KINGSWAY FINANCIAL SERVICES INC
Form 10-K
March 13, 2017
UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
FORM 10-K

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x ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the fiscal year ended December 31, 2016
OR
o 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 001-15204
Kingsway Financial Services Inc.
(Exact name of registrant as specified in its charter)

Ontario, Canada	Not Applicable
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

45 St. Clair Avenue West, Suite 400 Toronto, Ontario	M4V 1K9
(Address of principal executive offices)	(Zip Code)

1-416-848-1171
(Registrant's telephone number, including area code)
Securities registered pursuant to Section 12(b) of the Act:

Title of Each Class	Name of Each Exchange on Which Registered
Common Stock, no par value	New York Stock Exchange

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 o 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 o 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 o
Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of 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 o
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. x
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See the definitions of “large accelerated filer,” “accelerated filer” and “smaller reporting company” in Rule 12b-2 of the Exchange Act. Large accelerated filer o Accelerated filer x Non-accelerated filer o Smaller reporting company o
Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes o No x

As of June 30, 2016, the aggregate market value of the registrant's voting common stock held by non-affiliates of registrant was $68,251,572 based upon the closing sale price of the common stock as reported by the New York Stock Exchange. Solely for purposes of this calculation, all executive officers and directors of the registrant are considered affiliates.
The number of shares of the Registrant's Common Stock outstanding as of March 13, 2017 was 21,458,190.

DOCUMENTS INCORPORATED BY REFERENCE
Part III of this Form 10-K is incorporated by reference to certain sections of the Proxy Statement for the 2016 Annual Meeting of Shareholders, which will be filed with the Securities and Exchange Commission no later than 120 days after the end of our fiscal year ended December 31, 2016.

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Caution Regarding Forward-Looking Statements

This 2016 Annual Report on Form 10-K (the "2016 Annual Report"), including the accompanying consolidated financial statements of Kingsway Financial Services Inc. ("Kingsway") and its subsidiaries (individually and collectively referred to herein as the "Company") and the notes thereto appearing in Item 8 herein (the "Consolidated Financial Statements"), Management's Discussion and Analysis of Financial Condition and Results of Operations appearing in Item 7 herein (the "MD&A"), and the other Exhibits and Financial Statement Schedules filed as a part hereof or incorporated by reference herein may contain or incorporate by reference information that includes or is based on forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934.

Forward-looking statements relate to future events or future performance and reflect Kingsway management's current beliefs, based on information currently available. The words "anticipate," "expect," "believe," "may," "should," "estimate," "project," "outlook," "forecast" and variations or similar words and expressions are used to identify such forward looking information, but these words are not the exclusive means of identifying forward-looking statements. Specifically, statements about (i) the Company's ability to preserve and use its net operating losses; (ii) the Company's expected liquidity; and (iii) the potential impact of volatile investment markets and other economic conditions on the Company's investment portfolio and underwriting results, among others, are forward-looking, and the Company may also make forward-looking statements about, among other things:

- its results of operations and financial condition (including, among other things, premium volume, premium rates, net and operating income, investment income and performance, return on equity, and expected current returns and combined ratios);
- changes in facts and circumstances affecting assumptions used in determining the provision for unpaid loss and loss adjustment expenses;
- the number and severity of insurance claims (including those associated with catastrophe losses) and their impact on the adequacy of the provision for unpaid loss and loss adjustment expenses;
- the impact of emerging claims issues as well as other insurance and non-insurance litigation;
- orders, interpretations or other actions by regulators that impact the reporting, adjustment and payment of claims;
- changes in industry trends and significant industry developments;
- uncertainties related to regulatory approval of insurance rates, policy forms, license applications and similar matters;
- the impact of certain guarantees made by the Company;
- the ability to complete current or future acquisitions successfully;
- the ability to successfully implement our restructuring activities; and
- strategic initiatives.

For a discussion of some of the factors that could cause actual results to differ, see Item 1A,"Risk Factors," and Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations-Critical Accounting Estimates and Assumptions," in this 2016 Annual Report.

Except as expressly required by applicable securities laws, the Company disclaims any intention or obligation to update or revise any forward-looking statements, whether as a result of new information, future events or otherwise, that might arise subsequent to the date of this 2016 Annual Report.

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Part I

Item 1. BUSINESS

Kingsway Financial Services Inc. was incorporated under the Business Corporations Act (Ontario) on September 19, 1989. In this report, the terms "Kingsway," the "Company," "we," "us" or "our" mean Kingsway Financial Services Inc. and all entities included in our Consolidated Financial Statements.

The Company's registered office is located at 45 St. Clair Avenue West, Suite 400, Toronto, Ontario, Canada M4V 1K9. The common shares of Kingsway are listed on the Toronto Stock Exchange and the New York Stock Exchange under the trading symbol "KFS."

Kingsway is a Canadian holding company with operating subsidiaries located in the United States. The Company operates as a merchant bank primarily engaged, through its subsidiaries, in the property and casualty insurance business. Kingsway conducts its business through the following three reportable segments: Insurance Underwriting, Insurance Services and Leased Real Estate. Insurance Underwriting, Insurance Services and Leased Real Estate conduct their business and distribute their products in the United States. Certain of the business descriptions below, particularly "Investments," "Reinsurance" and "Regulatory Environment," are principally or exclusively related to Insurance Underwriting.

Financial information about Kingsway's reportable business segments for the years ended December 31, 2016, 2015 and 2014 is contained in the following sections of this 2016 Annual Report: (i) Note 25, "Segmented Information," to the Consolidated Financial Statements; and (ii) "Results of Continuing Operations" section of MD&A.

RESTATEMENT OF PREVIOUSLY ISSUED FINANCIAL STATEMENTS

The Company has restated its Consolidated Financial Statements as of and for the years ended December 31, 2015 and December 31, 2014. In addition, the Company has restated the balances for the years ended December 31, 2015 and December 31, 2014 included in the first table to Note 24, “Accumulated Other Comprehensive Loss.” The restatements reflect immaterial corrections of errors identified by management during the fourth quarter of 2016 in the Company’s intercompany eliminations related to accumulated other comprehensive loss and accumulated deficit. No change to shareholders’ equity attributable to common shareholders, total shareholders’ equity, the consolidated statements of operations or the consolidated statements of cash flows for the periods presented in the 2016 Annual Report results from the restatements. The restatements are more fully discussed in Note 3, "Restatement of Previously Issued Financial Statements," to the Consolidated Financial Statements.

Previously filed Annual Reports on Form 10-K and quarterly reports on Form 10-Q for the periods affected by the restatements have not been amended. All amounts in this 2016 Annual Report affected by the restatements reflect such amounts as restated.

REPORTING CURRENCY

The Consolidated Financial Statements have been presented in U.S. dollars because the Company's principal investments and cash flows are denominated in U.S. dollars. The Company's functional currency is the U.S. dollar since the substantial majority of its operations is conducted in the United States. Assets and liabilities of subsidiaries with non-U.S. dollar functional currencies are translated to U.S. dollars at period-end exchange rates, while revenue and expenses are translated at average monthly rates and shareholders' equity is translated at the rates in effect at dates of capital transactions. Foreign currency translation adjustments are included in shareholders' equity under the caption accumulated other comprehensive loss. Foreign currency gains and losses resulting from transactions which are denominated in currencies other than the entity's functional currency are reflected in foreign exchange losses, net in the consolidated statements of operations.

All of the dollar amounts in this 2016 Annual Report are expressed in U.S. dollars, except where otherwise indicated. References to "dollars" or "$" are to U.S. dollars, and any references to "C$" are to Canadian dollars.

GENERAL DEVELOPMENT OF BUSINESS

Acquisitions

CMC Industries, Inc.:

On July 14, 2016, the Company completed the acquisition of 81.0% of CMC Industries, Inc. ("CMC") for cash consideration of $1.5 million. CMC is included in the Leased Real Estate segment. CMC owns, through an indirect wholly owned subsidiary, a parcel of real property consisting of approximately 192 acres located in the State of Texas (the "Real Property"). The Real Property is leased to a third party pursuant to a long-term triple net lease. The Real Property is also subject to a mortgage in the principal amount of $180.0 million (the "Mortgage") at the date of acquisition. Further information is contained in Note 5, "Acquisitions," to the Consolidated Financial Statements.

Argo Management Group LLC:

Effective April 21, 2016, the Company issued 160,000 shares of its common stock to acquire Argo Management Group LLC ("Argo"). The Argo purchase price of $0.7 million was determined using the closing price of Kingsway common stock on the date the 160,000 shares were issued. Argo's primary business is to act as the Managing Member of Argo Holdings Fund I, LLC, an investment fund organized for purposes of making control-oriented equity investments in established lower middle market companies based in North America, with a focus on search fund investments. Further information is contained in Note 5, "Acquisitions," to the Consolidated Financial Statements.

Deconsolidation

During the third quarter of 2016, the Company's ownership percentage in 1347 Investors LLC ("1347 Investors") was reduced to 26.7%. As a result, the Company recorded a non-cash gain of $5.6 million during the third quarter of 2016 related to the deconsolidation of 1347 Investors. This gain results from removing the carrying value of the noncontrolling interest in 1347 Investors and the carrying value of the consolidated net assets of 1347 Investors, and recording the fair value of the Company's 26.7% retained noncontrolling investment in 1347 Investors. Further information is contained in Note 6, "Disposition, Deconsolidations and Discontinued Operations," to the Consolidated Financial Statements.

Private Placement

On November 16, 2016, the Company closed with non-affiliate investors a private placement of 1,615,384 shares of its common stock at a purchase price of $6.50 per share with gross proceeds to the Company of $10.5 million. Net proceeds to the Company were $10.5 million after deducting expenses.

INSURANCE UNDERWRITING SEGMENT

The Company's property and casualty insurance business operations are conducted primarily through the following subsidiaries: Mendota Insurance Company ("Mendota"), Mendakota Insurance Company ("Mendakota"), Mendakota Casualty Company ("MCC"), Kingsway Amigo Insurance Company ("Amigo") and Kingsway Reinsurance Corporation (collectively, "Insurance Underwriting").

The insurance subsidiaries in Insurance Underwriting issue insurance policies and retain the risk of operating profit or loss related to the ultimate loss and loss adjustment expenses incurred on the underlying policies. Insurance Underwriting provides non-standard automobile insurance to individuals who do not meet the criteria for coverage by standard automobile insurers. Insurance Underwriting has policyholders in 12 states; however, new business is accepted in only 8 states. In 2016, the following states accounted for 89.0% of Insurance Underwriting's gross premiums written: Florida (27.4%), Texas (17.7%), Illinois (13.3%), Nevada (11.3%), California (10.9%) and Colorado (8.4%).

The Company previously placed Amigo and MCC into voluntary run-off in 2012 and 2011, respectively. Each of Amigo and MCC entered into a comprehensive run-off plan which was approved by its respective state of domicile. Kingsway continues to manage Amigo and MCC in a manner consistent with the run-off plans. During the first quarter of 2015, MCC sent a letter of intent to the Illinois Department of Insurance to resume writing private passenger automobile policies in the state of Illinois. MCC began writing these policies on April 1, 2015.

Effective March 31, 2014, the Company's wholly owned subsidiary, 1347 Property Insurance Holdings, Inc. ("PIH"), formerly known as Maison Insurance Holdings, Inc., completed an initial public offering of its common stock. Upon completion of the transaction, the Company maintained a minority ownership interest in the common shares of PIH. The earnings of PIH are included in the consolidated statements of operations through the March 31, 2014 transaction date. Prior to the transaction, PIH was included in the Insurance Underwriting segment. As a result of the disposal of the Company's majority interest in PIH on March 31, 2014, all segmented information has been restated to exclude PIH from the Insurance Underwriting segment.

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Insurance Underwriting Products

Insurance Underwriting primarily markets automobile insurance products which provide coverage in three major areas: liability, accident benefits and physical damage. Liability insurance provides coverage for claims against the Company's insureds legally responsible for automobile accidents which have injured third-parties or caused property damage to third-parties. Accident benefit policies or personal injury protection policies provide coverage for loss of income, medical and rehabilitation expenses for insured persons who are injured in an automobile accident, regardless of fault. Physical damage policies cover damages to an insured automobile arising from a collision with another object or from other risks such as fire or theft.

Table 1 and Table 2 summarize Insurance Underwriting's gross premiums written by line of business and by state, respectively, for the years ended December 31, 2016, 2015 and 2014.

TABLE 1 Gross premiums written by line of business

For the years ended December 31 (in thousands of dollars, except for percentages)

	2016	% of Total	2015	% of Total	2014	% of Total
Private passenger auto liability	90,114	67.9 %	78,811	67.7 %	76,487	67.1 %
Auto physical damage	42,575	32.1 %	37,592	32.3 %	37,515	32.9 %
Total gross premiums written	132,689	100.0 %	116,403	100.0 %	114,002	100.0 %

TABLE 2 Gross premiums written by state

For the years ended December 31 (in thousands of dollars, except for percentages)

	2016	% of Total	2015	% of Total	2014	% of Total
Florida	36,378	27.4 %	27,935	24.0 %	21,440	18.8 %
Texas	23,525	17.7 %	18,989	16.3 %	20,142	17.7 %
Illinois	17,644	13.3 %	18,265	15.7 %	17,786	15.6 %
California	14,429	10.9 %	12,046	10.3 %	11,363	10.0 %
Nevada	15,015	11.3 %	11,572	9.9 %	10,863	9.5 %
Colorado	11,122	8.4 %	10,027	8.6 %	11,033	9.7 %
Other	14,576	11.0 %	17,569	15.2 %	21,375	18.7 %
Total gross premiums written	132,689	100.0 %	116,403	100.0 %	114,002	100.0 %

Non-standard automobile insurance is principally provided to individuals who do not qualify for standard automobile insurance coverage because of their payment history, driving record, place of residence, age, vehicle type or other factors. Such drivers typically represent higher than normal risks and pay higher insurance rates for comparable coverage.

Non-standard automobile insurance loss experience is generally driven by higher frequency and lower severity than the standard automobile market. The higher frequency, however, is mitigated to some extent by higher premium rates; the tendency of high-risk individuals to own low-value automobiles; and generally lower limits of insurance coverage as insureds tend to purchase coverage at the minimum prescribed limits. In the United States, non-standard automobile insurance policies generally have lower limits of insurance commensurate with the minimum coverage requirements under the statute of the states in which we write the business. These limits of liability are typically not greater than $50,000 per occurrence.

The insuring of non-standard automobile drivers is often transitory. When their driving records improve, insureds may qualify to obtain insurance in the standard market at lower premium rates. We often cancel policies for non-payment of premium and, following a period of lapse in coverage, insureds frequently return to purchase a new policy at a later date. As a result, our non-standard automobile insurance policies experience a retention rate that is lower than that experienced for standard market risks. This creates an on-going requirement to replace non-renewing policyholders with new policyholders and to react promptly to issue cancellation notices for non-payment of premiums to mitigate potential bad debt write-offs. Most of our insureds pay their premiums on a monthly installment basis, and we typically limit our risk related to non-payment of premiums by requiring a deposit for future insurance premiums and

the prepayment of subsequent installments.
In the United States, automobile insurers are generally required to participate in various involuntary residual market pools and assigned risk plans that provide automobile insurance coverage to individuals or other entities that are unable to purchase such

coverage in the voluntary market. Participation in these pools in most jurisdictions is in proportion to voluntary writings of selected lines of business in those jurisdictions.

Non-standard automobile insurance accounted for 100.0% of Insurance Underwriting's gross premiums written in 2016, 2015 and 2014. For the year ended December 31, 2016, gross premiums written for non-standard automobile insurance increased 14.0% to $132.7 million as compared to $116.4 million in 2015. For the year ended December 31, 2015, gross premium written for non-standard automobile insurance increased 2.1% to $116.4 million as compared to $114.0 million in 2014. The increase in gross premiums written during 2016 compared to 2015 reflects a change in the mix of business by state resulting from Insurance Underwriting's strategic shift to emphasize certain states and de-emphasize others while also reflecting the competitive market dynamics of each state. Of particular note, the Company has recorded increased premiums written in Florida, Texas and Nevada while reducing premiums written in Virginia, a state in which Insurance Underwriting ceased writing new business beginning in the third quarter of 2015. The increase in gross premiums written during 2015 compared to 2014, resulted primarily from increased premium volumes written in Florida during the year ended December 31, 2015 compared to prior year.

Marketing and Distribution

Our strategy focuses on developing and maintaining strong relationships with our independent agents. Insurance Underwriting's products and services are marketed through approximately 3,800 independent agencies. We maintain an "open market" approach which enables these agents to place business with us without the obligation of minimum production commitments, providing us with a broad, flexible and scalable distribution network. We continually strive to provide excellent service in the markets in which we operate, communicating through a variety of channels as we look for opportunities to increase efficiency and reduce operating costs with our agents. Our independent agents have the ability to bind insurance policies on our behalf, subject to our underwriting guidelines. Our proprietary point-of-sale systems, however, prevent any agent from binding an unacceptable risk. We do not, though, delegate authority to settle or adjust claims, establish underwriting guidelines, develop rates or enter into other transactions or commitments through our independent agents.

Texas business is originated through an affiliated managing general agent and written through an unaffiliated Texas county mutual insurance company. This business is then 100% assumed through a quota-share arrangement by one of our insurance subsidiaries. This represents a common way of originating non-standard automobile business in the state of Texas due to the greater rating and underwriting flexibility accorded Texas county mutual insurance companies under Texas statutes.

No customer or group of affiliated customers accounts for 10% or more of Insurance Underwriting's revenues, and no loss of a customer or group of affiliated customers would have a material adverse effect on the Company.

Competition

Insurance Underwriting operates in a highly competitive environment. Our core non-standard automobile offerings are policies at the minimum prescribed limits in each state produced entirely through our independent agents. We compete with large national insurance companies and smaller regional insurance companies which produce through independent agents. We also compete with insurance companies which sell policies directly to their customers.

Large national insurance companies and direct underwriters typically operate in standard lines of personal automobile and property insurance in addition to non-standard lines and generally bring with them increased name recognition obtained through extensive media advertising, loyalty of the customer base to the insurer rather than to an independent agency and, potentially, reduced policy acquisition costs and increased customer retention.

From time to time, the non-standard automobile market attracts competition from new entrants. In many cases, these entrants are looking for growth and, as a result, price their insurance below the rates that we believe provide an acceptable return for the related risk. We firmly believe that it is not in our best interest to compete solely on price; consequently, we are willing to experience a loss of market share during periods of intense price competition or soft market conditions. During the last few years, the Company carried out a detailed review of its premium adequacy in the territories in which it operates and implemented steps to terminate business where premium adequacy was unlikely

to be achieved within an acceptable period of time.
In order to stay competitive while striving to generate an economic rate of return, we compete on a number of factors such as distribution strength and breadth, premium adequacy, agency relationships, ease of doing business and market reputation. Ultimately, we believe that our ability to compete successfully in our industry is based, among other things, on our ability to:

- identify markets that are most likely to produce an underwriting profit;
- operate with a disciplined underwriting approach;

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- practice prudent claims management;
- establish an appropriate provision for unpaid loss and loss adjustment expenses;
- strive for cost containment and the economics of shared support functions where deemed appropriate; and
- provide our independent agents and brokers with competitive commissions, an ease of doing business and additional value-added products and services for them and their customers.

Insurance Underwriting generally does not compete on the basis of ratings assigned by insurance rating agencies. Previously, the Company's insurance subsidiaries were assigned ratings by A.M. Best. In October, 2011 the Company had the A.M. Best ratings for all of its insurance subsidiaries withdrawn. As a result, the Company's insurance subsidiaries are currently unrated.

Underwriting

Our underwriting philosophy stresses receiving an adequate premium and spread of risks for the business we accept. We regularly monitor premium adequacy by territory, line of business and agency and take actions as necessary. Actions include, but are not limited to, tightening underwriting requirements, filing for rate increases, terminating underperforming programs and agents, non-renewing policies (where permitted) and other administrative changes. Typically, we do not reduce our premiums when competitors underwrite at premium rates that we believe are below acceptable levels. Instead, we focus on maintaining our premium per risk rather than writing a large number of risks at premiums that we believe would be inadequate and thus unprofitable. As a result, our premium volumes may be negatively impacted during a soft market.

Claims Management

Claims management is the process by which Insurance Underwriting determines the validity and amount of a claim. We believe that claims management is fundamental to our operating results. With respect to Insurance Underwriting, proper and efficient claims management has a direct effect on the operating profit or loss which has been retained related to the ultimate loss and loss adjustment expenses incurred on the underlying policies.

Insurance Underwriting primarily employs its own claims adjusters who are responsible for investigating and settling claims. Our goal is to settle claims fairly for the benefit of our insureds in a manner that is consistent with the insurance policy language and our regulatory and legal obligations.

In addition to claims adjusters, our operating subsidiaries also employ appraisers, special investigators and salvage, subrogation and other personnel who are responsible for helping us reduce the net cost of claim-handling, particularly with respect to identifying instances of fraud. We also outsource certain of these activities when we believe outsourcing represents a more efficient approach to performing these activities. We aggressively combat fraud and have processes in place to investigate suspicious claim activity. We may also engage independent appraisers, private investigators, various experts and legal counsel to assist us in adjusting claims. When necessary, we defend litigation against our insureds generally by retaining outside legal counsel.

INSURANCE SERVICES SEGMENT

Insurance Services includes the following subsidiaries of the Company: IWS Acquisition Corporation ("IWS") and Trinity Warranty Solutions LLC ("Trinity"), (collectively, "Insurance Services").

IWS is a licensed motor vehicle service agreement company and is a provider of after-market vehicle protection services distributed by credit unions in 23 states to their members.

Trinity is a provider of warranty products and maintenance support to consumers and businesses in the heating, ventilation, air conditioning ("HVAC"), standby generator, commercial LED lighting and refrigeration industries. Trinity distributes its warranty products through original equipment manufacturers, HVAC distributors and commercial and residential contractors. Trinity distributes its maintenance support direct through corporate owners of retail spaces throughout the United States.

Effective April 1, 2015, the Company closed on the sale of its wholly owned subsidiary, Assigned Risk Solutions Ltd. ("ARS"). As a result, ARS has been classified as discontinued operations and the results of their operations are reported separately for all periods presented. Prior to the transaction, ARS was included in the Insurance Services segment. As a result of classifying ARS as a discontinued operation, all segmented information has been restated to exclude ARS from the Insurance Services segment. Further information is contained in Note 6, "Disposition, Deconsolidations and Discontinued Operations," to the Consolidated Financial Statements.

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Insurance Services Products
IWS markets and administers vehicle service agreements and related products for new and used automobiles throughout the United States. A vehicle service agreement is an agreement between IWS and the vehicle purchaser under which IWS agrees to replace or repair, for a specific term, designated vehicle parts in the event of a mechanical breakdown. IWS serves as the administrator on all contracts it originates. Vehicle service agreements supplement, or are in lieu of, manufacturers' warranties and provide a variety of extended coverage options. Vehicle service agreements typically range from three months to seven years and/or 3,000 miles to 100,000 miles. The cost of the vehicle service agreement is a function of the contract term, coverage limits and type of vehicle.
In addition to marketing vehicle service agreements, IWS also brokers a guaranteed asset protection product ("GAP") through its distribution channel. GAP generally covers a consumer's out-of-pocket amount, related to an automobile loan or lease, if the vehicle is stolen or damaged beyond repair. IWS earns a commission when a consumer purchases a GAP certificate but does not take on any insurance risk.
Trinity is a provider of HVAC, standby generator, commercial LED lighting and refrigeration warranty products and provider of equipment breakdown and maintenance support services to companies across the United States. As a provider of warranty products, Trinity markets and administers product warranty contracts for certain new and used products in the HVAC, standby generator, commercial LED lighting and refrigeration industries throughout the United States. A warranty contract is an agreement between Trinity and the purchaser of such HVAC, standby generator, commercial LED lighting and refrigeration equipment to replace or repair, for a specific term, designated parts in the event of a mechanical breakdown. As a provider of equipment breakdown and maintenance support services, Trinity acts as a single point of contact to its clients for both certain equipment breakdowns and scheduled maintenance of equipment. Trinity will provide such repair and breakdown services by contracting with certain HVAC providers.
Marketing and Distribution
IWS markets its products primarily through credit unions. IWS enters into an exclusive agreement with each credit union whereby the credit union receives a stipulated access fee for each vehicle service agreement issued to its members. The credit unions are served by IWS employee representatives located throughout the United States in close geographical proximity to the credit unions they serve. IWS distributes and markets its products in 23 states.
Trinity directly markets and distributes its warranty products to manufacturers, distributors and installers of HVAC, standby generator, commercial LED lighting and refrigeration equipment. As a provider of equipment breakdown and maintenance support, Trinity directly markets and distributes its product through its clients, which are primarily companies that directly own and operate numerous locations across the United States.
No customer or group of affiliated customers accounts for 10% or more of Insurance Service's revenues, and no loss of a customer or group of affiliated customers would have a material adverse effect on the Company.
Competition
IWS focuses exclusively on the automotive finance market with its core vehicle service agreement and related product offerings, while much of its competition in the credit union channel has a less targeted product approach. IWS' typical competitor takes a generalist approach to market by providing credit unions with a variety of different product offerings. They are thus unable to deliver specialty expertise on par with IWS and do not give vehicle service agreement products the attention they require for healthy profitability and strong risk management.
Trinity operates in an environment with few market competitors. Trinity competes on two important facets: its belief that it provides superior customer service relative to its competitors and its ability, through the support of its insurance company partners, to provide warranty solutions to a wider range of HVAC, standby generator, commercial LED lighting and refrigeration equipment than that of its competitors.
Claims Management
Claims management is the process by which Insurance Services determines the validity and amount of a claim. We believe that claims management is fundamental to our operating results. The individual operating subsidiaries in

Insurance Services primarily employ their own claims adjusters who are responsible for investigating and settling claims. Our goal is to settle claims fairly for the benefit of our insureds and the insureds of our insurance company partners in a manner that is consistent with the insurance policy language and our regulatory and legal obligations.

