

SOUTHSIDE BANCSHARES INC  
Form 10-Q  
November 08, 2011

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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended September 30, 2011

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number 0-12247

SOUTHSIDE BANCSHARES, INC.

(Exact name of registrant as specified in its charter)

TEXAS

(State or other jurisdiction of incorporation  
or organization)

75-1848732

(I.R.S. Employer Identification No.)

1201 S. Beckham, Tyler, Texas

(Address of principal executive offices)

75701

(Zip Code)

903-531-7111

(Registrant's telephone number, including area code)

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  No

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 (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

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. (Check one):

|   |  |
|---|--|
| Large accelerated filer <input type="radio"/> | Accelerated filer <input checked="" type="radio"/> |
| Non-accelerated filer <input type="radio"/>   | Smaller reporting company <input type="radio"/>    |

(Do not check if a smaller reporting company)

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes  No

The number of shares of the issuer's common stock, par value \$1.25, outstanding as of October 31, 2011 was 16,465,690 shares.

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ITEM 1. FINANCIAL STATEMENTSSOUTHSIDE BANCSHARES, INC. AND SUBSIDIARIES  
CONSOLIDATED BALANCE SHEETS  
(UNAUDITED)  
(in thousands, except share amounts)

|   | September 30,<br>2011 | December 31,<br>2010 |
|---|-----------------------|----------------------|
| <b>ASSETS</b>                                     |                       |                      |
| Cash and due from banks                           | \$ 42,527             | \$ 56,188            |
| Interest earning deposits                         | 4,604                 | 22,885               |
| Total cash and cash equivalents                   | 47,131                | 79,073               |
| Investment securities:                            |                       |                      |
| Available for sale, at estimated fair value       | 304,994               | 299,344              |
| Held to maturity, at amortized cost               | 1,496                 | 1,495                |
| Mortgage-backed and related securities:           |                       |                      |
| Available for sale, at estimated fair value       | 1,263,528             | 946,043              |
| Held to maturity, at amortized cost               | 389,178               | 417,862              |
| FHLB stock, at cost                               | 29,057                | 34,712               |
| Other investments, at cost                        | 2,064                 | 2,064                |
| Loans held for sale                               | 5,491                 | 6,583                |
| Loans:  |                       |                      |
| Loans   | 1,040,471             | 1,077,920            |
| Less: allowance for loan losses                   | (18,189 )             | (20,711 )            |
| Net Loans   | 1,022,282             | 1,057,209            |
| Premises and equipment, net                       | 50,481                | 50,144               |
| Goodwill  | 22,034                | 22,034               |
| Other intangible assets, net                      | 580                   | 777                  |
| Interest receivable                               | 15,957                | 18,033               |
| Deferred tax asset                                | -                     | 6,677                |
| Other assets                                      | 56,006                | 57,571               |
| <b>TOTAL ASSETS</b>                               | <b>\$ 3,210,279</b>   | <b>\$ 2,999,621</b>  |
| <b>LIABILITIES AND EQUITY</b>                     |                       |                      |
| Deposits:   |                       |                      |
| Noninterest bearing                               | \$ 477,128            | \$ 423,304           |
| Interest bearing                                  | 1,816,632             | 1,711,124            |
| Total Deposits                                    | 2,293,760             | 2,134,428            |
| Short-term obligations:                           |                       |                      |
| Federal funds purchased and repurchase agreements | 2,997                 | 3,844                |
| FHLB advances                                     | 287,204               | 189,094              |
| Other obligations                                 | 2,226                 | 2,651                |
| Total Short-term obligations                      | 292,427               | 195,589              |
| Long-term obligations:                            |                       |                      |
| FHLB advances                                     | 275,458               | 373,479              |
| Long-term debt                                    | 60,311                | 60,311               |
| Total Long-term obligations                       | 335,769               | 433,790              |
| Deferred tax liability                            | 7,030                 | -                    |
| Other liabilities                                 | 23,150                | 20,378               |

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|  |              |              |
|--|--------------|--------------|
| TOTAL LIABILITIES  | 2,952,136    | 2,784,185    |
| Off-Balance-Sheet Arrangements, Commitments and Contingencies (Note 10)  |              |              |
| Shareholders' equity:  |              |              |
| Common stock - \$1.25 par, 40,000,000 shares authorized, 18,489,528 shares issued in 2011 and 17,660,312 shares issued in 2010 | 23,112       | 22,075       |
| Paid-in capital  | 176,086      | 162,877      |
| Retained earnings  | 70,028       | 64,567       |
| Treasury stock (2,023,838 shares at cost)  | (28,377 )    | (28,377 )    |
| Accumulated other comprehensive income (loss)  | 17,294       | (6,819 )     |
| TOTAL SHAREHOLDERS' EQUITY   | 258,143      | 214,323      |
| Noncontrolling interest  | –            | 1,113        |
| TOTAL EQUITY   | 258,143      | 215,436      |
| TOTAL LIABILITIES AND EQUITY   | \$ 3,210,279 | \$ 2,999,621 |

The accompanying notes are an integral part of these consolidated financial statements.

