2018	2017	2018	2017	Affected line item within the statements of operations and comprehensive income (loss)
(Dollars in thousands)					
URA(D) on securities	$ 350	$ (11,067)	$ (9,975)	$ (17,775)	Other net realized capital gains (losses)
	(101)	2,074	1,452	6,583	Income tax expense (benefit)
	$ 249	$ (8,993)	$ (8,523)	$ (11,192)	Net income (loss)
Benefit plan net gain (loss)	$ 2,297	$ 3,083	$ 4,595	$ 6,166	Other underwriting expenses
	(482)	(1,079)	(965)	(2,158)	Income tax expense (benefit)
	$ 1,815	$ 2,004	$ 3,630	$ 4,008	Net income (loss)

The following table presents the components of accumulated other comprehensive income (loss), net of tax, in the consolidated balance sheets for the periods indicated:

(Dollars in thousands)	Six Months Ended June 30, 2018	Twelve Months Ended December 31, 2017
Beginning balance of URA (D) on securities	$ 49,969	$ 115,558
Current period change in URA (D) of investments - temporary	(241,114)	(67,268)
Current period change in URA (D) of investments - non-credit OTTI	191	(4,030)
Reclass due to early adoption of ASU 2018-02	-	5,709
Cumulative change due to ASU 2016-01	(1,201)	-
Ending balance of URA (D) on securities	(192,155)	49,969
Beginning balance of foreign currency translation adjustments	(138,931)	(266,818)
Current period change in foreign currency translation adjustments	(45,953)	121,917
Reclass due to early adoption of ASU 2018-02	-	5,970
Ending balance of foreign currency translation adjustments	(184,884)	(138,931)
Beginning balance of benefit plan net gain (loss)	(71,929)	(65,504)
Current period change in benefit plan net gain (loss)	3,630	6,504
Reclass due to early adoption of ASU 2018-02	-	(12,929)
Ending balance of benefit plan net gain (loss)	(68,299)	(71,929)
Ending balance of accumulated other comprehensive income (loss)	$ (445,338)	$ (160,891)

(Some amounts may not reconcile due to rounding.)

10. CREDIT FACILITIES

The Company has two active credit facilities for a total commitment of up to $1,050,000 thousand and an additional credit facility for a total commitment of up to £145,000 thousand, providing for the issuance of letters of credit and/or unsecured revolving credit lines. The following table presents the interest and fees incurred in connection with the two credit facilities for the periods indicated:

	Three Months Ended June 30,		Six Months Ended June 30,	
(Dollars in thousands)	2018	2017	2018	2017
Credit facility interest and fees incurred	$ 105	$ 106	$ 210	$ 210

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The terms and outstanding amounts for each facility are discussed below:

Group Credit Facility

Effective May 26, 2016, Group, Everest Reinsurance (Bermuda), Ltd. ("Bermuda Re") and Everest International Reinsurance, Ltd. ("Everest International"), both direct subsidiaries of Group, entered into a five year, $800,000 thousand senior credit facility with a syndicate of lenders, which amended and restated in its entirety the June 22, 2012, four year, $800,000 thousand senior credit facility. Both the May 26, 2016 and June 22, 2012 senior credit facilities, which have similar terms, are referred to as the "Group Credit Facility". Wells Fargo Corporation ("Wells Fargo Bank") is the administrative agent for the Group Credit Facility, which consists of two tranches. Tranche one provides up to $200,000 thousand of unsecured revolving credit for liquidity and general corporate purposes, and for the issuance of unsecured standby letters of credit. The interest on the revolving loans shall, at the Company's option, be either (1) the Base Rate (as defined below) or (2) an adjusted London Interbank Offered Rate ("LIBOR") plus a margin. The Base Rate is the higher of (a) the prime commercial lending rate established by Wells Fargo Bank, (b) the Federal Funds Rate plus 0.5% per annum or (c) the one month LIBOR Rate plus 1.0% per annum. The amount of margin and the fees payable for the Group Credit Facility depends on Group's senior unsecured debt rating. Tranche two exclusively provides up to $600,000 thousand for the issuance of standby letters of credit on a collateralized basis.

The Group Credit Facility requires Group to maintain a debt to capital ratio of not greater than 0.35 to 1 and to maintain a minimum net worth. Minimum net worth is an amount equal to the sum of $5,370,979 thousand plus 25% of consolidated net income for each of Group's fiscal quarters, for which statements are available ending on or after March 31, 2016 and for which consolidated net income is positive, plus 25% of any increase in consolidated net worth during such period attributable to the issuance of ordinary and preferred shares, which at June 30, 2018, was $5,939,502 thousand. As of June 30, 2018, the Company was in compliance with all Group Credit Facility covenants.

(Dollars in thousands)		At June 30, 2018			At December 31, 2017		
Bank		Commitment	In Use	Date of Expiry	Commitment	In Use	Date of Expiry
Wells Fargo Bank Group Credit Facility	Tranche One	$ 200,000	$ -		$ 200,000	$ -	
	Tranche Two	600,000	571,792	12/31/2018	600,000	538,214	12/31/2018
Total Wells Fargo Bank Group Credit Facility		$ 800,000	$ 571,792		$ 800,000	$ 538,214	

Bermuda Re Letter of Credit Facility

Effective December 29, 2017, Bermuda Re renewed its letter of credit issuance facility with Citibank N.A. referred to as the "Bermuda Re Letter of Credit Facility", which commitment is reconfirmed annually with updated fees. The current renewal of the Bermuda Re Letter of Credit Facility provides for the issuance of up to $250,000 thousand of secured letters of credit to collateralize reinsurance obligations as a non-admitted reinsurer. The interest on drawn letters of credit shall be (A) 0.35% per annum of the principal amount of issued standard letters of credit (expiry of 15 months or less) and (B) 0.45% per annum of the principal amount of issued extended tenor letters of credit (expiry maximum of up to 60 months). The commitment fee on undrawn credit shall be 0.15% per annum.

The following table summarizes the outstanding letters of credit for the periods indicated:

(Dollars in thousands)	At June 30, 2018			At December 31, 2017		
Bank	Commitment	In Use	Date of Expiry	Commitment	In Use	Date of Expiry
Citibank Bilateral Letter of Credit Agreement	$250,000	$3,672	11/24/2018	$250,000	$3,297	2/28/2018
		64,126	12/31/2018		3,672	11/24/2018
		2,412	2/28/2019		73,626	12/31/2018
		328	8/30/2019		344	8/30/2019
		2,416	12/31/2019		93,855	12/30/2021
		91,905	6/30/2022		-	
Total Citibank Bilateral Agreement	$250,000	$164,859		$250,000	$174,794	

Everest International Credit Facility

Effective November 9, 2016, Everest International renewed its credit facility with Lloyds Bank plc ("Everest International Credit Facility"). The current renewal of the Everest International Credit Facility, along with a May 17, 2017 amendment, has a four year term and provides up to £145,000 thousand for the issuance of standby letters of credit on a collateralized basis. The Company pays a commitment fee of 0.1% per annum on the average daily amount of the remainder of (1) the aggregate amount available under the facility and (2) the aggregate amount of drawings outstanding under the facility. The Company pays a credit commission fee of 0.35% per annum on drawings outstanding under the facility.

The Everest International Credit Facility requires Group to maintain a debt to capital ratio of not greater than 0.35 to 1 and to maintain a minimum net worth. Minimum net worth is an amount equal to the sum of $5,326,009 thousand (70% of consolidated net worth as of December 31, 2015), plus 25% of consolidated net income for each of Group's fiscal quarters, for which statements are available ending on or after January 1, 2015 and for which net income is positive, plus 25% of any increase in consolidated net worth of Group during such period attributable to the issuance of ordinary and preferred shares, which at June 30, 2018, was $5,939,502 thousand. As of June 30, 2018, the Company was in compliance with all Everest International Credit Facility requirements.

The following table summarizes the outstanding letters of credit for the periods indicated:

(Dollars in thousands)	At June 30, 2018			At December 31, 2017		
Bank	Commitment	In Use	Date of Expiry	Commitment	In Use	Date of Expiry
Lloyd's Bank plc	£145,000	£ -		£145,000	£ -	
	-	-		-	-	
Total Lloyd's Bank Credit Facility	£145,000	£ -		£145,000	£ -	

11. COLLATERALIZED REINSURANCE AND TRUST AGREEMENTS

Certain subsidiaries of Group have established trust agreements, which effectively use the Company's investments as collateral, as security for assumed losses payable to certain non-affiliated ceding companies. At June 30, 2018, the total amount on deposit in trust accounts was $897,645 thousand.

The Company reinsures some of its catastrophe exposures with the segregated accounts of Mt. Logan Re. Mt. Logan Re is a Class 3 insurer registered in Bermuda effective February 27, 2013 under The Segregated Accounts Companies Act 2000 and 100% of the voting common shares are owned by Group. Separate segregated accounts for Mt. Logan Re began being established effective July 1, 2013 and non-voting, redeemable preferred shares have been issued to capitalize the segregated accounts. Each segregated account invests predominately in a diversified set of catastrophe exposures, diversified by risk/peril and across different geographic regions globally.

The following table summarizes the premiums and losses that are ceded by the Company to Mt. Logan Re segregated accounts and assumed by the Company from Mt. Logan Re segregated accounts.

	Three Months Ended June 30,		Six Months Ended June 30,	
Mt. Logan Re Segregated Accounts	2018	2017	2018	2017
(Dollars in thousands)				

Ceded written premiums	45,887	42,728	126,923	96,946
Ceded earned premiums	65,067	57,886	126,476	98,483
Ceded losses and LAE	133,762	24,812	154,831	44,397
Assumed written premiums	1,604	3,763	4,647	6,495
Assumed earned premiums	1,604	3,763	4,647	6,495
Assumed losses and LAE	-	-	-	-

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Each segregated account is permitted to assume net risk exposures equal to the amount of its available posted collateral, which in the aggregate was $1,151,595 thousand and $837,202 thousand at June 30, 2018 and December 31, 2017, respectively. Of this amount, Group had investments valued at $46,095 thousand and $50,373 thousand at June 30, 2018 and December 31, 2017, respectively, in the segregated accounts.

Effective April 1, 2018, the Company entered into a retroactive reinsurance transaction with one of the Mt. Logan Re segregated accounts to retrocede $269,198 thousand of casualty reserves held by Bermuda Re related to accident years 2002 through 2015. As consideration for entering the agreement, the Company transferred cash of $252,000 thousand to the Mt. Logan Re segregated account. The maximum liability to be retroceded under the agreement will be $319,000 thousand. The Company will retain liability for any amounts exceeding the maximum liability.

On April 24, 2014, the Company entered into two collateralized reinsurance agreements with Kilimanjaro Re Limited ("Kilimanjaro"), a Bermuda based special purpose reinsurer, to provide the Company with catastrophe reinsurance coverage. These agreements are multi-year reinsurance contracts which cover specified named storm and earthquake events. The first agreement provides up to $250,000 thousand of reinsurance coverage from named storms in specified states of the Southeastern United States. The second agreement provides up to $200,000 thousand of reinsurance coverage from named storms in specified states of the Southeast, Mid-Atlantic and Northeast regions of the United States and Puerto Rico as well as reinsurance coverage from earthquakes in specified states of the Southeast, Mid-Atlantic, Northeast and West regions of the United States, Puerto Rico and British Columbia. These reinsurance agreements expired in April, 2018.

On November 18, 2014, the Company entered into a collateralized reinsurance agreement with Kilimanjaro to provide the Company with catastrophe reinsurance coverage. This agreement is a multi-year reinsurance contract which covers specified earthquake events. The agreement provides up to $500,000 thousand of reinsurance coverage from earthquakes in the United States, Puerto Rico and Canada.

On December 1, 2015 the Company entered into two collateralized reinsurance agreements with Kilimanjaro to provide the Company with catastrophe reinsurance coverage. These agreements are multi-year reinsurance contracts which cover named storm and earthquake events. The first agreement provides up to $300,000 thousand of reinsurance coverage from named storms and earthquakes in the United States, Puerto Rico and Canada. The second agreement provides up to $325,000 thousand of reinsurance coverage from named storms and earthquakes in the United States, Puerto Rico and Canada.

On April 13, 2017 the Company entered into six collateralized reinsurance agreements with Kilimanjaro to provide the Company with annual aggregate catastrophe reinsurance coverage. The initial three agreements are four year reinsurance contracts which cover named storm and earthquake events. These agreements provide up to $225,000 thousand, $400,000 thousand and $325,000 thousand, respectively, of annual aggregate reinsurance coverage from named storms and earthquakes in the United States, Puerto Rico and Canada. The subsequent three agreements are five year reinsurance contracts which cover named storm and earthquake events. These agreements provide up to $50,000 thousand, $75,000 thousand and $175,000 thousand, respectively, of annual aggregate reinsurance coverage from named storms and earthquakes in the United States, Puerto Rico and Canada.

On April 30, 2018 the Company entered into four collateralized reinsurance agreements with Kilimanjaro Re to provide the Company with catastrophe reinsurance coverage. These agreements are multi-year reinsurance contracts which cover named storm and earthquake events. The first two agreements are four year reinsurance contracts which provide up to $62,500 thousand and $200,000 thousand, respectively, of annual aggregate reinsurance coverage from named storms and earthquakes in the United States, Puerto Rico, the U.S. Virgin Islands and Canada. The remaining two agreements are five year reinsurance contracts which provide up to $62,500 thousand and $200,000 thousand, respectively, of annual aggregate reinsurance coverage from named storms and earthquakes in the United States, Puerto Rico, the U.S. Virgin Islands and Canada.

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Recoveries under these collateralized reinsurance agreements with Kilimanjaro are primarily dependent on estimated industry level insured losses from covered events, as well as, the geographic location of the events. The estimated industry level of insured losses is obtained from published estimates by an independent recognized authority on insured property losses. As of December 31, 2017, none of the published insured loss estimates for the 2017 catastrophe events have exceeded the single event retentions under the terms of the agreements that would result in a recovery. In addition, the aggregation of the to-date published insured loss estimates for the 2017 covered events have not exceeded the aggregated retentions for recovery. However, if the published estimates for insured losses for the covered 2017 events increase, the aggregate losses may exceed the aggregate event retentions under the agreements resulting in a recovery.

Kilimanjaro has financed the various property catastrophe reinsurance coverages by issuing catastrophe bonds to unrelated, external investors. On April 24, 2014, Kilimanjaro issued $450,000 thousand of notes ("Series 2014-1 Notes"). The $450,000 thousand of Series 2014-1 Notes were fully redeemed on April 30, 2018 and are no longer outstanding. On November 18, 2014, Kilimanjaro issued $500,000 thousand of notes ("Series 2014-2 Notes"). On December 1, 2015, Kilimanjaro issued $625,000 thousand of notes ("Series 2015-1 Notes). On April 13, 2017, Kilimanjaro issued $950,000 thousand of notes ("Series 2017-1 Notes) and $300,000 thousand of notes ("Series 2017-2 Notes). On April 30, 2018, Kilimanjaro issued $262,500 thousand of notes ("Series 2018-1 Notes") and $262,500 thousand of notes ("Series 2018-2 Notes"). The proceeds from the issuance of the Notes listed above are held in reinsurance trust throughout the duration of the applicable reinsurance agreements and invested solely in US government money market funds with a rating of at least "AAAm" by Standard & Poor's.