IWS effectively and efficiently manages claims by utilizing in-house expertise and information systems. IWS employs an experienced claims staff comprised of Automotive Service Excellence certified mechanics, knowledgeable in all aspects of vehicle repairs and potential claims. Additionally, IWS owns its own proprietary database of historical claims data dating back over twenty years. Management analyzes this database to drive real-time pricing adjustments and strategic decision-making.

Trinity claims on warranty products are managed by the insurance companies with which Trinity partners. Trinity may, at times, act as a third-party administrator of such claims; however, at no time does Trinity bear the loss of claims on warranty products.

LEASED REAL ESTATE SEGMENT

Leased Real Estate includes the Company's subsidiary, CMC, which was acquired on July 14, 2016. CMC owns, through an indirect wholly owned subsidiary, the Real Property, which is subject to a long-term triple net lease agreement. The Real Property is also subject to the Mortgage. All cash rental income generated by the Real Property is applied to make principal and interest payments on the Mortgage.

PRICING AND PRODUCT MANAGEMENT

Responsibility for pricing and product management rests with the Company's individual operating subsidiaries in each of Insurance Underwriting and Insurance Services. Typically, teams comprised of pricing actuaries, product managers and business development managers work together by territory to develop policy forms and language, rating structures, regulatory filings and new product ideas. Data solutions and claims groups track loss performance on a monthly basis so as to alert the operating subsidiaries to the potential need to adjust forms or rates.

UNPAID LOSS AND LOSS ADJUSTMENT EXPENSES

Kingsway records a provision for its unpaid losses that have occurred as of a given evaluation date as well as for its estimated liability for loss adjustment expenses. The provision for unpaid losses includes a provision, commonly referred to as case reserves, for losses related to reported claims as well as a provision for losses related to claims incurred but not reported ("IBNR"). The provision for loss adjustment expenses represents the cost to investigate and settle claims.

The provision for unpaid loss and loss adjustment expenses does not represent an exact calculation of the liability but instead represents management's best estimate at a given accounting date, utilizing actuarial and statistical procedures, of the undiscounted estimates of the ultimate net cost of all unpaid loss and loss adjustment expenses. Management continually reviews its estimates and adjusts its provision as new information becomes available. In establishing the provision for unpaid loss and loss adjustment expenses, the Company also takes into account estimated recoveries, reinsurance, salvage and subrogation.

Any adjustments to the provision for unpaid loss and loss adjustment expenses are reflected in the consolidated statements of operations in the periods in which they become known, and the adjustments are accounted for as changes in estimates. Even after such adjustments, ultimate liability or recovery may exceed or be less than the revised provisions. An adjustment that increases the provision for unpaid loss and loss adjustment expenses is known as an unfavorable development or a deficiency and will reduce net income while an adjustment that decreases the provision is known as a favorable development or a redundancy and will increase net income.

Process for Establishing the Provision for Unpaid Loss and Loss Adjustment Expenses

The process for establishing the provision for unpaid loss and loss adjustment expenses reflects the uncertainties and significant judgmental factors inherent in predicting future results of both reported and IBNR claims. As such, the process is inherently complex and imprecise and estimates are constantly refined. The process of establishing the provision for unpaid loss and loss adjustment expenses relies on the judgment and opinions of a large number of individuals, including the opinions of the Company's actuaries.

Factors affecting the provision for unpaid loss and loss adjustment expenses include the continually evolving and changing regulatory and legal environment, actuarial studies, professional experience and expertise of the Company's claims departments' personnel and independent adjusters retained to handle individual claims, the quality of the data used for projection purposes, existing claims management practices including claims handling and settlement practices, the effect of inflationary trends on future loss settlement costs, court decisions, economic conditions and public attitudes.

The process for establishing the provision for loss and loss adjustment expenses begins with the collection and analysis of claim data. Data on individual reported claims, both current and historical, including paid amounts and individual claim adjuster estimates, are grouped by common characteristics and evaluated by actuaries in their analyses of ultimate claim liabilities by product line. Such data is occasionally supplemented with external data as available and when appropriate. The process of analyzing the provision is undertaken on a regular basis, generally quarterly, in light of continually updated information.

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Multiple estimation methods are available for the analysis of the provision for loss and loss adjustment expenses. Each estimation method has its own set of assumption variables and its own advantages and disadvantages, with no single estimation method being better than the others in all situations and no one set of assumption variables being meaningful for all product line components. The relative strengths and weaknesses of the particular estimation methods when applied to a particular group of claims can also change over time; therefore, the actual choice of estimation method can change with each evaluation. The estimation methods chosen are those that are believed to produce the most reliable indication at that particular evaluation date.

In most cases, multiple estimation methods will be valid for the evaluation of the provision for loss and loss adjustment expenses. This will result in a range of reasonable estimates for the provision. Reported values found to be closer to the endpoints of a range of reasonable estimates are subject to further detailed reviews. These reviews may substantiate the validity of management's recorded provision or lead to a change in the reported provision.

The exact boundary points of these ranges are more qualitative than quantitative in nature, as no clear line of demarcation exists to determine when the set of underlying assumptions for an estimation method switches from being reasonable to unreasonable. As a result, the Company does not believe that the endpoints of these ranges are or would be comparable across companies. In addition, potential interactions among the different estimation assumptions for different product lines make the aggregation of individual ranges a highly judgmental and inexact process.

A basic premise in most actuarial analyses is that past patterns demonstrated in the data will repeat themselves in the future, absent a material change in the associated risk factors discussed below. To the extent a material change affecting the ultimate provision for loss and loss adjustment expenses is known, such change is quantified to the extent possible through an analysis of internal company data and, if available and when appropriate, external data. Such a measurement is specific to the facts and circumstances of the particular claim portfolio and the known change being evaluated. Significant structural changes to the available data, product mix or organization can materially impact the provision for loss and loss adjustment expenses.

Informed judgment is applied throughout the process. This includes the application of various individual experiences and expertise to multiple sets of data and analyses. In addition to actuaries, experts involved with the reserving process also include underwriting and claims personnel and lawyers, as well as other company management. As a result, management may have to consider varying individual viewpoints when establishing the provision for loss and loss adjustment expenses.

Variables Influencing the Provision for Unpaid Loss and Loss Adjustment Expenses

The variables discussed above have different impacts on estimation uncertainty for a given product line, depending on the length of the claim tail, the reporting lag, the impact of individual claims and the complexity of the claim process for a given product line.

Property and casualty insurance policies are either written on a claims-made or occurrence basis. Claims-made policies generally cover, subject to requirements in individual policies, claims reported during the policy period. Policies that are written on an occurrence basis require that the insured demonstrate that a loss occurred in the policy period, even if the insured reports the loss in a later policy period.

Product lines are generally classifiable as either long-tail or short-tail, based on the average length of time between the event triggering claims under a policy and the final resolution of those claims. Short-tail claims are reported and settled quickly, resulting in less estimation variability. The longer the time before final claim resolution, the greater the exposure to estimation risks and hence the greater the estimation uncertainty.

A major component of the claim tail is the reporting lag. The reporting lag, which is the time between the event triggering a claim and the reporting of the claim to the insurer, makes estimating IBNR inherently more uncertain. In addition, the greater the reporting lag, the greater the proportion of IBNR to the total provision for the product line. Writing new products with material reporting lags can result in adding several years' worth of IBNR claim exposure before the reporting lag exposure becomes clearly observable, thereby increasing the risk associated with pricing and reserving such products.

For some lines, the impact of large individual claims or loss events, such as catastrophes, can be material to the analysis. These lines are generally referred to as being "low frequency/high severity," while lines without this "large claim" sensitivity are referred to as "high frequency/low severity." The provision for low frequency/high severity lines can be sensitive to the impact of a small number of potentially large claims or a small number of significant loss events, such as catastrophes. As a result, the role of judgment is much greater for these provisions. In contrast, for high frequency/low severity lines, the impact of individual claims is relatively minor and the range of reasonable provision estimates is narrower and more stable.

Claim complexity can also greatly affect the estimation process by impacting the number of assumptions needed to produce the estimate, the potential stability of the underlying data and claim process, and the ability to gain an understanding of the data. Product lines with greater claim complexity have inherently greater estimation uncertainty. Actuaries have to exercise a considerable degree of judgment in the evaluation of all these factors in their analysis of the provision for loss and loss adjustment expenses. The human element in the application of actuarial judgment is unavoidable when faced with material uncertainty. Different actuaries may choose different assumptions when faced with such uncertainty, based on their individual backgrounds, professional experiences and areas of focus. Hence, the estimates selected by the various actuaries may differ materially from each other.

Lastly, significant structural changes to the available data, product mix or organization can also materially impact the process for establishing the provision for loss and loss adjustment expenses.

Property and Casualty Insurance

The Company's insurance policies are generally written on an occurrence basis. Non-standard automobile includes both short and long-tail coverages. The payments that are made quickly typically pertain to auto physical damage and property damage claims. The payments that take longer to finalize and are more difficult to estimate relate to bodily injury claims. Reporting lags are relatively short, and the claim settlement process for personal automobile liability generally is the least complex of the liability products. Given that our core non-standard automobile offerings are policies at the minimum prescribed limits in each state, our non-standard automobile business is generally viewed as a high frequency, low severity business.

Examples of common risk factors that could change and, thus, affect the provision for loss and loss adjustment expenses for the non-standard automobile product line include, but are not limited to:

- trends in jury awards;
- changes in the underlying court system and its philosophy;
- changes in case law;
- litigation trends;
- frequency of claims with payment capped by policy limits;
- change in average severity of accidents, or proportion of severe accidents;
- subrogation opportunities;
- degree of patient responsiveness to treatment;
- changes in claim handling philosophies;
- effectiveness of no-fault laws;
- frequency of visits to health providers;
- number of medical procedures given during visits to health providers;
- types of health providers used;
- types of medical treatments received;
- changes in cost of medical treatments;
- changes in policy provisions (e.g., deductibles, policy limits, endorsements, etc.);
- changes in underwriting standards; and
- changes in the use of credit data for rating and underwriting.

Rollforward of Property and Casualty Unpaid Loss and Loss Adjustment Expenses

Table 3 shows a rollforward of the provision for property and casualty unpaid loss and loss adjustment expenses, net of amounts recoverable from reinsurers. The effect on the Company's net loss (income) during the past three years due to changes in estimates

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of prior year property and casualty unpaid loss and loss adjustment expenses is shown as the "prior years" contribution to incurred losses. The consolidated financial statements are presented on a calendar year basis for all data. Calendar year results reflect payments and re-estimation of the provision that have been recorded in the consolidated financial statements during the applicable reporting period without regard to the periods in which the original losses were incurred. Calendar year results do not change after the end of the applicable reporting period, even as new information develops.

TABLE 3 Rollforward of property and casualty unpaid loss and loss adjustment expenses
As of December 31 (in thousands of dollars)

	2016	2015	2014
Balance at beginning of period, gross	55,471	63,895	84,534
Less reinsurance recoverable related to property and casualty unpaid loss and loss adjustment expenses	1,207	3,203	7,942
Balance at beginning of period, net	54,264	60,692	76,592
Incurred related to:			
Current year	96,289	86,439	84,577
Prior years	8,095	616	(5,123)
Paid related to:			
Current year	(62,978)	(54,415)	(52,521)
Prior years	(42,556)	(39,068)	(42,428)
Disposal of unpaid loss and loss adjustment expenses related to PIH	—	—	(405)
Balance at end of period, net	53,114	54,264	60,692
Plus reinsurance recoverable related to property and casualty unpaid loss and loss adjustment expenses	681	1,207	3,203
Balance at end of period, gross	53,795	55,471	63,895

INVESTMENTS

We manage our investments to support the liabilities of our insurance operations, preserve capital, maintain adequate liquidity and maximize after-tax investment returns within acceptable risks. The fixed maturities portfolios are managed by a third-party firm and are comprised predominantly of high-quality fixed maturities with relatively short durations. Equity, limited liability and other investments are managed by a team of employees and advisors dedicated to the identification of investment opportunities that offer asymmetric risk/reward potential with a margin of safety supported by private market values. The Investment Committee of the Board of Directors is responsible for monitoring the performance of our investments and compliance with the Company's investment policies and guidelines, which it reviews annually. We are also subject to the applicable state regulations that prescribe the type, quality and concentration of investments that individual insurance companies can make.

For further descriptions of the Company's investments, see our disclosures under the headings "Net Investment Income," "Net Realized Gains," "Investments," "Liquidity and Capital Resources" and "Critical Accounting Estimates and Assumptions" in the MD&A and Note 7, "Investments," and Note 26, "Fair Value of Financial Instruments," to the Consolidated Financial Statements.

REINSURANCE

For most of the non-standard automobile business that we write, our exposure is generally limited to the minimum statutory liability limits, which are typically not greater than $50,000 per occurrence, depending on the state. We have from time to time, though, entered into different types of reinsurance arrangements as part of the management of our non-standard automobile business. For 2016 and 2015, we entered into an excess of loss reinsurance arrangement to reduce our exposure to losses related to certain catastrophic events which may occur in any of the states in which we write non-standard automobile business. Upon the expiration in January, 2017 of this excess of loss reinsurance arrangement, we concluded not to renew it.

Reinsurance ceded does not relieve us of our ultimate liability to our insureds in the event that any reinsurer is unable to meet its obligations under its reinsurance contracts. We therefore enter into reinsurance contracts with only those reinsurers which we believe have sufficient financial resources to meet their obligations to us. Reinsurance treaties generally have terms of one year and, as a result, are subject to renegotiation annually.

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Because our reinsurance recoverable is generally unsecured, we regularly evaluate the financial condition of our reinsurers and monitor the concentrations of credit risk to minimize our exposure to significant losses as a result of the insolvency of a reinsurer. We believe that the amounts we have recorded as reinsurance recoverable are appropriately established. Estimating our reinsurance recoverable, however, is subject to various uncertainties and the amounts ultimately recoverable may vary from amounts currently recorded. Estimating amounts of reinsurance recoverable is also impacted by the uncertainties involved in the establishment of provisions for unpaid loss and loss adjustment expenses. As our underlying provision develops, the amounts ultimately recoverable may vary from amounts currently recorded.

As of December 31, 2016, we had $0.8 million recoverable from third-party reinsurers. As shown in Table 4 below, at December 31, 2016, 100.0% of the amounts recoverable from third-party reinsurers were due from reinsurers that were rated "A-" or higher by the A.M. Best rating service. We regularly evaluate our reinsurers and their respective amounts recoverable, and an allowance for uncollectible reinsurance is provided, if needed.

TABLE 4 Composition of amounts due from reinsurers by A.M. Best rating

As of December 31, 2016

A+	53.0 %
A-	47.0 %
Total	100.0 %

DEBT

Debt consists of the following instruments:

TABLE 5 Debt

As of December 31 (in thousands of dollars)

	2016		2015	
	Principal	Fair Value	Principal	Fair Value
Note payable	178,781	190,074	—	—
Subordinated debt	90,500	43,619	90,500	39,898
Total	269,281	233,693	90,500	39,898

Further information regarding our debt is discussed within the "Debt" section of MD&A as well as in Note 15, "Debt," to the Consolidated Financial Statements.

REGULATORY ENVIRONMENT

Our insurance subsidiaries are subject to extensive regulation in the states in which they do business. Such regulation pertains to a variety of matters, including, but not limited to, policy forms, premium rate plans, licensing of agents, licenses to transact business, trade practices, claims practices, investments, payment of dividends, transactions with affiliates and solvency. The majority of our insurance is written in states requiring prior approval by regulators before proposed rates for property and casualty policies may be implemented.

Our U.S. insurance subsidiaries are subject to the insurance holding company laws in the jurisdictions in which they conduct business. These regulations require that each U.S insurance company in the holding company system register with the insurance department of its state of domicile and furnish information concerning the operations of companies in the holding company system which may materially affect the operations, management or financial condition of the insurers in the holding company domiciled in that state. We have U.S. insurance subsidiaries that are organized and domiciled under the insurance statutes of Illinois, Minnesota and Florida. The insurance laws in each of these states similarly provide that all transactions among members of a holding company system be done at arm’s length and be shown to be fair and reasonable to the regulated insurer. Transactions between insurance company subsidiaries and their parents and affiliates typically must be disclosed to the state regulators, and any material or extraordinary transaction requires prior approval of the applicable state insurance regulator. A change of control of a domestic insurer or of any controlling person requires the prior approval of the state insurance regulator. In general, any person who acquires 10% or more of the outstanding voting securities of the insurer or its parent company is presumed to have acquired control of the domestic insurer. To the best of our knowledge, we are in compliance with the regulations discussed above.

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The liquidity of the holding company is managed separately from its subsidiaries. Actions available to the holding company to raise liquidity in order to meet its obligations include the sale of passive investments; sale of subsidiaries; issuance of debt or equity securities; and giving notice to its Trust Preferred trustees of its intention to exercise its voluntary right to defer interest payments for up to 20 quarters, which right the Company previously exercised during the period from the first quarter of 2011 through the fourth quarter of 2015.

Receipt of dividends from the Insurance Underwriting subsidiaries is not generally considered a source of liquidity for the holding company. The insurance subsidiaries require regulatory approval for the return of capital and, in certain circumstances, prior to the payment of dividends. At December 31, 2016, the U.S. insurance subsidiaries of the Company were restricted from making any dividend payments to the holding company without regulatory approval pursuant to the domiciliary state insurance regulations.

Receipt of dividends from the Leased Real Estate segment is not generally considered a source of liquidity for the holding company. All cash rental income generated by the Real Property is applied to make principal and interest payments on the Mortgage. As a result, the Company does not expect any positive cash flow to be available from the Leased Real Estate segment to help the Company meet its holding company obligations until the occurrence of one of the three events defined in the management services agreement entered into at the time of the acquisition of CMC. There can be no assurance as to the timing of the occurrence, or the resulting outcome, from one of these events. Refer to the "Liquidity and Capital Resources" section of MD&A for further discussion.

Insurance companies are required to report their financial condition and results of operation in accordance with statutory accounting principles prescribed or permitted by state insurance regulators in conjunction with the National Association of Insurance Commissioners ("NAIC"). State insurance regulators also prescribe the form and content of statutory financial statements, perform periodic financial examinations of insurers, set minimum reserve and loss ratio requirements, establish standards for the types and amounts of investments and require minimum capital and surplus levels. Such statutory capital and surplus requirements reflect risk-based capital ("RBC") standards promulgated by the NAIC. These RBC standards are intended to assess the level of risk inherent in an insurance company's business and consider items such as asset risk, credit risk, underwriting risk and other business risks relevant to its operations. In accordance with RBC formulas, an insurance company's RBC requirements are calculated and compared to its total adjusted capital, as defined by the NAIC, to determine whether regulatory intervention is warranted. In general, insurers reporting surplus as regards policyholders below 200% of the authorized control level, as defined by the NAIC, at December 31 are subject to varying levels of regulatory action, including discontinuation of operations. As of December 31, 2016, surplus as regards policyholders reported by each of our insurance subsidiaries exceeded the 200% threshold.

Our insurance subsidiaries are required under the guaranty fund laws of most states in which they transact business to pay assessments up to prescribed limits to fund policyholder losses or liabilities of insolvent insurance companies. Our insurance subsidiaries also are required to participate in various involuntary pools or assigned risk pools. In most states, the involuntary pool participation of our insurance subsidiaries is in proportion to their voluntary writings of related lines of business in such states.

We operate under licenses issued by various state insurance authorities. These licenses govern, among other things, the types of insurance coverage and agency and claim services that we may offer consumers in these states. Such licenses typically are issued only after we file an appropriate application and satisfy prescribed criteria. We must apply for and obtain the appropriate new licenses before we can implement any plan to expand into a new state or offer a new line of insurance or other new product that requires separate licensing.

The insurance laws of most states in which our insurance subsidiaries operate require insurance companies to file insurance rate schedules and insurance policy forms for review and approval. State insurance regulators have broad discretion in judging whether our rates are adequate, not excessive and not unfairly discriminatory and whether our policy forms comply with law. The speed at which we can change our rates depends, in part, on the method by which the applicable state's rating laws are administered. Generally, state insurance regulators have the authority to disapprove our rates or request changes in our rates. In addition, certain states in which we operate have laws and regulations that limit an automobile insurance company's ability to cancel or not renew policies.

We are subject to state laws and regulations that require diversification of our investment portfolios and that limit the amount of investments in certain categories. Failure to comply with these laws and regulations would cause non-conforming investments to be treated as non-admitted assets for purposes of measuring statutory surplus and, in some instances, would require divestiture.

The state insurance departments that have jurisdiction over our insurance company subsidiaries may conduct on-site visits and examinations of the insurance companies' affairs, especially as to their financial condition, ability to fulfill their obligations to policyholders, market conduct, claims practices and compliance with other laws and applicable regulations. Typically, these examinations are conducted every three to five years. In addition, if circumstances dictate, regulators are authorized to conduct special or target examinations of insurance companies to address particular concerns or issues. The results of these examinations can give rise to regulatory orders requiring remedial, injunctive or other corrective action on the part of the company that is the subject of the examination or the assessment of fines or other penalties against that company.

The Gramm-Leach-Bliley Act protects consumers from the unauthorized dissemination of certain personal information. The majority of states have implemented additional regulations to address privacy issues. These laws and regulations apply to all financial institutions, including insurance companies, and require us to maintain appropriate procedures for managing and protecting certain personal information of our customers and to fully disclose our privacy practices to our customers. We may also be exposed to future privacy laws and regulations, which could impose additional costs and impact our results of operations or financial condition.

In July 2010, the Dodd-Frank Act (the "DFA") was enacted into law. Among other things, the DFA forms within the Treasury Department a Federal Insurance Office ("FIO") that is charged with monitoring all aspects of the insurance industry, gathering data, and conducting a study on methods to modernize and improve the insurance regulatory system in the United States. FIO's report, which was delivered to Congress in 2013, concluded that a hybrid approach to regulation, involving a combination of state and federal government action, could improve the U.S. insurance system by attaining uniformity, efficiency and consistency, particularly with respect to solvency and market conduct regulation. A hybrid approach was also recommended to address the perceived need for uniform supervision of insurance companies with national and global activities. FIO established the Federal Advisory Committee on Insurance ("FACI") whose mission is to provide recommendations to FIO on issues it monitors for Congress. While the NAIC continues to promote the strengths of the U.S. state-based insurance regulatory system, both FIO/FACI and international standard setting authorities such as the International Association of Insurance Supervisors are actively seeking a role in shaping the future of the U.S. insurance regulatory framework.

Title V of the Wall Street Reform Act instructs the FIO Director to submit an update to the report that FIO submitted to Congress in 2013 describing the impact of Part II of the Nonadmitted and Reinsurance Reform Act of 2010 ("NRRA") on the ability of state regulators to access reinsurance information for regulated entities in their jurisdictions. The update, submitted by FIO in May 2015, concludes that Part II of NRRA has not had an adverse impact on the ability of state regulators to access reinsurance information from regulated companies. It is not yet known whether or how these organizations' recommendations might result in changes to the current state-based system of insurance industry regulation or ultimately impact Kingsway’s operations.