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SOUTHSIDE BANCSHARES, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF INCOME  
(UNAUDITED)  
(in thousands, except per share data)

|   | Three Months        |           | Nine Months         |           |
|---|---------------------|-----------|---------------------|-----------|
|   | Ended September 30, |           | Ended September 30, |           |
|   | 2011                | 2010      | 2011                | 2010      |
| Interest income   |                     |           |                     |           |
| Loans   | \$ 16,229           | \$ 16,926 | \$ 50,630           | \$ 52,128 |
| Investment securities – taxable   | 11                  | 20        | 49                  | 72        |
| Investment securities – tax-exempt                                      | 3,069               | 2,366     | 9,507               | 8,209     |
| Mortgage-backed and related securities                                  | 13,292              | 13,378    | 37,899              | 37,937    |
| FHLB stock and other investments  | 50                  | 59        | 182                 | 200       |
| Other interest earning assets   | 2                   | 4         | 15                  | 19        |
| Total interest income   | 32,653              | 32,753    | 98,282              | 98,565    |
| Interest expense  |                     |           |                     |           |
| Deposits  | 3,879               | 4,874     | 11,966              | 14,612    |
| Short-term obligations  | 1,643               | 2,086     | 5,077               | 5,633     |
| Long-term obligations   | 3,115               | 4,504     | 10,397              | 14,585    |
| Total interest expense  | 8,637               | 11,464    | 27,440              | 34,830    |
| Net interest income   | 24,016              | 21,289    | 70,842              | 63,735    |
| Provision for loan losses   | 1,454               | 3,201     | 5,452               | 9,328     |
| Net interest income after provision for loan losses                     | 22,562              | 18,088    | 65,390              | 54,407    |
| Noninterest income  |                     |           |                     |           |
| Deposit services  | 4,098               | 4,280     | 12,005              | 12,744    |
| Gain on sale of securities available for sale                           | 3,863               | 8,008     | 9,672               | 23,024    |
| Total other-than-temporary impairment losses                            | –                   | –         | –                   | (39)      |
| Portion of loss recognized in other comprehensive income (before taxes) | –                   | –         | –                   | (36)      |
| Net impairment losses recognized in earnings                            | –                   | –         | –                   | (75)      |
| Gain on sale of loans   | 402                 | 517       | 967                 | 1,197     |
| Trust income  | 672                 | 645       | 1,968               | 1,736     |
| Bank owned life insurance income  | 288                 | 297       | 835                 | 867       |
| Other   | 957                 | 931       | 3,021               | 2,728     |
| Total noninterest income  | 10,280              | 14,678    | 28,468              | 42,221    |
| Noninterest expense   |                     |           |                     |           |
| Salaries and employee benefits  | 11,280              | 10,891    | 34,593              | 33,048    |
| Occupancy expense   | 1,866               | 1,720     | 5,365               | 5,025     |
| Equipment expense   | 540                 | 532       | 1,558               | 1,441     |
| Advertising, travel & entertainment                                     | 591                 | 616       | 1,694               | 1,697     |
| ATM and debit card expense  | 235                 | 223       | 716                 | 602       |
| Director fees   | 193                 | 197       | 584                 | 590       |
| Supplies  | 186                 | 189       | 571                 | 665       |
| Professional fees   | 571                 | 418       | 1,583               | 1,363     |
| Postage   | 178                 | 195       | 543                 | 612       |
| Telephone and communications  | 285                 | 349       | 967                 | 1,068     |

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|  |          |          |          |          |
|--|----------|----------|----------|----------|
| FDIC Insurance   | 212      | 804      | 1,710    | 2,172    |
| Other  | 1,559    | 1,521    | 4,660    | 4,803    |
| Total noninterest expense                                    | 17,696   | 17,655   | 54,544   | 53,086   |
| Income before income tax expense                             | 15,146   | 15,111   | 39,314   | 43,542   |
| Provision for income tax expense                             | 3,629    | 3,811    | 8,086    | 10,296   |
| Net income   | 11,517   | 11,300   | 31,228   | 33,246   |
| Less: Net income attributable to the noncontrolling interest | –        | (252 )   | (1,358 ) | (1,301 ) |
| Net income attributable to Southside Bancshares, Inc.        | \$11,517 | \$11,048 | \$29,870 | \$31,945 |
| Earnings per common share – basic                            | \$0.70   | \$0.67   | \$1.82   | \$1.93   |
| Earnings per common share – diluted                          | \$0.70   | \$0.67   | \$1.82   | \$1.93   |
| Dividends paid per common share                              | \$0.18   | \$0.17   | \$0.52   | \$0.51   |

The accompanying notes are an integral part of these consolidated financial statements.