12. SENIOR NOTES

The table below displays Holdings' outstanding senior notes. Market value is based on quoted market prices, but due to limited trading activity, these senior notes are considered Level 2 in the fair value hierarchy.

				June 30, 2018		December 31, 2017	
(Dollars in thousands)	Date Issued	Date Due	Principal Amounts	Consolidated Balance Sheet Amount	Market Value	Consolidated Balance Sheet Amount	Market Value
4.868% Senior notes	06/05/2014	06/01/2044	400,000	$ 396,894	$ 396,728	$ 396,834	$ 420,340

On June 5, 2014, Holdings issued $400,000 thousand of 30 year senior notes at 4.868%, which will mature on June 1, 2044. Interest will be paid semi-annually on June 1 and December 1 of each year.

Interest expense incurred in connection with these senior notes is as follows for the periods indicated:

	Three Months Ended June 30,		Six Months Ended June 30,	
(Dollars in thousands)	2018	2017	2018	2017
Interest expense incurred	$ 4,868	$ 4,868	$ 9,736	$ 9,736

13. LONG TERM SUBORDINATED NOTES

The table below displays Holdings' outstanding fixed to floating rate long term subordinated notes. Market value is based on quoted market prices, but due to limited trading activity, these subordinated notes are considered Level 2 in the fair value hierarchy.

			Maturity Date		June 30, 2018		December 31, 2017	
(Dollars in thousands)	Date Issued	Original Principal Amount	Scheduled	Final	Consolidated Balance Sheet Amount	Market Value	Consolidated Balance Sheet Amount	Market Value
6.6% Long term subordinated notes	04/26/2007	$ 400,000	05/15/2037	05/01/2067	$ 236,610	$ 236,651	$ 236,561	$ 233,072

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During the fixed rate interest period from May 3, 2007 through May 14, 2017, interest was at the annual rate of 6.6%, payable semi-annually in arrears on November 15 and May 15 of each year, commencing on November 15, 2007. During the floating rate interest period from May 15, 2017 through maturity, interest will be based on the 3 month LIBOR plus 238.5 basis points, reset quarterly, payable quarterly in arrears on February 15, May 15, August 15 and November 15 of each year, subject to Holdings' right to defer interest on one or more occasions for up to ten consecutive years. Deferred interest will accumulate interest at the applicable rate compounded quarterly for periods from and including May 15, 2017. The reset quarterly interest rate for May 15, 2018 to August 14, 2018 is 4.73%.

Holdings may redeem the long term subordinated notes on or after May 15, 2017, in whole or in part at 100% of the principal amount plus accrued and unpaid interest; however, redemption on or after the scheduled maturity date and prior to May 1, 2047 is subject to a replacement capital covenant. This covenant is for the benefit of certain senior note holders and it mandates that Holdings receive proceeds from the sale of another subordinated debt issue, of at least similar size, before it may redeem the subordinated notes. Effective upon the maturity of the Company's 5.40% senior notes on October 15, 2014, the Company's 4.868% senior notes, due on June 1, 2044, have become the Company's long term indebtedness that ranks senior to the long term subordinated notes.

On March 19, 2009, Group announced the commencement of a cash tender offer for any and all of the 6.60% fixed to floating rate long term subordinated notes. Upon expiration of the tender offer, the Company had reduced its outstanding debt by $161,441 thousand.

Interest expense incurred in connection with these long term subordinated notes is as follows for the periods indicated:

	Three Months Ended June 30,		Six Months Ended June 30,	
(Dollars in thousands)	2018	2017	2018	2017
Interest expense incurred	$ 2,702	$ 3,033	$ 5,093	$ 6,970

14. SEGMENT REPORTING

The U.S. Reinsurance operation writes property and casualty reinsurance and specialty lines of business, including Marine, Aviation, Surety and Accident and Health ("A&H") business, on both a treaty and facultative basis, through reinsurance brokers, as well as directly with ceding companies primarily within the U.S. The International operation writes non-U.S. property and casualty reinsurance through Everest Re's branches in Canada and Singapore and through offices in Brazil, Miami and New Jersey. The Bermuda operation provides reinsurance and insurance to worldwide property and casualty markets through brokers and directly with ceding companies from its Bermuda office and reinsurance to the United Kingdom and European markets through its UK branch and Ireland Re. The Insurance operation writes property and casualty insurance directly and through brokers, surplus lines brokers and general agents within the U.S., Canada and Europe.

These segments are managed independently, but conform with corporate guidelines with respect to pricing, risk management, control of aggregate catastrophe exposures, capital, investments and support operations. Management generally monitors and evaluates the financial performance of these operating segments based upon their underwriting results.

Underwriting results include earned premium less losses and loss adjustment expenses ("LAE") incurred, commission and brokerage expenses and other underwriting expenses. We measure our underwriting results using ratios, in particular loss, commission and brokerage and other underwriting expense ratios, which, respectively, divide incurred losses, commissions and brokerage and other underwriting expenses by premiums earned.

For inter-affiliate reinsurance and business written through the Lloyd's Syndicate, business is generally reported within the segment in which the business was first produced, consistent with how the business is managed.

The Company does not maintain separate balance sheet data for its operating segments. Accordingly, the Company does not review and evaluate the financial results of its operating segments based upon balance sheet data.

The following tables present the underwriting results for the operating segments for the periods indicated:

U.S. Reinsurance	Three Months Ended June 30,		Six Months Ended June 30,	
(Dollars in thousands)	2018	2017	2018	2017
Gross written premiums	$652,109	$474,993	$1,296,331	$1,053,951
Net written premiums	566,303	385,267	1,112,134	902,636
Premiums earned	$603,884	$478,494	$1,167,269	$960,018
Incurred losses and LAE	509,653	267,621	1,054,846	529,687
Commission and brokerage	148,712	112,423	276,032	214,781
Other underwriting expenses	15,472	14,278	32,358	28,529
Underwriting gain (loss)	$(69,953)	$84,172	$(195,967)	$187,021

International	Three Months Ended June 30,		Six Months Ended June 30,	
(Dollars in thousands)	2018	2017	2018	2017
Gross written premiums	$399,024	$319,786	$765,748	$586,203
Net written premiums	355,309	272,369	700,464	518,031
Premiums earned	$363,795	$263,816	$707,399	$535,397
Incurred losses and LAE	301,406	172,488	428,430	331,989
Commission and brokerage	92,088	64,847	174,265	130,997
Other underwriting expenses	10,349	9,814	20,925	19,294
Underwriting gain (loss)	$(40,048)	$16,667	$83,779	$53,117

Bermuda	Three Months Ended June 30,		Six Months Ended June 30,	
(Dollars in thousands)	2018	2017	2018	2017
Gross written premiums	$369,440	$237,570	$785,126	$558,692
Net written premiums	355,236	217,814	750,204	522,846
Premiums earned	$353,698	$263,457	$672,832	$498,563
Incurred losses and LAE	250,097	165,305	379,610	293,737
Commission and brokerage	80,318	63,486	161,805	121,909
Other underwriting expenses	10,762	9,022	20,895	18,502
Underwriting gain (loss)	$12,521	$25,644	$110,522	$64,415

Insurance	Three Months Ended June 30,		Six Months Ended June 30,	

(Dollars in thousands)	2018	2017	2018	2017
Gross written premiums	$645,948	$569,300	$1,150,923	$1,003,747
Net written premiums	469,530	463,683	855,782	809,434
Premiums earned	$408,441	$363,914	$801,745	$687,800
Incurred losses and LAE	280,158	255,861	535,605	476,650
Commission and brokerage	62,284	59,200	128,939	114,538
Other underwriting expenses	56,516	45,755	115,205	88,431
Underwriting gain (loss)	$9,483	$3,098	$21,996	$8,181

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The following table reconciles the underwriting results for the operating segments to income before taxes as reported in the consolidated statements of operations and comprehensive income (loss) for the periods indicated:

	Three Months Ended June 30,		Six Months Ended June 30,	
(Dollars in thousands)	2018	2017	2018	2017
Underwriting gain (loss)	$(87,997)	$129,581	$20,330	$312,734
Net investment income	141,322	134,508	279,616	256,797
Net realized capital gains (losses)	15,776	25,268	(9,125)	77,996
Net derivative gain (loss)	2,987	766	3,260	3,396
Corporate expenses	(6,633)	(6,919)	(15,629)	(15,376)
Interest, fee and bond issue cost amortization expense	(7,728)	(8,059)	(15,146)	(17,023)
Other income (expense)	3,036	388	15,100	(4,578)
Income (loss) before taxes	$60,763	$275,533	$278,406	$613,946

The Company produces business in the U.S., Bermuda and internationally. The net income deriving from and assets residing in the individual foreign countries in which the Company writes business are not identifiable in the Company's financial records. Based on gross written premium, the table below presents the largest country, other than the U.S., in which the Company writes business, for the periods indicated:

	Three Months Ended June 30,		Six Months Ended June 30,	
(Dollars in thousands)	2018	2017	2018	2017
United Kingdom gross written premium	$177,072	$204,965	$435,331	$375,785

No other country represented more than 5% of the Company's revenues.

15. SHARE-BASED COMPENSATION PLANS

For the three months ended June 30, 2018, share-based compensation awards granted were 375 restricted shares, granted on May 15, 2018, with a fair value of $226.950 per share.

16. RETIREMENT BENEFITS

The Company maintains both qualified and non-qualified defined benefit pension plans and a retiree health plan for its U.S. employees employed prior to April 1, 2010.

Net periodic benefit cost for U.S. employees included the following components for the periods indicated:

Pension Benefits	Three Months Ended June 30,		Six Months Ended June 30,	
(Dollars in thousands)	2018	2017	2018	2017
Service cost	$ 2,977	$ 3,299	$5,954	$6,598
Interest cost	2,585	2,276	5,170	4,552
Expected return on plan assets	(3,670)	(3,154)	(7,341)	(6,309)

Amortization of net (income) loss	2,237	3,041	4,473	6,081
Net periodic benefit cost	$ 4,129	$ 5,461	$ 8,256	$ 10,921

Other Benefits	Three Months Ended June 30,		Six Months Ended June 30,	
(Dollars in thousands)	2018	2017	2018	2017
Service cost	$ 446	$ 441	$ 893	$ 881
Interest cost	307	249	614	498
Amortization of prior service cost	(33)	(33)	(66)	(66)
Amortization of net (income) loss	94	75	188	151
Net periodic benefit cost	$ 814	$ 732	$ 1,629	$ 1,464

(Some amounts may not reconcile due to rounding.)

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The service cost component of net periodic benefit costs is included within other underwriting expenses on the consolidated statement of operations and comprehensive income (loss). In accordance with ASU 2017-07, other staff compensation costs are also primarily recorded within this line item.

The Company did not make any contributions to the qualified pension benefit plan for the three and six months ended June 30, 2018 and 2017.

17. INCOME TAXES

The Company is domiciled in Bermuda and has significant subsidiaries and/or branches in Canada, Ireland, Singapore, the United Kingdom, and the United States. The Company's Bermuda domiciled subsidiaries are exempt from income taxation under Bermuda law until 2035. The Company's non-Bermudian subsidiaries and branches are subject to income taxation at varying rates in their respective domiciles.

The Company generally applies the estimated annual effective tax rate approach for calculating its tax provision for interim periods as prescribed by ASC 740-270, Interim Reporting. Under the estimated annual effective tax rate approach, the estimated annual effective tax rate is applied to the interim year-to-date pre-tax income/loss to determine the income tax expense or benefit for the year-to-date period. If the annual effective tax rate approach produces a year-to-date tax benefit which exceeds the amount which is estimated to be recoverable for the full year, then the tax benefit for the interim reporting period will be limited as prescribed under ASC 740-270 to the estimated recoverable based on the year-to-date result. The tax expense or benefit for the quarter represents the difference between the year-to-date tax expense or benefit for the current year-to-date period less such amount for the immediately preceding year-to-date period. Management considers the impact of all known events in its estimation of the Company's annual pre-tax income/loss and effective tax rate.

18. SUBSEQUENT EVENTS

The Company has evaluated known recognized and non-recognized subsequent events. The Company does not have any subsequent events to report.

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

Industry Conditions.
The worldwide reinsurance and insurance businesses are highly competitive, as well as cyclical by product and market. As such, financial results tend to fluctuate with periods of constrained availability, higher rates and stronger profits followed by periods of abundant capacity, lower rates and constrained profitability. Competition in the types of reinsurance and insurance business that we underwrite is based on many factors, including the perceived overall financial strength of the reinsurer or insurer, ratings of the reinsurer or insurer by A.M. Best and/or Standard & Poor's, underwriting expertise, the jurisdictions where the reinsurer or insurer is licensed or otherwise authorized, capacity and coverages offered, premiums charged, other terms and conditions of the reinsurance and insurance business offered, services offered, speed of claims payment and reputation and experience in lines written. Furthermore, the market impact from these competitive factors related to reinsurance and insurance is generally not consistent across lines of business, domestic and international geographical areas and distribution channels.

We compete in the U.S., Bermuda and international reinsurance and insurance markets with numerous global competitors. Our competitors include independent reinsurance and insurance companies, subsidiaries or affiliates of established worldwide insurance companies, reinsurance departments of certain insurance companies, domestic and international underwriting operations, including underwriting syndicates at Lloyd's of London and certain government sponsored risk transfer vehicles. Some of these competitors have greater financial resources than we do and have established long term and continuing business relationships, which can be a significant competitive advantage. In addition, the lack of strong barriers to entry into the reinsurance business and recently, the securitization of reinsurance and insurance risks through capital markets provide additional sources of potential reinsurance and insurance capacity and competition.

Worldwide insurance and reinsurance market conditions continued to be very competitive, particularly in the property catastrophe and casualty reinsurance lines of business. Generally, there was ample insurance and reinsurance capacity relative to demand, as well as, additional capital from the capital markets through insurance linked financial instruments. These financial instruments such as side cars, catastrophe bonds and collateralized reinsurance funds, provide capital markets with access to insurance and reinsurance risk exposure. The capital markets demand for these products is being primarily driven by the current low interest environment and the desire to achieve greater risk diversification and potentially higher returns on their investments. This increased competition is generally having a negative impact on rates, terms and conditions; however, the impact varies widely by market and coverage.

Rates tend to fluctuate by specific region and products, particularly areas recently impacted by large catastrophic events. There was an unprecedented series of catastrophes in the third quarter of 2017 with Hurricanes Harvey, Irma and Maria, as well as a significant earthquake in Mexico City. Additional catastrophe events occurred in the fourth quarter of 2017 with the wild fires in California and Hurricanes Nate and Ophelia. The total industry losses for all of these worldwide events have been estimated to exceed $140 billion. This was the second consecutive year with higher than average catastrophe losses. During 2016, catastrophe losses included the Fort McMurray Canadian wildfire, Hurricane Matthew which affected a large area of the Caribbean and southeastern United States, storms and an earthquake in Ecuador. There are industry reports that the catastrophe losses for 2016 reached their highest level in four years and the United States experienced the most loss events since 1980 and the highest total losses since 2012. While the future impact on market conditions from these catastrophes cannot be determined at this time, there was some firming in the markets impacted by the 2016 catastrophes and as catastrophe losses increased in 2017, there is a growing industry consensus that there will be some firming of (re)insurance rates for the areas impacted by the catastrophes.