Vehicle service agreements are regulated in all states in the United States, and IWS is subject to these regulations. Most states utilize the approach of the Uniform Service Contract Act which was adopted by the NAIC in the early 1990's. Under that scheme, states regulate vehicle service contract companies by requiring them annually to file documentation, together with a copy of the contract of insurance covering their liability under the service contracts, which complies with the particular state's regulatory requirements. IWS is in compliance with the regulations of each state in which it sells vehicle service agreements.

Certain, but not all, states regulate the sale of HVAC and equipment warranty contracts. Trinity is licensed as a service contract provider in those states where it is required.

EMPLOYEES

At December 31, 2016, we employed 299 personnel supporting our continuing operations, of which 292 were full-time employees.

ACCESS TO REPORTS

Our Annual Report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934 are made available free of charge through our website at www.kingsway-financial.com as soon as reasonably practicable after such material is electronically filed with, or furnished to, the U.S. Securities and Exchange Commission ("SEC").

Item 1A. Risk Factors

Most issuers, including Kingsway, are exposed to numerous risk factors that could cause actual results to differ materially from recent results or anticipated future results. The risks and uncertainties described below are those specific to the Company which we currently believe have the potential to be material, but they may not be the only ones we face. If any of the following risks, or any other risks and uncertainties that we have not yet identified or that we currently consider not to be material, actually occur or become material risks, our business, prospects, financial condition, results of operations and cash flows could be materially and adversely affected. Investors are advised to consider these factors along with the other information included in this 2016 Annual Report and to consult any further disclosures Kingsway makes on related subjects in its filings with the SEC.

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FINANCIAL RISK

Kingsway is a holding company, and its operating insurance subsidiaries are subject to dividend restrictions and are required to maintain minimum capital and surplus levels, which could limit our operations and have a material adverse effect on our financial condition.

Kingsway is a holding company with assets consisting primarily of the capital stock of its subsidiaries. Our operations are and will continue to be limited by the earnings of our subsidiaries and their ability to pay dividends to us. The payment of dividends by our operating insurance subsidiaries is subject to various statutory and regulatory restrictions imposed by the insurance laws of the domiciliary jurisdiction, including Barbados, of each such subsidiary. As a result of operating losses recorded in recent years, at this time none of our U.S. insurance subsidiaries is able to declare and pay a dividend to the holding company without prior regulatory approval. The Company expects these restrictions to continue. In the case of other subsidiaries not currently subject to these restrictions, these subsidiaries may be limited in their ability to make dividend payments or advance funds to Kingsway in the future because of the need to support their own capital levels. The inability of our subsidiaries to pay dividends to us could have a material adverse effect on our financial condition.

See the "Liquidity and Capital Resources" section of MD&A for a detailed description of the liquidity requirements of the holding company and the regulatory capital requirements of the operating insurance subsidiaries. No assurances can be given that the operating insurance subsidiaries will be able to maintain compliance with these regulatory capital requirements.

We have substantial outstanding recourse debt, which could adversely affect our ability to obtain financing in the future, react to changes in our business and satisfy our obligations.

As of December 31, 2016, we had $90.5 million principal value of outstanding recourse subordinated debt, in the form of trust preferred debt instruments, with redemption dates beginning in December, 2032. Because of our substantial outstanding recourse debt:

- our ability to engage in acquisitions without raising additional equity or obtaining additional debt financing could be limited;
- our ability to obtain additional financing for working capital, capital expenditures, acquisitions, debt service requirements or general corporate purposes and our ability to satisfy our obligations with respect to our debt may be impaired in the future;
- a large portion of our cash flow must be dedicated to the payment of principal and interest on our debt, thereby reducing the funds available to us for other purposes;
- we are exposed to the risk of increased interest rates because our outstanding subordinated debt, representing $90.5 million of principal value, bears interest directly related to the London interbank offered interest rate for three-month U.S. dollar deposits ("LIBOR");
- it may be more difficult for us to satisfy our obligations to our creditors, resulting in possible defaults on, and acceleration of, such debt;
- we may be more vulnerable to general adverse economic and industry conditions;
- we may be at a competitive disadvantage compared to our competitors with proportionately less debt or with comparable debt on more favorable terms and, as a result, they may be better positioned to withstand economic downturns;
- our ability to refinance debt may be limited or the associated costs may increase;
- our flexibility to adjust to changing market conditions and ability to withstand competitive pressures could be limited; and
- we may be prevented from carrying out capital spending that is, among other things, necessary or important to our growth strategy and efforts to improve the operating results of our businesses.

Increases in interest rates would increase the cost of servicing our debt and could adversely affect our results of operation.

Our outstanding recourse debt of $90.5 million principal value bears interest directly related to LIBOR. As a result, increases in LIBOR would increase the cost of servicing our debt and could adversely affect our results of operations. As of December 31, 2016, each one hundred basis point increase in LIBOR would result in an approximately $0.9 million increase in our annual interest expense.

Our operations are restricted by the terms of our debt indentures, which could limit our ability to plan for or react to market conditions or meet our capital needs.

Our debt indentures contain numerous covenants that may limit our ability, among other things, to make particular types of restricted payments and pay dividends or redeem capital stock. The covenants under our debt agreements could limit our ability to plan for or react to market conditions or to meet our capital needs. No assurances can be given that we will be able to maintain compliance with these covenants.

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If we are not able to comply with the covenants and other requirements contained in the debt indentures, an event of default under the relevant debt instrument could occur. If an event of default does occur, it could trigger a default under our other debt instruments, and the holders of the defaulted debt instrument could declare amounts outstanding with respect to such debt to become immediately due and payable. Upon such an event, our assets and cash flow may not be sufficient to fully repay borrowings under our outstanding debt instruments. In addition, such a repayment under an event of default could adversely affect our liquidity and force us to sell assets to repay borrowings.

The Investment Committee of the Board of Directors closely monitors the debt and capital position and, from time to time, recommends capital initiatives based upon the circumstances of the Company.

The Real Property is leased pursuant to a long-term triple net lease and the failure of the tenant to satisfy its obligations under the lease may adversely affect the condition of the Real Property or the results of the Leased Real Estate segment.

Because the Real Property is leased pursuant to a long-term triple net lease, we depend on the tenant to pay all insurance, taxes, utilities, common area maintenance charges, maintenance and repair expenses and to indemnify, defend and hold us harmless from and against various claims, litigation and liabilities arising in connection with its business, including any environmental liabilities. There can be no assurance that the tenant will have sufficient assets, income and access to financing to enable it to satisfy its payment obligations to us under the lease. The inability or unwillingness of the tenant to meet its rent obligations to CMC or to satisfy its other obligations, including indemnification obligations, could materially adversely affect the business, financial position or results of operations of our Leased Real Estate segment. Furthermore, the inability or unwillingness of the tenant to satisfy its other obligations under the lease, such as the payment of insurance, taxes and utilities, could materially and adversely affect the condition of the Real Property.

Our triple net lease agreement requires that the tenant maintain comprehensive liability and hazard insurance. However, there are certain types of losses (including losses arising from environmental conditions or of a catastrophic nature, such as earthquakes, hurricanes and floods) that may be uninsurable or not economically insurable. Insurance coverage may not be sufficient to pay the full current market value or current replacement cost of a loss. Inflation, changes in building codes and ordinances, environmental considerations, and other factors also might make it infeasible to use insurance proceeds to replace the property after such property has been damaged or destroyed. In addition, if we experience a loss that is uninsured or that exceeds policy coverage limits, we could lose the capital invested in the property as well as the anticipated future cash flows from the property.

We may not be able to realize our investment objectives, which could significantly reduce our earnings and liquidity.

We depend on our investments, particularly our fixed maturities, for a substantial portion of our liquidity. As of December 31, 2016, the fair value of our investments included $61.8 million of fixed maturities. Given the low interest rate environment which exists for fixed maturities, a significant increase in investment yields or an impairment of investments that we own could have a material adverse effect on our business, results of operations and financial condition by reducing the fair value of the investments we own, particularly if we were forced to liquidate investments at a loss. The low interest rate environment for fixed maturities which has existed for years also exposes us to reinvestment risk as these investments mature because the funds may be reinvested at rates lower than those of the maturing investments.

Our ability to achieve our investment objectives is affected by general economic conditions that are beyond our control. General economic conditions can adversely affect the markets for interest rate-sensitive instruments, including the extent and timing of investor participation in such markets, the level and volatility of interest rates and, consequently, the fair value of fixed maturities.

In addition, changing economic conditions can result in increased defaults by the issuers of investments that we own. Interest rates are highly sensitive to many factors, including monetary policies, domestic and international economic and political conditions and other factors beyond our control. General economic conditions, stock market conditions and many other factors can also adversely affect the securities markets and, consequently, the fair value of the investments we own. We may not be able to realize our investment objectives, which could reduce our profitability significantly.

A difficult economy generally may materially adversely affect our business, results of operations and financial condition.

An adverse change in market conditions leading to instability in the global credit markets presents additional risks and uncertainties for our business. In particular, deterioration in the public debt markets could lead to investment losses and an erosion of capital in our insurance company subsidiaries as a result of a reduction in the fair value of investments.

Depending on market conditions going forward, we could incur substantial realized and unrealized losses in future periods, which could have an adverse impact on our results of operations and financial condition. We could also experience a reduction in capital in our insurance subsidiaries below levels required by the regulators in the jurisdictions in which they operate. Certain trust accounts and letters of credit for the benefit of related companies and third-parties have been established with collateral on deposit under the terms and conditions of the relevant trust and/or letter of credit agreements. The value of collateral could fall below the levels required under these agreements putting the subsidiary or subsidiaries in breach of the agreements. Market volatility may also make it more difficult to value certain of our investments if trading becomes less frequent. Disruptions, uncertainty and volatility in the global credit markets may also impact our ability to obtain financing for future acquisitions. If financing is available, it may only be available at an unattractive cost of capital, which would decrease our profitability. There can be no assurance that market conditions will not deteriorate in the near future.

Financial disruption or a prolonged economic downturn may materially and adversely affect our business.

Worldwide financial markets have recently experienced periods of extraordinary disruption and volatility, resulting in heightened credit risk, reduced valuation of investments and decreased economic activity. Moreover, many companies have experienced reduced liquidity and uncertainty as to their ability to raise capital during such periods of market disruption and volatility. In the event that these conditions recur or result in a prolonged economic downturn, our results of operations, financial position and/or liquidity could be materially and adversely affected. These market conditions may affect the Company's ability to access debt and equity capital markets. In addition, as a result of recent financial events, we may face increased regulation. Many of the other risk factors discussed in this Risk Factors section identify risks that result from, or are exacerbated by, financial economic downturn. These include risks related to our investments portfolio, the competitive environment, adequacy of unpaid loss and loss adjustment expenses and regulatory developments.

We have provided a third-party guarantee which could materially adversely affect our business, results of operations and financial condition.

We provided an indemnity and hold harmless agreement to a third-party for customs bonds reinsured by Lincoln General Insurance Company ("Lincoln General") during the time Lincoln General was a subsidiary of ours. This agreement may require us to compensate the third-party if Lincoln General is unable to fulfill its obligations relating to the customs bonds. Our potential exposure under this agreement is not determinable, and no assurances can be given that we will not be required to perform under this agreement in a manner that has a material adverse effect on our business, results of operations and financial condition.

We have generated net operating loss carryforwards for U.S. income tax purposes, but our ability to use these net operating losses may be limited by our inability to generate future taxable income.

Our U.S. businesses have generated consolidated net operating loss carryforwards ("U.S. NOLs") for U.S. federal income tax purposes of approximately $859.5 million as of December 31, 2016. These U.S. NOLs can be available to reduce income taxes that might otherwise be incurred on future U.S. taxable income. The utilization of these U.S. NOLs would have a positive effect on our cash flow. Our operations, however, remain challenged, and there can be no assurance that we will generate the taxable income in the future necessary to utilize these U.S. NOLs and realize the positive cash flow benefit. Also, our U.S. NOLs have expiration dates. There can be no assurance that, if and when we generate taxable income in the future from operations or the sale of assets or businesses, we will generate such taxable income before our U.S. NOLs expire.

We have generated U.S. NOLs, but our ability to preserve and use these U.S. NOLs may be limited or impaired by future ownership changes.

Our ability to utilize the U.S. NOLs after an "ownership change" is subject to the rules of Section 382 of the U.S. Internal Revenue Code of 1986, as amended ("Section 382"). An ownership change occurs if, among other things, the shareholders (or specified groups of shareholders) who own or have owned, directly or indirectly, five (5%) percent or more of the value of our shares or are otherwise treated as five (5%) percent shareholders under Section 382 and the regulations promulgated thereunder increase their aggregate percentage ownership of the value of our shares by more than 50 percentage points over the lowest percentage of the value of the shares owned by these shareholders over a three-year rolling period. An ownership change could also be triggered by other activities, including the sale of our shares that are owned by our five (5%) shareholders. In the event of an ownership change, Section 382 would impose an annual limitation on the amount of taxable income we may offset with U.S. NOLs. This annual limitation is generally equal to the product of the value of our shares on the date of the ownership change multiplied by the long-term tax-exempt rate in effect on the date of the ownership change. The long-term tax-exempt rate is published monthly by the Internal Revenue Service. Any unused Section 382 annual limitation may be carried over to later years until the applicable expiration date for the respective U.S. NOLs. In the event an ownership change as defined under Section 382 were to occur, our ability to utilize our U.S. NOLs would become substantially limited. The consequence of this limitation would be the potential loss of a significant future cash flow benefit because we would no longer be able to substantially offset future taxable income with U.S. NOLs. There can be no assurance that such ownership change will not occur in the future.

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Expiration of our tax benefit preservation plan may increase the probability that we will experience an ownership change as defined under Section 382.

In order to reduce the likelihood that we would experience an ownership change without the approval of our Board of Directors, our shareholders ratified and approved the tax benefit preservation plan agreement (the "Plan"), dated as of September 28, 2010, between the Company and Computershare Investor Services Inc., as rights agent, for the sole purpose of protecting the U.S. NOLs. The Plan expired on September 28, 2013. There can be no assurance that our Board of Directors will recommend to our shareholders that a similar tax benefit preservation plan be approved to replace the expired Plan; furthermore, there can be no assurance that our shareholders would approve any new tax benefit preservation plan were our Board of Directors to present one for shareholder approval. The expiration of the Plan, without a new tax benefit preservation plan, exposes us to certain changes in share ownership which we would not be able to prevent as we would have been able to prevent under the Plan. Such changes in share ownership could trigger an ownership change as defined under Section 382 resulting in restrictions on the use of NOLs in future periods, as discussed above.

We will only be able to utilize our U.S. NOLs against the future taxable income generated by companies we acquire if we are able to include the acquired companies in our U.S. consolidated tax return group.

We have in the past acquired companies and expect to do so in the future. Our ability to include acquired companies in our U.S. consolidated tax return group is subject to the rules of Section 1504 of the U.S. Internal Revenue Code of 1986, as amended. If it were ever determined that an acquired company did not qualify to be included in our U.S. consolidated tax return group, such acquired company would be required to file a U.S. tax return separate and apart from our U.S. consolidated tax return group. In that instance, the acquired company would be required to pay U.S. income tax on its taxable income despite the existence of our U.S. NOLs, which would be a use of cash at the acquired company; furthermore, were the income tax obligation of the acquired company in such instance to be greater than its available cash, we could be obligated to contribute cash to our subsidiary to meet its income tax obligation. There can be no assurance that an acquired company will generate taxable income and, if an acquired company does generate taxable income, there can be no assurance that the acquired company will be allowed to be included in our U.S. consolidated tax return group.

Our being registered as a Canadian domestic company subjects us to being taxed in Canada on foreign accrual property income that cannot be offset by our U.S. NOLs.

Canadian domestic companies are subject to taxation on certain non-Canadian sourced income called foreign accrual property income ("FAPI"). FAPI is traditionally comprised of passive income (i.e. interest, dividends, rents, capital gains and income generated from triple net leases). As a result, our investment portfolio, triple net lease and merchant banking activities are generally deemed to be sources of FAPI. Active trades or businesses are generally not considered sources of FAPI; however, pursuant to current Canadian tax law, our U.S. property-casualty insurance companies may be considered sources of FAPI. Our FAPI is subject to taxation in Canada regardless of whether we separately utilize our U.S. NOLs to offset that same income for U.S. income tax purposes. As a result, we could be required to pay Canadian income tax on FAPI despite the existence of our U.S. NOLs. We are currently in a position to offset some amount of FAPI using available Canadian NOLs and foreign accrual property losses ("FAPLs") that have been generated based upon our prior year loss activity. In the event that we do not have sufficient Canadian NOLs and FAPLs to offset future FAPI, however, we would be required to pay Canadian income tax, which would have a negative effect on our cash flow. There can be no assurance that our available Canadian NOLs and FAPLs will offset our future FAPI. In order for us to avoid paying Canadian income tax on future FAPI, we would have to redomesticate to a non-Canadian jurisdiction.

COMPLIANCE RISK

If we fail to comply with applicable insurance and securities laws or regulatory requirements, our business, results of operations and financial condition could be adversely affected.

As a publicly traded holding company listed on the Toronto and New York Stock Exchanges and which owns several property and casualty insurance subsidiaries, we are subject to numerous laws and regulations. These laws and regulations delegate regulatory, supervisory and administrative powers to federal, provincial or state regulators. Insurance regulations are generally designed to protect policyholders rather than shareholders and are related to matters including:

- rate-setting;
- risk-based capital and solvency standards;
- restrictions on the amount, type, nature, quality and quantity of investments;
- the maintenance of adequate provisions for unearned premiums and unpaid loss and loss adjustment expenses;
- restrictions on the types of terms that can be included in insurance policies;
- standards for accounting;

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- marketing practices;
- claims-settlement practices;
- the examination of insurance companies by regulatory authorities, including periodic financial and market conduct examinations;
- the licensing of insurers and their agents;
- limitations on dividends and transactions with affiliates;
- approval of certain reinsurance transactions; and
- insolvency proceedings.

In light of losses incurred in recent years, Kingsway and its regulated subsidiaries have been subject to intense review and supervision by insurance regulators. Regulators have taken significant steps to protect the policyholders of the companies we own. These steps have included:

- requesting additional capital contributions from Kingsway to its insurance subsidiaries; and
- requiring more frequent reporting, including with respect to capital and liquidity positions.

These and other actions have made it challenging for the Company to continue to maintain focus on the operation and development of its businesses. The Company does not expect these conditions to change in the foreseeable future.

In light of financial performance and a number of material transactions executed during the year, the Company has been asked to respond to questions from and provide information to regulatory bodies overseeing insurance and/or securities laws in Canada and the United States. The Company has cooperated in all respects with these reviews and has responded to information requests on a timely basis.

Any failure to comply with applicable laws or regulations could result in the imposition of fines or significant restrictions on our ability to do business, which could adversely affect our results of operations or financial condition. In addition, any changes in laws or regulations, including the adoption of consumer initiatives regarding rates charged for automobile or other insurance coverage or claims-handling procedures, could materially adversely affect our business, results of operations and financial condition. It is not possible to predict the future impact of changing federal, state and provincial regulation on our operations, and there can be no assurance that laws and regulations enacted in the future will not be more restrictive than existing laws and regulations.

Our business is subject to risks related to litigation and regulatory actions.

We are a defendant in a number of legal actions relating to our insurance and other business operations. We may from time to time be subject to a variety of legal and regulatory actions relating to our current and past business operations, including, but not limited to:

- disputes over coverage or claims adjudication;
- disputes regarding sales practices, disclosure, premium refunds, licensing, regulatory compliance and compensation arrangements;
- disputes with our agents, producers or network providers over compensation and termination of contracts and related claims;
- disputes with taxing authorities regarding our tax liabilities; and
- disputes relating to certain businesses acquired or disposed of by us.

In addition, plaintiffs continue to bring new types of legal actions against insurance and related companies. Current and future court decisions and legislative activity may increase our exposure to these types of claims. Multiparty or class action claims may present additional exposure to substantial economic, non-economic or punitive damage awards. The loss of even one of these claims, if it resulted in a significant award or a judicial ruling that was otherwise detrimental, could create a precedent in our industry that could have a material adverse effect on our results of operations and financial condition. This risk of potential liability may make reasonable settlements of claims more difficult to obtain. We cannot determine with any certainty what new theories of recovery may evolve or what their impact may be on our business.

We may be subject to governmental or administrative investigations and proceedings in the context of our highly regulated businesses. We cannot predict the outcome of these investigations, proceedings and reviews, and cannot assure that such investigations, proceedings or reviews or related litigation or changes in operating policies and practices would not materially adversely affect our results of operations and financial condition. In addition, if we were to experience difficulties with our relationship with a regulatory body in a given jurisdiction, it could have a material adverse effect on our ability to do business in that jurisdiction.

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We have identified a material weakness in our internal control over financial reporting, which could, if not sufficiently remediated, result in material misstatements in our consolidated financial statements.
We are required, pursuant to Section 404 of the Sarbanes-Oxley Act, to furnish a report by management on the effectiveness of our internal control over financial reporting. In addition, our independent registered public accounting firm must report on its evaluation of our internal control over financial reporting. As disclosed in Item 9A of this 2016 Annual Report, we have identified a material weakness as of December 31, 2016 in our internal control over financial reporting related to income tax accounting for non-routine transactions.
Our management plans to enhance its internal control over financial reporting related to non-routine transactions by supplementing with outside resources as necessary and enhancing the design and documentation of management review controls. Although we plan to take steps intended to remediate this material weakness, we can provide no assurance that our remediation efforts will be effective or that additional material weaknesses in our internal control over financial reporting will not be identified in the future.

STRATEGIC RISK
The achievement of our strategic objectives is highly dependent on effective change management.
We have restructured our operating insurance subsidiaries, including exiting states and lines of business, placing subsidiaries into voluntary run-off and terminating managing general agent relationships, with the objective of focusing on core lines of business, creating a more effective and efficient operating structure and focusing on profitability. These actions resulted in changes to our structure and business processes. While these changes are expected to bring us benefits in the form of a more agile and focused business, success is dependent on management effectively realizing the intended benefits. Ineffective change management may result in disruptions to the operations of the business or may cause employees to act in a manner which is inconsistent with our objectives. Any of these events could negatively impact our performance. We may not always achieve the expected cost savings and other benefits of our initiatives.
We may experience difficulty continuing to reduce our holding company expenses while at the same time retaining staff given the significant reduction in size and scale of our businesses.
We have divested a number of subsidiaries and significantly reduced our written premium in the insurance subsidiaries we continue to own. At the same time, we have been downsizing our holding company expense base in an attempt to compensate for the reduction in scale. There can be no assurance that our remaining businesses will produce enough cash flow to adequately compensate and retain staff and to service our other holding company obligations, particularly the interest expense burden of our remaining outstanding debt.
The insurance industry and related businesses in which we operate may be subject to periodic negative publicity which may negatively impact our financial results.
Our products and services are ultimately distributed to individual consumers. From time to time, consumer advocacy groups or the media may focus attention on insurance products and services, thereby subjecting our industry to periodic negative publicity. We also may be negatively impacted if participants in one or more of our markets engage in practices resulting in increased public attention to our businesses. Negative publicity may also result in increased regulation and legislative scrutiny of practices in the property and casualty insurance industry as well as increased litigation. These factors may further increase our costs of doing business and adversely affect our profitability by impeding our ability to market our products and services, requiring us to change our products or services, or by increasing the regulatory burdens under which we operate.
The highly competitive environment in which we operate could have an adverse effect on our business, results of operations and financial condition.
The property and casualty markets in which we operate are highly competitive. We compete with major North American and other insurers, many of which have more financial, marketing and management resources than we do. There may also be other companies of which we are not aware that may be planning to enter the property and casualty

insurance industry. Insurers in our markets generally compete on the basis of price, consumer recognition, coverages offered, claims handling, financial stability, customer service and geographic coverage. Although our pricing is influenced to some degree by that of our competitors, we generally believe that it is not in our best interest to compete solely on price. As a result, we are willing to experience from time to time a loss of market share during periods of intense price competition. Our business could be adversely impacted by the loss of business to competitors offering competitive insurance products at lower prices. This competition could affect our ability to attract and retain profitable business.

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In our non-standard automobile business, we compete with both large national underwriters and smaller regional companies. Our competitors include other companies that, like us, serve the independent agency market, as well as companies that sell insurance directly to customers. Direct underwriters may have certain competitive advantages over agency underwriters, including increased name recognition, loyalty of the customer base to the insurer rather than to an independent agency and reduced costs to acquire policies.

Additionally, in certain states, government-operated risk plans may provide non-standard automobile insurance products at lower prices than we provide.

From time to time, our markets may also attract competition from new entrants. In some cases, such entrants may, because of inexperience, the desire for new business or for other reasons, price their insurance below the rates that we believe offer acceptable premiums for the related risk. Further, a number of our competitors, including new entrants to our markets, are developing e-business capabilities which may impact the level of business transacted through our more traditional distribution channels or that may affect pricing in the market as a whole.