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SOUTHSIDE BANCSHARES, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF CHANGES IN EQUITY  
(UNAUDITED)

(in thousands, except share amounts)

|   | Nine Months Ended<br>September 30, |           |
|---|------------------------------------|-----------|
|   | 2011                               | 2010      |
| <b>Common Stock</b>   |                                    |           |
| Balance, beginning of period  | \$22,075                           | \$20,928  |
| Issuance of common stock (44,352 shares in 2011 and 136,419 shares in 2010)   | 56                                 | 171       |
| Stock dividend declared   | 981                                | 943       |
| Balance, end of period  | 23,112                             | 22,042    |
| <b>Paid-in capital</b>  |                                    |           |
| Balance, beginning of period  | 162,877                            | 146,357   |
| Issuance of common stock (44,352 shares in 2011 and 136,419 shares in 2010)   | 804                                | 1,080     |
| Stock compensation expense  | 143                                | –         |
| Tax benefit of incentive stock options  | 2                                  | 328       |
| Purchase of noncontrolling interest   | (2,754 )                           | –         |
| Stock dividend declared   | 15,014                             | 14,570    |
| Balance, end of period  | 176,086                            | 162,335   |
| <b>Retained earnings</b>  |                                    |           |
| Balance, beginning of period  | 64,567                             | 53,812    |
| Net income attributable to Southside Bancshares, Inc.   | 29,870                             | 31,945    |
| Dividends paid on common stock (\$0.52 per share in 2011 and \$0.51 per share in 2010)  | (8,414 )                           | (7,916 )  |
| Stock dividend declared   | (15,995 )                          | (15,513 ) |
| Balance, end of period  | 70,028                             | 62,328    |
| <b>Treasury Stock</b>   |                                    |           |
| Balance, beginning of period  | (28,377 )                          | (23,545 ) |
| Purchase of common stock (255,377 shares in 2010)   | –                                  | (4,716 )  |
| Balance, end of period  | (28,377 )                          | (28,261 ) |
| <b>Accumulated other comprehensive income (loss)</b>  |                                    |           |
| Balance, beginning of period  | (6,819 )                           | 4,229     |
| Net unrealized gains on available for sale securities, net of tax   | 29,707                             | 13,669    |
| Reclassification adjustment for gains on sales of available for sale securities included in net income, net of tax              | (6,287 )                           | (14,966 ) |
| Noncredit portion of other-than-temporary impairment losses on available for sale securities, net of tax                        | –                                  | 23        |
| Reclassification of other-than-temporary impairment charges on available for sale securities included in net income, net of tax | –                                  | 49        |
| Adjustment to net periodic benefit cost, net of tax   | 693                                | 611       |
| Net change in accumulated other comprehensive income (loss)   | 24,113                             | (614 )    |
| Balance, end of period  | 17,294                             | 3,615     |
| <b>Total shareholders' equity</b>   |                                    |           |
|   | 258,143                            | 222,059   |
| <b>Noncontrolling interest</b>  |                                    |           |
| Balance, beginning of period  | 1,113                              | 468       |
| Net income attributable to noncontrolling interest shareholders   | 1,358                              | 1,301     |
| Capital distribution to noncontrolling interest shareholders  | (475 )                             | (310 )    |
| Purchase of noncontrolling interest   | (1,996 )                           | –         |



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|  |           |           |
|--|-----------|-----------|
| Balance, end of period   | –         | 1,459     |
| Total equity   | \$258,143 | \$223,518 |
| <b>Comprehensive income</b>                                      |           |           |
| Net income   | \$31,228  | \$33,246  |
| Net change in accumulated other comprehensive income (loss)      | 24,113    | (614 )    |
| Comprehensive income   | 55,341    | 32,632    |
| Comprehensive income attributable to the noncontrolling interest | (1,358 )  | (1,301 )  |
| Comprehensive income attributable to Southside Bancshares, Inc.  | \$53,983  | \$31,331  |

The accompanying notes are an integral part of these consolidated financial statements.