Commencing in 2015, we initiated a strategic build out of our insurance platform through the investment in key leadership hires which in turn has brought significant underwriting talent and stronger direction in achieving our

insurance program strategic goals of increased premium volume and improved underwriting results. Recent growth is coming from highly diversified areas including newly launched lines of business, as well as, product and geographic expansion in existing lines of business. We are building a world-class

insurance platform capable of offering products across lines and geographies, complementing our leading global reinsurance franchise. As part of this initiative, we launched a new syndicate through Lloyd's of London and formed Ireland Insurance, providing us access to additional international business and new product opportunities to further diversify and broaden our insurance portfolio.

Overall, we believe that given our size, strong ratings, distribution system, reputation, expertise and capital market vehicle activity the current marketplace conditions provide profit opportunities. We continue to employ our strategy of targeting business that offers the greatest profit potential, while maintaining balance and diversification in our overall portfolio.

Financial Summary.
We monitor and evaluate our overall performance based upon financial results. The following table displays a summary of the consolidated net income (loss), ratios and shareholders' equity for the periods indicated.

	Three Months Ended June 30,		Percentage Increase/	Six Months Ended June 30,		Percentage Increase/
(Dollars in millions)	2018	2017	(Decrease)	2018	2017	(Decrease)
Gross written premiums	$2,066.5	$1,601.6	29.0%	$3,998.1	$3,202.6	24.8%
Net written premiums	1,746.4	1,339.1	30.4%	3,418.6	2,752.9	24.2%
REVENUES:						
Premiums earned	$1,729.8	$1,369.7	26.3%	$3,349.2	$2,681.8	24.9%
Net investment income	141.3	134.5	5.1%	279.6	256.8	8.9%
Net realized capital gains (losses)	15.8	25.3	-37.6%	(9.1)	78.0	-111.7%
Net derivative gain (loss)	3.0	0.8	NM	3.3	3.4	-4.0%
Other income (expense)	3.0	0.4	NM	15.1	(4.6)	NM
Total revenues	1,892.9	1,530.6	23.7%	3,638.1	3,015.4	20.7%
CLAIMS AND EXPENSES:						
Incurred losses and loss adjustment expenses	1,341.3	861.3	55.7%	2,398.5	1,632.1	47.0%
Commission, brokerage, taxes and fees	383.4	300.0	27.8%	741.0	582.2	27.3%
Other underwriting expenses	93.1	78.9	18.0%	189.4	154.8	22.4%
Corporate expenses	6.6	6.9	-4.1%	15.6	15.4	1.6%
Interest, fees and bond issue cost amortization expense	7.7	8.1	-4.1%	15.1	17.0	-11.0%
Total claims and expenses	1,832.2	1,255.1	46.0%	3,359.7	2,401.4	39.9%
INCOME (LOSS) BEFORE TAXES	60.8	275.5	-77.9%	278.4	613.9	-54.7%
Income tax expense (benefit)	(9.1)	29.9	-130.6%	(1.8)	76.6	-102.4%
NET INCOME (LOSS)	$69.9	$245.7	-71.5%	$280.2	$537.3	-47.8%
			Point			Point
RATIOS:			Change			Change
Loss ratio	77.5%	62.9%	14.6	71.6%	60.8%	10.8
Commission and brokerage ratio	22.2%	21.9%	0.3	22.1%	21.7%	0.4
Other underwriting expense ratio	5.4%	5.7%	(0.3)	5.7%	5.8%	(0.1)

Combined ratio	105.1	%	90.5	%	14.6	99.4	%	88.3	%	11.1

(Dollars in millions, except per share amounts)	At June 30, 2018	At December 31, 2017	Percentage Increase/ (Decrease)	
Balance sheet data:				
Total investments and cash	$ 18,205.7	$ 18,626.5	-2.3	%
Total assets	23,885.9	23,591.8	1.2	%
Loss and loss adjustment expense reserves	12,043.3	11,884.3	1.3	%
Total debt	633.5	633.4	0.0	%
Total liabilities	15,644.5	15,222.6	2.8	%
Shareholders' equity	8,241.3	8,369.2	-1.5	%
Book value per share	201.70	204.95	-1.6	%

(NM, not meaningful)
(Some amounts may not reconcile due to rounding.)

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Revenues.
Premiums. Gross written premiums increased by 29.0% to $2,066.5 million for the three months ended June 30, 2018, compared to $1,601.6 million for the three months ended June 30, 2017, reflecting a $388.2 million, or 37.6%, increase in our reinsurance business and a $76.6 million, or 13.5%, increase in our insurance business. The increase in reinsurance premiums was mainly due to increases in treaty property business, treaty casualty business, Latin American business and business written through our U.K. branch and Ireland office. The rise in insurance premiums was primarily due to increases in many lines of business, including casualty, accident and health and business written through the Lloyd's Syndicate. Gross written premiums increased by 24.8% to $3,998.1 million for the six months ended June 30, 2018, compared to $3,202.6 million for the six months ended June 30, 2017, reflecting a $648.4 million, or 29.5%, increase in our reinsurance business and a $147.2 million, or 14.7%, increase in our insurance business. The increase in reinsurance premiums was mainly due to increases in treaty property business, treaty casualty business, Latin American business and business written through our U.K. branch and Ireland office, as well as a positive impact of $25.0 million from the movement of foreign exchange rates. The rise in insurance premiums was primarily due to increases in many lines of business, including casualty, accident and health and business written through the Lloyd's Syndicate.

Net written premiums increased by 30.4% to $1,746.4 million for the three months ended June 30, 2018, compared to $1,339.1 million for the three months ended June 30, 2017. Net written premiums increased by 24.2% to $3,418.6 million for the six months ended June 30, 2018, compared to $2,752.9 million for the six months ended June 30, 2017. These changes are consistent with the changes in gross written premiums. Premiums earned increased by 26.3% to $1,729.8 million for the three months ended June 30, 2018, compared to $1,369.7 million for the three months ended June 30, 2017. Premiums earned increased by 24.9% to $3,349.2 million for the six months ended June 30, 2018, compared to $2,681.8 million for the six months ended June 30, 2017. The change in premiums earned relative to net written premiums is the result of timing; premiums are earned ratably over the coverage period whereas written premiums are recorded at the initiation of the coverage period.

Net Investment Income. Net investment income increased by 5.1% to $141.3 million for the three months ended June 30, 2018, compared with investment income of $134.5 million for the three months ended June 30, 2017. Net investment income increased by 8.9% to $279.6 million for the six months ended June 30, 2018, compared with investment income of $256.8 million for the six months ended June 30, 2017. Net pre-tax investment income, as a percentage of average invested assets, was 3.1% for the three months ended June 30, 2018 compared to 3.0% for the three months ended June 30, 2017. Net pre-tax investment income, as a percentage of average invested assets, was 3.1% for the six months ended June 30, 2018 compared to 2.9% for the six months ended June 30, 2017. The increases in both income and yield were primarily the result of higher income from our limited partnerships and higher income from our fixed income portfolio, partially offset by lower dividend income from our equity portfolio.

Net Realized Capital Gains (Losses). Net realized capital gains were $15.8 million and $25.3 million for the three months ended June 30, 2018 and 2017, respectively. The net realized capital gains of $15.8 million for the three months ended June 30, 2018 were comprised of $18.8 million of net gains from fair value re-measurements, partially offset by $2.1 million of net realized capital losses from sales of investments and $0.9 million of other-than-temporary impairments. The net realized capital gains of $25.3 million for the three months ended June 30, 2017 were comprised of $14.4 million of net realized capital gains from sales of investments and $13.4 million of net gains from fair value re-measurements, partially offset by $2.5 million of other-than-temporary impairments.

Net realized capital losses were $9.1 million and net realized capital gains were $78.0 million for the six months ended June 30, 2018 and 2017, respectively. The net realized capital losses of $9.1 million for the six months ended June 30, 2018 were comprised of $16.5 million of net losses from fair value re-measurements and $1.0 million of other-than-temporary impairments, partially offset by $8.4 million of net realized capital gains from sales of investments. The net realized capital gains of $78.0 million for the six months ended June 30, 2017 were comprised of $54.9 million of net gains from fair value re-measurements and $26.8 million of net realized capital gains from sales of investments, partially offset by $3.7 million of other-than-temporary impairments.

Net Derivative Gain (Loss). In 2005 and prior, we sold seven equity index put option contracts, six of which remain outstanding. These contracts meet the definition of a derivative in accordance with FASB guidance and as such, are fair valued each quarter with the change recorded as net derivative gain or loss in the consolidated statements of operations and comprehensive income (loss). As a result of these adjustments in value, we recognized net derivative gains of $3.0 million and $0.8 million for the three months ended June 30, 2018 and 2017, respectively, and net derivative gains of $3.3 million and $3.4 million for the six months ended June 30, 2018 and 2017, respectively. The change in the fair value of these equity index put option contracts is generally indicative of the change in the equity markets and interest rates over the same periods.

Other Income (Expense). We recorded other income of $3.0 million and $0.4 million for the three months ended June 30, 2018 and 2017, respectively. We recorded other income of $15.1 million and other expense of $4.6 million for the six months ended June 30, 2018 and 2017, respectively. The changes were primarily the result of fluctuations in foreign currency exchange rates, income related to Mt. Logan Re and changes in deferred gains related to any retroactive reinsurance transactions. We recognized foreign currency exchange income of $19.1 million and foreign currency exchange expense of $1.1 million for the three months ended June 30, 2018 and 2017, respectively. We recognized foreign currency exchange income of $29.0 million and foreign currency exchange expense of $5.0 million for the six months ended June 30, 2018 and 2017, respectively.

Claims and Expenses.

Incurred Losses and Loss Adjustment Expenses. The following tables present our incurred losses and loss adjustment expenses ("LAE") for the periods indicated.

	Three Months Ended June 30,					
(Dollars in millions)	Current Year	Ratio %/ Pt Change	Prior Years	Ratio %/ Pt Change	Total Incurred	Ratio %/ Pt Change
2018						
Attritional	$941.6	54.3%	$(97.4)	-5.6 %	$844.2	48.7 %
Catastrophes	65.0	3.8 %	432.2	25.0%	497.2	28.8 %
Total	$1,006.6	58.1%	$334.8	19.4%	$1,341.3	77.5 %
2017						
Attritional	$808.3	59.0%	$(0.6)	0.0 %	$807.8	59.0 %
Catastrophes	53.5	3.9 %	-	0.0 %	53.5	3.9 %
Total	$861.8	62.9%	$(0.6)	0.0 %	$861.3	62.9 %
Variance 2018/2017						
Attritional	$133.3	(4.7) pts	$(96.8)	(5.6) pts	$36.4	(10.3) pts
Catastrophes	11.5	(0.1) pts	432.2	25.0 pts	443.6	24.9 pts
Total	$144.8	(4.8) pts	$335.2	19.4 pts	$480.0	14.6 pts

	Six Months Ended June 30,					
(Dollars in millions)	Current Year	Ratio %/ Pt Change	Prior Years	Ratio %/ Pt Change	Total Incurred	Ratio %/ Pt Change
2018						
Attritional	$1,898.8	56.7%	$(97.4)	-2.9 %	$1,801.3	53.8%
Catastrophes	65.0	1.9 %	532.2	15.9%	597.2	17.8%
Total	$1,963.8	58.6%	$434.7	13.0%	$2,398.5	71.6%
2017						
Attritional	$1,559.0	58.1%	$(0.4)	0.0 %	$1,558.6	58.1%
Catastrophes	73.5	2.7 %	-	0.0 %	73.5	2.7 %
Total	$1,632.5	60.8%	$(0.4)	0.0 %	$1,632.1	60.8%
Variance 2018/2017						
Attritional	$339.8	(1.4) pts	$(97.0)	(2.9) pts	$242.7	(4.3) pts
Catastrophes	(8.5)	(0.8) pts	532.2	15.9 pts	523.7	15.1 pts
Total	$331.3	(2.2) pts	$435.1	13.0 pts	$766.4	10.8 pts

(Some amounts may not reconcile due to rounding.)

Incurred losses and LAE increased by 55.7% to $1,341.3 million for the three months ended June 30, 2018, compared to $861.3 million for the three months ended June 30, 2017, primarily due to unfavorable development of $432.2 million on prior years catastrophe losses, mainly related to Hurricanes Harvey, Irma and Maria, and an increase in

current year attritional losses of $133.3 million, mainly due to the impact of the increase in premiums earned and changes in the mix of business. The increase in loss estimates for Hurricanes Harvey, Irma and Maria was mostly driven by re-opened claims reported in the second quarter of 2018 and loss inflation from higher than expected loss adjustment expenses and in particular, their impact on aggregate covers. These increases in losses were partially offset by favorable development on prior years attritional losses of $97.4 million in 2018. The current year catastrophe losses of $65.0 million for the three months ended June 30, 2018 related to Cyclone Mekunu ($50.0 million) and the U.S. winter storms ($15.0 million). The current year catastrophe losses of $53.5 million for the three months ended June 30, 2017 related to the South Africa Knysna fires ($25.0 million), the 2017 U.S. Midwest storms ($15.0 million) and the Peru storms ($13.5 million).

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Incurred losses and LAE increased by 47.0% to $2,398.5 million for the six months ended June 30, 2018, compared to $1,632.1 million for the six months ended June 30, 2017, primarily due to unfavorable development of $532.2 million on prior years catastrophe losses, mainly related to Hurricanes Harvey, Irma and Maria and the 2017 California wildfires, and an increase in current year attritional losses of $339.8 million, mainly due to the impact of the increase in premiums earned and changes in the mix of business. The increase in loss estimates for Hurricanes Harvey, Irma and Maria was mostly driven by re-opened claims reported in the second quarter of 2018 and loss inflation from higher than expected loss adjustment expenses and in particular, their impact on aggregate covers. The increase in losses was partially offset by favorable development on prior years attritional losses of $97.4 million in 2018. The current year catastrophe losses of $65.0 million for the six months ended June 30, 2018 related to Cyclone Mekunu ($50.0 million) and the U.S. winter storms ($15.0 million). The current year catastrophe losses of $73.5 million for the six months ended June 30, 2017 related to the South Africa Knysna fires ($25.0 million), Cyclone Debbie in Australia ($20.0 million), the 2017 U.S. Midwest storms ($15.0 million) and the Peru storms ($13.5 million).

Commission, Brokerage, Taxes and Fees. Commission, brokerage, taxes and fees increased by 27.8% to $383.4 million for the three months ended June 30, 2018 compared to $300.0 million for the three months ended June 30, 2017. Commission, brokerage, taxes and fees increased by 27.3% to $741.0 million for the six months ended June 30, 2018 compared to $582.2 million for the six months ended June 30, 2017. The changes were primarily due to the impact of the increases in premiums earned and changes in the mix of business towards additional pro rata business.