The vehicle service agreement market in which we compete is comprised of a few large companies, which market service agreements to credit unions on a national basis and have significantly more financial, marketing and management resources than we do, as well as several other companies that are somewhat similar in size to IWS that market service agreements to credit unions either on a regional basis or a less robust national basis. There may also be other companies of which we are not aware that may be planning to enter the vehicle service agreement industry. Competitors in our market generally compete on coverages offered, claims handling, customer service, financial stability and, to a lesser extent, price. Larger competitors of ours benefit from added advantages such as industry endorsements and preferred vendor status. We do not believe that it is in our best interest to compete solely on price. Instead, we focus our marketing on the total value experience to the credit union and its member, with an emphasis on customer service. While we historically have been able to adjust our product offering to remain competitive when competitors have focused on price, our business could be adversely impacted by the loss of business to competitors offering vehicle service agreements at lower prices.

Engaging in acquisitions involves risks, and, if we are unable to effectively manage these risks, our business may be materially harmed.

From time to time we engage in discussions concerning acquisition opportunities and, as a result of such discussions, may enter into acquisition transactions.

Acquisitions entail numerous risks, including the following:

- difficulties in the integration of the acquired business;
- assumption of unknown material liabilities, including deficient provisions for unpaid loss and loss adjustment expenses;
- diversion of management's attention from other business concerns;
- failure to achieve financial or operating objectives; and
- potential loss of policyholders or key employees of acquired companies.

We may not be able to integrate or operate successfully any business, operations, personnel, services or products that we may acquire in the future.

Engaging in new business start-ups involves risks, and, if we are unable to effectively manage these risks, our business may be materially harmed.

From time to time we engage in discussions concerning the formation of a new business venture and, as a result of such discussions, may form and capitalize a new business.

New business start-ups entail numerous risks, including the following:

- identification of appropriate management to run the new business;
- understanding the strategic, competitive and marketplace dynamics of the new business and, perhaps, industry;
- establishment of proper financial and operational controls;
- diversion of management's attention from other business concerns; and

• failure to achieve financial or operating objectives.

We may not be able to operate successfully any business, operations, personnel, services or products that we may organize as a new business start-up in the future.

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Our company has executive officers who also serve as directors and executive officers for 1347 Property Insurance Holdings, Inc., Atlas Financial Holdings, Inc., Limbach Holdings, Inc., Itasca Capital Ltd. and 1347 Energy Holdings LLC, entities in which we hold investments, which may lead to conflicting interests.

As a result of our having previously spun off 1347 Property Insurance Holdings, Inc. ("PIH") and Atlas Financial Holdings, Inc. ("Atlas"); formed 1347 Capital Corp., which later entered into a business combination with Limbach Holdings, Inc. ("Limbach"); and invested in Itasca Capital Ltd. ("ICL") and 1347 Energy Holdings LLC ("1347 Energy"), entities in which we hold investments, we have executive officers who also serve as directors for PIH, Atlas, Limbach, ICL and 1347 Energy and who serve as executive officers, pursuant to a management services agreement, for ICL. Our executive officers and members of our Company's board of directors have fiduciary duties to our stockholders; likewise, persons who serve in similar capacities at PIH, Atlas, Limbach, ICL and 1347 Energy have fiduciary duties to those companies' stockholders. We may find, though, the potential for a conflict of interest if our Company and one or more of these other companies pursue acquisitions, investments and other business opportunities that may be suitable for each of us. Our executive officers who find themselves in these multiple roles may, as a result, have conflicts of interest or the appearance of conflicts of interest with respect to matters involving or affecting more than one of the companies to which they owe fiduciary duties. Furthermore, our executive officers who find themselves in these multiple roles own stock options, shares of common stock and other securities in some of these entities. These ownership interests could create, or appear to create, potential conflicts of interest when the applicable individuals are faced with decisions that could have different implications for our Company and these other entities. Our Audit Committee reviews potential conflicts that may arise on a case-by-case basis, keeping in mind the applicable fiduciary duties owed by the executive officers and directors of each entity. From time to time, we may enter into transactions with or participate jointly in investments with PIH, Atlas, Limbach, ICL or 1347 Energy. There can be no assurance that we will not create new situations where our directors or executive officers serve as directors or executive officers in future investment holdings of our Company.

OPERATIONAL RISK

Our provisions for unpaid loss and loss adjustment expenses may be inadequate, which would result in a reduction in our net income and might adversely affect our financial condition.

Our provisions for unpaid loss and loss adjustment expenses do not represent an exact calculation of our actual liability but are estimates involving actuarial and statistical projections at a given point in time of what we expect to be the cost of the ultimate settlement and administration of reported and IBNR claims. The process for establishing the provision for unpaid loss and loss adjustment expenses reflects the uncertainties and significant judgmental factors inherent in estimating future results of both reported and IBNR claims and, as such, the process is inherently complex and imprecise. These estimates are based upon various factors, including:

- actuarial projections of the cost of settlement and administration of claims reflecting facts and circumstances then known;
- estimates of future trends in claims severity and frequency;
- legal theories of liability;
- variability in claims-handling procedures;
- economic factors such as inflation;
- judicial and legislative trends, actions such as class action lawsuits, and judicial interpretation of coverages or policy exclusions; and
- the level of insurance fraud.

Most or all of these factors are not directly quantifiable, particularly on a prospective basis, and the effects of these and unforeseen factors could negatively impact our ability to accurately assess the risks of the policies that we write. In addition, there may be significant reporting lags between the occurrence of insured events and the time they are actually reported to us and additional lags between the time of reporting and final settlement of claims.

As time passes and more information about the claims becomes known, the estimates are appropriately adjusted upward or downward to reflect this additional information. Because of the elements of uncertainty encompassed in this estimation process, and the extended time it can take to settle many of the more substantial claims, several years of experience may be required before a meaningful comparison can be made between actual losses and the original provision for unpaid loss and loss adjustment expenses.

We cannot assure that we will not have unfavorable development in the future. In addition, we have in the past, and may in the future, acquire other insurance companies. We cannot assure that the provisions for unpaid loss and loss adjustment expenses of the companies that we acquire are or will be adequate.

In addition, government regulators for our insurance subsidiaries could require that we increase our provisions for unpaid loss and loss adjustment expenses if they determine that our provisions are understated. Such an increase to the provision for unpaid loss and loss adjustment expenses for one of our insurance subsidiaries could cause a reduction in its surplus as regards policyholders, which could adversely affect our ability to sell insurance policies.

Our Insurance Services subsidiaries' deferred service fees may be inadequate, which would result in a reduction in our net income and might adversely affect our financial condition.

Our Insurance Services subsidiaries' deferred service fees do not represent an exact calculation but are estimates involving actuarial and statistical projections at a given point in time of what we expect to be the remaining future revenue to be recognized in relation to our remaining future obligations to provide policy administration and claim-handling services. The process for establishing deferred service fees reflects the uncertainties and significant judgmental factors inherent in estimating the length of time and the amount of work related to our future service obligations. If we amortize the deferred service fees too quickly, we could overstate current revenues which may adversely affect future reported operating results.

As time passes and more information about the remaining service obligations becomes known, the estimates are appropriately adjusted upward or downward to reflect this additional information. We cannot assure that we will not have unfavorable re-estimations in the future of our deferred service fees. In addition, we have in the past, and may in the future, acquire companies which record deferred service fees. We cannot assure that the deferred service fees of the companies that we acquire are or will be adequate.

Our reliance on independent agents can impact our ability to maintain business, and it exposes us to credit risk.

We market and distribute our automobile insurance products through a network of independent agents in the United States. As a result, we rely heavily on these agents to attract new business. They typically represent more than one insurance company, which may expose us to competition within the agencies and, therefore, we cannot rely on their commitment to our insurance products. Loss of all or a substantial portion of the business provided by these intermediaries could have a material adverse effect on our business, results of operations and financial condition.

In accordance with industry practice, our customers sometimes pay the premiums for their policies to agents for remittance to us. These premiums are considered paid when received by the agents and thereafter the customer is no longer liable to us for those amounts, whether or not we have actually received the premiums from the agents. Consequently, we assume a degree of risk associated with our reliance on independent agents in connection with the settlement of insurance balances.

Our reliance on credit unions can impact our ability to maintain business.

We market and distribute our vehicle service agreements through a network of credit unions in the United States. As a result, we rely heavily on these credit unions to attract new business. While these distribution arrangements tend to be exclusive between us and each credit union, we have competitors which offer similar products exclusively through credit unions. Loss of all or a substantial portion of our existing credit union relationships could have a material adverse effect on our business, results of operations and financial condition.

Our reliance on a limited number of warranty and maintenance support clients and customers can impact our ability to maintain business.

We market and distribute our warranty products and equipment breakdown and maintenance support services through a limited number of customers and clients across the United States. Loss of all or a substantial portion of our existing customers and clients could have a material adverse effect on our business, results of operations and financial condition.

Our gross premiums written are derived from the non-standard automobile markets. If the demand for insurance in this market declines, our results of operations could be adversely affected.

For the year ended December 31, 2016, 100.0% of the gross premiums written from our Insurance Underwriting segment were attributable to non-standard automobile insurance. The size of the non-standard automobile insurance market can be affected significantly by many factors outside of our control, such as the underwriting capacity and underwriting criteria of standard automobile insurance carriers, and we may be specifically affected by these factors. Additionally, the non-standard automobile insurance market tends to contract during periods of high unemployment.

To the extent that the non-standard automobile insurance markets are affected adversely for any reason, our gross premiums written will be disproportionately affected due to our substantial reliance on these insurance markets.

We derive the majority of our non-standard automobile insurance gross premiums written from a few geographic areas, which may cause our business to be affected by catastrophic losses or business conditions in these areas.
Certain jurisdictions, specifically Florida, Texas, Illinois, California, Colorado and Nevada, generated 89.0% of our non-standard automobile insurance gross premiums written during 2016.
Our results of operations may, therefore, be adversely affected by any catastrophic losses in these areas. Catastrophic losses can be caused by a wide variety of events, including earthquakes, hurricanes, tropical storms, tornadoes, wind, ice storms, hail, fires, terrorism, riots and explosions, and their incidence and severity are inherently unpredictable. Catastrophic losses are characterized by low frequency but high severity due to aggregation of losses and could result in adverse effects on our results of operations or financial condition. Our results of operations may also be adversely affected by general economic conditions, competition, regulatory actions or other business conditions that affect losses or business conditions in the specific areas in which we conduct most of our business.
If reinsurance rates rise significantly or reinsurance becomes unavailable or reinsurers are unable to pay amounts due to us, we may be adversely affected.
In the past, we have purchased reinsurance from third-parties in order to reduce our liability on individual risks. Reinsurance does not relieve us of our primary liability to our insureds. A third-party reinsurer's insolvency, inability or unwillingness to make payments under the terms of a reinsurance treaty could have a material adverse effect on our financial condition or results of operations. As of December 31, 2016, we had $1.5 million recoverable from third-party reinsurers, including reinsurance recoverable related to property and casualty unpaid loss and loss adjustment expenses.
The amount and cost of reinsurance available to our insurance companies are subject, in large part, to prevailing market conditions beyond our control. Our ability to provide insurance at competitive premium rates and coverage limits on a continuing basis may depend in part upon the extent to which we can obtain adequate reinsurance in amounts and at rates that will not adversely affect our competitive position. If we determine in the future that access to reinsurance facilities is desirable or necessary in order for us to conduct business, we cannot assure that we will be able to obtain reinsurance in adequate amounts and at favorable rates. If this were to occur, we may need to modify our underwriting practices or reduce our underwriting commitments.
Disruptions or security failures in our information technology systems could create liability for us and/or limit our ability to effectively monitor, operate and control our operations and adversely impact our reputation, business, financial condition, results of operation and cash flows.
Our information technology systems facilitate our ability to monitor, operate and control our operations. Changes or modifications to our information technology systems could cause disruption to our operations or cause challenges with respect to our compliance with laws, regulations or other applicable standards. For example, delays, higher than expected costs or unsuccessful implementation of new information technology systems could adversely impact our operations. In addition, any disruption in or failure of our information technology systems to operate as expected could, depending on the magnitude of the problem, adversely impact our business, financial condition, results of operation and cash flows, including by limiting our capacity to monitor, operate and control our operations effectively. Failures of our information technology systems could also lead to violations of privacy laws, regulations, trade guidelines or practices related to our customers and employees. If our disaster recovery plans do not work as anticipated, or if the third-party vendors to which we have outsourced certain information technology or other services fail to fulfill their obligations to us, our operations may be adversely impacted. Any of these circumstances could adversely impact our reputation, business, financial condition, results of operation and cash flows.
Our success depends on our ability to price accurately the risks we underwrite.
Our results of operation and financial condition depend on our ability to underwrite and set premium rates accurately for a wide variety of risks. Adequate rates are necessary to generate premiums sufficient to pay loss and loss adjustment expenses and other expenses and to earn a profit. To price our products accurately, we must collect and properly analyze a substantial amount of data; develop, test and apply appropriate pricing techniques; closely monitor

and timely recognize changes in trends; and project both severity and frequency of losses with reasonable accuracy. Our ability to undertake these efforts successfully, and as a result price our products accurately, is subject to a number of risks and uncertainties, some of which are outside our control, including:
- the availability of reliable data and our ability to properly analyze available data;
- the uncertainties that inherently characterize estimates and assumptions;
- our selection and application of appropriate pricing techniques; and
- changes in applicable legal liability standards and in the civil litigation system generally.

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Consequently, we could underprice risks, which would adversely affect our underwriting results, or we could overprice risks, which would reduce our sales volume and competitiveness. In either case, our results of operation could be materially and adversely affected.

Our results of operation may fluctuate as a result of cyclical changes in the property and casualty insurance industry.

Our results of operation are primarily attributable to the property and casualty insurance industry, which as an industry is cyclical in nature and has historically been characterized by soft markets followed by hard markets. A soft market is a period of relatively high levels of price competition, less restrictive underwriting standards and generally low premium rates. A hard market is a period of capital shortages resulting in lack of insurance availability, relatively low levels of competition, more selective underwriting of risks and relatively high premium rates. If we find it necessary to reduce premiums or limit premium increases due to competitive pressures on pricing in a softening market, we may experience a reduction in our premiums written and, therefore, in our earned premium revenues, which could adversely affect our results of operation.

Our results of operation and financial condition could be adversely affected by the results of our voluntary run-off of two of our insurance subsidiaries.

The Company currently has two of its insurance subsidiaries, MCC and Amigo, operating in voluntary run-off. Our success at managing these run-offs is highly dependent upon proper claim-handling and the availability of the necessary liquidity to pay claims when due. As a result, we are dependent in part on our ability to retain the services of appropriately trained and supervised claim-handling personnel. The loss of the services of any of our key claim-handling personnel working in our run-offs, or the inability to identify, hire and retain other highly qualified claim-handling personnel in the future, could adversely affect our results of operations. We are also dependent on the continuing availability of the necessary liquidity, from the sale of securities, collection of reinsurance recoverables and, potentially, capital contributions, to properly settle claims. Our inability to sell securities when needed or to collect outstanding reinsurance recoverables when due could have an adverse effect on our results of operation or financial condition. See the "Liquidity and Capital Resources" section of MD&A for additional detail regarding the voluntary run-offs of MCC and Amigo.

HUMAN RESOURCES RISK

Our business depends upon key employees, and if we are unable to retain the services of these key employees or to attract and retain additional qualified personnel, our business may be adversely affected.

Our success at improving our performance will be dependent in part on our ability to retain the services of our existing key employees and to attract and retain additional qualified personnel in the future. The loss of the services of any of our key employees, or the inability to identify, hire and retain other highly qualified personnel in the future, could adversely affect our results of operations.

Item 1B. Unresolved Staff Comments

None.

Item 2. Properties

Leased Properties

Insurance Underwriting leases facilities with an aggregate square footage of approximately 68,274 at four locations in four states. The latest expiration date of the existing leases is in November 2019.

Insurance Services leases facilities with an aggregate square footage of approximately 14,361 at two locations in two states. The latest expiration date of the existing leases is in November 2019.

The Company leases facilities for its corporate offices with an aggregate square footage of approximately 8,086 at two locations in one state. The latest expiration date of the existing leases is in November 2020.

The properties described above are in good condition. We consider our office facilities suitable and adequate for our current levels of operations.

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Owned Properties

Leased Real Estate owns the Real Property, which is subject to a long-term triple net lease agreement. The Real Property includes rail car tracks which provide rail car storage spaces and has 72 miles of double-ended rail track. The Real Property also contains a 5,760 square foot office building with an attached observation tower comprised of 1,150 square feet.

The Company also owns two buildings located in Illinois consisting of approximately 4,636 square feet. The buildings are used for rental purposes and corporate offices.

Item 3. Legal Proceedings

In connection with its operations in the ordinary course of business, the Company and its subsidiaries are named as defendants in various actions for damages and costs allegedly sustained by the plaintiffs. While it is not possible to estimate the loss, or range of loss, if any, that may be incurred in connection with any of the various proceedings at this time, it is possible that some of the actions may result in losses having a material adverse effect on the Company's financial condition or results of operations.

Item 4. Mine Safety Disclosures

Not applicable.

Part II

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

Market Information

Our common shares are listed on the Toronto Stock Exchange ("TSX") and the New York Stock Exchange ("NYSE") under the trading symbol "KFS."

The following table sets forth, for the calendar quarters indicated, the high and low sales price for our common shares as reported on the TSX and NYSE.

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	TSX High - C$	Low - C$	NYSE High - US$	Low - US$
2016				
Quarter 4	C$8.36	C$7.42	$6.25	$5.45
Quarter 3	7.63	6.65	5.79	5.23
Quarter 2	6.90	5.59	5.37	4.48
Quarter 1	6.34	5.33	4.79	3.72
2015				
Quarter 4	6.51	5.43	4.90	4.09
Quarter 3	7.62	5.95	5.97	4.43
Quarter 2	7.62	6.69	6.12	5.47
Quarter 1	7.49	6.44	5.94	5.41

Shareholders of Record

As of March 10, 2017, the closing sales price of our common shares as reported by the TSX was C$7.80 per share and as reported by the NYSE was $5.75 per share.

As of March 13, 2017, we had 21,458,190 common shares issued and outstanding, held by approximately 3,700 shareholders of record.

Dividends

The Company has not declared a dividend since the first quarter of 2009. The declaration and payment of dividends is subject to the discretion of our Board of Directors after taking into account many factors, including financial condition, results of operations, anticipated cash needs and other factors deemed relevant by our Board of Directors. For a discussion of our cash resources and needs, see the "Liquidity and Capital Resources" section of MD&A.

Securities Authorized for Issuance under Equity Compensation Plans

As of December 31, 2016, we had one equity compensation plan under which our shares of common stock have been authorized for issuance to key officers of the Company and its subsidiaries, namely our 2013 Equity Incentive Plan (the "2013 Plan") adopted by the Board of Directors in 2013. The 2013 Plan has been approved by the shareholders of the Company.

The following summary information is presented with respect to shares of our common stock that may be issued under our equity compensation plan as of December 31, 2016:

Equity Compensation Plan Information

Plan category	Number of securities to be issued upon exercise of outstanding options, warrants and rights (a)	Weighted-average exercise price of outstanding options, warrants and rights (b)	Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a)) (c)
Equity compensation plans approved by security holders	651,875	$4.51	—
Equity compensation plans not approved by security holders	N/A	N/A	N/A
Total	651,875	$4.51	—

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Recent Sales of Unregistered Securities

On November 9, 2016, the Company entered into separate Stock Purchase Agreements with GrizzlyRock Institutional Value Partners, LP, W.H.I. Growth Fund Q.P., L.P. and Yorkmont Capital Partners, LP for the private placement (the "Private Placement") of 1,615,384 shares of its common stock at a purchase price of $6.50 per share with gross proceeds to the Company of $10.5 million. No brokerage, finder's, placement agent or investment banking fees or commissions were payable by the Company in connection with the Private Placement. The Private Placement closed on November 16, 2016.

Issuer Purchases of Equity Securities

In November 2015, the Company's Board of Directors approved a share repurchase program under which the Company is authorized to repurchase up to 5% of its currently issued and outstanding common stock through November 2016. Refer to Note 23, "Shareholders' Equity," to the Consolidated Financial Statements for further discussion related to the share repurchase program. During the three months ended December 31, 2016, we did not have any repurchases of our equity securities.

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Performance Graph

The following stock performance graph shows a comparison of cumulative total shareholder return on the Company's common stock for the period beginning on December 31, 2011 and ending on December 31, 2016 with cumulative total return of the Russell MicroCap Index and the SNL MicroCap U.S. Financial Services Index. Kingsway is not a constituent of either of these two indices. The graph shows the change in value of an initial one hundred dollar investment over the period indicated, assuming all dividends have been reinvested.

	Years ended December 31,					
Company/Index	2011	2012	2013	2014	2015	2016
Kingsway	$100	$183	$188	$267	$220	$300
Russell MicroCap	$100	$120	$174	$181	$171	$206
SNL Micro Cap U.S. Financial Services	$100	$123	$148	$148	$108	$106

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Item 6. Selected Financial Data

The following table has selected financial data as of and for the years ended December 31, 2016, 2015, 2014, 2013 and 2012 and should be read in conjunction with the Consolidated Financial Statements and MD&A included in this 2016 Annual Report. Historical results are not necessarily indicative of future results.

For the years ended December 31 (in thousands of dollars, except per share data)

	2016	2015	2014	2013	2012
Consolidated Statements of Operations Data [1]:					
Net premiums earned	127,608	117,433	117,593	109,608	114,937
Service fee and commission income	24,232	22,966	24,659	49,543	35,491
Rental income	5,419	—	—	—	—
Net investment income	8,200	2,918	1,616	2,186	3,165
Net realized gains	360	1,197	5,041	3,505	1,084
Loss from continuing operations	(733)	(11,415)	(14,666)	(43,311)	(53,278)
Basic loss per share - continuing operations	(0.04)	(0.60)	(0.95)	(3.12)	(3.96)
Diluted loss per share - continuing operations	(0.04)	(0.60)	(0.95)	(3.12)	(3.96)
Consolidated Balance Sheet Data:					
Cash and invested assets	163,519	159,437	158,317	167,784	168,813
Total Assets	501,021	241,022	301,722	324,639	372,800
Note payable	190,074	—	—	—	—
LROC preferred units, at fair value	—	—	13,618	14,854	13,655
Senior unsecured debentures, at fair value	—	—	—	14,356	23,730
Subordinated debt, at fair value	43,619	39,898	40,659	28,471	23,774
Total Liabilities	437,759	190,925	253,526	287,719	307,386
Total Shareholders' Equity	56,835	43,703	41,866	36,920	65,414

[1] The Company disposed of its subsidiary, ARS, on April 1, 2015. The financial results of ARS are presented as discontinued operations for the years ended December 31, 2015 and 2014. Refer to Note 6, "Disposition, Deconsolidations and Discontinued Operations," to the Consolidated Financial Statements, for further discussion.

The Company disposed of its majority interest in its subsidiary, PIH, effective March 31, 2014. The earnings of PIH are included in the consolidated statements of operations for the three months ended March 31, 2014 and for the years ended December 31, 2013 and 2012. Refer to Note 6, "Disposition, Deconsolidations and Discontinued Operations," to the Consolidated Financial Statements, for further discussion.

The Company acquired its subsidiary, Trinity, effective May 22, 2013. The consolidated statements of operations include the earnings of Trinity from the date of acquisition.

The Company acquired its subsidiary, IWS, effective November 16, 2012. The consolidated statements of operations include the earnings of IWS from the date of acquisition.

Item 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

OVERVIEW

Kingsway is a Canadian holding company with operating subsidiaries located in the United States. The Company operates as a merchant bank primarily engaged, through its subsidiaries, in the property and casualty insurance business. Kingsway conducts its business through the following three reportable segments: Insurance Underwriting, Insurance Services and Leased Real Estate.

Insurance Underwriting includes the following subsidiaries of the Company: Mendota Insurance Company ("Mendota"), Mendakota Insurance Company, Mendakota Casualty Company ("MCC"), Kingsway Amigo Insurance Company ("Amigo") and Kingsway Reinsurance Corporation. Throughout Management's Discussion and Analysis, the term "Insurance Underwriting" is used to refer to this segment.