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SOUTHSIDE BANCSHARES, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF CASH FLOWS  
(UNAUDITED)  
(in thousands)

Nine Months Ended  
September 30,  
2011                      2010

## OPERATING ACTIVITIES:

|   |           |           |
|---|-----------|-----------|
| Net income  | \$ 31,228 | \$ 33,246 |
| Adjustments to reconcile net income to net cash provided by operations: |           |           |
| Depreciation  | 2,515     | 2,397     |
| Amortization of premium   | 26,175    | 25,982    |
| Accretion of discount and loan fees                                     | (3,386 )  | (3,497 )  |
| Provision for loan losses   | 5,452     | 9,328     |
| Stock compensation expense  | 143       | –         |
| Decrease in interest receivable   | 2,076     | 3,417     |
| Increase in other assets  | (2,413 )  | (4,726 )  |
| Net change in deferred taxes  | 723       | 998       |
| Decrease in interest payable  | (861 )    | (696 )    |
| Increase in other liabilities   | 3,598     | 3,504     |
| Decrease (increase) in loans held for sale                              | 1,092     | (3,241 )  |
| Gain on sale of securities available for sale                           | (9,672 )  | (23,024 ) |
| Net other-than-temporary impairment losses                              | –         | 75        |
| Loss (gain) on sale of assets   | 3         | (7 )      |
| Loss on retirement of assets  | 90        | –         |
| Impairment on other real estate owned                                   | 184       | 20        |
| Gain on sale of other real estate owned                                 | (242 )    | (26 )     |
| Net cash provided by operating activities                               | 56,705    | 43,750    |

## INVESTING ACTIVITIES:

|   |             |             |
|---|-------------|-------------|
| Proceeds from sales of investment securities available for sale           | 54,351      | 103,953     |
| Proceeds from sales of mortgage-backed securities available for sale      | 642,943     | 956,496     |
| Proceeds from maturities of investment securities available for sale      | 15,622      | 17,271      |
| Proceeds from maturities of investment securities held to maturity        | 500         | –           |
| Proceeds from maturities of mortgage-backed securities available for sale | 209,828     | 263,335     |
| Proceeds from maturities of mortgage-backed securities held to maturity   | 35,376      | 55,656      |
| Proceeds from redemption of FHLB stock                                    | 16,461      | 2,638       |
| Purchases of investment securities available for sale                     | (42,576 )   | (75,697 )   |
| Purchases of investment securities held to maturity                       | (500 )      | –           |
| Purchases of mortgage-backed securities available for sale                | (1,177,556) | (1,026,453) |
| Purchases of mortgage-backed securities held to maturity                  | (11,375 )   | (258,935 )  |
| Purchases of FHLB stock and other investments                             | (10,806 )   | (139 )      |
| Net decrease (increase) in loans  | 27,344      | (15,193 )   |
| Purchases of premises and equipment                                       | (2,951 )    | (5,582 )    |
| Proceeds from sales of premises and equipment                             | 6           | 38          |
| Proceeds from sales of other real estate owned                            | 676         | 948         |
| Proceeds from sales of repossessed assets                                 | 3,933       | 3,713       |
| Net cash (used in) provided by investing activities                       | (238,724 )  | 22,049      |

The accompanying notes are an integral part of these consolidated financial statements.

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SOUTHSIDE BANCSHARES, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF CASH FLOWS (continued)  
(UNAUDITED)  
(in thousands)

|  | Nine Months Ended<br>September 30, |             |
|--|------------------------------------|-------------|
|  | 2011                               | 2010        |
| <b>FINANCING ACTIVITIES:</b>   |                                    |             |
| Net increase in demand and savings accounts                                    | 133,513                            | 117,405     |
| Net increase in certificates of deposit  | 30,099                             | 49,927      |
| Net decrease in federal funds purchased and repurchase agreements              | (847 )                             | (9,514 )    |
| Proceeds from FHLB advances  | 8,005,080                          | 6,119,530   |
| Repayment of FHLB advances   | (8,004,991)                        | (6,304,778) |
| Net capital distributions to noncontrolling interest in consolidated entities  | (475 )                             | (310 )      |
| Purchase of noncontrolling interest  | (4,750 )                           | –           |
| Tax benefit of incentive stock options   | 2                                  | 328         |
| Purchase of common stock   | –                                  | (4,716 )    |
| Proceeds from the issuance of common stock                                     | 860                                | 1,251       |
| Dividends paid   | (8,414 )                           | (7,916 )    |
| Net cash provided by (used in) financing activities                            | 150,077                            | (38,793 )   |
| Net (decrease) increase in cash and cash equivalents                           | (31,942 )                          | 27,006      |
| Cash and cash equivalents at beginning of period                               | 79,073                             | 52,166      |
| Cash and cash equivalents at end of period                                     | \$47,131                           | \$79,172    |
| <b>SUPPLEMENTAL DISCLOSURES FOR CASH FLOW INFORMATION:</b>                     |                                    |             |
| Interest paid  | \$28,301                           | \$35,525    |
| Income taxes paid  | 6,500                              | 9,550       |
| <b>SUPPLEMENTAL DISCLOSURES OF NONCASH INVESTING AND FINANCING ACTIVITIES:</b> |                                    |             |
| Acquisition of other repossessed assets and real estate through foreclosure    | \$4,790                            | \$5,416     |
| 5% stock dividend  | 15,995                             | 15,513      |
| Adjustment to pension liability  | (1,066 )                           | (939 )      |
| Unsettled trades to purchase securities  | –                                  | (18,160 )   |
| Unsettled trades to sell securities  | –                                  | 18,723      |

The accompanying notes are an integral part of these consolidated financial statements.