Other Underwriting Expenses. Other underwriting expenses were $93.1 million and $78.9 million for the three months ended June 30, 2018 and 2017, respectively. Other underwriting expenses were $189.4 million and $154.8 million for the six months ended June 30, 2018 and 2017, respectively. The increases in other underwriting expenses were mainly due to the impact of the increases in premiums earned and costs incurred to support the continued expansion of the insurance business.

Corporate Expenses. Corporate expenses, which are general operating expenses that are not allocated to segments, remained consistent at $6.6 million and $6.9 million for the three months ended June 30, 2018 and 2017, respectively, and $15.6 million and $15.4 million for the six months ended June 30, 2018 and 2017, respectively.

Interest, Fees and Bond Issue Cost Amortization Expense. Interest, fees and other bond amortization expense was $7.7 million and $8.1 million for the three months ended June 30, 2018 and 2017, respectively. Interest, fees and other bond amortization expense was $15.1 million and $17.0 million for the six months ended June 30, 2018 and 2017, respectively. The decreases in expense for both the three and six month periods were primarily due to the conversion of the long term subordinated notes from a fixed rate of 6.6% to a floating rate, which is reset quarterly per the note agreement. The floating rate was 4.7% as of June 30, 2018.

Income Tax Expense (Benefit). We had an income tax benefit of $9.1 million and an income tax expense of $29.9 million for the three months ended June 30, 2018 and 2017, respectively, and income tax benefit of $1.8 million and an income tax expense of $76.6 million for the six months ended June 30, 2018 and 2017, respectively. Income tax expense is primarily a function of the geographic location of the Company's pre-tax income and the statutory tax rates in those jurisdictions, as affected by tax-exempt investment income and foreign tax credits and as calculated under the annualized effective tax rate ("AETR") method. Variations in the AETR generally result from changes in the relative levels of pre-tax income, including the impact of catastrophe losses and net capital gains (losses), among jurisdictions with different tax rates. The change in income tax expense (benefit) for the three and six months ended June 30, 2018 compared to the three and six months ended June 30, 2017 was primarily due to the additional unfavorable catastrophe loss development in 2018. In addition, the tax rate was lowered from 35% in 2017 to 21% in 2018 under the Tax Cuts and Jobs Act ("TCJA") which was enacted on December 22, 2017.

Net Income (Loss).
Our net income was $69.9 million and $245.7 million for the three months ended June 30, 2018 and 2017, respectively. Our net income was $280.2 million and $537.3 million for the six months ended June 30, 2018 and 2017, respectively. The changes were primarily driven by the financial component fluctuations explained above.

Ratios.
Our combined ratio increased by 14.6 points to 105.1% for the three months ended June 30, 2018, compared to 90.5% for the three months ended June 30, 2017, and increased by 11.1 points to 99.4% for the six months ended June 30, 2018, compared to 88.3% for the six months ended June 30, 2017. The loss ratio component increased 14.6 points and 10.8 points for the three and six months ended June 30, 2018, respectively, over the same periods last year mainly due to higher prior year catastrophe losses primarily related to Hurricanes Harvey, Irma and Maria and the 2017 California wildfires. The commission and brokerage ratio components increased slightly to 22.2% for the three months ended June 30, 2018 compared to 21.9% for the three months ended June 30, 2017, and increased slightly to 22.1% for the six months ended June 30, 2018 compared to 21.7% for the six months ended June 30, 2017, reflecting changes in the mix of business. The other underwriting expense ratios were comparable at 5.4% and 5.7% for the three months ended June 30, 2018 and 2017, respectively, and 5.7% and 5.8% for the six months ended June 30, 2018 and 2017, respectively.

Shareholders' Equity.
Shareholders' equity decreased by $127.9 million to $8,241.3 million at June 30, 2018 from $8,369.2 million at December 31, 2017, principally as a result of $240.9 million of unrealized depreciation on investments net of tax, $106.5 million of shareholder dividends, $46.0 million of net foreign currency translation adjustments and repurchase of 0.1 million common shares for $25.3 million, partially offset by $280.2 million of net income, $6.9 million of share-based compensation transactions and $3.6 million of net benefit plan obligation adjustments, net of tax.

Consolidated Investment Results

Net Investment Income.
Net investment income increased by 5.1% to $141.3 million for the three months ended June 30, 2018, compared with investment income of $134.5 million for the three months ended June 30, 2017. Net investment income increased by 8.9% to $279.6 million for the six months ended June 30, 2018, compared with investment income of $256.8 million for the six months ended June 30, 2017. The increases were primarily due to an increase in limited partnership income and higher income from our fixed income portfolio, partially offset by lower dividend income from our equity portfolio.

The following table shows the components of net investment income for the periods indicated.

	Three Months Ended June 30,		Six Months Ended June 30,	
(Dollars in millions)	2018	2017	2018	2017
Fixed maturities	$ 114.8	$ 108.1	$ 223.5	$ 211.4
Equity securities	6.7	8.4	13.5	17.1
Short-term investments and cash	2.1	0.9	3.8	1.5
Other invested assets				
Limited partnerships	22.0	20.1	45.4	31.1
Other	2.7	2.3	7.0	4.6
Gross investment income before adjustments	148.2	139.7	293.2	265.6
Funds held interest income (expense)	1.9	1.7	5.6	4.9
Future policy benefit reserve income (expense)	(0.4)	(0.4)	(0.6)	(0.7)

Gross investment income	149.8	141.0	298.2	269.7
Investment expenses	(8.5)	(6.5)	(18.6)	(12.9)
Net investment income	$ 141.3	$ 134.5	$ 279.6	$ 256.8

(Some amounts may not reconcile due to rounding.)

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The following tables show a comparison of various investment yields for the periods indicated.

	At June 30, 2018	At December 31, 2017
Imbedded pre-tax yield of cash and invested assets	3.3%	3.0%
Imbedded after-tax yield of cash and invested assets	2.9%	2.8%

	Three Months Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
Annualized pre-tax yield on average cash and invested assets	3.1%	3.0%	3.1%	2.9%
Annualized after-tax yield on average cash and invested assets	2.7%	2.5%	2.7%	2.5%

Net Realized Capital Gains (Losses).
The following table presents the composition of our net realized capital gains (losses) for the periods indicated.

	Three Months Ended June 30,			Six Months Ended June 30,		
(Dollars in millions)	2018	2017	Variance	2018	2017	Variance
Gains (losses) from sales:						
Fixed maturity securities, market value:						
Gains	$ 6.8	$ 17.1	$ (10.3)	$ 19.8	$ 32.6	$ (12.8)
Losses	(6.9)	(3.6)	(3.3)	(9.5)	(7.7)	(1.8)
Total	(0.1)	13.5	(13.6)	10.3	24.9	(14.6)
Fixed maturity securities, fair value:						
Gains	$ -	$ -	$ -	$ -	$ -	$ -
Losses	(1.1)	-	(1.1)	(1.1)	-	(1.1)
Total	(1.1)	-	(1.1)	(1.1)	-	(1.1)
Equity securities, market value:						
Gains	-	-	-	-	-	-
Losses	-	-	-	-	(3.4)	3.4
Total	-	-	-	-	(3.4)	3.4
Equity securities, fair value:						
Gains	7.3	3.9	3.4	14.0	12.1	1.9
Losses	(9.0)	(3.1)	(5.9)	(15.6)	(6.8)	(8.8)
Total	(1.6)	0.8	(2.4)	(1.5)	5.3	(6.8)
Other Invested Assets						
Gains	0.6	-	0.6	0.6	-	0.6
Losses	-	-	-	-	-	-

Total	0.6	-	0.6	0.6	-	0.6
Total net realized capital gains (losses) from sales:						
Gains	14.8	21.0	(6.2)	34.5	44.7	(10.2)
Losses	(16.9)	(6.7)	(10.2)	(26.1)	(17.9)	(8.2)
Total	(2.1)	14.4	(16.5)	8.4	26.8	(18.4)
Other-than-temporary impairments:	(0.9)	(2.5)	1.6	(1.0)	(3.7)	2.7
Gains (losses) from fair value adjustments:						
Fixed maturities, fair value	1.0	-	1.0	1.0	-	1.0
Equity securities, fair value	17.8	13.4	4.4	(17.5)	54.9	(72.4)
Total	18.8	13.4	5.4	(16.5)	54.9	(71.4)
Total net realized capital gains (losses)	$ 15.8	$ 25.3	$ (9.4)	$ (9.1)	$ 78.0	$ (87.1)

(Some amounts may not reconcile due to rounding.)

Net realized capital gains were $15.8 million and $25.3 million for the three months ended June 30, 2018 and 2017, respectively. For the three months ended June 30, 2018, we recorded $18.8 million of net gains from fair value re-measurements, partially offset by $2.1 million of net realized capital losses from sales of investments and $0.9 million of other-than-temporary impairments. For the three months ended June 30, 2017, we recorded $14.4 million of net realized capital gains from sales of investments and $13.4 million of net gains from fair value re-measurements, partially offset by $2.5 million of other-than-temporary impairments. The fixed maturity and equity sales for the three months ended June 30, 2018 and 2017 related primarily to adjusting the portfolios for overall market changes and individual credit shifts.

Net realized capital losses were $9.1 million and net realized capital gains were $78.0 million for the six months ended June 30, 2018 and 2017, respectively. For the six months ended June 30, 2018, we recorded $16.5 million of net losses from fair value re-measurements and $1.0 million of other-than-temporary impairments, partially offset by $8.4 million of net realized capital gains from sales of investments. For the six months ended June 30, 2017, we recorded $54.9 million of net gains from fair value re-measurements and $26.8 million of net realized capital gains from sales of investments, partially offset by $3.7 million of other-than-temporary impairments. The fixed maturity and equity sales for the six months ended June 30, 2018 and 2017 related primarily to adjusting the portfolios for overall market changes and individual credit shifts.

Segment Results.
The U.S. Reinsurance operation writes property and casualty reinsurance and specialty lines of business, including Marine, Aviation, Surety and Accident and Health ("A&H") business, on both a treaty and facultative basis, through reinsurance brokers, as well as directly with ceding companies primarily within the U.S. The International operation writes non-U.S. property and casualty reinsurance through Everest Re's branches in Canada and Singapore and through offices in Brazil, Miami and New Jersey. The Bermuda operation provides reinsurance and insurance to worldwide property and casualty markets through brokers and directly with ceding companies from its Bermuda office and reinsurance to the United Kingdom and European markets through its UK branch and Ireland Re. The Insurance operation writes property and casualty insurance directly and through brokers, surplus lines brokers and general agents within the U.S., Canada and Europe.

These segments are managed independently, but conform with corporate guidelines with respect to pricing, risk management, control of aggregate catastrophe exposures, capital, investments and support operations. Management generally monitors and evaluates the financial performance of these operating segments based upon their underwriting results.

Underwriting results include earned premium less losses and loss adjustment expenses ("LAE") incurred, commission and brokerage expenses and other underwriting expenses. We measure our underwriting results using ratios, in particular loss, commission and brokerage and other underwriting expense ratios, which, respectively, divide incurred losses, commissions and brokerage and other underwriting expenses by premiums earned.

For inter-affiliate reinsurance and business written through the Lloyd's Syndicate, business is generally reported within the segment in which the business was first produced, consistent with how the business is managed.

The Company does not maintain separate balance sheet data for its operating segments. Accordingly, the Company does not review and evaluate the financial results of its operating segments based upon balance sheet data.

Our loss and LAE reserves are management's best estimate of our ultimate liability for unpaid claims. We re-evaluate our estimates on an ongoing basis, including all prior period reserves, taking into consideration all available information and, in particular, recently reported loss claim experience and trends related to prior periods. Such re-evaluations are recorded in incurred losses in the period in which re-evaluation is made.

The following discusses the underwriting results for each of our segments for the periods indicated.

U.S. Reinsurance.
The following table presents the underwriting results and ratios for the U.S. Reinsurance segment for the periods indicated.

	Three Months Ended June 30,				Six Months Ended June 30,			
(Dollars in millions)	2018	2017	Variance	% Change	2018	2017	Variance	% Change
Gross written premiums	$652.1	$475.0	$177.1	37.3 %	$1,296.3	$1,054.0	$242.3	23.0 %
Net written premiums	566.3	385.3	181.0	47.0 %	1,112.1	902.6	209.5	23.2 %
Premiums earned	$603.9	$478.5	$125.4	26.2 %	$1,167.3	$960.0	$207.3	21.6 %
Incurred losses and LAE	509.7	267.6	242.1	90.4 %	1,054.8	529.7	525.1	99.1 %
Commission and brokerage	148.7	112.4	36.3	32.3 %	276.0	214.8	61.3	28.5 %
Other underwriting expenses	15.5	14.3	1.2	8.4 %	32.4	28.5	3.8	13.4 %
Underwriting gain (loss)	$(70.0)	$84.2	$(154.1)	-183.0 %	$(196.0)	$187.0	$(383.0)	-204.8 %
				Point Chg				Point Chg
Loss ratio	84.4 %	55.9 %		28.5	90.4 %	55.2 %		35.2
Commission and brokerage ratio	24.6 %	23.5 %		1.1	23.6 %	22.4 %		1.2
Other underwriting expense ratio	2.6 %	3.0 %		(0.4)	2.8 %	2.9 %		(0.1)
Combined ratio	111.6%	82.4 %		29.2	116.8 %	80.5 %		36.3

(Some amounts may not reconcile due to rounding.)

<u>Premiums.</u> Gross written premiums increased by 37.3% to $652.1 million for the three months ended June 30, 2018 from $475.0 million for the three months ended June 30, 2017, primarily due to increases in treaty property business, treaty casualty business and marine and aviation business. Net written premiums increased by 47.0% to $566.3 million for the three months ended June 30, 2018 compared to $385.3 million for the three months ended June 30, 2017. The difference between the change in gross written premiums compared to the change in net written premiums is primarily due to varying utilization of reinsurance. Premiums earned increased by 26.2% to $603.9 million for the three months ended June 30, 2018, compared to $478.5 million for the three months ended June 30, 2017. The change in premiums earned relative to net written premiums is primarily the result of changes in the mix of business towards additional pro rata business and timing; premiums are earned ratably over the coverage period whereas written premiums are recorded at the initiation of the coverage period.

Gross written premiums increased by 23.0% to $1,296.3 million for the six months ended June 30, 2018 from $1,054.0 million for the six months ended June 30, 2017, primarily due to increases in treaty property business, treaty casualty business and marine and aviation business. Net written premiums increased by 23.2% to $1,112.1 million for the six months ended June 30, 2018 compared to $902.6 million for the six months ended June 30, 2017, which is

consistent with the change in gross written premiums. Premiums earned increased by 21.6% to $1,167.3 million for the six months ended June 30, 2018, compared to $960.0 million for the six months ended June 30, 2017. The change in premiums earned relative to net written premiums is primarily the result of timing; premiums are earned ratably over the coverage period whereas written premiums are recorded at the initiation of the coverage period.

Incurred Losses and LAE. The following tables present the incurred losses and LAE for the U.S. Reinsurance segment for the periods indicated.