Insurance Underwriting provides non-standard automobile insurance to individuals who do not meet the criteria for coverage by standard automobile insurers. Insurance Underwriting has policyholders in 12 states; however new business is accepted in only 8 states. In 2016, production in the following states represented 89.0% of Insurance Underwriting's gross premiums written: Florida (27.4%), Texas (17.7%), Illinois (13.3%), Nevada (11.3%), California (10.9%) and Colorado (8.4%). For the year ended December 31, 2016, non-standard automobile insurance accounted for 100.0% of Insurance Underwriting's gross premiums written.

The Company previously placed Amigo and MCC into voluntary run-off in 2012 and 2011, respectively. Each of Amigo and MCC entered into a comprehensive run-off plan which was approved by its respective state of domicile. Kingsway continues to manage Amigo and MCC in a manner consistent with the run-off plans. During the first quarter of 2015, MCC sent a letter of intent to the Illinois Department of Insurance to resume writing private passenger automobile policies in the state of Illinois. MCC began writing these policies on April 1, 2015.

Insurance Services includes the following subsidiaries of the Company: IWS Acquisition Corporation ("IWS") and Trinity Warranty Solutions LLC ("Trinity"). Throughout this 2016 Annual Report, the term "Insurance Services" is used to refer to this segment.

IWS is a licensed motor vehicle service agreement company and is a provider of after-market vehicle protection services distributed by credit unions in 23 states to their members.

Trinity is a provider of warranty products and maintenance support to consumers and businesses in the heating, ventilation, air conditioning ("HVAC"), standby generator, commercial LED lighting and refrigeration industries. Trinity distributes its warranty products through original equipment manufacturers, HVAC distributors and commercial and residential contractors. Trinity distributes its maintenance support direct through corporate owners of retail spaces throughout the United States.

Leased Real Estate includes the Company's subsidiary, CMC Industries, Inc. ("CMC"), which was acquired on July 14, 2016. CMC owns, through an indirect wholly owned subsidiary (the "Property Owner"), a parcel of real property consisting of approximately 192 acres located in the State of Texas (the "Real Property"), which is subject to a long-term triple net lease agreement. The Real Property is also subject to a mortgage (the "Mortgage"). Throughout Management's Discussion and Analysis, the term "Leased Real Estate" is used to refer to this segment.

Effective April 1, 2015, the Company closed on the sale of its wholly owned subsidiary, Assigned Risk Solutions Ltd. ("ARS"). As a result, ARS has been classified as discontinued operations and the results of their operations are reported separately for all periods presented. Prior to the transaction, ARS was included in the Insurance Services segment. As a result of classifying ARS as a discontinued operation, all segmented information has been restated to exclude ARS from the Insurance Services segment.

Effective March 31, 2014, the Company's wholly owned subsidiary, 1347 Property Insurance Holdings, Inc. ("PIH"), formerly known as Maison Insurance Holdings, Inc., completed an initial public offering of its common stock. Upon completion of the transaction, the Company maintained a minority ownership interest in the common shares of PIH. The earnings of PIH are included in the consolidated statements of operations through the March 31, 2014 transaction date. Prior to the transaction, PIH was included in the Insurance Underwriting segment. As a result of the disposal of the Company's majority interest in PIH on March 31, 2014, all segmented information has been restated to exclude PIH from the Insurance Underwriting segment.

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NON U.S.-GAAP FINANCIAL MEASURES

Throughout this 2016 Annual Report, we present our operations in the way we believe will be most meaningful, useful and transparent to anyone using this financial information to evaluate our performance. In addition to the U.S. GAAP presentation of net income (loss), we show certain statutory reporting information and other non-U.S. GAAP financial measures that we believe are relevant in managing our business and drawing comparisons to our peers. These measures are segment operating (loss) income, gross premiums written, net premiums written and underwriting ratios. Following is a list of non-U.S. GAAP measures found throughout this report with their definitions, relationships to U.S. GAAP measures and explanations of their importance to our operations.

Segment Operating (Loss) Income

Segment operating (loss) income represents one measure of the pretax profitability of our segments and is derived by subtracting direct segment expenses from direct segment revenues. Revenues and expenses are presented in the consolidated statements of operations, but are not subtotaled by segment; however, this information is available in total and by segment in Note 25, "Segmented Information," to the Consolidated Financial Statements, regarding reportable segment information. The nearest comparable U.S. GAAP measure is loss from continuing operations before income tax (benefit) expense which, in addition to segment operating (loss) income, includes net investment income, net realized gains, other-than-temporary impairment loss, amortization of intangible assets, contingent consideration benefit, impairment of asset held for sale, interest expense not allocated to segments, other income not allocated to segments, general and administrative expenses, foreign exchange losses, net, (loss) gain on change in fair value of debt, loss on disposal of subsidiary, loss on disposal of asset held for sale, gain (loss) on deconsolidation of subsidiaries and equity in net loss of investees. A reconciliation of segment operating (loss) income to loss from continuing operations before income tax (benefit) expense for the years ended December 31, 2016, 2015 and 2014 is presented in Tables 1 and 2 of the "Results of Continuing Operations" section of MD&A.

Gross Premiums Written

While net premiums earned is the related U.S. GAAP measure used in the consolidated statements of operations, gross premiums written is the component of net premiums earned that measures insurance business produced before the impact of ceding reinsurance premiums, but without respect to when those premiums will be recognized as actual revenue. We use this measure as an overall gauge of gross business volume in Insurance Underwriting.

Net Premiums Written

While net premiums earned is the related U.S. GAAP measure used in the consolidated statements of operations, net premiums written is the component of net premiums earned that measures the difference between gross premiums written and the impact of ceding reinsurance premiums, but without respect to when those premiums will be recognized as actual revenue. We use this measure as an indication of retained or net business volume in Insurance Underwriting.

Underwriting Ratios

Kingsway, like many insurance companies, analyzes performance based on underwriting ratios such as loss and loss adjustment expense ratio, expense ratio and combined ratio. The loss and loss adjustment expense ratio is derived by dividing the amount of net loss and loss adjustment expenses incurred by net premiums earned. The expense ratio is derived by dividing the sum of commissions and premium taxes; general and administrative expenses and policy fee income by net premiums earned. The combined ratio is the sum of the loss and loss adjustment expense ratio and the expense ratio. A combined ratio below 100% demonstrates underwriting profit whereas a combined ratio over 100% demonstrates an underwriting loss.

CRITICAL ACCOUNTING ESTIMATES AND ASSUMPTIONS

The preparation of consolidated financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect application of policies and the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the year. Actual results could differ from these estimates. Estimates and their underlying assumptions are reviewed on an ongoing basis. Changes in estimates are recorded in the accounting period in which they are determined. The critical accounting estimates and assumptions in the accompanying consolidated financial statements include the provision for unpaid loss and loss adjustment expenses; valuation of fixed maturities and equity investments; impairment assessment of investments; valuation of limited liability investment at fair value; valuation of deferred income taxes; valuation and impairment assessment of intangible assets; goodwill recoverability; deferred acquisition costs; fair value assumptions for derivative financial instruments; fair value assumptions for subordinated debt obligations; and contingent consideration.

Provision for Unpaid Loss and Loss Adjustment Expenses

A significant degree of judgment is required to determine amounts recorded in the consolidated financial statements for the provision for unpaid loss and loss adjustment expenses. The process for establishing the provision for unpaid loss and loss adjustment expenses reflects the uncertainties and significant judgmental factors inherent in predicting future results of both known and unknown loss events. As such, the process is inherently complex and imprecise and estimates are constantly refined. The process of establishing the provision for unpaid loss and loss adjustment expenses relies on the judgment and opinions of a large number of individuals, including the opinions of the Company's actuaries. Further information regarding estimates used in determining our provision for unpaid loss and loss adjustment expenses is discussed in the “Unpaid Loss and Loss Adjustment Expenses” section of Part I, Item 1 of this 2016 Annual Report and Note 14, "Unpaid Loss and Loss Adjustment Expenses," to the Consolidated Financial Statements.

Factors affecting the provision for unpaid loss and loss adjustment expenses include the continually evolving and changing regulatory and legal environment; actuarial studies; the professional experience and expertise of the Company's claims personnel and independent adjusters retained to handle individual claims; the quality of the data used for projection purposes; existing claims management practices including claims handling and settlement practices; the effect of inflationary trends on future loss settlement costs; court decisions; economic conditions; and public attitudes.

The Company utilizes external actuaries to evaluate the adequacy of our provision for unpaid loss and loss adjustment expenses under the terms of our insurance policies and vehicle service agreements. The provision is evaluated by the Company's actuaries with the results then shared with management, which is responsible for establishing the provision recorded in the consolidated balance sheets.

In the year-end actuarial review process, an analysis of the provision for unpaid loss and loss adjustment expenses is completed for each insurance subsidiary and IWS. Unpaid deferred cost containment expenses and unpaid adjusting and other expenses, which are components of the provision for loss adjustment expenses, and unpaid losses are each separately analyzed by line of business and by accident year utilizing a wide range of actuarial methods. These unpaid losses and loss adjustment expenses are further analyzed by looking separately at case reserves, which are specific reserves established for specific claims, and reserves for losses incurred but not reported ("IBNR").

Because the establishment of the provision for unpaid loss and loss adjustment expenses is an inherently uncertain process involving estimates, current provisions may need to be updated. Adjustments to the provision, both favorable and unfavorable, are reflected in the consolidated statements of operations for the periods in which such estimates are updated. The Company's actuaries develop a range of reasonable estimates and a point estimate of unpaid loss and loss adjustment expenses. The actuarial point estimate is intended to represent the actuaries' best estimate and will not necessarily be at the mid-point of the high and low estimates of the range.

Valuation of Fixed Maturities and Equity Investments

Our equity investments, including warrants, are recorded at fair value using quoted market values based on latest bid prices, where active markets exist, or models based on significant market observable inputs, where no active markets exist. For fixed maturities, we use observable inputs such as quoted prices in inactive markets, quoted prices in active markets for similar instruments, benchmark interest rates, broker quotes and other relevant inputs. We do not have any fixed maturities and equity investments in our portfolio which require us to use unobservable inputs.

Gains and losses realized on the disposition of investments are determined on the first-in first-out basis and credited or charged to the consolidated statements of operations. Premium and discount on investments are amortized and accredited using the interest method and charged or credited to net investment income.

Impairment Assessment of Investments

The establishment of an other-than-temporary impairment on an investment requires a number of judgments and estimates. We perform a quarterly analysis of the individual investments to determine if declines in market value are other-than-temporary. The analysis includes some or all of the following procedures, as applicable:

- identifying all unrealized loss positions that have existed for at least six months;
- identifying other circumstances which management believes may impact the recoverability of the unrealized loss positions;

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- obtaining a valuation analysis from third-party investment managers regarding the intrinsic value of these investments based on their knowledge and experience together with market-based valuation techniques;
- reviewing the trading range of certain investments over the preceding calendar period;
- assessing if declines in market value are other-than-temporary for debt instruments based on the investment grade credit ratings from third-party rating agencies;
- assessing if declines in market value are other-than-temporary for any debt instrument with a non-investment grade credit rating based on the continuity of its debt service record;
- determining the necessary provision for declines in market value that are considered other-than-temporary based on the analyses performed; and
- assessing the Company's ability and intent to hold these investments at least until the investment impairment is recovered.

The risks and uncertainties inherent in the assessment methodology used to determine declines in market value that are other-than-temporary include, but may not be limited to, the following:

- the opinions of professional investment managers could be incorrect;
- the past trading patterns of individual investments may not reflect future valuation trends;
- the credit ratings assigned by independent credit rating agencies may be incorrect due to unforeseen or unknown facts related to a company's financial situation; and
- the debt service pattern of non-investment grade instruments may not reflect future debt service capabilities and may not reflect a company's unknown underlying financial problems.

As a result of the analysis performed by the Company to determine declines in market value that are other-than-temporary, the Company recorded write downs of $0.1 million and $0.1 million for other-than-temporary impairment related to equity investments and limited liability investments, respectively, for the year ended December 31, 2016 and $0.0 million for other-than-temporary impairment related to fixed maturities for the year ended December 31, 2015. The Company did not recognize any impairment related to its investments that was considered other-than-temporary for the year ended December 31, 2014.

Valuation of Limited Liability Investment, at Fair Value

In connection with the deconsolidation of 1347 Investors LLC ("1347 Investors") during the third quarter of 2016, the Company retained a minority investment in 1347 Investors. The Company has made an irrevocable election to account for this investment at fair value with changes in fair value reported in the consolidated statements of operations. The fair value of this investment is calculated based on an internally developed model that distributes the net equity of 1347 Investors to all classes of membership interests. The model uses quoted market prices and significant market observable inputs.

Valuation of Deferred Income Taxes

The provision for income taxes is calculated based on the expected tax treatment of transactions recorded in our consolidated financial statements. In determining our provision for income taxes, we interpret tax legislation in a variety of jurisdictions and make assumptions about the expected timing of the reversal of deferred income tax assets and liabilities and the valuation of deferred income taxes.

The ultimate realization of the deferred income tax asset balance is dependent upon the generation of future taxable income during the periods in which the Company's temporary differences reverse and become deductible. A valuation allowance is established when it is more likely than not that all or a portion of the deferred income tax asset balance will not be realized. In determining whether a valuation allowance is needed, management considers all available positive and negative evidence affecting specific deferred income tax asset balances, including the Company's past and anticipated future performance, the reversal of deferred income tax liabilities, and the availability of tax planning strategies.

Objective positive evidence is necessary to support a conclusion that a valuation allowance is not needed for all or a portion of a company's deferred income tax asset balances when significant negative evidence exists. Cumulative losses are the most compelling form of negative evidence considered by management in this determination. To the extent a valuation allowance is established in a period, an expense must be recorded within the income tax provision in the consolidated statements of operations. As of December 31, 2016, the Company maintains a valuation allowance of $276.6 million, $269.7 million of which relates to its U.S. deferred income taxes. The largest component of the U.S. deferred income tax asset balance relates to tax loss carryforwards that have arisen as a result of losses generated from the Company's U.S. operations. Uncertainty over the Company's ability to utilize these losses over the short-term has led the Company to record a valuation allowance.

Future events may result in the valuation allowance being adjusted, which could materially impact our financial position and results of operations. If sufficient positive evidence were to arise in the future indicating that all or a portion of the deferred income tax

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assets would meet the more likely than not standard, the valuation allowance would be reversed in the period that such a conclusion was reached.

Valuation and Impairment Assessment of Intangible Assets

Intangible assets are recorded at their estimated fair values at the date of acquisition. Intangible assets with definite useful lives consist of vehicle service agreements in-force ("VSA in-force"), database, customer relationships, contract-based revenues and in-place lease. Intangible assets with definite useful lives are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset or asset group may not be recoverable. If circumstances require that a definite-lived intangible asset be tested for possible impairment, we first compare the undiscounted cash flows expected to be generated by that definite-lived intangible asset to its carrying amount. If the carrying amount of the definite-lived intangible asset is not recoverable on an undiscounted cash flow basis, an impairment is recognized to the extent that the carrying amount exceeds its fair value.

Indefinite-lived intangible assets consist of a tenant relationship, insurance licenses and trade name. Intangible assets with an indefinite life are assessed for impairment annually as of December 31, or more frequently if events or circumstances indicate that the carrying value may not be recoverable. The Company has the option to perform a qualitative assessment to determine whether it is more likely than not that an indefinite-lived intangible asset is impaired. If facts and circumstances indicate that it is more likely than not that the intangible asset is impaired, a fair value-based impairment test would be required. Management must make estimates and assumptions in determining the fair value of indefinite-lived intangible assets that may affect any resulting impairment write-down. This includes assumptions regarding future cash flows and future revenues from the related intangible assets or their reporting units. Management then compares the fair value of the indefinite-lived intangible assets to their respective carrying amounts. If the carrying amount of an intangible asset exceeds the fair value of that intangible asset, an impairment is recorded. Additional information regarding our intangible assets is included in Note 12, "Intangible Assets," to the Consolidated Financial Statements.

Goodwill Recoverability

Goodwill is assessed for impairment annually as of December 31, or more frequently if events or circumstances indicate that the carrying value may not be recoverable. The Company has the option to perform a qualitative assessment to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount. If facts and circumstances indicate that it is more likely than not that the goodwill is impaired, a fair value-based impairment test would be required. The goodwill impairment test is a two-step process that requires management to make judgments in determining what assumptions to use in the calculation. The first step of the process consists of estimating the fair value of each reporting unit based on valuation techniques, including a discounted cash flow model using revenue and profit forecasts, and comparing those estimated fair values with the carrying values of the assets and liabilities of the reporting unit, which includes the allocated goodwill. If the estimated fair value is less than the carrying value, a second step is performed to compute the amount of the impairment, if any, by determining an implied fair value of goodwill. The determination of the implied fair value of goodwill of a reporting unit requires management to allocate the estimated fair value of the reporting unit to the assets and liabilities of the reporting unit. Any unallocated fair value represents the implied fair value of goodwill, which is compared to its corresponding carrying value. For reporting units with a negative book value, qualitative factors are evaluated to determine whether it is necessary to perform the second step of the goodwill impairment test. Additional information regarding our goodwill is included in Note 11, "Goodwill," to the Consolidated Financial Statements.

Deferred Acquisition Costs

Deferred acquisition costs represent the deferral of expenses that we incur related to successful efforts to acquire new business or renew existing business. Acquisition costs, primarily commissions, premium taxes and underwriting and agency expenses related to issuing insurance policies and vehicle service agreements, are deferred and charged against income ratably over the terms of the related insurance policies and vehicle service agreements. Management regularly reviews the categories of acquisition costs that are deferred and assesses the recoverability of this asset. For Insurance Underwriting, a premium deficiency and a corresponding charge to income is recognized if the sum of the expected losses and loss adjustment expenses, unamortized acquisition costs and maintenance costs exceeds related unearned premiums and anticipated net investment income.

Derivative Financial Instruments

Derivative financial instruments include investments in warrants and performance shares issued to the Company under various performance share grant agreements. Refer to Note 27, "Related Party Transactions," to the Consolidated Financial Statements, for further details regarding the performance shares. Warrants are classified as equity investments in the consolidated balance sheets.

We measure derivative financial instruments at fair value. Warrants are recorded at fair value using quoted market values based on latest bid prices, where active markets exist, or models based on significant market observable inputs, where no active markets exist. The performance shares, for which no active market exists, are required to be valued at fair value as determined in good faith by the Company. Such determination of fair value would require us to develop a model based upon relevant observable market inputs as well as significant unobservable inputs, including developing a sufficiently reliable estimate for an appropriate discount to reflect the illiquidity and unique structure of the security. The Company determined that its model for the performance shares was not sufficiently reliable. As a result, we have assigned a fair value of zero to the performance shares.

Fair Value Assumptions for Subordinated Debt Obligations

Our subordinated debt is measured and reported at fair value. The fair value of the subordinated debt is calculated using a model based on significant market observable inputs and inputs developed by a third-party. These inputs include credit spread assumptions developed by a third-party and market observable swap rates.

Contingent Consideration

The consideration for certain of the Company's acquisitions includes future payments to the former owners that are contingent upon the achievement of certain targets over future reporting periods. Liabilities for contingent consideration are measured and reported at fair value at the date of acquisition with subsequent changes reported in the consolidated statements of operations as contingent consideration benefit or expense. The fair value of contingent consideration liabilities is estimated using valuation models designed to estimate the probability of such contingent payments based on various assumptions. Estimated payments are discounted using present value techniques to arrive at the estimated fair value at the balance sheet date. We revalue these contingent consideration liabilities each reporting period. Changes in the fair value of contingent consideration liabilities can result from changes to one or multiple inputs, including adjustments to the discount rates or changes in the assumed achievement or timing of any targets. These fair value measurements are based on significant inputs not observable in the market. Management must use judgment in determining the appropriateness of these assumptions as of the acquisition date and for each subsequent period. Changes in assumptions could have a material impact on the amount of contingent consideration benefit or expense reported in the consolidated statements of operations and an impact on the payout of contingent consideration liabilities. Additional information regarding our contingent consideration liabilities is included in Note 26, "Fair Value of Financial Instruments," to the Consolidated Financial Statements.

KINGSWAY FINANCIAL SERVICES INC.
Management's Discussion and Analysis

RESULTS OF CONTINUING OPERATIONS

Comparison of the Years Ended December 31, 2016 and 2015:
A reconciliation of total segment operating loss to net income (loss) for the years ended December 31, 2016 and 2015 is presented in Table 1 below:
Table 1 Segment Operating (Loss) Income for the Years Ended December 31, 2016 and 2015
For the years ended December 31 (in thousands of dollars)

	2016	20
Segment operating (loss) income		
Insurance Underwriting	(8,202)	(1
Insurance Services	506	(6
Leased Real Estate	627	—
Total segment operating loss	(7,069)	(1
Net investment income	8,200	2,
Net realized gains	360	1,
Other-than-temporary impairment loss	(157)	(1
Amortization of intangible assets	(1,242)	(1
Contingent consideration benefit	657	1,
Interest expense not allocated to segments	(4,496)	(5
Other income and expenses not allocated to segments, net	(7,596)	(3
Foreign exchange losses, net	(15)	(1
(Loss) gain on change in fair value of debt	(3,721)	1,

Note 6 Borrowings

Borrowings at September 30, 2016 and 2015, and December 31, 2015 consisted of the following (dollars in thousands):

	September 30, 2016	September 30, 2015	December 31, 2015
Securities sold under agreements with customers to repurchase	$ 345,559	$ 324,150	$ 310,330
Federal funds purchased	8,200	6,725	6,325
Advances from Federal Home Loan Bank of Dallas	160,000	170,028	299,020
Total	$ 513,759	$ 500,903	$ 615,675

Securities sold under repurchase agreements are generally with significant customers of the Company that require short-term liquidity for their funds for which the Company pledges certain securities that have a fair value equal to at least the amount of the borrowings. The agreements mature daily and therefore the risk arising from a decline in the fair value of the collateral pledged is minimal. The securities pledged are mortgage-backed securities. These agreements do not include right of set-off provisions and therefore the Company does not offset such agreements for financial reporting purposes.

Note 7 - Income Taxes

Income tax expense was $7,440,000 for the third quarter of 2016 as compared to $8,021,000 for the same period in 2015. The Company s effective tax rates on pretax income were 22.52% and 23.66% for the third quarters of 2016 and 2015, respectively. Income tax expense was $23,544,000 for the nine months ended September 30, 2016 as compared to $23,867,000 for the same period in 2015. The Company s effective tax rates on pretax income were 23.16% and 24.09% for the nine months ended September 30, 2016 and 2015, respectively. The effective tax rates differ from the statutory federal tax rate of 35% primarily due to tax exempt interest income earned on certain investment securities and loans and the deductibility of dividends paid to our employee stock ownership plan.

Note 8 - Stock Option Plan and Restricted Stock Plan

The Company grants incentive stock options for a fixed number of shares with an exercise price equal to the fair value of the shares at the date of grant to employees. Through September 30, 2016, no options have been granted in 2016. On October 27, 2015, the Company granted 455,000 shares in incentive stock options at an exercise price of $33.89 to its employees. The Company recorded stock option expense totaling $220,000 and $182,000 for the three-month periods ended September 30, 2016 and 2015, respectively. The Company recorded stock option expense totaling $661,000 and $543,000 for the nine months ended September 30, 2016 and 2015, respectively. The additional disclosure requirements under authoritative accounting guidance have been omitted due to the amounts being insignificant.

On April 28, 2015, shareholders of the Company approved a restricted stock plan for selected employees, officers, non-employee directors and consultants. On July 21, 2015, 7,070 shares were granted to the ten non-employee directors. Total value of these shares totaled $250,000 and was expensed over the period from grant date to April 26, 2016, the annual shareholders meeting at which these director s term expired. On April 26, 2016, upon re-election of existing directors, 7,660 shares with a total value of $250,000 were granted to the ten non-employee directors and is being expensed over the period from grant day to April 25, 2017, the next scheduled annual shareholders meeting at which the current directors current term will expire. The Company recorded director expense related to these restricted stock grants of $63,000 and $56,000, respectively, for the three months ended September 30, 2016 and 2015 and $215,000 and $56,000, respectively, for the nine months ended September 30, 2016 and 2015. On October 27, 2015, the Company also granted 32,748 shares with a total value of $1,110,000 to certain officers that is being expensed over the vesting period of three years. The Company recorded restricted stock grant expense for officers of $88,000 for the three month period ended September 30, 2016. The Company recorded restricted stock grant expense for officers of $262,000 for the nine month period ended September 30, 2016.