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SOUTHSIDE BANCSHARES, INC. AND SUBSIDIARIES  
NOTES TO FINANCIAL STATEMENTS

1. Basis of Presentation

In this report, the words “the Company,” “we,” “us,” and “our” refer to the combined entities of Southside Bancshares, Inc. and its subsidiaries. The words “Southside” and “Southside Bancshares” refer to Southside Bancshares, Inc. The words “Southside Bank” and “the Bank” refer to Southside Bank (which, subsequent to the internal merger of Fort Worth National Bank (“FWNB”) with and into Southside Bank, includes FWNB). “FWBS” refers to Fort Worth Bancshares, Inc., a bank holding company acquired by Southside of which FWNB was a wholly-owned subsidiary. “SFG” refers to Southside Financial Group, LLC, of which Southside Bank owns a 100% interest as of September 30, 2011. On July 15, 2011, Southside Bank acquired the remaining 50% interest in SFG increasing our ownership to 100%. The purchase price was \$4.8 million and resulted in a decrease to shareholders’ equity of approximately \$2.8 million and the elimination of the noncontrolling interest. SFG is consolidated in our financial statements and this purchase will not limit or change our ability to allocate capital.

The consolidated balance sheet as of September 30, 2011, and the related consolidated statements of income, equity and cash flows and notes to the financial statements for the three and nine month periods ended September 30, 2011 and 2010 are unaudited; in the opinion of management, all adjustments necessary for a fair statement of such financial statements have been included. Such adjustments consisted only of normal recurring items. All significant intercompany accounts and transactions are eliminated in consolidation. The preparation of these consolidated financial statements in conformity with U.S. generally accepted accounting principles (“GAAP”) requires the use of management’s estimates. These estimates are subjective in nature and involve matters of judgment. Actual amounts could differ from these estimates.

Interim results are not necessarily indicative of results for a full year. These financial statements should be read in conjunction with the financial statements and notes thereto in our Annual Report on Form 10-K for the year ended December 31, 2010. All share data has been adjusted to give retroactive recognition to stock splits and stock dividends. For a description of our significant accounting and reporting policies, refer to Note 1 of the Notes to Financial Statements in our Annual Report on Form 10-K for the year ended December 31, 2010.

Accounting Standards

ASU No. 2011-01, “Deferral of the Effective Date of Disclosures about Troubled Debt Restructurings in Update No. 2010-20 (Topic 310)”, was issued January 2011 deferring the new disclosure requirements (paragraphs 310-10-50-31 through 50-34 of the FASB Accounting Standards Codification) about troubled debt restructurings to be concurrent with the effective date of the guidance for determining what constitutes a troubled debt restructuring, as presented in proposed Accounting Standards Update, Receivables (Topic 310): Clarifications to Accounting for Troubled Debt Restructurings by Creditors. As a result of the issuance of Update 2011-02, the provisions of Update 2011-01 became effective for us on September 30, 2011, and was applied retrospectively to the beginning of the annual period of adoption. The adoption of the Update did not have a material effect on our consolidated financial statements.

ASU No. 2011-02, “Receivables (Topic 310) - A Creditor’s Determination of Whether a Restructuring Is a Troubled Debt Restructuring.” ASU 2011-02 clarifies which loan modifications constitute troubled debt restructurings and is intended to assist creditors in determining whether a modification of the terms of a receivable meets the criteria to be considered a troubled debt restructuring, both for purposes of recording an impairment loss and for disclosure of troubled debt restructurings. In evaluating whether a restructuring constitutes a troubled debt restructuring, a creditor must separately conclude, under the guidance clarified by ASU 2011-02, that both of the following exist: (a) the restructuring constitutes a concession; and (b) the debtor is experiencing financial difficulties. ASU 2011-02 became

effective for us on July 1, 2011, and was applied retrospectively to restructurings occurring on or after January 1, 2011. The adoption of ASU 2011-02 did not have a significant impact on our consolidated financial statements.

ASU No. 2011-03, "Transfers and Servicing (Topic 860) - Reconsideration of Effective Control for Repurchase Agreements." ASU 2011-03 is intended to improve financial reporting of repurchase agreements and other agreements that both entitle and obligate a transferor to repurchase or redeem financial assets before their maturity. ASU 2011-03 removes from the assessment of effective control (i) the criterion requiring the transferor to have the ability to repurchase or redeem the financial assets on substantially the agreed terms, even in the event of default by the transferee, and (ii) the collateral maintenance guidance related to that criterion. ASU 2011-03 will be effective for us on January 1, 2012 and is not expected to have a significant impact on our consolidated financial statements.