	Three Months Ended June 30,					
(Dollars in millions)	Current Year	Ratio %/ Pt Change	Prior Years	Ratio %/ Pt Change	Total Incurred	Ratio %/ Pt Change
2018						
Attritional	$293.8	48.6%	$(69.1)	-11.4%	$224.7	37.2%
Catastrophes	4.5	0.7%	280.5	46.5%	285.0	47.2%
Total Segment	$298.3	49.3%	$211.4	35.1%	$509.7	84.4%
2017						
Attritional	$278.6	58.2%	$(7.6)	-1.6%	$271.0	56.6%
Catastrophes	2.8	0.6%	(6.2)	-1.3%	(3.4)	-0.7%
Total Segment	$281.4	58.8%	$(13.8)	-2.9%	$267.6	55.9%
Variance 2018/2017						
Attritional	$15.2	(9.6) pts	$(61.5)	(9.8) pts	$(46.3)	(19.4) pts
Catastrophes	1.7	0.1 pts	286.7	47.8 pts	288.4	47.9 pts
Total Segment	$16.9	(9.5) pts	$225.2	38.0 pts	$242.1	28.5 pts

	Six Months Ended June 30,					
(Dollars in millions)	Current Year	Ratio %/ Pt Change	Prior Years	Ratio %/ Pt Change	Total Incurred	Ratio %/ Pt Change
2018						
Attritional	$620.2	53.1%	$(69.1)	-5.9%	$551.0	47.2%
Catastrophes	4.5	0.4%	499.3	42.8%	503.8	43.2%
Total Segment	$624.7	53.5%	$430.2	36.9%	$1,054.8	90.4%
2017						
Attritional	$541.1	56.4%	$(8.8)	-0.9%	$532.3	55.5%
Catastrophes	3.8	0.4%	(6.4)	-0.7%	(2.6)	-0.3%
Total Segment	$544.9	56.8%	$(15.2)	-1.6%	$529.7	55.2%
Variance 2018/2017						
Attritional	$79.1	(3.3) pts	$(60.3)	(5.0) pts	$18.7	(8.3) pts
Catastrophes	0.7	- pts	505.7	43.5 pts	506.4	43.5 pts
Total Segment	$79.8	(3.3) pts	$445.4	38.5 pts	$525.1	35.2 pts

(Some amounts may not reconcile due to rounding.)

Incurred losses increased by 90.4% to $509.7 million for the three months ended June 30, 2018, compared to $267.6 million for the three months ended June 30, 2017. The increase was primarily due to $280.5 million of unfavorable development on prior years catastrophe losses in 2018, primarily related to Hurricanes Harvey, Irma and Maria and an increase of $15.2 million in current year attritional losses mainly due to the impact of the increase in premiums

earned. The increase in loss estimates for Hurricanes Harvey, Irma and Maria was mostly driven by re-opened claims reported in the second quarter of 2018 and loss inflation from higher than expected loss adjustment expenses and in particular, their impact on aggregate covers. The increases were partially offset by $69.1 million favorable development on prior years attritional losses in 2018 mainly related to property and casualty business. The current year catastrophe losses of $4.5 million for the three months ended June 30, 2018 related primarily to the U.S. winter storms ($4.5 million). The $2.8 million of current year catastrophe losses for the three months ended June 30, 2017 mainly related to the 2017 U.S. Midwest storms ($3.0 million).

Incurred losses increased by 99.1% to $1,054.8 million for the six months ended June 30, 2018, compared to $529.7 million for the six months ended June 30, 2017. The increase was primarily due to $499.3 million of unfavorable development on prior years catastrophe losses in 2018 primarily related to Hurricanes Harvey, Irma and Maria and the 2017 California wildfires and an increase of $79.1 million in current year attritional losses mainly due to the impact of the increase in premiums earned. The increase in loss estimates for Hurricanes Harvey, Irma and Maria was mostly driven by re-opened claims reported in the second quarter of 2018 and loss inflation from higher than expected loss adjustment expenses and in particular, their impact on aggregate covers. The increases were partially offset by $69.1 million of favorable development on prior years attritional losses in 2018 mainly related to property and casualty business. The current year catastrophe losses of $4.5 million for the six months ended June 30, 2018 related primarily to the U.S. winter storms ($4.5 million). The $3.8 million of current year catastrophe losses for the six months ended June 30, 2017 mainly related to the 2017 U.S. Midwest storms ($3.0 million) and Cyclone Debbie in Australia ($0.9 million).

Segment Expenses. Commission and brokerage expenses increased by 32.3% to $148.7 million for the three months ended June 30, 2018 compared to $112.4 million for the three months ended June 30, 2017. Commission and brokerage expenses increased by 28.5% to $276.0 million for the six months ended June 30, 2018 compared to $214.8 million for the six months ended June 30, 2017. The increases are mainly due to the impact of the increases in premiums earned and changes in the mix of business towards additional pro rata business.

Segment other underwriting expenses increased to $15.5 million for the three months ended June 30, 2018 from $14.3 million for the three months ended June 30, 2017 and increased to $32.4 million for the six months ended June 30, 2018 from $28.5 million for the six months ended June 30, 2017. The increases were mainly due to the impact of the increases in premiums earned and changes in the mix of business.

International.
The following table presents the underwriting results and ratios for the International segment for the periods indicated.

	Three Months Ended June 30,				Six Months Ended June 30,			
(Dollars in millions)	2018	2017	Variance	% Change	2018	2017	Variance	% Change
Gross written premiums	$399.0	$319.8	$ 79.2	24.8 %	$765.7	$586.2	$ 179.5	30.6 %
Net written premiums	355.3	272.4	82.9	30.5 %	700.5	518.0	182.4	35.2 %
Premiums earned	$363.8	$263.8	$ 100.0	37.9 %	$707.4	$535.4	$ 172.0	32.1 %
Incurred losses and LAE	301.4	172.5	128.9	74.7 %	428.4	332.0	96.4	29.0 %
Commission and brokerage	92.1	64.8	27.2	42.0 %	174.3	131.0	43.3	33.0 %
Other underwriting expenses	10.3	9.8	0.5	5.5 %	20.9	19.3	1.6	8.5 %
Underwriting gain (loss)	$(40.0)	$16.7	$ (56.7)	NM	$83.8	$53.1	$ 30.7	57.7 %
				Point Chg				Point Chg
Loss ratio	82.8 %	65.4 %		17.4	60.5 %	62.0 %		(1.5)
Commission and brokerage ratio	25.3 %	24.6 %		0.7	24.6 %	24.5 %		0.1
Other underwriting expense ratio	2.9 %	3.7 %		(0.8)	3.1 %	3.6 %		(0.5)
Combined ratio	111.0%	93.7 %		17.3	88.2 %	90.1 %		(1.9)

(NM, not meaningful)

(Some amounts may not
reconcile due to rounding.)

Premiums. Gross written premiums increased by 24.8% to $399.0 million for the three months ended June 30, 2018 compared to $319.8 million for the three months ended June 30, 2017, primarily due to the increases in Latin American business and business written through our Canada and Singapore branches. Net written premiums increased by 30.5% to $355.3 million for the three months ended June 30, 2018 compared to $272.4 million for the three months ended June 30, 2017. The difference between the change in gross written premiums compared to the change in net written premiums was primarily due to varying utilization of reinsurance. Premiums earned increased 37.9% to $363.8 million for the three months ended June 30, 2018 compared to $263.8 million for the three months ended June 30, 2017. The change in

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premiums earned relative to net written premiums is primarily the result of timing; premiums are earned ratably over the coverage period whereas written premiums are recorded at the initiation of the coverage period.

Gross written premiums increased by 30.6% to $765.7 million for the six months ended June 30, 2018 compared to $586.2 million for the six months ended June 30, 2017, primarily due to the increases in Latin American, Middle East/Africa, Asian and Canadian business. Net written premiums increased by 35.2% to $700.5 million for the six months ended June 30, 2018 compared to $518.0 million for the six months ended June 30, 2017. The difference between the change in gross written premiums compared to the change in net written premiums was primarily due to varying utilization of reinsurance. Premiums earned increased 32.1% to $707.4 million for the six months ended June 30, 2018 compared to $535.4 million for the six months ended June 30, 2017. The change in premiums earned relative to net written premiums is primarily the result of timing; premiums are earned ratably over the coverage period whereas written premiums are recorded at the initiation of the coverage period.

Incurred Losses and LAE. The following tables present the incurred losses and LAE for the International segment for the periods indicated.

	Three Months Ended June 30,					
(Dollars in millions)	Current Year	Ratio %/ Pt Change	Prior Years	Ratio %/ Pt Change	Total Incurred	Ratio %/ Pt Change
2018						
Attritional	$174.6	48.0%	$(27.3)	-7.5 %	$ 147.3	40.5%
Catastrophes	50.0	13.7%	104.1	28.6%	154.1	42.3%
Total Segment	$224.6	61.7%	$76.8	21.1%	$ 301.4	82.8%
2017						
Attritional	$132.0	50.0%	$-	0.0 %	$ 132.0	50.0%
Catastrophes	37.7	14.3%	2.8	1.1 %	40.5	15.4%
Total Segment	$169.7	64.3%	$2.8	1.1 %	$ 172.5	65.4%
Variance 2018/2017						
Attritional	$42.6	(2.0) pts	$(27.3)	(7.5) pts	$ 15.3	(9.5) pts
Catastrophes	12.3	(0.6) pts	101.3	27.5 pts	113.6	26.9 pts
Total Segment	$54.9	(2.6) pts	$74.0	20.0 pts	$ 128.9	17.4 pts

	Six Months Ended June 30,					
(Dollars in millions)	Current Year	Ratio %/ Pt Change	Prior Years	Ratio %/ Pt Change	Total Incurred	Ratio %/ Pt Change
2018						
Attritional	$356.6	50.4%	$(27.3)	-3.9%	$ 329.3	46.5%
Catastrophes	50.0	7.1 %	49.1	6.9 %	99.1	14.0%
Total Segment	$406.6	57.5%	$21.8	3.0 %	$ 428.4	60.5%
2017						
Attritional	$273.6	51.1%	$-	0.0 %	$ 273.6	51.1%
Catastrophes	55.8	10.4%	2.6	0.5 %	58.4	10.9%
Total Segment	$329.4	61.5%	$2.6	0.5 %	$ 332.0	62.0%

<u>Variance 2018/2017</u>									
Attritional	$83.0	(0.7)	pts	$(27.3)	(3.9)	pts	$ 55.7	(4.6)	pts
Catastrophes	(5.8)	(3.3)	pts	46.5	6.4	pts	40.7	3.1	pts
Total Segment	$77.2	(4.0)	pts	$19.2	2.5	pts	$ 96.4	(1.5)	pts

(Some amounts may not reconcile due to rounding.)

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Incurred losses and LAE increased by 74.7% to $301.4 million for the three months ended June 30, 2018 compared to $172.5 million for the three months ended June 30, 2017, primarily due to $104.1 million of unfavorable development on prior years catastrophe losses in 2018 related to Hurricanes Harvey, Irma and Maria and the 2017 Mexico City earthquake and an increase of $42.6 million in current year attritional losses mainly due to the impact of the increase in premiums earned. The increases were partially offset by favorable development of $27.3 million on prior years attritional losses in 2018 mainly related to property and casualty business. The current year catastrophe losses of $50.0 million for the three months ended June 30, 2018 related primarily to Cyclone Mekunu ($50.0 million). The $37.7 million of current year catastrophe losses for the three months ended June 30, 2017 primarily related to the South Africa Knysna fires ($25.0 million) and the Peru storms ($13.7 million).

Incurred losses and LAE increased by 29.0% to $428.4 million for the six months ended June 30, 2018 compared to $332.0 million for the six months ended June 30, 2017, primarily due to an increase of $83.0 million in current year attritional losses related to the increase in premiums earned and $49.1 million of unfavorable development on prior years catastrophe losses in 2018 related to Hurricanes Harvey, Irma and Maria and the Mexico City earthquake. These increases in losses were partially offset by favorable development of $27.3 million on prior years attritional losses in 2018 mainly related to property and casualty business. The current year catastrophe losses of $50.0 million for the six months ended June 30, 2018 related primarily to Cyclone Mekunu ($50.0 million). The $55.8 million of current year catastrophe losses for the six months ended June 30, 2017 related to the South Africa Knysna fires ($25.0 million), Cyclone Debbie in Australia ($17.1 million) and the Peru storms ($13.7 million).

Segment Expenses. Commission and brokerage increased by 42.0% to $92.1 million for the three months ended June 30, 2018 compared to $64.8 million for the three months ended June 30, 2017. Commission and brokerage increased by 33.0% to $174.3 million for the six months ended June 30, 2018 compared to $131.0 million for the six months ended June 30, 2017. These increases are mainly due to the impact of the increases in premiums earned and changes in the mix of business.

Segment other underwriting expenses increased slightly to $10.3 million for the three months ended June 30, 2018 compared to $9.8 million for the three months ended June 30, 2017 and increased slightly to $20.9 million for the six months ended June 30, 2018 compared to $19.3 million for the six months ended June 30, 2017.

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Bermuda.
The following table presents the underwriting results and ratios for the Bermuda segment for the periods indicated.

	Three Months Ended June 30,				Six Months Ended June 30,			
(Dollars in millions)	2018	2017	Variance	% Change	2018	2017	Variance	% Change
Gross written premiums	$369.4	$237.6	$131.9	55.5 %	$785.1	$558.7	$226.4	40.5 %
Net written premiums	355.2	217.8	137.4	63.1 %	750.2	522.8	227.4	43.5 %
Premiums earned	$353.7	$263.5	$90.2	34.3 %	$672.8	$498.6	$174.3	35.0 %
Incurred losses and LAE	250.1	165.3	84.8	51.3 %	379.6	293.7	85.9	29.2 %
Commission and brokerage	80.3	63.5	16.8	26.5 %	161.8	121.9	39.9	32.7 %
Other underwriting expenses	10.8	9.0	1.7	19.3 %	20.9	18.5	2.4	12.9 %
Underwriting gain (loss)	$12.5	$25.6	$(13.1)	-51.2 %	$110.5	$64.4	$46.1	71.6 %
				Point Chg				Point Chg
Loss ratio	70.7 %	62.7 %		8.0	56.5 %	58.9 %		(2.4)
Commission and brokerage ratio	22.7 %	24.1 %		(1.4)	24.0 %	24.5 %		(0.5)
Other underwriting expense ratio	3.1 %	3.5 %		(0.4)	3.1 %	3.7 %		(0.6)
Combined ratio	96.5 %	90.3 %		6.2	83.6 %	87.1 %		(3.5)

(Some amounts may not reconcile due to rounding.)

Premiums. Gross written premiums increased by 55.5% to $369.4 million for the three months ended June 30, 2018 compared to $237.6 million for the three months ended June 30, 2017, primarily due to increased production from the U.K. and Ireland offices, an increase in Bermuda property business and a positive impact of $6.8 million from the movement of foreign exchange rates. Net written premiums increased by 63.1% to $355.2 million for the three months ended June 30, 2018 compared to $217.8 million for the three months ended June 30, 2017. The difference between the change in gross written premiums compared to the change in net written premiums was primarily due to varying utilization of reinsurance. Premiums earned increased 34.3% to $353.7 million for the three months ended June 30, 2018 compared to $263.5 million for the three months ended June 30, 2017. The change in premiums earned relative to net written premiums is the result of timing; premiums are earned ratably over the coverage period whereas written premiums are recorded at the initiation of the coverage period.