Note 9 - Pension Plan

The Company s defined benefit pension plan was frozen effective January 1, 2004, whereby no new participants will be added to the plan and no additional years of service will accrue to participants, unless the pension plan is reinstated at a future date. The pension plan covered substantially all of the Company s employees at the time. The benefits for each employee were based on years of service and a percentage of the employee s qualifying compensation during the final years of employment. The Company s funding policy was and is to contribute annually the amount necessary to satisfy the Internal Revenue Service s funding standards. Contributions to the pension plan, prior to freezing the plan, were intended to provide not only for benefits attributed to service to date but also for those expected to be earned in the future. As a result of the Pension Protection Act of 2006 (the Protection Act), the Company will be required to contribute amounts in future years to fund any shortfalls. The Company has evaluated the provisions of the Protection Act as well as the Internal Revenue Service s funding standards to develop a plan for funding in future years. The Company made a contribution totaling $500,000 in 2015 and through September 30, 2016 has made a contribution of $500,000.

Net periodic benefit costs totaling $82,000 and $83,000 were recorded for the three months ended September 30, 2016 and 2015, respectively. Net periodic benefit costs totaling $247,000 and $232,000 were recorded for the nine months ended September 30, 2016 and 2015, respectively.

Note 10 - Fair Value Disclosures

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

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

Level 1 Inputs Unadjusted quoted prices in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date.

Level 2 Inputs Inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly or indirectly. These include quoted prices for similar assets or liabilities in active markets, quoted prices for identical or similar assets or liabilities in markets that are not active, inputs other than quoted prices that are observable for the asset or liability (for example, interest rates, volatilities, prepayment speeds, loss severities, credit risks and default rates) or inputs that are derived principally from or corroborated by observable market data by correlation or other means.

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

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

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

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

There were no transfers between Level 2 and Level 3 during the three and nine months ended September 30, 2016 and 2015, and the year ended December 31, 2015.

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The following table summarizes financial assets and financial liabilities measured at fair value on a recurring basis as of September 30, 2016 and 2015, and December 31, 2015, respectively, segregated by the level of the valuation inputs within the fair value hierarchy utilized to measure fair value (dollars in thousands):

September 30, 2016

	Level 1 Inputs	Level 2 Inputs	Level 3 Inputs	Total Fair Value
Available-for-sale investment securities:				
U.S. Treasury securities	$ 10,739	$	$	$ 10,739
Obligations of U. S. government sponsored enterprises and agencies		115,720		115,720
Obligations of states and political subdivisions		1,502,716		1,502,716
Corporate bonds		65,037		65,037
Residential mortgage-backed securities		766,499		766,499
Commercial mortgage-backed securities		263,747		263,747
Other securities	4,572			4,572
Total	$ 15,311	$ 2,713,719	$	$ 2,729,030

September 30, 2015

	Level 1 Inputs	Level 2 Inputs	Level 3 Inputs	Total Fair Value
Available-for-sale investment securities:				
U.S. Treasury securities	$ 10,917	$	$	$ 10,917
Obligations of U. S. government sponsored enterprises and agencies		155,197		155,197
Obligations of states and political subdivisions		1,437,151		1,437,151
Corporate bonds		86,342		86,342
Residential mortgage-backed securities		832,859		832,859
Commercial mortgage-backed securities		209,920		209,920
Other securities	4,967			4,967
Total	$ 15,884	$ 2,721,469	$	$ 2,737,353

December 31, 2015

	Level 1 Inputs	Level 2 Inputs	Level 3 Inputs	Total Fair Value
Available-for-sale investment securities:				
U.S. Treasury securities	$ 10,795	$	$	$ 10,795

Obligations of U. S. government sponsored enterprises and agencies		148,554		148,554
Obligations of states and political subdivisions		1,451,127		1,451,127
Corporate bonds		83,254		83,254
Residential mortgage-backed securities		788,882		788,882
Commercial mortgage-backed securities		246,586		246,586
Other securities	4,701			4,701
Total	$ 15,496	$ 2,718,403	$	$ 2,733,899

Certain financial assets and financial liabilities are measured at fair value on a nonrecurring basis, that is, the instruments are not measured at fair value on an ongoing basis but are subject to fair value

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adjustments in certain circumstances (for example, when there is evidence of impairment). Financial assets and financial liabilities measured at fair value on a non-recurring basis include the following at September 30, 2016:

Impaired Loans Impaired loans are reported at the fair value of the underlying collateral if repayment is expected solely from the collateral. Collateral values are estimated using Level 2 inputs based on observable market data. At September 30, 2016, impaired loans with a carrying value of $33,712,000 were reduced by specific valuation reserves totaling $7,042,000 resulting in a net fair value of $26,670,000.

Loans Held-for-Sale Loans held-for-sale are reported at the lower of cost or fair value. In determining whether the fair value of loans held-for-sale is less than cost when quoted market prices are not available, the Company considers investor commitments/contracts. These loans are considered Level 2 of the fair value hierarchy. At September 30, 2016, the Company s mortgage loans held-for-sale were recorded at cost as fair value exceeded cost.

Certain non-financial assets and non-financial liabilities measured at fair value on a non-recurring basis include other real estate owned, goodwill and other intangible assets and other non-financial long-lived assets. Non-financial assets measured at fair value on a non-recurring basis during the three months and nine months ended September 30, 2016 and 2015 include other real estate owned which, subsequent to their initial transfer to other real estate owned from loans, were re-measured at fair value through a write-down included in gain (loss) on sale of foreclosed assets. During the reported periods, all fair value measurements for foreclosed assets utilized Level 2 inputs based on observable market data, generally third-party appraisals, or Level 3 inputs based on customized discounting criteria. These appraisals are evaluated individually and discounted as necessary due to the age of the appraisal, lack of comparable sales, expected holding periods of property or special use type of the property. Such discounts vary by appraisal based on the above factors but generally range from 5% to 25% of the appraised value. Re-evaluation of other real estate owned is performed at least annually as required by regulatory guidelines or more often if particular circumstances arise. The following table presents other real estate owned that were re-measured subsequent to their initial transfer to other real estate owned (dollars in thousands):

	Three Months Ended September 30,	
	2016	2015
Carrying value of other real estate owned prior to re-measurement	$	$
Write-downs included in gain (loss) on sale of other real estate owned		
Fair value	$	$

	Nine Months Ended September 30,	
	2016	2015
Carrying value of other real estate owned prior to re-measurement	$	$ 351
Write-downs included in gain (loss) on sale of other real estate owned		(95)

Fair value	$	$ 256

At September 30, 2016 and 2015, and December 31, 2015, other real estate owned totaled $241,000, $360,000, and $153,000, respectively.

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

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

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

Cash and due from banks, federal funds sold, interest-bearing deposits and time deposits in banks and accrued interest receivable and payable are liquid in nature and considered Levels 1 or 2 of the fair value hierarchy.

Financial instruments with stated maturities have been valued using a present value discounted cash flow with a discount rate approximating current market for similar assets and liabilities and are considered Levels 2 and 3 of the fair value hierarchy. Financial instrument liabilities with no stated maturities have an estimated fair value equal to both the amount payable on demand and the carrying value and are considered Level 1 of the fair value hierarchy.

The carrying value and the estimated fair value of the Company s contractual off-balance-sheet unfunded lines of credit, loan commitments and letters of credit, which are generally priced at market at the time of funding, are not material.

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The estimated fair values and carrying values of all financial instruments under current authoritative guidance at September 30, 2016 and 2015, and December 31, 2015, were as follows (in thousands):

	September 30, 2016		September 30, 2015		December 31, 2015		
	Carrying Value	Estimated Fair Value	Carrying Value	Estimated Fair Value	Carrying Value	Estimated Fair Value	Fair Value Hierarchy
Cash and due from banks	$ 166,981	$ 166,981	$ 133,340	$ 133,340	$ 179,140	$ 179,140	Level 1
Federal funds sold	3,400	3,400	2,790	2,790	3,810	3,810	Level 1
Interest-bearing deposits in banks	117,334	117,334	4,268	4,268	89,936	89,936	Level 1
Interest-bearing time deposits in banks	1,707	1,709	4,491	4,498	3,495	3,500	Level 2
Available-for-sale Securities	2,729,030	2,729,030	2,737,353	2,737,353	2,733,899	2,733,899	Levels 1 and 2
Held-to-maturity securities	129	133	286	291	278	283	Level 2
Loans	3,324,086	3,334,965	3,248,002	3,249,558	3,308,716	3,316,243	Level 3
Accrued interest receivable	26,209	26,209	26,888	26,888	34,697	34,697	Level 2
Deposits with stated maturities	535,793	537,167	652,919	654,705	620,852	622,572	Level 2
Deposits with no stated maturities	4,699,671	4,699,671	4,444,364	4,444,364	4,569,317	4,569,317	Level 1
Borrowings	513,759	513,759	500,903	500,903	615,675	615,675	Level 2
Accrued interest Payable	230	230	261	261	240	240	Level 2

Note 11 - Recently Issued Authoritative Accounting Guidance

Accounting Standards Update (ASU) 2014-09, Revenue from Contracts with Customers. ASU 2014-09 implements a comprehensive new revenue recognition standard that will supersede substantially all existing revenue recognition guidance. The new standard s core principle is that a company will recognize revenue when it transfers promised goods or services to customers in an amount that reflects the consideration to which the company expects to be entitled in exchange for those goods or services. In doing so, companies will need to use more judgment and make more estimates than under existing guidance. These may include identifying performance obligations in the contract, estimating the amount of variable consideration to include in the transaction price and allocating the transaction price to each separate performance obligation. The new standard will be effective in the first quarter of 2018. The Company does not expect implementation of this new guidance to have a significant impact on the

Company s financial statements but is continuing to evaluate the potential impact to the Company s financial statements.

ASU 2014-11, Transfers and Servicing. ASU 2014-11 amended guidance related to repurchase-to-maturity transactions to require that repurchase-to-maturity transactions be accounted for as secured borrowings consistent with the accounting for other repurchase agreements. In addition, the amendment requires separate accounting for repurchase financings, which entails the transfer of a financial asset executed contemporaneously with a repurchase agreement with the same counterparty. The amendment requires entities to disclose certain information about transfers accounted for as sales in transactions that are economically similar to repurchase agreements. In addition, the amendment requires disclosures

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related to collateral, remaining contractual term and of the potential risks associated with repurchase agreements, securities lending transactions and repurchase-to-maturity transactions. The amendment was effective for the Company on January 1, 2015 and did not have a significant impact on the Company s financial statements.

ASU 2014-14, Receivables Troubled Debt Restructuring by Creditors. ASU 2014-14 clarified that an in substance repossession or foreclosure occurs, and a creditor is considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan, upon either (1) the creditor obtaining legal title to the residential real estate property upon completion of a foreclosure or (2) the borrower conveying all interest in the residential real estate property to the creditor to satisfy that loan through completion of a deed in lieu of foreclosure or through a similar legal agreement. Additionally, the amendment requires interim and annual disclosure of both (1) the amount of foreclosed residential real estate property held by the creditor and (2) the recorded investment in consumer mortgage loans collateralized by residential real estate property that are in the process of foreclosure according to local requirements of the applicable jurisdiction. The new guidance was effective for the Company on January 1, 2015 and did not have a significant impact to the Company s financial statements.

ASU 2015-01, Income Statement Extraordinary and Unusual Items. ASU 2015-01 eliminated from U.S. GAAP the concept of extraordinary items, which, among other things, required an entity to show the item separately in the income statement, net of tax, after income from continuing operations. The new guidance became effective for the Company beginning January 1, 2016, and did not have a significant impact on the Company s financial statements.

ASU 2015-05, Intangibles Goodwill and Other Internal-Use Software Customer s Accounting for Fees Paid in a Cloud Computing Arrangement. ASU 2015-05 addresses accounting for fees paid by a customer in cloud computing arrangements such as (i) software as a service, (ii) platform as a service, (iii) infrastructure as a service and (iv) other similar hosting arrangements. ASU 2015-05 provides guidance to customers about whether a cloud computing arrangement includes a software license. If a cloud computing arrangement includes a software license, then the customer should account for the software license element of the arrangement consistent with the acquisition of other software licenses. If a cloud computing arrangement does not include a software license, the customer should account for the arrangement as a service contract. ASU 2015-05 became effective on January 1, 2016 and did not have a significant impact on the Company s financial statements.

ASU 2015-16, Business Combinations Simplifying the Accounting Measurement Period Adjustments. ASU 2015-16 amended business combination guidance to require that an acquirer recognize adjustments to provisional amounts that are identified during the measurement period in the reporting period in which the adjustment amounts are determined. The acquirer must record, in the same period s financial statements, the effect of earnings on changes in depreciation, amortization, or other income effects, if any, as a result of the changes to the provisional amounts, calculated as if the accounting had been completed at the acquisition date. Additionally, the entity is required to present separately on the face of the income statement or disclose in the notes the portion of the amount recorded in current-period earnings by line item that would have been recorded in previous reporting periods if the adjustment to the provisional amounts had been recognized as of the acquisition date. The amended guidance became effective for the Company on January 1, 2016, and did not have a significant impact on the Company s financial statements.

ASU 2016-1, No. 2016-01, Financial Instruments Overall: Recognition and Measurement of Financial Assets and Financial Liabilities. ASU 2016-1, among other things, (i) requires equity investments, with certain exceptions, to be measured at fair value with changes in fair value recognized in net income, (ii) simplifies the impairment assessment of equity investments without readily determinable fair values by requiring a qualitative assessment to identify impairment, (iii) eliminates the requirement for public business entities to disclose the methods and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured at amortized cost on the balance sheet, (iv) requires public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes, (v) requires an entity to present separately in other comprehensive income the portion of the total change in the fair value of a liability resulting from a change in the instrument-specific credit risk when the entity has elected to measure the liability at fair value in accordance with the fair value option for financial instruments, (vi) requires separate presentation of financial assets and financial liabilities by measurement category and form of financial asset on the balance sheet or the accompanying notes to the financial statements and (vii) clarifies that an entity should evaluate the need for a valuation allowance on a deferred tax asset related to available-for-sale securities. ASU 2016-1 will be effective for us on January 1, 2018 and is not expected to have a significant impact on the Company s financial statements.

ASU 2016-02, Leases. ASU 2016-02 will amend current lease accounting to require lessees to recognize (i) a lease liability, which is a lessee s obligation to make lease payments arising from a lease, measured on a discounted basis, and (ii) a right-of-use asset, which is an asset that represents the lessee s right to use, or control the use of, a specified asset for the lease term. ASU 2016-02 does not significantly change lease accounting requirements applicable to lessors; however, certain changes were made to align, where necessary, lessor accounting with the lessee accounting model. The amended guidance will be effective in the first quarter of 2019 and will require transition using a modified retrospective approach for leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements. The Company is evaluating the potential impact of ASU 2016-02 on the Company s financial statements.

ASU 2016-09, Compensation Stock Compensation: Improvements to Employee Share-Based Payment Accounting. ASU 2016-09 will amend current guidance such that all excess tax benefits and tax deficiencies related to share-based payment awards will be recognized as income tax expense or benefit in the income statement during the period in which they occur. Additionally, excess tax benefits will be classified along with other income tax cash flows as an operating activity rather than a financing activity. ASU 2016-09 also provides that any entity can make an entity-wide accounting policy election to either estimate the number of awards that are expected to vest, which is the current requirement, or account for forfeitures when they occur. ASU 2016-09 will be effective January 1, 2017 and is not expected to have a significant impact on our financial statements.

ASU 2016-13, Financial Instruments Credit Losses. ASU 2016-13 implements a comprehensive change in estimating the allowances for loan losses from the current model of losses inherent in the loan portfolio to a current expected credit loss model that generally is expected to result in earlier recognition of allowances for losses. Additionally, purchase accounting rules have been modified as well as credit losses on held-to-maturity debt securities. ASU 2016-13 will be effective in the first quarter of 2020. While the Company generally expects that the implementation of ASU 2016-13 will increase their allowance for loan losses balance, the Company is continuing to evaluate the potential impact on the Company s financial statements.

Note 12 Acquisition and Asset Purchase

On April 1, 2015, we entered into an agreement and plan of reorganization to acquire FBC Bancshares, Inc. and its wholly owned bank subsidiary, First Bank, N.A., Conroe, Texas (First Bank). On July 31, 2015, the transaction was completed. Pursuant to the agreement, we issued 1,755,374 shares of the Company s common stock in exchange for all of the outstanding shares of FBC Bancshares, Inc. At closing, FBC Bancshares, Inc. was merged into the Company and First Bank was merged into First Financial Bank, National Association, Abilene, Texas, a wholly owned subsidiary of the Company. The primary purpose of the acquisition was to expand the Company s market share along Interstate Highway 45 in southern Texas, north of Houston. Factors that contributed to a purchase price resulting in goodwill include First Bank s historic record of earnings, strong local economic environment and opportunity for growth. The results of operations from this acquisition are included in the consolidated earnings of the Company commencing August 1, 2015.

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The assets acquired and liabilities assumed were recorded on the consolidated balance sheet at estimated fair value on the acquisition date. The acquisition was not considered to be a significant business combination. The following table presents the amounts recorded on the consolidated balance sheet on the acquisition date (dollars in thousands):

Fair value of consideration paid:	
Common stock issued (1,755,374 shares)	$ 59,648
Fair value of identifiable assets acquired:	
Cash and cash equivalents	65,197
Securities available-for-sale	42,903
Loans	248,380
Identifiable intangible assets	2,343
Other assets	15,262
Total identifiable assets acquired	374,085
Fair value of liabilities assumed:	
Deposits	343,583
Subordinated debt	13,125
Other liabilities	1,651
Total liabilities assumed	358,359
Fair value of net identifiable assets acquired	15,726
Goodwill resulting from acquisition	$ 43,922

Goodwill recorded in the acquisition was accounted for in accordance with the authoritative business combination guidance. Accordingly, goodwill will not be amortized, but will be tested for impairment annually. The goodwill recorded is not deductible for federal income tax purposes.

The subordinated debt of $13,125,000 was paid off August 3, 2015, subsequent to closing.

The fair value of total loans acquired was $248,380,000 at acquisition compared to contractual amounts of $252,458,000. The fair value of purchased credit impaired loans at acquisition was $1,398,000 compared to contractual amounts of $1,704,000. Additional purchased credit impaired loan disclosures were omitted due to immateriality. All other acquired loans were considered performing loans.

First Bank had branches in Conroe, Magnolia, Montgomery, Tomball, Cut and Shoot and Huntsville, all located north of Houston, Texas. On February 26, 2016, the Company closed First Bank s Huntsville location and consolidated the branch with the Company s existing Huntsville location.

On April 8, 2015, the Company announced that it had entered into an asset purchase agreement with 4Trust Mortgage, Inc. for a cash purchase price of $1,900,000. The asset purchase was finalized on May 31, 2015, which we refer to herein as the 4Trust asset purchase. The total asset purchase price exceeded the estimated fair value of assets purchased by approximately $1,750,000 and the Company recorded such excess as goodwill.

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Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations
Forward-Looking Statements

This Form 10-Q contains certain forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. When used in this Form 10-Q, words such as anticipate, believe, estimate, expect, intend, predict, project, and similar expressions, as they relate to us o management, identify forward-looking statements. These forward-looking statements are based on information currently available to our management. Actual results could differ materially from those contemplated by the forward-looking statements as a result of certain factors, including, but not limited, to those listed in Item 1A- Risk Factors in our Annual Report on Form 10-K and the following:

general economic conditions, including our local, state and national real estate markets and employment trends;

volatility and disruption in national and international financial and commodity markets;

government intervention in the U.S. financial system including the effects of recent legislative, tax, accounting and regulatory actions and reforms, including the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act), the Jumpstart Our Business Startups Act, the Consumer Financial Protection Bureau and the capital ratios of Basel III as adopted by the federal banking authorities;

political instability;

the ability of the Federal government to address the national economy;

changes in our competitive environment from other financial institutions and financial service providers;

the effects of and changes in trade, monetary and fiscal policies and laws, including interest rate policies of the Board of Governors of the Federal Reserve System (the Federal Reserve Board);

the effect of changes in accounting policies and practices, as may be adopted by the regulatory agencies, as well as the Public Company Accounting Oversight Board, the Financial Accounting Standards Board and other accounting standard setters;

the effect of changes in laws and regulations (including laws and regulations concerning taxes, banking, securities and insurance) with which we and our subsidiaries must comply;

changes in the demand for loans;

fluctuations in the value of collateral securing our loan portfolio and in the level of the allowance for loan losses;

the accuracy of our estimates of future loan losses;

the accuracy of our estimates and assumptions regarding the performance of our securities portfolio;

soundness of other financial institutions with which we have transactions;

inflation, interest rate, market and monetary fluctuations;

changes in consumer spending, borrowing and savings habits;

changes in commodity prices (e.g., oil and gas, cattle and wind energy);

our ability to attract deposits and increase market share;

changes in our liquidity position;

changes in the reliability of our vendors, internal control system or information systems;

cyber attacks on our technology information systems;

our ability to attract and retain qualified employees;

acquisitions and integration of acquired businesses;

the possible impairment of goodwill associated with our acquisitions;

consequences of continued bank mergers and acquisitions in our market area, resulting in fewer but much larger and stronger competitors;

expansion of operations, including branch openings, new product offerings and expansion into new markets;

changes in compensation and benefit plans; and

acts of God or of war or terrorism.

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Such forward-looking statements reflect the current views of our management with respect to future events and are subject to these and other risks, uncertainties and assumptions relating to our operations, results of operations, growth strategy and liquidity. All subsequent written and oral forward-looking statements attributable to us or persons acting on our behalf are expressly qualified in their entirety by this paragraph. We undertake no obligation to publicly update or otherwise revise any forward-looking statements, whether as a result of new information, future events or otherwise (except as required by law).

Introduction

As a financial holding company, we generate most of our revenue from interest on loans and investments, trust fees, and service charges. Our primary source of funding for our loans and investments are deposits held by our subsidiary, First Financial Bank, National Association, Abilene, Texas. Our largest expense is salaries and related employee benefits. We usually measure our performance by calculating our return on average assets, return on average equity, our regulatory leverage and risk based capital ratios and our efficiency ratio, which is calculated by dividing noninterest expense by the sum of net interest income on a tax equivalent basis and noninterest income.

The following discussion and analysis of operations and financial condition should be read in conjunction with the financial statements and accompanying footnotes included in Item 1 of this Form 10-Q as well as those included in the Company s 2015 Annual Report on Form 10-K.

Critical Accounting Policies

We prepare consolidated financial statements based on GAAP and customary practices in the banking industry. These policies, in certain areas, require us to make significant estimates and assumptions.

We deem a policy critical if (1) the accounting estimate required us to make assumptions about matters that are highly uncertain at the time we make the accounting estimate; and (2) different estimates that reasonably could have been used in the current period, or changes in the accounting estimate that are reasonably likely to occur from period to period, would have a material impact on the financial statements.

We deem our most critical accounting policies to be (1) our allowance for loan losses and our provision for loan losses and (2) our valuation of securities. We have other significant accounting policies and continue to evaluate the materiality of their impact on our consolidated financial statements, but we believe these other policies either do not generally require us to make estimates and judgments that are difficult or subjective, or it is less likely they would have a material impact on our reported results for a given period. A discussion of (1) our allowance for loan losses and our provision for loan losses and (2) our valuation of securities is included in note 5 and note 4, respectively, to our notes to consolidated financial statements (unaudited) which begins on page 9.

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Results of Operations

Performance Summary. Net earnings for the third quarter of 2016 were $25.60 million compared to $25.89 million for the same quarter in 2015, or a 1.09% decrease.

Basic earnings per share for the third quarter of 2016 were $0.39 compared to $0.40 for the same quarter last year. The return on average assets was 1.54% for the third quarter of 2016, as compared to 1.61% for the third quarter of 2016. The return on average equity was 11.72% for the third quarter of 2016 as compared to 13.63% for the third quarter of 2015.

Net earnings for the nine-month period ended September 30, 2016 were $78.11 million compared to $75.19 million for the same period in 2015, or a 3.88% increase.

Basic earnings per share for the first nine months of 2016 were $1.18 compared to $1.16 for the same period in 2015, or a 1.72% increase. The return on average assets was 1.59% for the first nine months of 2016, as compared to 1.64% for the same period in 2015. The return on average equity was 12.33% for the first nine months of 2016, as compared to 13.99% a year ago.

Net Interest Income. Net interest income is the difference between interest income on earning assets and interest expense on liabilities incurred to fund those assets. Our earning assets consist primarily of loans and investment securities. Our liabilities to fund those assets consist primarily of noninterest-bearing and interest-bearing deposits.