ASU 2011-04, "Fair Value Measurement (Topic 820) - Amendments to Achieve Common Fair Value Measurements and Disclosure Requirements in U.S. GAAP and IFRSs." ASU 2011-04 amends Topic 820, "Fair Value Measurements and Disclosures," to converge the fair value measurement guidance in U.S. generally accepted accounting principles and International Financial Reporting Standards. ASU 2011-04 clarifies the application of existing fair value measurement requirements, changes certain principles in Topic 820 and requires additional fair value disclosures. ASU 2011-04 is effective for annual periods beginning after December 15, 2011, and is not expected to have a significant impact on our consolidated financial statements.

ASU 2011-05, "Comprehensive Income (Topic 220) - Presentation of Comprehensive Income." ASU 2011-05 amends Topic 220, "Comprehensive Income," to require that all nonowner changes in stockholders' equity be presented in either a single continuous statement of comprehensive income or in two separate but consecutive statements. Additionally, ASU 2011-05 requires entities to present, on the face of the financial statements, reclassification adjustments for items that are reclassified from other comprehensive income to net income in the statement or statements where the components of net income and the components of other comprehensive income are presented. The option to present components of other comprehensive income as part of the statement of changes in stockholders' equity was eliminated. ASU 2011-05 is effective for annual periods beginning after December 15, 2011, and is not expected to have a significant impact on our consolidated financial statements.

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ASU 2011-08, “Intangibles - Goodwill and Other (Topic 350) - Testing Goodwill for Impairment.” ASU 2011-08 amends Topic 350, “Intangibles – Goodwill and Other,” to give entities the option to first assess qualitative factors to determine whether the existence of events or circumstances leads to a determination that it is more likely than not that the fair value of a reporting unit is less than its carrying amount. If, after assessing the totality of events or circumstances, an entity determines it is not more likely than not that the fair value of a reporting unit is less than its carrying amount, then performing the two-step impairment test is unnecessary. However, if an entity concludes otherwise, then it is required to perform the first step of the two-step impairment test by calculating the fair value of the reporting unit and comparing the fair value with the carrying amount of the reporting unit. ASU 2011-08 is effective for annual and interim impairment tests beginning after December 15, 2011, and is not expected to have a significant impact on our consolidated financial statements.

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## 2. Earnings Per Share

Earnings per share attributable to Southside Bancshares, Inc. on a basic and diluted basis have been adjusted to give retroactive recognition to stock splits and stock dividends and is calculated as follows (in thousands, except per share amounts):

|   | Three Months<br>Ended September 30, |          | Nine Months<br>Ended September 30, |          |
|---|-------------------------------------|----------|------------------------------------|----------|
|   | 2011                                | 2010     | 2011                               | 2010     |
| <b>Basic and Diluted Earnings:</b>          |                                     |          |                                    |          |
| Net income – Southside Bancshares, Inc.     | \$11,517                            | \$11,048 | \$29,870                           | \$31,945 |
| Basic weighted-average shares outstanding   | 16,454                              | 16,543   | 16,439                             | 16,563   |
| Add: Stock options                          | 7                                   | 10       | 7                                  | 35       |
| Diluted weighted-average shares outstanding | 16,461                              | 16,553   | 16,446                             | 16,598   |
| <b>Basic Earnings Per Share:</b>            |                                     |          |                                    |          |
| Net Income - Southside Bancshares, Inc.     | \$0.70                              | \$0.67   | \$1.82                             | \$1.93   |
| <b>Diluted Earnings Per Share:</b>          |                                     |          |                                    |          |
| Net Income - Southside Bancshares, Inc.     | \$0.70                              | \$0.67   | \$1.82                             | \$1.93   |

On March 31, 2011, our board of directors declared a 5% stock dividend to common stock shareholders of record as of April 20, 2011, and payable on May 11, 2011.

During the second quarter, our board of directors approved equity grants in the form of stock options and restricted stock units. These equity grants were made pursuant to the shareholder-approved Southside Bancshares, Inc. 2009 Incentive Plan.

For the three and nine month periods ended September 30, 2011, there were approximately 28,000 and 9,000 antidilutive options, respectively. For the three and nine months ended September 30, 2010, there were no antidilutive options.