Premiums. Gross written premiums increased by 40.5% to $785.1 million for the six months ended June 30, 2018 compared to $558.7 million for the six months ended June 30, 2017, primarily due to increased production from the U.K. and Ireland offices, an increase in Bermuda property business and a positive impact of $20.1 million from the movement of foreign exchange rates. Net written premiums increased by 43.5% to $750.2 million for the six months ended June 30, 2018 compared to $522.8 million for the six months ended June 30, 2017, which is consistent with the change in gross written premiums. Premiums earned increased 35.0% to $672.8 million for the six months ended June 30, 2018 compared to $498.6 million for the six months ended June 30, 2017. The change in premiums earned relative to net written premiums is the result of timing; premiums are earned ratably over the coverage period whereas written premiums are recorded at the initiation of the coverage period.

Incurred Losses and LAE. The following tables present the incurred losses and LAE for the Bermuda segment for the periods indicated.

	Three Months Ended June 30,					
(Dollars in millions)	Current Year	Ratio %/ Pt Change	Prior Years	Ratio %/ Pt Change	Total Incurred	Ratio %/ Pt Change
2018						
Attritional	$202.6	57.3%	$-	0.0 %	$ 202.6	57.3%
Catastrophes	-	0.0 %	47.5	13.4%	47.5	13.4%
Total Segment	$202.6	57.3%	$47.5	13.4%	$ 250.1	70.7%
2017						
Attritional	$161.9	61.4%	$-	0.0 %	$ 161.9	61.4%
Catastrophes	-	0.0 %	3.4	1.3 %	3.4	1.3 %
Total Segment	$161.9	61.4%	$3.4	1.3 %	$ 165.3	62.7%
Variance 2018/2017						
Attritional	$40.7	(4.1) pts	$-	- pts	$ 40.7	(4.1) pts
Catastrophes	-	- pts	44.1	12.1 pts	44.1	12.1 pts
Total Segment	$40.7	(4.1) pts	$44.1	12.1 pts	$ 84.8	8.0 pts

	Six Months Ended June 30,					
(Dollars in millions)	Current Year	Ratio %/ Pt Change	Prior Years	Ratio %/ Pt Change	Total Incurred	Ratio %/ Pt Change
2018						
Attritional	$391.3	58.2%	$-	0.0 %	$ 391.3	58.2%
Catastrophes	-	0.0 %	(11.7)	-1.7%	(11.7)	-1.7 %
Total Segment	$391.3	58.2%	$(11.7)	-1.7%	$ 379.6	56.5%
2017						
Attritional	$288.9	57.9%	$-	0.0 %	$ 288.9	57.9%
Catastrophes	0.9	0.2 %	3.9	0.8 %	4.8	1.0 %
Total Segment	$289.8	58.1%	$3.9	0.8 %	$ 293.7	58.9%
Variance 2018/2017						
Attritional	$102.4	0.3 pts	$-	- pts	$ 102.4	0.3 pts
Catastrophes	(0.9)	(0.2) pts	(15.6)	(2.5) pts	(16.5)	(2.7) pts
Total Segment	$101.5	0.1 pts	$(15.6)	(2.5) pts	$ 85.9	(2.4) pts

(Some amounts may not reconcile due to rounding.)

Incurred losses and LAE increased by 51.3% to $250.1 million for the three months ended June 30, 2018 compared to $165.3 million for the three months ended June 30, 2017, primarily due to $47.5 million of unfavorable development on prior years catastrophe losses in 2018 mainly related to Hurricanes Harvey, Irma and Maria and an increase of $40.7 million in current year attritional losses related primarily to the impact of the increase in premiums earned.

There were no current year catastrophe losses for the three months ended June 30, 2018 and 2017.

Incurred losses and LAE increased by 29.2% to $379.6 million for the six months ended June 30, 2018 compared to $293.7 million for the six months ended June 30, 2017, primarily due to an increase of $102.4 million in current year attritional losses related primarily to the impact of the increase in premiums earned, partially offset by $11.7 million of favorable development on prior years catastrophe losses in 2018. There were no current year catastrophe losses for the six months ended June 30, 2018. The $0.9 million of current year catastrophe losses for the six months ended June 30, 2017 were due to Cyclone Debbie in Australia ($0.9 million).

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Segment Expenses. Commission and brokerage increased by 26.5% to $80.3 million for the three months ended June 30, 2018 compared to $63.5 million for the three months ended June 30, 2017. Commission and brokerage increased by 32.7% to $161.8 million for the six months ended June 30, 2018 compared to $121.9 million for the six months ended June 30, 2017. The increases were mainly due to the impact of the increase in premiums earned.

Segment other underwriting expenses increased to $10.8 million for the three months ended June 30, 2018 compared to $9.0 million for the three months ended June 30, 2017 and increased to $20.9 million for the six months ended June 30, 2018 compared to $18.5 million for the six months ended June 30, 2017. The increases are mainly due to the impact of the increases in premiums earned and changes in the mix of business.

Insurance.
The following table presents the underwriting results and ratios for the Insurance segment for the periods indicated.

	Three Months Ended June 30,					Six Months Ended June 30,				
				%					%	
(Dollars in millions)	2018	2017	Variance	Change		2018	2017	Variance	Change	
Gross written premiums	$645.9	$569.3	$ 76.6	13.5	%	$1,150.9	$1,003.7	$ 147.2	14.7	%
Net written premiums	469.5	463.7	5.8	1.3	%	855.8	809.4	46.3	5.7	%
Premiums earned	$408.4	$363.9	$ 44.5	12.2	%	$801.7	$687.8	$ 113.9	16.6	%
Incurred losses and LAE	280.2	255.9	24.3	9.5	%	535.6	476.7	58.9	12.4	%
Commission and brokerage	62.3	59.2	3.1	5.2	%	128.9	114.5	14.4	12.6	%
Other underwriting expenses	56.5	45.8	10.8	23.5	%	115.2	88.4	26.8	30.3	%
Underwriting gain (loss)	$9.5	$3.1	$ 6.4	206.1	%	$22.0	$8.2	$ 13.8	168.9	%
				Point Chg					Point Chg	
Loss ratio	68.7 %	70.3 %		(1.6	)	66.8 %	69.3 %		(2.5	)
Commission and brokerage ratio	15.2 %	16.3 %		(1.1	)	16.1 %	16.7 %		(0.6	)
Other underwriting expense ratio	13.8 %	12.5 %		1.3		14.4 %	12.8 %		1.6	
Combined ratio	97.7 %	99.1 %		(1.4	)	97.3 %	98.8 %		(1.5	)

(Some amounts may not reconcile due to rounding.)

Premiums. Gross written premiums increased by 13.5% to $645.9 million for the three months ended June 30, 2018 compared to $569.3 million for the three months ended June 30, 2017. This increase was driven by improvement in various insurance lines of business including casualty, accident and health and premiums written through the Lloyd's Syndicate. Net written premiums increased by 1.3% to $469.5 million for the three months ended June 30, 2018 compared to $463.7 million for the three months ended June 30, 2017. The difference between the change in gross written premiums compared to the change in net written premiums was primarily due to varying utilization of reinsurance. Premiums earned increased 12.2% to $408.4 million for the three months ended June 30, 2018 compared to $363.9 million for the three months ended June 30, 2017. The change in premiums earned relative to net written premiums is the result of timing; premiums are earned ratably over the coverage period whereas written premiums are recorded at the initiation of the coverage period.

Gross written premiums increased by 14.7% to $1,150.9 million for the six months ended June 30, 2018 compared to $1,003.7 million for the six months ended June 30, 2017. This increase was driven by expansion of various insurance lines of business including casualty, accident and health and premiums written through the Lloyd's Syndicate. Net written premiums increased by 5.7% to $855.8 million for the six months ended June 30, 2018 compared to $809.4 million for the six months ended June 30, 2017. The difference between the change in gross written premiums compared to the change in net written premiums was primarily due to varying utilization of reinsurance. Premiums earned increased 16.6% to $801.7 million for the six months ended June 30, 2018 compared to $687.8 million for the six months ended June 30, 2017. The change in premiums earned relative to net written premiums is the result of timing; premiums

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are earned ratably over the coverage period whereas written premiums are recorded at the initiation of the coverage period.

Incurred Losses and LAE. The following tables present the incurred losses and LAE for the Insurance segment for the periods indicated.

	Three Months Ended June 30,					
(Dollars in millions)	Current Year	Ratio %/ Pt Change	Prior Years	Ratio %/ Pt Change	Total Incurred	Ratio %/ Pt Change
2018						
Attritional	$270.7	66.3%	$(1.0)	-0.2%	$269.7	66.1%
Catastrophes	10.5	2.6 %	-	0.0 %	10.5	2.6 %
Total Segment	$281.2	68.9%	$(1.0)	-0.2%	$280.2	68.7%
2017						
Attritional	$235.8	64.8%	$7.0	1.9 %	$242.8	66.7%
Catastrophes	13.1	3.6 %	-	0.0 %	13.1	3.6 %
Total Segment	$248.9	68.4%	$7.0	1.9 %	$255.9	70.3%
Variance 2018/2017						
Attritional	$34.9	1.5 pts	$(8.0)	(2.1) pts	$26.9	(0.6) pts
Catastrophes	(2.6)	(1.0) pts	-	- pts	(2.6)	(1.0) pts
Total Segment	$32.3	0.5 pts	$(8.0)	(2.1) pts	$24.3	(1.6) pts

	Six Months Ended June 30,					
(Dollars in millions)	Current Year	Ratio %/ Pt Change	Prior Years	Ratio %/ Pt Change	Total Incurred	Ratio %/ Pt Change
2018						
Attritional	$530.7	66.2%	$(1.0)	-0.1%	$529.7	66.1%
Catastrophes	10.5	1.3 %	(4.6)	-0.6%	5.9	0.7 %
Total Segment	$541.2	67.5%	$(5.6)	-0.7%	$535.6	66.8%
2017						
Attritional	$455.4	66.2%	$8.3	1.2 %	$463.7	67.4%
Catastrophes	13.1	1.9 %	(0.1)	0.0 %	13.0	1.9 %
Total Segment	$468.5	68.1%	$8.2	1.2 %	$476.7	69.3%
Variance 2018/2017						
Attritional	$75.3	- pts	$(9.3)	(1.3) pts	$66.0	(1.3) pts
Catastrophes	(2.6)	(0.6) pts	(4.5)	(0.6) pts	(7.1)	(1.2) pts
Total Segment	$72.7	(0.6) pts	$(13.8)	(1.9) pts	$58.9	(2.5) pts

(Some amounts may not reconcile due to rounding.)

Incurred losses and LAE increased by 9.5% to $280.2 million for the three months ended June 30, 2018 compared to $255.9 million for the three months ended June 30, 2017, mainly due to an increase of $34.9 million in current year attritional losses primarily related to the increase in premiums earned, partially offset by favorable development on prior years attritional losses in 2017 of $7.0 million which did not recur in 2018. The current year catastrophe losses of $10.5 million for the three months ended June 30, 2018 related primarily to the U.S. winter storms ($10.5 million). The $13.1 million of current year catastrophe losses for the three months ended June 30, 2017 were due to the 2017 U.S. Midwest storms ($12.0 million) and Cyclone Debbie ($1.0 million).

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Incurred losses and LAE increased by 12.4% to $535.6 million for the six months ended June 30, 2018 compared to $476.7 million for the six months ended June 30, 2017, mainly due to an increase of $75.3 million in current year attritional losses, primarily related to the increase in premiums earned, partially offset by a decrease in prior years attritional losses of $9.3 million. The current year catastrophe losses of $10.5 million for the six months ended June 30, 2018 related primarily to the U.S. winter storms ($10.5 million). The $13.1 million of current year catastrophe losses for the six months ended June 30, 2017 were due to the 2017 U.S. Midwest storms ($12.0 million) and Cyclone Debbie ($1.0 million).

Segment Expenses. Commission and brokerage increased by 5.2% to $62.3 million for the three months ended June 30, 2018 compared to $59.2 million for the three months ended June 30, 2017. Commission and brokerage increased by 12.6% to $128.9 million for the six months ended June 30, 2018 compared to $114.5 million for the six months ended June 30, 2017. The increases were mainly due to the impact of the increases in premiums earned.

Segment other underwriting expenses increased to $56.5 million for the three months ended June 30, 2018 compared to $45.8 million for the three months ended June 30, 2017. Segment other underwriting expenses increased to $115.2 million for the six months ended June 30, 2018 compared to $88.4 million for the six months ended June 30, 2017. The increases were mainly due to the impact of the increases in premiums earned and increased expenses related to the continued build out of the insurance business.

FINANCIAL CONDITION

Cash and Invested Assets. Aggregate invested assets, including cash and short-term investments, were $18,205.7 million at June 30, 2018, a decrease of $420.9 million compared to $18,626.5 million at December 31, 2017. This decrease was primarily the result of $262.5 million of pre-tax unrealized depreciation, $158.4 million in fair value re-measurements, $106.5 million paid out in dividends to shareholders, $78.4 million due to fluctuations in foreign currencies, $33.4 million of unsettled securities, $17.7 million of amortization of bond premium and $1.0 million of other-than-temporary impairments, partially offset by $132.6 million of cash flows from operations and $45.9 million in equity adjustments of our limited partnership investments.

Our principal investment objectives are to ensure funds are available to meet our insurance and reinsurance obligations and to maximize after-tax investment income while maintaining a high quality diversified investment portfolio. Considering these objectives, we view our investment portfolio as having two components: 1) the investments needed to satisfy outstanding liabilities (our core fixed maturities portfolio) and 2) investments funded by our shareholders' equity.

For the portion needed to satisfy global outstanding liabilities, we generally invest in taxable and tax-preferenced fixed income securities with an average credit quality of A1. For the U.S. portion of this portfolio, our mix of taxable and tax-preferenced investments is adjusted periodically, consistent with our current and projected U.S. operating results, market conditions and our tax position. This global fixed maturity securities portfolio is externally managed by an independent, professional investment manager using portfolio guidelines approved by internal management.

Over the past several years, we have expanded the allocation of our investments funded by shareholders' equity to include: 1) a greater percentage of publicly traded equity securities, 2) emerging market fixed maturities through mutual fund structures, as well as individual holdings, 3) high yield fixed maturities, 4) bank and private loan securities and 5) private equity limited partnership investments. The objective of this portfolio diversification is to enhance the risk-adjusted total return of the investment portfolio by allocating a prudent portion of the portfolio to higher return asset classes, which are also less subject to changes in value with movements in interest rates. We limit our allocation to these asset classes because of 1) the potential for volatility in their values and 2) the impact of these investments on regulatory and rating agency capital adequacy models. We use investment managers experienced in these markets and adjust our allocation to these investments based upon market conditions. At June 30, 2018, the

market value of investments in these investment market sectors, carried at both market and fair value, approximated 55.0% of shareholders' equity.