Tax-equivalent net interest income was $63.00 million for the third quarter of 2016, as compared to $62.08 million for the same period last year. The increase in 2016 compared to 2015 was largely attributable to the increase in volume of interest earning assets due primarily to the First Bank acquisition. Average earning assets increased $246.56 million for the third quarter of 2016 over the same period in 2015. Average loans and tax exempt securities increased $188.23 million and $102.60 million, respectively, for the third quarter of 2016 over the same quarter of 2015. Average interest bearing liabilities increased $162.25 million for the third quarter of 2016, as compared to the same period in 2015. The yield on earning assets decreased seven basis points and the rate paid on interest-bearing liabilities increased two basis points for the third quarter of 2016 over the third quarter of 2015.

Tax-equivalent net interest income was $188.86 million for the first nine months of 2016, as compared to $176.37 million for the same period last year. The increase in 2016 compared to 2015 was largely attributable to the increase in volume of interest earning assets due primarily to the First Bank acquisition. Average earning assets increased $402.99 million for the first nine months of 2016 over the same period in 2015. Average loans and tax exempt securities increased $302.65 million and $160.69 million, respectively, for the first nine months of 2016 over the same period of 2015. Average interest bearing liabilities increased $266.10 million for the first nine months of 2016, as compared to the same period in 2015. The yield on earning assets increased two basis points and the rate paid on interest-bearing liabilities increased two basis points for the first nine months of 2016 over the first nine months of 2015.

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

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

	Three Months Ended September 30, 2016 Compared to Three Months Ended September 30, 2015			Nine Months Ended September 30, 2016 Compared to Nine Months Ended September 30, 2015		
	Change Attributable to		Total	Change Attributable to		Total
	Volume	Rate	Change	Volume	Rate	Change
Short-term investments	$ 17	$ 41	$ 58	$ (24)	$ 74	$ 50
Taxable investment securities	(360)	(161)	(521)	(840)	(495)	(1,335)
Tax-exempt investment securities (1)	1,194	(674)	520	5,626	(1,415)	4,211
Loans (1) (2)	2,369	(1,210)	1,159	11,200	(670)	10,530
Interest income	3,220	(2,004)	1,216	15,962	(2,506)	13,456
Interest-bearing deposits	47	132	179	171	265	436
Short-term borrowings		121	121	37	493	530
Interest expense	47	253	300	208	758	966
Net interest income	$ 3,173	$ (2,257)	$ 916	$ 15,754	$ (3,264)	$ 12,490

(1) Computed on a tax-equivalent basis assuming a marginal tax rate of 35%.
(2) Non-accrual loans are included in loans.

The net interest margin for the third quarter of 2016 was 4.04%, a decrease of nine basis points from the same period in 2015. The net interest margin for the nine months ended September 30, 2016 was 4.10%, unchanged from the same period in 2015. Although the Federal Reserve slightly increased rates in late 2015 and continues to consider future increases in rates in the fourth quarter of 2016 and future years, we expect interest rates to remain at lower levels which will continue the downward pressure on our net interest margin.

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

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

	Three Months Ended September 30, 2016			2015		
	Average Balance	Income/ Expense	Yield/ Rate	Average Balance	Income/ Expense	Yield/ Rate
Assets						
Short-term investments (1)	$ 73,881	$ 99	0.53%	$ 50,417	$ 41	0.32%
Taxable investment securities (2)	1,305,103	6,775	2.08	1,372,834	7,296	2.13
Tax-exempt investment securities (2)(3)	1,478,719	16,541	4.47	1,376,119	16,021	4.66
Loans (3)(4)	3,349,458	40,948	4.86	3,161,229	39,789	4.99
Total earning assets	6,207,161	$ 64,363	4.13%	5,960,599	$ 63,147	4.20%
Cash and due from banks	152,080			146,921		
Bank premises and equipment, net	122,944			113,662		
Other assets	55,358			51,208		
Goodwill and other intangible assets, net	143,854			129,962		
Allowance for loan losses	(45,997)			(39,579)		
Total assets	$ 6,635,400			$ 6,362,773		
Liabilities and Shareholders Equity						
Interest-bearing deposits	$ 3,460,208	$ 1,111	0.13%	$ 3,295,411	$ 932	0.11%
Short-term borrowings	569,883	254	0.18	572,431	133	0.09
Total interest-bearing liabilities	4,030,091	$ 1,365	0.13%	3,867,842	$ 1,065	0.11%
Noninterest-bearing deposits	1,663,460			1,687,285		
Other liabilities	72,611			54,034		
Total liabilities	5,766,162			5,609,161		
Shareholders equity	869,238			753,612		
Total liabilities and shareholders equity	$ 6,635,400			$ 6,362,773		
Net interest income		$ 62,998			$ 62,082	
Rate Analysis:						
Interest income/earning assets			4.13%			4.20%
Interest expense/earning assets			0.09			0.07
Net yield on earning assets			4.04%			4.13%

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	Nine Months Ended September 30,					
	2016			2015		
	Average Balance	Income/ Expense	Yield/ Rate	Average Balance	Income/ Expense	Yield/ Rate
Assets						
Short-term investments (1)	$ 54,908	$ 221	0.54%	$ 63,833	$ 171	0.36%
Taxable investment securities (2)	1,325,935	21,167	2.13	1,377,363	22,502	2.18
Tax-exempt investment securities (2)(3)	1,448,933	49,313	4.54	1,288,242	45,102	4.67
Loans (3)(4)	3,319,337	122,162	4.92	3,016,686	111,632	4.95
Total earning assets	6,149,113	$ 192,863	4.19%	5,746,124	$ 179,407	4.17%
Cash and due from banks	151,485			146,676		
Bank premises and equipment, net	119,664			107,394		
Other assets	55,094			48,244		
Goodwill and other intangible assets, net	144,091			108,478		
Allowance for loan losses	(44,487)			(38,447)		
Total assets	$ 6,574,960			$ 6,118,469		
Liabilities and Shareholders Equity						
Interest-bearing deposits	$ 3,431,572	$ 3,197	0.12%	$ 3,231,925	$ 2,761	0.11%
Short-term borrowings	573,464	811	0.19	507,011	281	0.07
Total interest-bearing liabilities	4,005,036	$ 4,008	0.13%	3,738,936	$ 3,042	0.11%
Noninterest-bearing deposits	1,656,935			1,607,931		
Other liabilities	66,855			53,077		
Total liabilities	5,728,826			5,399,944		
Shareholders equity	846,134			718,525		
Total liabilities and shareholders equity	$ 6,574,960			$ 6,118,469		
Net interest income		$ 188,855			$ 176,365	
Rate Analysis:						
Interest income/earning assets			4.19%			4.17%
Interest expense/earning assets			0.09			0.07
Net yield on earning assets			4.10%			4.10%

(1) Short-term investments are comprised of Fed Funds sold, interest-bearing deposits in banks and interest-bearing time deposits in banks.
(2) Average balances include unrealized gains and losses on available-for-sale securities.
(3) Computed on a tax-equivalent basis assuming a marginal tax rate of 35%.

(4) Non-accrual loans are included in loans.

Noninterest Income. Noninterest income for the third quarter of 2016 was $22.15 million, an increase of $1.71 million compared to the same period in 2015. ATM, interchange and credit card fees and service charges on deposit accounts increased 3.56 percent and 3.07 percent, respectively, to $6.00 million and $4.80 million compared with $5.79 million and $4.65 million, respectively, in the same quarter last year due to continued growth in net new accounts and debit cards. Real estate mortgage fees increased 25.52 percent in the third quarter of 2016 to $4.70 million compared with $3.74 million in the same quarter a year ago. Trust fees increased to $5.07 million in the third quarter of 2016 compared with $4.82 million in the same quarter last year, due to continued growth in the fair value of Trust assets managed to $4.22 billion from $3.83 billion a year ago. This growth offset a $76 thousand decline in Trust oil and gas fee income in the third quarter of 2016 compared to the same quarter a year ago due to the decrease in oil and gas prices. Interest on loan recoveries increased $386 thousand in the third quarter of 2016 over the same period in 2015.

Noninterest income for the nine-month period ended September 30, 2016 was $63.41 million, an increase of $9.26 million compared to the same period in 2015. ATM, interchange and credit card fees and service charges on deposit accounts increased 8.09 percent and 9.42 percent, respectively, to $17.52 million and $13.61 million compared with $16.21 million and $12.44 million, respectively, in the same period last year due primarily to the First Bank acquisition and the continued growth in net new accounts and debit cards. Real estate mortgage fees increased 61.85 percent in the first nine months of 2016 to $11.85

million compared with $7.32 million in the same period a year ago, primarily resulting from additional loan origination production from the 4Trust asset purchase. Trust fees increased $157 thousand to $14.45 million in the first nine months of 2016 compared with $14.29 million in the same period in 2015, due to continued growth in the fair value of Trust assets managed to $4.22 billion from $3.83 billion a year ago. This growth offset a $447 thousand decline in Trust oil and gas fee income in the first nine months of 2016 compared to the same period a year ago due to the decrease in oil and gas prices. Gain on sale of available-for-sale securities totaled $1.15 million in the first nine months of 2016 compared to $380 thousand in the same period in 2015. Interest on loan recoveries increased $1.14 million for the nine months ended September 30, 2016 compared to the same period in 2015.

ATM and interchange fees are charges that merchants pay to us and other card-issuing banks for processing electronic payment transactions. ATM and interchange fees consist of income from debit card usage, point of sale income for debit card transactions and ATM service fees. Federal Reserve rules applicable to financial institutions that have assets of $10 billion or more provide that the maximum permissible interchange fee for an electronic debit transaction is the sum of 21 cents per transaction and 5 basis points multiplied by the value of the transaction. While we currently have assets under $10 billion, we are monitoring the effect of this reduction in per transaction fee income as we approach the $10 billion asset level.

Table 3 - Noninterest Income (in thousands):

	Three Months Ended September 30,			Nine Months Ended September 30,		
	2016	Increase (Decrease)	2015	2016	Increase (Decrease)	2015
Trust fees	$ 5,066	$ 248	$ 4,818	$ 14,446	$ 157	$ 14,289
Service charges on deposit accounts	4,796	143	4,653	13,614	1,172	12,442
ATM, interchange and credit card fees	6,000	206	5,794	17,521	1,312	16,209
Real estate mortgage operations	4,697	955	3,742	11,849	4,528	7,321
Net gain on sale of available-for-sale securities	239	103	136	1,153	773	380
Net gain (loss) on sale of foreclosed assets	(10)	(38)	28	343	333	10
Gain (loss) on sale of assets	(168)	(157)	(11)	271	282	(11)
Interest on loan recoveries	709	386	323	1,970	1,136	834
Other:						
Check printing fees	51	(8)	59	137	(32)	169
Safe deposit rental fees	115	3	112	426	10	416
Credit life and debt protection fees	240	63	177	474	(60)	534
Brokerage commissions	47	(163)	210	300	(277)	577
Miscellaneous income	370	(35)	405	906	(76)	982
Total other	823	(140)	963	2,243	(435)	2,678
Total Noninterest Income	$ 22,152	$ 1,706	$ 20,446	$ 63,410	$ 9,258	$ 54,152

Noninterest Expense. Total noninterest expense for the third quarter of 2016 was $42.00 million, an increase of $2.03 million compared to the same period in 2015. An important measure in determining whether a financial institution effectively manages noninterest expense is the efficiency ratio, which is calculated by dividing noninterest expense by the sum of net interest income on a tax-equivalent basis and noninterest income. Lower ratios indicate better efficiency since more income is generated with a lower noninterest expense total. Our efficiency ratio for the third quarter of 2016 was 49.33%, compared to 48.44% from the same period in 2015.

Salaries and employee benefits for the third quarter of 2016 totaled $22.93 million, an increase of $1.28 million compared to the same period in 2015. The increase was primarily driven by the addition of First Bank employees and annual merit pay increases. In addition, our healthcare claims increased $767 thousand in the third quarter of 2016 over the same quarter in 2015, which was offset by lower profit sharing expense of $903 thousand.

All other categories of noninterest expense for the third quarter of 2016 totaled $19.07 million, an increase of $747 thousand compared to the same quarter in 2015. This increase primarily resulted from increases in equipment, ATM, interchange and credit card, telephone and professional fee expenses also largely driven by the 4Trust asset purchase and First Bank acquisition. Included in noninterest expense in the third quarter of 2015 were technology contract termination and conversion related costs totaling $1.14 million related to the First Bank acquisition.

Total noninterest expense for the first nine months of 2016 was $123.84 million compared to $109.12 million in the same period of 2015. Our efficiency ratio for the first nine months of 2016 was 49.09%, compared to 47.34% from the same period in 2015.

Salaries and employee benefits for the first nine months of 2016 totaled $67.67 million, an increase of $8.58 million compared to the same period in 2015. The increase was primarily driven by the addition of 4Trust and First Bank employees and annual pay increases. In addition, our healthcare claims increased $2.57 million in the first nine months of 2016 over the same period in 2015, which was offset by lower profit sharing expense of $2.30 million.

All other categories of noninterest expense for the first nine months of 2016 totaled $56.17 million, an increase of approximately $6.14 million, as compared to the same period in 2015. The increase primarily resulted from increases in equipment, ATM, interchange and credit card, telephone and professional fee expenses also largely driven by the 4Trust asset purchase and First Bank acquisition.

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Table 4 - Noninterest Expense (in thousands):

	Three Months Ended September 30,			Nine Months Ended September 30,		
	2016	Increase (Decrease)	2015	2016	Increase (Decrease)	2015
Salaries	$ 17,846	$ 1,219	$ 16,627	$ 52,583	$ 7,205	$ 45,378
Medical	2,222	767	1,455	6,449	2,567	3,882
Profit sharing	738	(903)	1,641	1,893	(2,297)	4,190
Pension	82	(1)	83	247	15	232
401(k) match expense	591	49	542	1,794	281	1,513
Payroll taxes	1,143	25	1,118	3,778	430	3,348
Stock option and stock grant expense	309	127	182	924	381	543
Total salaries and employee benefits	22,931	1,283	21,648	67,668	8,582	59,086
Net occupancy expense	2,672	(378)	3,050	7,886	246	7,640
Equipment expense	3,420	306	3,114	10,186	1,181	9,005
FDIC assessment fees	513	(306)	819	2,155	(161)	2,316
ATM, interchange and credit card expense	1,859	350	1,509	5,352	508	4,844
Professional and service fees	1,883	735	1,148	5,099	1,729	3,370
Printing, stationery and supplies	536	(58)	594	1,504	(158)	1,662
Amortization of intangible assets	172	(28)	200	570	208	362
Other:						
Data processing fees	119	(704)	823	333	(686)	1,019
Postage	406	(27)	433	1,223	(39)	1,262
Advertising	924	5	919	2,655	146	2,509
Correspondent bank service charges	240	2	238	726	40	686
Telephone	883	280	603	2,488	911	1,577
Public relations and business development	805	160	645	2,055	162	1,893
Directors fees	301	6	295	1,000	223	777
Audit and accounting fees	440	(28)	468	1,340	51	1,289
Legal fees	479	154	325	1,532	100	1,432
Regulatory exam fees	281	16	265	848	72	776
Travel	332	(52)	384	938	30	908
Courier expense	222	28	194	625	6	619
Operational and other losses	533	136	397	1,452	545	907
Other real estate	34	(2)	36	176	68	108
Other miscellaneous expense	2,018	152	1,866	6,029	954	5,075
Total other	8,017	126	7,891	23,420	2,583	20,837
Total Noninterest Expense	$ 42,003	$ 2,030	$ 39,973	$ 123,840	$ 14,718	$ 109,122

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Balance Sheet Review

Loans. Our portfolio is comprised of loans made to businesses, professionals, individuals, and farm and ranch operations located in the primary trade areas served by our subsidiary bank. Real estate loans represent loans primarily for 1-4 family residences and commercial real estate, which are primarily owner-occupied. The structure of loans in the real estate mortgage area generally provides re-pricing intervals to minimize the interest rate risk inherent in long-term fixed rate loans. As of September 30, 2016, total loans held for investment were $3.34 billion, an increase of $20.74 million, as compared to December 31, 2015 balances. As compared to December 31, 2015, commercial loans decreased $32.58 million, agricultural loans decreased $17.64 million, real estate loans increased $55.03 million, and consumer loans increased $15.93 million. Loans averaged $3.35 billion during the third quarter of 2016, an increase of $188.23 million from the prior year third quarter average balances. Loans averaged $3.32 billion during the nine-month period ended September 30, 2016, an increase of $302.65 million from the prior year nine-month average balances.

Table 5 - Composition of Loans (in thousands):

	September 30,		December 31,
	2016	2015	2015
Commercial	$ 663,581	$ 698,406	$ 696,163
Agricultural	84,716	99,232	102,351
Real estate	2,191,260	2,088,002	2,136,233
Consumer	398,236	381,177	382,303
Total loans held-for-investment	$ 3,337,793	$ 3,266,817	$ 3,317,050

At September 30, 2016, our real estate loans represent approximately 65.65% of our loan portfolio and are comprised of (i) 1-4 family residence loans of 44.87%, (ii) commercial real estate loans of 24.22%, generally owner occupied, (iii) other loans, which includes ranches, hospitals and universities, of 16.63%, (iv) residential development and construction loans of 9.19%, which includes our custom and speculation home construction loans and (v) commercial development and construction loans of 5.09%.

Loans held for sale, consisting of secondary market mortgage loans, totaled $31.59 million, $21.61 million, and $33.54 million at September 30, 2016 and 2015, and December 31, 2015, respectively, which are valued using the lower of cost or market method.

Asset Quality. Our loan portfolio is subject to periodic reviews by our centralized independent loan review group as well as periodic examinations by bank regulatory agencies. Loans are placed on nonaccrual status when, in the judgment of management, the collectability of principal or interest under the original terms becomes doubtful. Nonaccrual, past due 90 days or more and still accruing, and restructured loans plus foreclosed assets were $34.94 million at September 30, 2016, as compared to $22.74 million at September 30, 2015 and $29.77 million at December 31, 2015. As a percent of loans and foreclosed assets, these assets were 1.04% at September 30, 2016, as compared to 0.69% at September 30, 2015 and 0.89% at December 31, 2015. As a percent of total assets, these assets were 0.52% at September 30, 2016, as compared to 0.35% at September 30, 2015 and 0.45% at December 31, 2015. The increase in the Company s nonperforming assets as a percentage of loans and foreclosed assets ratio and total assets at September 30, 2016 primarily resulted from the addition of one commercial loan to the Company s quarter-end nonaccrual balances. We believe the level of these assets to be manageable and are not aware of any material classified credits not properly disclosed as nonperforming at September 30, 2016.

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Supplemental Oil and Gas Information. As of September 30, 2016, the Company s exposure to the oil and gas industry remained at 2.58% of gross loans, or $86.79 million, down slightly from December 31, 2015 year-end levels, and consisted (based on collateral supporting the loan) of (i) development and production loans of 5.10%, (ii) oil and gas field servicing loans of 13.84%, (iii) real estate loans of 37.68%, (iv) accounts receivable and inventory of 18.99% and (v) other of 24.39%. These loans have experienced increased stress due to continued depressed oil and gas prices. The Company has instituted additional monitoring procedures for these loans and has classified, downgraded and charged-off loans as appropriate. The following oil and gas information is as of and for the quarters ended September 30, 2016 and 2015, and December 31, 2015:

	September 30, 2016	**September 30, 2015**	**December 31, 2015**
Oil and gas related loans	$ 86,785	$ 92,382	$ 96,712
Oil and gas related loans as a % of total loans	2.58%	2.81%	2.89%
Classified oil and gas related loans	$ 31,541	$ 30,028	$ 34,506
Nonaccrual oil and gas related loans	5,140	2,589	5,404
Net charge-offs for oil and gas related loans	104	567	1,370
Allowance for oil and gas related loans as a % of oil and gas loans	5.60%	6.48%	6.35%

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

	September 30, 2016	**September 30, 2015**	**December 31, 2015**
Non-accrual loans*	$ 33,712	$ 21,788	$ 28,601
Loans still accruing and past due 90 days or more	107	49	341
Troubled debt restructured loans**	750	204	199
Foreclosed assets	369	701	627
Total nonperforming assets	$ 34,938	$ 22,742	$ 29,768
As a % of loans and foreclosed assets	1.04%	0.69%	0.89%
As a % of total assets	0.52%	0.35%	0.45%

* Includes $1.85 million, $2.42 million and $2.18 million of purchased credit impaired loans as of September 30, 2016 and 2015, and December 31, 2015, respectively.

** Troubled debt restructured loans of $7.51 million, $6.46 million and $6.11 million, whose interest collection, after considering economic and business conditions and collection efforts, is doubtful are included in non-accrual loans at September 30, 2016 and 2015, and December 31, 2015, respectively.

We record interest payments received on non-accrual loans as reductions of principal. Prior to the loans being placed on non-accrual, we recognized interest income on impaired loans as of December 31, 2015 of approximately $780 thousand during the year ended December 31, 2015. If interest on these impaired loans had been recognized on a full accrual basis during the year ended December 31, 2015, such income would have approximated $2.74 million. Such amounts for the three months and nine months periods in 2016 were not significant.

Provision and Allowance for Loan Losses. The allowance for loan losses is the amount we determine as of a specific date to be appropriate to absorb probable losses on existing loans in which full collectability is unlikely based on our review and evaluation of the loan portfolio. For a discussion of our methodology, see note 5 to our notes to the consolidated financial statements (unaudited). The provision for loan losses was $3.83 million for the third quarter of 2016, as compared to $2.66 million for the third quarter of 2015. The provision for loan losses was $8.22 million for the nine-month period ended September 30, 2016, as compared to $5.51 million for the same period in 2015. The continued provision for loan losses in 2016 and 2015 reflects the continued levels of nonperforming and classified assets, gross charge-offs, as well as the economic effects related to the oil and gas industry. As a percent of average loans, net loan charge-offs were 0.43% for the third quarter of 2016, as compared to 0.16% for the third quarter of 2015. As a percent of average loans, net loan charge-offs were 0.19% for the first nine months of 2016, as compared to 0.08% for the first nine months of 2015. The increase in the net charge-off rate for both the three and nine-month periods ended September 30, 2016 was primarily due to one commercial loan, which totaled $3.00 million and $4.00 million, respectively. The allowance for loan losses as a percent of loans was 1.34% as of September 30, 2016, as compared to 1.23% as of September 30, 2015 and 1.25% as of December 31, 2015. Included in Table 7 is further analysis of our allowance for loan losses.

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	**2015**	**2016**	**2015**
Allowance for loan losses at period-end	$ 45,298	$ 40,420	$ 45,298	$ 40,420
Loans held for investment at period-end	3,337,793	3,266,817	3,337,793	3,266,817
Average loans for period	3,349,458	3,161,229	3,319,337	3,016,686
Net charge-offs/average loans (annualized)	0.43%	0.16%	0.19%	0.08%
Allowance for loan losses/period-end loans	1.34%	1.23%	1.34%	1.23%
Allowance for loan losses/non-accrual loans, past due 90 days still accruing and restructured loans	131.04%	183.39%	131.04%	183.29%

Interest-Bearing Deposits in Banks. At September 30, 2016, our interest-bearing deposits in banks were $119.04 million compared to $8.76 million at September 30, 2015 and $93.43 million at December 31, 2015, respectively. At September 30, 2016, interest-bearing deposits in banks included $1.71 million invested in FDIC-insured certificates of deposit, $117.05 million maintained at the Federal Reserve Bank of Dallas and $281 thousand on deposit with the Federal Home Loan Bank of Dallas (FHLB).

Available-for-Sale and Held-to-Maturity Securities. At September 30, 2016, securities with a fair value of $2.73 billion were classified as securities available-for-sale and securities with an amortized cost of $129 thousand were classified as securities held-to-maturity. As compared to December 31, 2015, the available-for-sale portfolio at September 30, 2016 reflected (i) a decrease of $32.83 million in obligations of U.S. government sponsored enterprises and agencies, (ii) an increase of $51.59 million in obligations of states and political subdivisions, (iii) a decrease of $18.35 million in corporate bonds and other, (iv) a decrease of $5.22 million in mortgage-backed securities and (v) a decrease of $56 thousand in U.S. Treasury securities. Our mortgage related securities are backed by GNMA, FNMA or FHLMC or are collateralized by securities backed by these agencies.

See note 4 to the consolidated financial statements (unaudited) for additional disclosures relating to the investment portfolio at September 30, 2016 and 2015, and December 31, 2015.