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## 3. Comprehensive Income (Loss)

The components of other comprehensive income (loss) are as follows (in thousands):

|  | Nine Months Ended September 30, 2011 |                |                      |
|--|--------------------------------------|----------------|----------------------|
|  | Before-Tax<br>Amount                 | Tax<br>Expense | Net-of-Tax<br>Amount |
| Unrealized gains on securities:                                    |                                      |                |                      |
| Unrealized holding gains arising during period                     | \$45,703                             | \$(15,996 )    | \$29,707             |
| Less: reclassification adjustment for gains included in net income | 9,672                                | (3,385 )       | 6,287                |
| Net unrealized gains on securities                                 | 36,031                               | (12,611 )      | 23,420               |
| Change in pension plans  | 1,066                                | (373 )         | 693                  |
| Other comprehensive income   | \$37,097                             | \$(12,984 )    | \$24,113             |

|  | Three Months Ended September 30,<br>2011 |                |                      |
|--|--|----------------|----------------------|
|  | Before-Tax<br>Amount                     | Tax<br>Expense | Net-of-Tax<br>Amount |
| Unrealized gains on securities:                                    |  |                |                      |
| Unrealized holding gains arising during period                     | \$18,050                                 | \$(6,318 )     | \$11,732             |
| Less: reclassification adjustment for gains included in net income | 3,863                                    | (1,352 )       | 2,511                |
| Net unrealized gains on securities                                 | 14,187                                   | (4,966 )       | 9,221                |
| Change in pension plans  | 355                                      | (124 )         | 231                  |
| Other comprehensive income   | \$14,542                                 | \$(5,090 )     | \$9,452              |

|  | Nine Months Ended September 30, 2010 |                             |                      |
|--|--------------------------------------|-----------------------------|----------------------|
|  | Before-Tax<br>Amount                 | Tax<br>(Expense)<br>Benefit | Net-of-Tax<br>Amount |
| Unrealized losses on securities:   |                                      |                             |                      |
| Unrealized holding gains arising during period   | \$21,029                             | \$(7,360 )                  | \$13,669             |
| Noncredit portion of other-than-temporary impairment losses on the AFS securities                          | 36                                   | (13 )                       | 23                   |
| Less: reclassification adjustment for gains included in net income   | 23,024                               | (8,058 )                    | 14,966               |
| Less: reclassification of other-than-temporary impairment charges on AFS securities included in net income | (75 )                                | 26                          | (49 )                |
| Net unrealized losses on securities  | (1,884 )                             | 659                         | (1,225 )             |
| Change in pension plans  | 939                                  | (328 )                      | 611                  |
| Other comprehensive loss   | \$(945 )                             | \$331                       | \$(614 )             |

|   | Three Months Ended September 30,<br>2010 |                             |                      |
|---|--|-----------------------------|----------------------|
|   | Before-Tax<br>Amount                     | Tax<br>(Expense)<br>Benefit | Net-of-Tax<br>Amount |
| Unrealized losses on securities:  |  |                             |                      |
| Unrealized holding gains arising during period                                    | \$7,170                                  | \$(2,509 )                  | \$4,661              |
| Noncredit portion of other-than-temporary impairment losses on the AFS securities | —  | —                           | —                    |

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|  |          |          |          |
|--|----------|----------|----------|
| Less: reclassification adjustment for gains included in net income   | 8,008    | (2,802 ) | 5,206    |
| Less: reclassification of other-than-temporary impairment charges on AFS securities included in net income | –        | –        | –        |
| Net unrealized losses on securities  | (838 )   | 293      | (545 )   |
| Change in pension plans  | 313      | (109 )   | 204      |
| Other comprehensive loss   | \$(525 ) | \$184    | \$(341 ) |

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## 4. Securities

The amortized cost and estimated market value of investment and mortgage-backed securities as of September 30, 2011 and December 31, 2010, are reflected in the tables below (in thousands):

|                                  | September 30, 2011 |                        |  |         |                      |
|----------------------------------|--------------------|------------------------|--|---------|----------------------|
|                                  | Amortized Cost     | Gross Unrealized Gains | Gross Unrealized Losses Noncredit OTTI | Other   | Estimated Fair Value |
| <b>AVAILABLE FOR SALE:</b>       |                    |                        |  |         |                      |
| Investment Securities:           |                    |                        |  |         |                      |
| State and Political Subdivisions | \$275,170          | \$28,906               | \$-                                    | \$29    | \$304,047            |
| Other Stocks and Bonds           | 2,925              | -                      | 1,978                                  | -       | 947                  |
| Mortgage-backed Securities:      |                    |                        |  |         |                      |
| U.S. Government Agencies         | 145,247            | 7,283                  | -                                      | 114     | 152,416              |
| Government-Sponsored Enterprises | 1,095,417          | 20,949                 | -                                      | 5,254   | 1,111,112            |
| Total                            | \$1,518,759        | \$57,138               | \$1,978                                | \$5,397 | \$1,568,522          |