The Company's limited partnership investments are comprised of limited partnerships that invest in private equities. Generally, the limited partnerships are reported on a quarter lag. We receive annual audited financial statements for all of the limited partnerships which are prepared using fair value accounting in accordance with FASB guidance. For the quarterly reports, the Company's staff performs reviews of the financial reports for any unusual changes in carrying value. If the Company becomes aware of a significant decline in value during the lag reporting period, the loss will be recorded in the period in which the Company identifies the decline.

The tables below summarize the composition and characteristics of our investment portfolio as of the dates indicated.

(Dollars in millions)	At June 30, 2018			At December 31, 2017		
Fixed maturities, market value	$14,242.9	78.2	%	$ 14,756.8	79.2	%
Fixed maturities, fair value	3.2	0.0	%	-	0.0	%
Equity securities, market value	-	0.0	%	129.5	0.7	%
Equity securities, fair value	1,220.8	6.7	%	963.6	5.2	%
Short-term investments	293.2	1.6	%	509.7	2.7	%
Other invested assets	1,826.1	10.1	%	1,631.9	8.8	%
Cash	619.5	3.4	%	635.1	3.4	%
Total investments and cash	$18,205.7	100.0	%	$ 18,626.5	100.0	%

(Some amounts may not reconcile due to rounding.)

	At June 30, 2018	At December 31, 2017
Fixed income portfolio duration (years)	3.2	3.1
Fixed income composite credit quality	A1	Aa3
Imbedded end of period yield, pre-tax	3.3%	3.0%
Imbedded end of period yield, after-tax	2.9%	2.8%

The following table provides a comparison of our total return by asset class relative to broadly accepted industry benchmarks for the periods indicated:

	Six Months Ended June 30, 2018	Twelve Months Ended December 31, 2017
Fixed income portfolio total return	-0.2%	2.5%
Barclay's Capital - U.S. aggregate index	-1.6%	3.5%
Common equity portfolio total return	0.4%	14.6%
S&P 500 index	2.7%	21.8%
Other invested asset portfolio total return	4.0%	8.4%

The pre-tax equivalent total return for the bond portfolio was approximately 0.8% and 4.3%, respectively, for the six months ended June 30, 2018 and the twelve months ended December 31, 2017. The pre-tax equivalent return adjusts the yield on tax-exempt bonds to the fully taxable equivalent.

Our fixed income and equity portfolios have different compositions than the benchmark indexes. Our fixed income portfolios have a shorter duration because we align our investment portfolio with our liabilities. We also hold foreign securities to match our foreign liabilities while the index is comprised of only U.S. securities. Our equity portfolios reflect an emphasis on dividend yield and growth equities, while the index is comprised of the largest 500 equities by market capitalization.

Reinsurance Receivables.

Reinsurance receivables for both paid and recoverable on unpaid losses totaled $1,779.6 million and $1,348.2 million at June 30, 2018 and December 31, 2017, respectively. At June 30, 2018, $630.9 million, or 35.5%, was receivable from Mt. Logan Re collateralized segregated accounts; $165.9 million, or 9.3%, was receivable from Zurich Vericherungs Gesellschaft ("Zurich"); and $135.5 million, or 7.6%, was receivable from Resolution Group Reinsurance (Barbados) Limited ("Resolution Group"). The receivables from Resolution Group are fully collateralized by an individual trust agreement. No other retrocessionaire accounted for more than 5% of our receivables.

Loss and LAE Reserves. Gross loss and LAE reserves totaled $12,043.3 million and $11,884.3 million at June 30, 2018 and December 31, 2017, respectively.

The following tables summarize gross outstanding loss and LAE reserves by segment, classified by case reserves and IBNR reserves, for the periods indicated.

	At June 30, 2018			
(Dollars in millions)	Case Reserves	IBNR Reserves	Total Reserves	% of Total
U.S. Reinsurance	$1,960.7	$1,895.6	$3,856.3	32.0 %
International	1,108.7	984.4	2,093.1	17.4 %
Bermuda	1,144.8	1,461.7	2,606.5	21.6 %
Insurance	1,023.6	2,066.5	3,090.1	25.7 %
Total excluding A&E	5,237.8	6,408.2	11,646.0	96.7 %
A&E	299.4	98.0	397.4	3.3 %
Total including A&E	$5,537.1	$6,506.2	$12,043.3	100.0%

(Some amounts may not reconcile due to rounding.)

	At December 31, 2017			
(Dollars in millions)	Case Reserves	IBNR Reserves	Total Reserves	% of Total
U.S. Reinsurance	$1,719.6	$2,041.0	$3,760.6	31.6 %
International	1,147.6	1,022.9	2,170.5	18.3 %
Bermuda	1,037.8	1,417.0	2,454.8	20.7 %
Insurance	1,049.4	2,000.0	3,049.4	25.7 %
Total excluding A&E	4,954.3	6,481.0	11,435.3	96.2 %
A&E	306.0	143.0	449.0	3.8 %
Total including A&E	$5,260.4	$6,623.9	$11,884.3	100.0%

(Some amounts may not reconcile due to rounding.)

Changes in premiums earned and business mix, reserve re-estimations, catastrophe losses and changes in catastrophe loss reserves and claim settlement activity all impact loss and LAE reserves by segment and in total.

Our loss and LAE reserves represent management's best estimate of our ultimate liability for unpaid claims. We continuously re-evaluate our reserves, including re-estimates of prior period reserves, taking into consideration all available information and, in particular, newly reported loss and claim experience. Changes in reserves resulting from such re-evaluations are reflected in incurred losses in the period when the re-evaluation is made. Our analytical methods and processes operate at multiple levels including individual contracts, groupings of like contracts, classes and lines of business, internal business units, segments, legal entities, and in the aggregate. In order to set appropriate reserves, we make qualitative and quantitative analyses and judgments at these various levels. Additionally, the attribution of reserves, changes in reserves and incurred losses among accident years requires qualitative and quantitative adjustments and allocations at these various levels. We utilize actuarial science, business expertise and management judgment in a manner intended to ensure the accuracy and consistency of our reserving practices. Nevertheless, our reserves are estimates, which are subject to variation, which may be significant.

There can be no assurance that reserves for, and losses from, claim obligations will not increase in the future, possibly by a material amount. However, we believe that our existing reserves and reserving methodologies lessen the probability that any such increase would have a material adverse effect on our financial condition, results of operations or cash flows.

Asbestos and Environmental Exposures. A&E exposures represent a separate exposure group for monitoring and evaluating reserve adequacy. The following table summarizes the outstanding loss reserves with respect to A&E reserves on both a gross and net of retrocessions basis for the periods indicated.

(Dollars in millions)	At June 30, 2018	At December 31, 2017
Gross reserves	$ 397.4	$ 449.0
Reinsurance receivable	(114.5)	(130.9)
Net reserves	$ 282.9	$ 318.1

(Some amounts may not reconcile due to rounding.)

With respect to asbestos only, at June 30, 2018, we had net asbestos loss reserves of $273.2 million, or 96.6%, of total net A&E reserves, all of which was for assumed business.

On July 13, 2015, we sold Mt. McKinley to Clearwater Insurance Company. Concurrently with the closing, we entered into a retrocession treaty with an affiliate of Clearwater. Per the retrocession treaty, we retroceded 100% of the liabilities associated with certain Mt. McKinley policies, which had been reinsured by Bermuda Re. As consideration for entering into the retrocession treaty, Bermuda Re transferred cash of $140.3 million, an amount equal to the net loss reserves as of the closing date. Of the $140.3 million of net loss reserves retroceded, $100.5 million were related to A&E business. The maximum liability retroceded under the retrocession treaty will be $440.3 million, equal to the retrocession payment plus $300.0 million. We will retain liability for any amounts exceeding the maximum liability retroceded under the retrocession treaty.

Ultimate loss projections for A&E liabilities cannot be accomplished using standard actuarial techniques. We believe that our A&E reserves represent management's best estimate of the ultimate liability; however, there can be no assurance that ultimate loss payments will not exceed such reserves, perhaps by a significant amount.

Industry analysts use the "survival ratio" to compare the A&E reserves among companies with such liabilities. The survival ratio is typically calculated by dividing a company's current net reserves by the three year average of annual paid losses. Hence, the survival ratio equals the number of years that it would take to exhaust the current reserves if future loss payments were to continue at historical levels. Using this measurement, our net three year asbestos survival ratio was 5.6 years at June 30, 2018. These metrics can be skewed by individual large settlements occurring in the prior three years and therefore, may not be indicative of the timing of future payments.

Shareholders' Equity. Our shareholders' equity decreased to $8,241.3 million as of June 30, 2018 from $8,369.2 million as of December 31, 2017. This decrease was the result of $240.9 million of unrealized depreciation on investments net of tax, $106.5 million of shareholder dividends, $46.0 million of net foreign currency translation adjustments and the repurchase of 0.1 million common shares for $25.3 million, partially offset by $280.2 million of net income, $6.9 million of share-based compensation transactions and $3.6 million of net benefit plan obligation adjustments, net of tax.

LIQUIDITY AND CAPITAL RESOURCES

Capital. Shareholders' equity at June 30, 2018 and December 31, 2017 was $8,241.3 million and $8,369.2 million, respectively. Management's objective in managing capital is to ensure its overall capital level, as well as the capital levels of its operating subsidiaries, exceed the amounts required by regulators, the amount needed to support our

current financial strength ratings from rating agencies and our own economic capital models. The Company's capital has historically exceeded these benchmark levels.

Our two main operating companies Bermuda Re and Everest Re are regulated by the Bermuda Monetary Authority ("BMA") and the State of Delaware, Department of Insurance, respectively. Both regulatory bodies have their own capital adequacy models based on statutory capital as opposed to GAAP basis equity. Failure to meet the required statutory capital levels could result in various regulatory restrictions, including business activity and the payment of dividends to their parent companies.

Commencing in 2017, the regulatory targeted capital required by the State of Delaware, Department of Insurance was expanded to include a provision for catastrophe exposure. This additional requirement added $759.8 million of regulatory targeted capital for Everest Re as of December 31, 2017.

The regulatory targeted capital and the actual statutory capital for Bermuda Re and Everest Re were as follows:

	Bermuda Re (1)		Everest Re (2)	
	At December 31,		At December 31,	
(Dollars in millions)	2017	2016	2017	2016
Regulatory targeted capital	$2,368.6	$2,025.7	$2,076.9	$1,411.4
Actual capital	$3,085.9	$2,950.5	$3,391.9	$3,635.1

(1) Regulatory targeted capital represents the target capital level from the applicable year's BSCR calculation.
(2) Regulatory targeted capital represents 200% of the RBC authorized control level calculation for the applicable year.

Our financial strength ratings as determined by A.M. Best, Standard & Poor's and Moody's are important as they provide our customers and investors with an independent assessment of our financial strength using a rating scale that provides for relative comparisons. We continue to possess significant financial flexibility and access to debt and equity markets as a result of our financial strength, as evidenced by the financial strength ratings as assigned by independent rating agencies.

We maintain our own economic capital models to monitor and project our overall capital, as well as, the capital at our operating subsidiaries. A key input to the economic models is projected income and this input is continually compared to actual results, which may require a change in the capital strategy.

Since the beginning of 2017, we repurchased 0.3 million shares for $75.3 million in the open market and paid $313.7 million in dividends to adjust our capital position and enhance long term expected returns to our shareholders. We may at times enter into a Rule 10b5-1 repurchase plan agreement to facilitate the repurchase of shares. On November 19, 2014, our existing Board authorization to purchase up to 25 million of our shares was amended to authorize the purchase of up to 30 million shares. As of June 30, 2018, we had repurchased 28.3 million shares under this authorization.

Liquidity. Our liquidity requirements are generally met from positive cash flow from operations. Positive cash flow results from reinsurance and insurance premiums being collected prior to disbursements for claims, which disbursements generally take place over an extended period after the collection of premiums, sometimes a period of many years. Collected premiums are generally invested, prior to their use in such disbursements, and investment income provides additional funding for loss payments. Our net cash flows from operating activities were $132.6 million and $634.4 million for the six months ended June 30, 2018 and 2017, respectively. Additionally, these cash flows reflected net tax recoveries of $44.2 million and net tax payments of $57.8 million for the six months ended June 30, 2018 and 2017, respectively, and net catastrophe loss payments of $573.2 million and $116.6 million for the six months ended June 30, 2018 and 2017, respectively.

If disbursements for claims and benefits, policy acquisition costs and other operating expenses were to exceed premium inflows, cash flow from reinsurance and insurance operations would be negative. The effect on cash flow from insurance operations would be partially offset by cash flow from investment income. Additionally, cash inflows from investment maturities and dispositions, both short-term investments and longer term maturities are available to supplement other operating cash flows.

As the timing of payments for claims and benefits cannot be predicted with certainty, we maintain portfolios of long term invested assets with varying maturities, along with short-term investments that provide additional liquidity for payment of claims. At June 30, 2018 and December 31, 2017, we held cash and short-term investments of $912.7 million and $1,144.7 million, respectively. Our short-term investments are generally readily marketable and can be converted to cash. Starting in the first quarter of 2016, we implemented a new liquidity sweep facility with investments in short maturity, investment grade, U.S. dollar denominated fixed income securities. The facility is structured as a limited liability corporation so it is classified on our balance sheet as part of other invested assets. This facility had $387.2 million of available liquidity at June 30, 2018. In addition to these cash and short-term investments, at June 30, 2018, we had $1,158.1 million of available for sale fixed maturity securities maturing within one year or less, $7,045.8 million maturing within one to five years and $3,245.3 million maturing after five years. Our $1,220.8 million of equity securities are comprised primarily of publicly traded securities that can be easily liquidated. We believe that these fixed maturity and equity securities, in conjunction with the short-term investments and positive cash flow from operations, provide ample sources of liquidity for the expected payment of losses in the near future. We do not anticipate selling a significant amount of securities or using available credit facilities to pay losses and LAE but have the ability to do so. Sales of securities might result in realized capital gains or losses. At June 30, 2018 we had $192.9 million of net pre-tax unrealized depreciation related to fixed maturity securities, comprised of $369.0 million of pre-tax unrealized depreciation and $176.1 million of pre-tax unrealized appreciation.

Management generally expects annual positive cash flow from operations, which reflects the strength of overall pricing. However, given the recent set of catastrophic events, cash flow from operations will probably decline and could become negative in the near term as significant claim payments are made related to the catastrophes. However, as indicated above, the Company has ample liquidity to settle its catastrophe claims.

In addition to our cash flows from operations and liquid investments, we also have multiple credit facilities that provide up to $200.0 million of unsecured revolving credit for liquidity but more importantly provide for up to $600.0 million and £145.0 million of collateralized standby letters of credit to support business written by our Bermuda operating subsidiaries.