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Table 8 - Maturities and Yields of Available-for-Sale Securities Held at September 30, 2016 (in thousands, except percentages):

	One Year or Less		After One Year Through Five Years		Maturing After Five Years Through Ten Years		After Ten Years		Total	
Available-for-Sale:	**Amount**	**Yield**	**Amount**	**Yield**	**Amount**	**Yield**	**Amount**	**Yield**	**Amount**	**Yield**
U.S. Treasury securities	$ 254	1.07%	$ 10,485	1.13%	$	%	$	%	$ 10,739	1.13%
Obligations of U.S. government sponsored enterprises and agencies	41,122	1.18	74,598	1.33					115,720	1.28
Obligations of states and political subdivisions	106,068	4.38	605,294	5.17	788,744	4.73	2,610	6.77	1,502,716	4.89
Corporate bonds and other securities	49,890	2.42	19,719	3.78					69,609	2.81
Mortgage-backed securities	13,580	3.22	844,577	2.13	172,089	2.53			1,030,246	2.21
Total	$ 210,914	3.22%	$ 1,554,673	3.29%	$ 960,833	4.33%	$ 2,610	6.77%	$ 2,729,030	3.65%

Amounts for held-to-maturity securities are not included herein due to insignificance.

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

As of September 30, 2016, the investment portfolio had an overall tax equivalent yield of 3.65%, a weighted average life of 4.12 years and modified duration of 3.70 years.

Deposits. Deposits held by our subsidiary bank represent our primary source of funding. Total deposits were $5.24 billion as of September 30, 2016, as compared to $5.10 billion as of September 30, 2015 and $5.19 billion as of December 31, 2015. Table 9 provides a breakdown of average deposits and rates paid for the three and nine month periods ended September 30, 2016 and 2015.

Table 9 Composition of Average Deposits (in thousands, except percentages):

Three Months Ended September 30,

	2016		2015	
	Average Balance	**Average Rate**	**Average Balance**	**Average Rate**
Noninterest-bearing deposits	$ 1,663,460	%	$ 1,687,285	%
Interest-bearing deposits:				
Interest-bearing checking	$ 1,688,540	0.11	1,617,367	0.09
Savings and money market accounts	1,230,111	0.09	1,042,610	0.06
Time deposits under $100,000	233,443	0.18	273,734	0.21
Time deposits of $100,000 or more	308,114	0.32	361,700	0.32
Total interest-bearing deposits	3,460,208	0.13%	3,295,411	0.11%
Total average deposits	$ 5,123,668		$ 4,982,696	

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	Nine Months Ended September 30,			
	2016		2015	
	Average Balance	Average Rate	Average Balance	Average Rate
Noninterest-bearing deposits	$ 1,656,935	%	$ 1,607,931	%
Interest-bearing deposits:				
Interest-bearing checking	1,712,095	0.11	1,601,087	0.09
Savings and money market accounts	1,146,368	0.07	1,004,584	0.06
Time deposits under $100,000	241,031	0.18	263,031	0.21
Time deposits of $100,000 or more	332,078	0.31	363,223	0.31
Total interest-bearing deposits	3,431,572	0.13%	3,231,925	0.11%
Total average deposits	$ 5,088,507		$ 4,839,856	

Borrowings. Included in borrowings were federal funds purchased, securities sold under repurchase agreements and advances from the FHLB of $513.76 million, $500.90 million and $615.68 million at September 30, 2016 and 2015 and December 31, 2015, respectively. Securities sold under repurchase agreements are generally with significant customers of the Company that require short-term liquidity for their funds for which we pledge certain securities that have a fair value equal to at least the amount of the borrowings. The average balance of federal funds purchased, securities sold under repurchase agreements and advances from the FHLB were $569.88 million and $572.43 million in the third quarters of 2016 and 2015, respectively. The weighted average interest rate paid on these borrowings were 0.18% and 0.09% for the third quarters of 2016 and 2015, respectively. The average balances of federal funds purchased, securities sold under repurchase agreements and advances from the FHLB was $573.46 million and $507.01 million for the nine-month periods ended September 30, 2016 and 2015, respectively. The weighted average interest rate paid on these short-term borrowings was 0.19% and 0.07% for the first nine months of 2016 and 2015, respectively.

Capital Resources

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

Total shareholders equity was $867.94 million, or 12.98% of total assets at September 30, 2016, as compared to $792.03 million, or 12.25% of total assets at September 30, 2015 and $804.99 million, or 12.08% of total assets at December 31, 2015. Included in shareholders equity at September 30, 2016 and 2015 and December 31, 2015, were $68.31 million, $53.37 million and $51.36 million, respectively, in unrealized gains on investment securities available-for-sale, net of related income taxes. For the third quarter of 2016, total shareholders equity averaged $869.24 million, or 13.10% of average assets, as compared to $753.61 million, or 11.84% of average assets, during the same period in 2015. For the nine months ended September 30, 2016, total shareholders equity averaged $846.13 or 12.87% as compared to $718.52 or 11.74% of total assets during the same period in 2015.

Banking regulators measure capital adequacy by means of the risk-based capital ratios and the leverage ratio under the Basel III regulatory capital framework and prompt corrective action regulations. The risk-based capital rules provide for the weighting of assets and off-balance-sheet commitments and contingencies according to prescribed risk categories. Regulatory capital is then divided by risk-weighted assets to determine the risk-adjusted capital ratios. The leverage ratio is computed by dividing shareholders equity less intangible assets by quarter-to-date average assets less intangible assets.

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Beginning in January 2016, under the Basel III regulatory capital framework, the implementation of the capital conservation buffer was effective for the Company starting at the 0.625% level and increasing 0.625% each year thereafter, until it reaches 2.5% on January 1, 2019. The capital conservation buffer is designed to absorb losses during periods of economic stress and requires increased capital levels for the purpose of capital distributions and other payments. Failure to meet the amount of the buffer will result in restrictions on the Company s ability to make capital distributions, including dividend payments and stock repurchases, and to pay discretionary bonuses to executive officers.

As of September 30, 2016 and 2015, and December 31, 2015, we had a total risk-based capital ratio of 18.28%, 16.70% and 16.97%, a Tier 1 capital to risk-weighted assets ratio of 17.12%, 15.65% and 15.90%; a common equity Tier 1 to risk-weighted assets ratio of 17.12%, 15.65% and 15.90% and a Tier 1 leverage ratio of 10.60%, 9.96% and 9.96%, respectively. The regulatory capital ratios as of September 30, 2016 and 2015, and December 31, 2015 were calculated under Basel III rules. There is no threshold for well-capitalized status for bank holding companies.

As of September 30, 2016 and 2015, and December 31, 2015, the regulatory capital ratios of the Company and Bank under the Basel III regulatory capital framework are as follows:

	Actual		Minimum Capital Required Under Basel III Phase-In		Minimum Capital Required-Basel III Fully Phased-In		Required to be Considered Well-Capitalized	
As of September 30, 2016:	**Amount**	**Ratio**	**Amount**	**Ratio**	**Amount**	**Ratio**	**Amount**	**Ratio**
Total Capital to Risk-Weighted Assets:								
Consolidated	$ 723,248	18.28%	$ 341,309	8.625%	$ 415,506	10.50%		N/A
First Financial Bank, N.A.	$ 629,168	15.94%	$ 340,429	8.625%	$ 414,436	10.50%	$ 394,701	10.00%
Tier 1 Capital to Risk-Weighted Assets:								
Consolidated	$ 677,289	17.12%	$ 262,165	6.625%	$ 336,362	8.50%		N/A
First Financial Bank, N.A.	$ 583,209	14.78%	$ 261,489	6.625%	$ 335,496	8.50%	$ 315,760	8.00%
Common Equity Tier 1 Capital to Risk-Weighted Assets:								
Consolidated	$ 677,289	17.12%	$ 202,807	5.125%	$ 277,004	7.00%		N/A
First Financial Bank, N.A.	$ 583,209	14.78%	$ 202,284	5.125%	$ 276,290	7.00%	$ 256,555	6.50%
Leverage Ratio:								
Consolidated	$ 677,289	10.60%	$ 255,659	4.00%	$ 255,659	4.00%		N/A
First Financial Bank, N.A.	$ 583,209	9.16%	$ 254,799	4.00%	$ 254,799	4.00%	$ 318,499	5.00%
As of September 30, 2015:								
Total Capital to Risk-Weighted Assets:								
Consolidated	$ 655,429	16.70%	$ 314,032	8.00%	$ 412,168	10.50%		N/A

First Financial Bank, N.A.	$ 567,379	14.48%	$ 313,379	8.00%	$ 411,310	10.50%	$ 391,724	10.00%
Tier 1 Capital to Risk-Weighted Assets:								
Consolidated	$ 614,184	15.65%	$ 235,524	6.00%	$ 333,659	8.50%		N/A
First Financial Bank, N.A.	$ 526,134	13.43%	$ 235,034	6.00%	$ 332,965	8.50%	$ 313,379	8.00%
Common Equity Tier 1 Capital to Risk-Weighted Assets:								
Consolidated	$ 614,184	15.65%	$ 176,643	4.50%	$ 274,778	7.00%		N/A
First Financial Bank, N.A.	$ 526,134	13.43%	$ 176,276	4.50%	$ 274,207	7.00%	$ 254,620	6.50%
Leverage Ratio:								
Consolidated	$ 614,184	9.96%	$ 246,784	4.00%	$ 246,784	4.00%		N/A
First Financial Bank, N.A.	$ 526,134	8.38%	$ 251,042	4.00%	$ 251,042	4.00%	$ 313,802	5.00%

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As of December 31, 2015:

Total Capital to Risk-Weighted Assets:								
Consolidated	$ 672,920	16.97%	$ 318,528	8.00%	$ 418,068	10.50%		N/A
First Financial Bank, N.A.	$ 570,910	14.37%	$ 317,788	8.00%	$ 417,097	10.50%	$ 397,235	10.00%
Tier 1 Capital to Risk-Weighted Assets:								
Consolidated	$ 630,413	15.90%	$ 238,896	6.00%	$ 338,436	8.50%		N/A
First Financial Bank, N.A.	$ 528,403	13.30%	$ 238,341	6.00%	$ 337,650	8.50%	$ 317,788	8.00%
Common Equity Tier 1 Capital to Risk-Weighted Assets:								
Consolidated	$ 630,413	15.90%	$ 179,172	4.50%	$ 278,712	7.00%		N/A
First Financial Bank, N.A.	$ 528,403	13.30%	$ 178,756	4.50%	$ 278,065	7.00%	$ 258,203	6.50%
Leverage Ratio:								
Consolidated	$ 630,413	9.96%	$ 256,368	4.00%	$ 256,368	4.00%		N/A
First Financial Bank, N.A.	$ 528,403	8.37%	$ 252,419	4.00%	$ 252,419	4.00%	$ 315,524	5.00%

We have performed a preliminary assessment using the regulatory capital estimation tool made available by the OCC and believe the Company and Bank are prepared to meet the new requirements upon full adoption of Basel III that will be effective December 31, 2019.

In connection with the adoption of the Basel III regulatory capital framework, our subsidiary bank made the election to continue to exclude most accumulated other comprehensive income (AOCI) from capital in connection with its March 31, 2015 quarterly financial filing and, in effect, to retain the AOCI treatment under the prior capital rules.

Interest Rate Risk

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

Our subsidiary bank has an asset liability management committee that monitors interest rate risk and compliance with investment policies. The subsidiary bank utilizes an earnings simulation model as the primary quantitative tool in measuring the amount of interest rate risk associated with changing market rates. The model quantifies the effects of various interest rate scenarios on projected net interest income and net income over the next twelve months. The model measures the impact on net interest income relative to a base case scenario of hypothetical fluctuations in interest rates over the next twelve months. These simulations incorporate assumptions regarding balance sheet growth and mix, pricing and the re-pricing and maturity characteristics of the existing and projected balance sheet.

As of September 30, 2016, the model simulations projected that 100 and 200 basis point increases in interest rates would result in positive variances in net interest income of positive 0.84% and 1.05%, respectively, relative to the current financial statement structure over the next twelve months, while a decrease in interest rates of 50 basis points would result in a negative variance in net interest income of 2.23% relative to the current financial statement structure over the next twelve months. We consider the likelihood of a decrease in interest rates beyond 50 basis points as of September 30, 2016 remote given current interest rate levels. Our model simulation as of September 30, 2016 indicate that our balance sheet is slightly more liability sensitive in the short-term one year category, due primarily to the level of short-term borrowings from the FHLB. These are good faith estimates and assume that the composition of our interest sensitive assets and liabilities existing at each year-end will remain constant over the relevant twelve month measurement period and that changes in market interest rates are instantaneous and sustained across the yield curve regardless of duration of pricing characteristics on specific assets or liabilities. Also, this analysis does not contemplate any actions that we might undertake in response to changes in market interest rates. We believe these estimates are not necessarily indicative of what actually could occur in the event of immediate interest rate increases or decreases of this magnitude. As interest-bearing assets and liabilities re-price in different time frames and proportions to market interest rate movements, various assumptions must be made based on historical relationships of these variables in reaching any conclusion. Since these correlations are based on competitive and market conditions, we anticipate that our future results will likely be different from the foregoing estimates, and such differences could be material.

Should we be unable to maintain a reasonable balance of maturities and repricing of our interest-earning assets and our interest-bearing liabilities, we could be required to dispose of our assets in an unfavorable manner or pay a higher than market rate to fund our activities. Our asset liability committee oversees and monitors this risk.

Liquidity

Liquidity is our ability to meet cash demands as they arise. Such needs can develop from loan demand, deposit withdrawals or acquisition opportunities. Potential obligations resulting from the issuance of standby letters of credit and commitments to fund future borrowings to our loan customers are other factors affecting our liquidity needs. Many of these obligations and commitments are expected to expire without being drawn upon; therefore the total commitment amounts do not necessarily represent future cash requirements affecting our liquidity position. The potential need for liquidity arising from these types of financial instruments is represented by the contractual notional amount of the instrument. Asset liquidity is provided by cash and assets which are readily marketable or which will mature in the near future. Liquid assets include cash, federal funds sold, and short-term investments in time deposits in banks. Liquidity is also provided by access to funding sources, which include core depositors and correspondent banks that maintain accounts with and sell federal funds to our subsidiary bank. Other sources of funds include our ability to borrow from short-term sources, such as purchasing federal funds from correspondent banks, sales of securities under agreements to repurchase and advances from the FHLB, which amounted to $513.76 million at September 30, 2016, and an unfunded $25.00 million revolving line of credit established with Frost Bank, a nonaffiliated bank, which matures in June 2017 (see next paragraph). Our subsidiary bank also has federal funds purchased lines of credit with two non-affiliated banks totaling $130.00 million. At September 30, 2016, no amounts were drawn on these lines of credit. Our subsidiary bank also has available a line of credit with the FHLB totaling $1.12 billion, at September 30, 2016, secured by portions of our loan portfolio and certain investment securities. At September 30, 2016, $160.00 million in advances were outstanding under this line of credit.

The Company renewed its loan agreement, effective June 30, 2015, with Frost Bank. Under the loan agreement, as renewed and amended, we are permitted to draw up to $25.00 million on a revolving line of credit. Prior to June 30, 2017, interest is paid quarterly at *The Wall Street Journal* Prime Rate and the line of credit matures June 30, 2017. If a balance exists at June 30, 2017, the principal balance converts to a term facility payable quarterly over five years and interest is paid quarterly at our election at *The Wall Street Journal* Prime Rate plus 50 basis points or LIBOR plus 250 basis points. The line of credit is unsecured. Among other provisions in the credit agreement, we must satisfy certain financial covenants during the term of the loan agreement, including, without limitation, covenants that require us to maintain certain capital, tangible net worth, loan loss reserve, non-performing asset and cash flow coverage ratios. In addition, the credit agreement contains certain operational covenants, which among others, restricts the payment of dividends above 55% of consolidated net income, limits the incurrence of debt (excluding any amounts acquired in an acquisition) and prohibits the disposal of assets except in the ordinary course of business. Since 1995, we have historically declared dividends as a percentage of our consolidated net income in a range of 37% (low) in 1995 to 53% (high) in 2003 and 2006. The Company was in compliance with the financial and operational covenants at September 30, 2016. There was no outstanding balance under the line of credit as of

September 30, 2016 or December 31, 2015.

In addition, we anticipate that future acquisitions of financial institutions, expansion of branch locations or offerings of new products could also place a demand on our cash resources. Available cash and cash equivalents at our parent company which totaled $81.85 million at September 30, 2016, investment securities which totaled $11.95 million at September 30, 2016 and mature over 7 to 14 years, available dividends from our subsidiaries which totaled $166.77 million at September 30, 2016, utilization of available lines of credit, and future debt or equity offerings are expected to be the source of funding for these potential acquisitions or expansions.

Our liquidity position is continuously monitored and adjustments are made to the balance between sources and uses of funds as deemed appropriate. Liquidity risk management is an important element in our asset/liability management process. We regularly model liquidity stress scenarios to assess potential liquidity outflows or funding problems resulting from economic disruptions, volatility in the financial markets, unexpected credit events or other significant occurrences deemed potentially problematic by management. These scenarios are incorporated into our contingency funding plan, which provides the basis for the identification of our liquidity needs. As of September 30, 2016, management is not aware of any events that are reasonably likely to have a material adverse effect on our liquidity, capital resources or operations. Given the strong core deposit base and relatively low loan to deposit ratios maintained at our subsidiary bank, we consider our current liquidity position to be adequate to meet our short-term and long-term liquidity needs. In addition, management is not aware of any regulatory recommendations regarding liquidity, that would have a material adverse effect on us.

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

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

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

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

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Table 10 Commitments as of September 30, 2016 (in thousands):

	Total Notional Amounts Committed
Unfunded lines of credit	$ 539,957
Unfunded commitments to extend credit	227,161
Standby letters of credit	23,327
Total commercial commitments	$ 790,445

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

Parent Company Funding. Our ability to fund various operating expenses, dividends, and cash acquisitions is generally dependent on our own earnings (without giving effect to our subsidiaries), cash reserves and funds derived from our subsidiaries. These funds historically have been produced by intercompany dividends and management fees that are limited to reimbursement of actual expenses. We anticipate that our recurring cash sources will continue to include dividends and management fees from our subsidiaries. At September 30, 2016, approximately $166.77 million was available for the payment of intercompany dividends by our subsidiaries without the prior approval of regulatory agencies. Our subsidiaries paid aggregate dividends of $25.60 million and $28.00 million for the nine-month periods ended September 30, 2016 and 2015, respectively.

Dividends. Our long-term dividend policy is to pay cash dividends to our shareholders of approximately 40% of annual net earnings while maintaining adequate capital to support growth. We are also restricted by a loan covenant within our line of credit agreement with Frost Bank to dividend no greater than 55% of net income, as defined in such loan agreement. The cash dividend payout ratios have amounted to 43.98% and 39.63% of net earnings for the first nine months of 2016 and 2015, respectively. Given our current capital position and projected earnings and asset growth rates, we do not anticipate any significant change in our current dividend policy.

Our bank subsidiary, which is a national banking association and a member of the Federal Reserve System, is required by federal law to obtain the prior approval of the OCC to declare and pay dividends if the total of all dividends declared in any calendar year would exceed the total of (1) such bank s net profits (as defined and interpreted by regulation) for that year plus (2) its retained net profits (as defined and interpreted by regulation) for the preceding two calendar years, less any required transfers to surplus.

To pay dividends, we and our subsidiary bank must maintain adequate capital above regulatory guidelines. In addition, if the applicable regulatory authority believes that a bank under its jurisdiction is engaged in or is about to engage in an unsafe or unsound practice (which, depending on the financial condition of the bank, could include the payment of dividends), the authority may require, after notice and hearing, that such bank cease and desist from the unsafe practice. The Federal Reserve, the FDIC and the OCC have each indicated that paying dividends that deplete a bank s capital base to an inadequate level would be an unsafe and unsound banking practice. The Federal Reserve, the OCC and the FDIC have issued policy statements that recommend that bank holding companies and insured banks should generally only pay dividends out of current operating earnings.

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Item 3. Quantitative and Qualitative Disclosures About Market Risk

Management considers interest rate risk to be a significant market risk for the Company. See Item 2 - Management s Discussion and Analysis of Financial Condition and Results of Operations Capital Resources - Interest Rate Risk for disclosure regarding this market risk.

Item 4. Controls and Procedures

As of September 30, 2016, we carried out an evaluation, under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, of the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rule 13a-15(e) or 15d-15(e) of the Securities Exchange Act of 1934). Our management, which includes our principal executive officer and our principal financial officer, does not expect that our disclosure controls and procedures will prevent all errors and all fraud.

A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within the Company have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty and that breakdowns can occur because of simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the control. The design of any system of controls also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions; over time, controls may become inadequate because of changes in conditions or the degree of compliance with the policies or procedures may deteriorate. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected. Our principal executive officer and principal financial officer have concluded, based on our evaluation of our disclosure controls and procedures, that our disclosure controls and procedures were effective at the reasonable assurance level as of September 30, 2016.

Subsequent to our evaluation, there were no significant changes in internal controls over financial reporting or other factors that have materially affected, or are reasonably likely to materially affect, these internal controls.

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PART II

OTHER INFORMATION

Item 1. Legal Proceedings

From time to time we and our subsidiaries are parties to lawsuits arising in the ordinary course of our banking business. However, there are no material pending legal proceedings to which we, our subsidiaries, or any of their properties, are currently subject. Other than regular, routine examinations by state and federal banking authorities, there are no proceedings pending or known to be contemplated by any governmental authorities.

Item 1A. Risk Factors

There has been no material change in the risk factors previously disclosed under Item 1A. of the Company s 2015 Annual Report on Form 10-K.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

None

Item 3. Defaults Upon Senior Securities

Not Applicable

Item 4. Mine Safety Disclosures

Not Applicable

Item 5. Other Information

None

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Item 6. Exhibits

The following exhibits are filed as part of this report:

2.1	Agreement and Plan of Merger between First Financial Bankshares, Inc., First Financial Bank, N.A., FBC Bancshares, Inc. and First Bank, N.A., Conroe, Texas, dated as of April 1, 2015 (Schedules have been omitted pursuant to Item 601(b)(2) of Regulation S-K) (incorporated by reference from Exhibit 2.1 to Registrant s Form 8-K filed April 3, 2015).
3.1	Amended and Restated Certificate of Formation (incorporated by reference from Exhibit 3.1 of the Registrant s Form 8-K filed April 28, 2015).
3.2	Amended and Restated Bylaws of the Registrant (incorporated by reference from Exhibit 3.2 of the Registrant s Form 8-K filed January 24, 2012).
4.1	Specimen certificate of First Financial Common Stock (incorporated by reference from Exhibit 3 of the Registrant s Amendment No. 1 to Form 8-A filed on Form 8-A/A No. 1 on January 7, 1994).
10.1	2002 Incentive Stock Option Plan (incorporated by reference from Exhibit 10.3 of the Registrant s Form 10-Q filed May 4, 2010)++
10.2	2012 Incentive Stock Option Plan (incorporated by reference from Appendix A of the Registrant s Definitive Proxy Statement Pursuant to Section 14(a) of the Securities Exchange Act of 1934 filed March 1, 2012).++
10.3	Loan agreement dated September 30, 2013, between First Financial Bankshares, Inc. and Frost Bank (incorporated by reference from Exhibit 10.1 of the Registrant s Form 8-K filed July 1, 2013).
10.4	First Amendment to Loan Agreement, dated September 30, 2015, between First Financial Bankshares Inc. and Frost Bank (incorporated by reference from Exhibit 10.1 of the Registrant s Form 8-K filed September 30, 2015).
10.5	2015 Restricted Stock Plan (incorporated by reference from Appendix A of the Registrant s Definitive Proxy Statement Pursuant to Section 14(a) of the Securities Exchange Act of 1934 filed March 2, 2015).++
10.6	Executive Recognition Agreement (incorporated by reference from Exhibit 10.1 of the Registrant s Form 8-K filed August 26, 2016).++
31.1	Rule 13a-14(a) / 15(d)-14(a) Certification of Chief Executive Officer of First Financial Bankshares, Inc.*
31.2	Rule 13a-14(a) / 15(d)-14(a) Certification of Chief Financial Officer of First Financial Bankshares, Inc.*
32.1	Section 1350 Certification of Chief Executive Officer of First Financial Bankshares, Inc.*
32.2	Section 1350 Certification of Chief Financial Officer of First Financial Bankshares, Inc.*
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

\+ Furnished herewith. This Exhibit shall not deemed filed for purposes of Section 18 of the Securities Exchange Act of 1934, or otherwise subject to the liability of that section, and shall not be deemed to be incorporated into any filing under the Securities Act of 1933 or the Securities Exchange Act of 1934.

++ Management contract or compensatory plan on arrangement.

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SIGNATURES

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

	FIRST FINANCIAL BANKSHARES, INC.
Date: October 25, 2016	**By: /s/ F. Scott Dueser** **F. Scott Dueser** **President and Chief Executive Officer**
Date: October 25, 2016	**By: /s/ J. Bruce Hildebrand** **J. Bruce Hildebrand** **Executive Vice President and Chief Financial Officer**