Effective May 26, 2016, Group, Bermuda Re and Everest International entered into a five year, $800.0 million senior credit facility with a syndicate of lenders, which amended and restated in its entirety the June 22, 2012, four year, $800.0 million senior credit facility. Both the May 26, 2016 and June 22, 2012 senior credit facilities, which have similar terms, are referred to as the "Group Credit Facility". Wells Fargo Corporation ("Wells Fargo Bank") is the administrative agent for the Group Credit Facility, which consists of two tranches. Tranche one provides up to $200.0 million of unsecured revolving credit for liquidity and general corporate purposes, and for the issuance of unsecured standby letters of credit. The interest on the revolving loans shall, at the Company's option, be either (1) the Base Rate (as defined below) or (2) an adjusted London Interbank Offered Rate ("LIBOR") plus a margin. The Base Rate is the higher of (a) the prime commercial lending rate established by Wells Fargo Bank, (b) the Federal Funds Rate plus 0.5% per annum or (c) the one month LIBOR Rate plus 1.0% per annum. The amount of margin and the fees payable for the Group Credit Facility depends on Group's senior unsecured debt rating. Tranche two exclusively provides up to $600.0 million for the issuance of standby letters of credit on a collateralized basis.

The Group Credit Facility requires Group to maintain a debt to capital ratio of not greater than 0.35 to 1 and to maintain a minimum net worth. Minimum net worth is an amount equal to the sum of $5,371.0 million plus 25% of consolidated net income for each of Group's fiscal quarters, for which statements are available ending on or after March 31, 2016 and for which consolidated net income is positive, plus 25% of any increase in consolidated net worth during such period attributable to the issuance of ordinary and preferred shares, which at June 30, 2018, was $5,939.5 million. As of June 30, 2018, the Company was in compliance with all Group Credit Facility covenants.

At June 30, 2018 and December 31, 2017, the Company had no outstanding short-term borrowings from the Group Credit Facility revolving credit line. At June 30, 2018, the Group Credit Facility had no outstanding letters of credit under tranche one and $571.8 million outstanding letters of credit under tranche two. At December 31, 2017, the Group Credit Facility had no outstanding letters of credit under tranche one and $538.2 million outstanding letters of credit under tranche two.

Effective November 9, 2016, Everest International renewed its credit facility with Lloyds Bank plc ("Everest International Credit Facility"). The current renewal of the Everest International Credit Facility, along with a May 17, 2017 amendment, has a four year term and provides up to £145.0 million for the issuance of standby letters of credit on a collateralized basis. The Company pays a commitment fee of 0.1% per annum on the average daily amount of the remainder of (1) the aggregate amount available under the facility and (2) the aggregate amount of drawings outstanding under the facility. The Company pays a credit commission fee of 0.35% per annum on drawings outstanding under the facility.

The Everest International Credit Facility requires Group to maintain a debt to capital ratio of not greater than 0.35 to 1 and to maintain a minimum net worth. Minimum net worth is an amount equal to the sum of $5,326.0 million (70% of consolidated net worth as of December 31, 2015), plus 25% of consolidated net income for each of Group's fiscal quarters, for which statements are available ending on or after January 1, 2015 and for which net income is positive, plus 25% of any increase in consolidated net worth of Group during such period attributable to the issuance of ordinary and preferred shares, which at June 30, 2018, was $5,939.5 million. As of June 30, 2018, the Company was in compliance with all Everest International Credit Facility requirements.

At June 30, 2018 and December 31, 2017, Everest International Credit Facility had £0.0 million outstanding letters of credit.

Costs incurred in connection with the Group Credit Facility and Everest International Credit Facility were $0.1 million for the three months ended June 30, 2018 and 2017, respectively. Costs incurred in connection with the Group Credit Facility and Everest International Credit Facility were $0.2 million for the six months ended June 30, 2018 and 2017, respectively.

Market Sensitive Instruments.
The SEC's Financial Reporting Release #48 requires registrants to clarify and expand upon the existing financial statement disclosure requirements for derivative financial instruments, derivative commodity instruments and other financial instruments (collectively, "market sensitive instruments"). We do not generally enter into market sensitive instruments for trading purposes.

Our current investment strategy seeks to maximize after-tax income through a high quality, diversified, taxable and tax-preferenced fixed maturity portfolio, while maintaining an adequate level of liquidity. Our mix of taxable and tax-preferenced investments is adjusted periodically, consistent with our current and projected operating results, market conditions and our tax position. The fixed maturity securities in the investment portfolio are comprised of non-trading available for sale securities. Additionally, we have invested in equity securities.

The overall investment strategy considers the scope of present and anticipated Company operations. In particular, estimates of the financial impact resulting from non-investment asset and liability transactions, together with our capital structure and other factors, are used to develop a net liability analysis. This analysis includes estimated payout characteristics for which our investments provide liquidity. This analysis is considered in the development of specific investment strategies for asset allocation, duration and credit quality. The change in overall market sensitive risk exposure principally reflects the asset changes that took place during the period.

Interest Rate Risk. Our $18.2 billion investment portfolio, at June 30, 2018, is principally comprised of fixed maturity securities, which are generally subject to interest rate risk and some foreign currency exchange rate risk, and some equity securities, which are subject to price fluctuations and some foreign exchange rate risk. The overall economic impact of the foreign exchange risks on the investment portfolio is partially mitigated by changes in the dollar value of foreign currency denominated liabilities and their associated income statement impact.

Interest rate risk is the potential change in value of the fixed maturity securities portfolio, including short-term investments, from a change in market interest rates. In a declining interest rate environment, it includes prepayment risk on the $2,307.7 million of mortgage-backed securities in the $14,246.1 million fixed maturity portfolio. Prepayment risk results from potential accelerated principal payments that shorten the average life and thus the expected yield of the security.

The table below displays the potential impact of market value fluctuations and after-tax unrealized appreciation on our fixed maturity portfolio (including $293.2 million of short-term investments) for the period indicated based on upward and downward parallel and immediate 100 and 200 basis point shifts in interest rates. For legal entities with a U.S. dollar functional currency, this modeling was performed on each security individually. To generate appropriate price estimates on mortgage-backed securities, changes in prepayment expectations under different interest rate environments were taken into account. For legal entities with a non-U.S. dollar functional currency, the effective duration of the involved portfolio of securities was used as a proxy for the market value change under the various interest rate change scenarios.

	Impact of Interest Rate Shift in Basis Points				
	At June 30, 2018				
	-200	-100	0	100	200
(Dollars in millions)					
Total Market/Fair Value	$15,445.6	$15,001.9	$14,539.3	$14,064.4	$13,589.7
Market/Fair Value Change from Base (%)	6.2 %	3.2 %	0.0 %	-3.3 %	-6.5 %
Change in Unrealized Appreciation					
After-tax from Base ($)	$821.3	$420.3	$-	$(432.8)	$(865.6)

We had $12,043.3 million and $11,884.3 million of gross reserves for losses and LAE as of June 30, 2018 and December 31, 2017, respectively. These amounts are recorded at their nominal value, as opposed to present value, which would reflect a discount adjustment to reflect the time value of money. Since losses are paid out over a period of time, the present value of the reserves is less than the nominal value. As interest rates rise, the present value of the reserves decreases and, conversely, as interest rates decline, the present value increases. These movements are the opposite of the interest rate impacts on the fair value of investments. While the difference between present value and nominal value is not reflected in our financial statements, our financial results will include investment income over time from the investment portfolio until the claims are paid. Our loss and loss reserve obligations have an expected duration of approximately 3.6 years, which is reasonably consistent with our fixed income portfolio. If we were to discount our loss and LAE reserves, net of ceded reserves, the discount would be approximately $1.3 billion resulting in a discounted reserve balance of approximately $9.1 billion, representing approximately 62.8% of the value of the fixed maturity investment portfolio funds.

Equity Risk. Equity risk is the potential change in fair and/or market value of the common stock, preferred stock and mutual fund portfolios arising from changing prices. Our equity investments consist of a diversified portfolio of individual securities and mutual funds, which invest principally in high quality common and preferred stocks that are traded on the major exchanges, and mutual fund investments in emerging market debt. The primary objective of the equity portfolio is to obtain greater total return relative to our core bonds over time through market appreciation and

income.

The table below displays the impact on fair/market value and after-tax change in fair/market value of a 10% and 20% change in equity prices up and down for the period indicated.

	Impact of Percentage Change in Equity Fair/Market Values At June 30, 2018				
(Dollars in millions)	-20%	-10%	0%	10%	20%
Fair/Market Value of the Equity Portfolio	$ 976.6	$ 1,098.7	$ 1,220.8	$ 1,342.8	$ 1,464.9
After-tax Change in Fair/Market Value	$ (198.8)	$ (99.4)	$ -	$ 99.4	$ 198.8

Foreign Currency Risk. Foreign currency risk is the potential change in value, income and cash flow arising from adverse changes in foreign currency exchange rates. Each of our non-U.S./Bermuda ("foreign") operations maintains capital in the currency of the country of its geographic location consistent with local regulatory guidelines. Each foreign operation may conduct business in its local currency, as well as the currency of other countries in which it operates. The primary foreign currency exposures for these foreign operations are the Canadian Dollar, the Singapore Dollar, the British Pound Sterling and the Euro. We mitigate foreign exchange exposure by generally matching the currency and duration of our assets to our corresponding operating liabilities. In accordance with FASB guidance, the impact on the market value of available for sale fixed maturities due to changes in foreign currency exchange rates, in relation to functional currency, is reflected as part of other comprehensive income. Conversely, the impact of changes in foreign currency exchange rates, in relation to functional currency, on other assets and liabilities is reflected through net income as a component of other income (expense). In addition, we translate the assets, liabilities and income of non-U.S. dollar functional currency legal entities to the U.S. dollar. This translation amount is reported as a component of other comprehensive income.

In June 2016, the United Kingdom approved a referendum to exit the European Union (commonly referred to as "Brexit") which resulted in volatility in global stock markets and currency exchange rates, and has increased political, economic and global market uncertainty. The formal negotiation process for the United Kingdom to exit the European Union will determine the timing and terms of such an exit. The Company has a Lloyd's of London Syndicate and Bermuda Re has a branch operation in the United Kingdom. The nature and extent of the impact of Brexit on regulation, interest rates, currency exchange rates and financial markets is still uncertain and may adversely affect our operations.

Safe Harbor Disclosure.
This report contains forward-looking statements within the meaning of the U.S. federal securities laws. We intend these forward-looking statements to be covered by the safe harbor provisions for forward-looking statements in the federal securities laws. In some cases, these statements can be identified by the use of forward-looking words such as "may", "will", "should", "could", "anticipate", "estimate", "expect", "plan", "believe", "predict", "potential" and "intend". Forward-looking statements contained in this report include information regarding our reserves for losses and LAE, the impact of the Tax Cut and Jobs Act, the adequacy of capital in relation to regulatory required capital, the adequacy of our provision for uncollectible balances, estimates of our catastrophe exposure, the effects of catastrophic events on our financial statements, the ability of Everest Re, Holdings, Holdings Ireland, Dublin Holdings, Bermuda Re and Everest International to pay dividends and the settlement costs of our specialized equity index put option contracts. Forward-looking statements only reflect our expectations and are not guarantees of performance. These statements involve risks, uncertainties and assumptions. Actual events or results may differ materially from our expectations. Important factors that could cause our actual events or results to be materially different from our expectations include those discussed under the caption ITEM 1A, "Risk Factors". We undertake no obligation to update or revise publicly any forward-looking statements, whether as a result of new information, future events or otherwise.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Market Risk Instruments. See "Liquidity and Capital Resources - Market Sensitive Instruments" in PART I – ITEM 2.

ITEM 4. CONTROLS AND PROCEDURES

As of the end of the period covered by this report, our management carried out an evaluation, with the participation of the Chief Executive Officer and Chief Financial Officer, of the effectiveness of our disclosure controls and procedures (as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934 (the "Exchange Act")). Based on their evaluation, the Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures are effective to ensure that information required to be disclosed by us in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission's rules and forms. Our management, with the participation of the Chief Executive Officer and Chief Financial Officer, also conducted an evaluation of our internal control over financial reporting to determine whether any changes occurred during the quarter covered by this report that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting. Based on that evaluation, there has been no such change during the quarter covered by this report.

PART II

ITEM 1. LEGAL PROCEEDINGS

In the ordinary course of business, the Company is involved in lawsuits, arbitrations and other formal and informal dispute resolution procedures, the outcomes of which will determine the Company's rights and obligations under insurance and reinsurance agreements. In some disputes, the Company seeks to enforce its rights under an agreement or to collect funds owing to it. In other matters, the Company is resisting attempts by others to collect funds or enforce alleged rights. These disputes arise from time to time and are ultimately resolved through both informal and formal means, including negotiated resolution, arbitration and litigation. In all such matters, the Company believes that its positions are legally and commercially reasonable. The Company considers the statuses of these proceedings when determining its reserves for unpaid loss and loss adjustment expenses.

Aside from litigation and arbitrations related to these insurance and reinsurance agreements, the Company is not a party to any other material litigation or arbitration.

ITEM 1A. RISK FACTORS

No material changes.

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

Issuer Purchases of Equity Securities.

Issuer Purchases of Equity Securities

	(a)	(b)	(c)	(d)
Period	Total Number of Shares (or Units) Purchased	Average Price Paid per Share (or Unit)	Total Number of Shares (or Units) Purchased as Part of Publicly Announced Plans or Programs	Maximum Number (or Approximate Dollar Value) of Shares (or Units) that May Yet Be Purchased Under the Plans or Programs (1)
April 1 - 30, 2018	0	$ -	0	1,785,507
May 1 - 31, 2018	67,877	$ 224.1978	67,000	1,718,507
June 1 - 30, 2018	45,747	$ 224.8436	45,747	1,672,760
Total	113,624	$ -	112,747	1,672,760

(1) On September 21, 2004, the Company's board of directors approved an amended share repurchase program authorizing the Company and/or its subsidiary Holdings to purchase up to an aggregate of 5,000,000 of the Company's common shares through open market transactions, privately negotiated transactions or both. On July 21, 2008; February 24, 2010; February 22, 2012; May 15, 2013; and November 19, 2014, the Company's executive committee of the Board of Directors has approved subsequent amendments to the share repurchase program authorizing the Company and/or its subsidiary Holdings, to purchase up to a current aggregate of 30,000,000 of the Company's shares (recognizing that the number of shares authorized for repurchase has been reduced by those shares that have already been purchased) in open market transactions, privately negotiated transactions or both.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

ITEM 4. MINE SAFETY DISCLOSURES

Not applicable.

ITEM 5. OTHER INFORMATION

None.

ITEM 6. EXHIBITS

Exhibit Index

Exhibit No.	Description
31.1	Section 302 Certification of Dominic J. Addesso
31.2	Section 302 Certification of Craig Howie
32.1	Section 906 Certification of Dominic J. Addesso and Craig Howie
101.INS	XBRL Instance Document
101.SCH	XBRL Taxonomy Extension Schema
101.CAL	XBRL Taxonomy Extension Calculation Linkbase
101.DEF	XBRL Taxonomy Extension Definition Linkbase
101.LAB	XBRL Taxonomy Extension Labels Linkbase
101.PRE	XBRL Taxonomy Extension Presentation Linkbase

Everest Re Group, Ltd.

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.

Everest Re Group, Ltd.
(Registrant)

/S/ CRAIG HOWIE
Craig Howie
Executive Vice President and
Chief Financial Officer

(Duly Authorized Officer and Principal Financial Officer)

Dated: August 9, 2018