|                                  | September 30, 2011 |                        |  |       |                      |
|----------------------------------|--------------------|------------------------|--|-------|----------------------|
|                                  | Amortized Cost     | Gross Unrealized Gains | Gross Unrealized Losses Noncredit OTTI | Other | Estimated Fair Value |
| <b>HELD TO MATURITY:</b>         |                    |                        |  |       |                      |
| Investment Securities:           |                    |                        |  |       |                      |
| State and Political Subdivisions | \$1,011            | \$188                  | \$-                                    | \$-   | \$1,199              |
| Other Stocks and Bonds           | 485                | 18                     | -                                      | -     | 503                  |
| Mortgage-backed Securities:      |                    |                        |  |       |                      |
| U.S. Government Agencies         | 24,675             | 1,374                  | -                                      | 75    | 25,974               |
| Government-Sponsored Enterprises | 364,503            | 14,412                 | -                                      | 10    | 378,905              |
| Total                            | \$390,674          | \$15,992               | \$-                                    | \$85  | \$406,581            |

|                                  | December 31, 2010 |                        |  |         |                      |
|----------------------------------|-------------------|------------------------|--|---------|----------------------|
|                                  | Amortized Cost    | Gross Unrealized Gains | Gross Unrealized Losses Noncredit OTTI | Other   | Estimated Fair Value |
| <b>AVAILABLE FOR SALE:</b>       |                   |                        |  |         |                      |
| Investment Securities:           |                   |                        |  |         |                      |
| U.S. Treasury                    | \$4,700           | \$-                    | \$-                                    | \$-     | \$4,700              |
| State and Political Subdivisions | 296,357           | 4,445                  | -                                      | 6,540   | 294,262              |
| Other Stocks and Bonds           | 3,117             | 1                      | 2,736                                  | -       | 382                  |
| Mortgage-backed Securities:      |                   |                        |  |         |                      |
| U.S. Government Agencies         | 149,402           | 5,311                  | -                                      | 179     | 154,534              |
| Government-Sponsored Enterprises | 777,921           | 16,049                 | -                                      | 2,461   | 791,509              |
| Total                            | \$1,231,497       | \$25,806               | \$2,736                                | \$9,180 | \$1,245,387          |

|                                  | December 31, 2010 |                        |  |       |                      |
|----------------------------------|-------------------|------------------------|--|-------|----------------------|
|                                  | Amortized Cost    | Gross Unrealized Gains | Gross Unrealized Losses Noncredit OTTI | Other | Estimated Fair Value |
| <b>HELD TO MATURITY:</b>         |                   |                        |  |       |                      |
| Investment Securities:           |                   |                        |  |       |                      |
| State and Political Subdivisions | \$ 1,012          | \$ 44                  | \$ -                                   | \$ -  | \$ 1,056             |
| Other Stocks and Bonds           | 483               | 14                     | -                                      | -     | 497                  |

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|                                  |            |          |      |        |            |
|----------------------------------|------------|----------|------|--------|------------|
| Mortgage-backed Securities:      |            |          | –    |        |            |
| U.S. Government Agencies         | 21,888     | 631      | –    | 55     | 22,464     |
| Government-Sponsored Enterprises | 395,974    | 8,743    | –    | 609    | 404,108    |
| Total                            | \$ 419,357 | \$ 9,432 | \$ – | \$ 664 | \$ 428,125 |

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The following table represents the unrealized loss on securities for the nine months ended September 30, 2011 and year ended December 31, 2010 (in thousands):

|                           | Less Than 12 Months |                 | More Than 12 Months |                 | Total      |                 |
|---------------------------|---------------------|-----------------|---------------------|-----------------|------------|-----------------|
|                           | Fair Value          | Unrealized Loss | Fair Value          | Unrealized Loss | Fair Value | Unrealized Loss |
| As of September 30, 2011: |                     |                 |                     |                 |            |                 |
| Available for Sale        |                     |                 |                     |                 |            |                 |
| State and Political       |                     |                 |                     |                 |            |                 |
| Subdivisions              | \$ 925              | \$ 12           | \$ 293              | \$ 17           | \$ 1,218   | \$ 29           |
| Other Stocks and Bonds    | –                   | –               | 947                 | 1,978           | 947        | 1,978           |
| Mortgage-Backed           |                     |                 |                     |                 |            |                 |
| Securities                | 533,508             | 5,290           | 6,444               | 78              | 539,952    | 5,368           |
| Total                     | \$ 534,433          | \$ 5,302        | \$ 7,684            | \$ 2,073        | \$ 542,117 | \$ 7,375        |
| Held to Maturity          |                     |                 |                     |                 |            |                 |
| Mortgage-Backed           |                     |                 |                     |                 |            |                 |
| Securities                | \$ 8,661            | \$ 85           | \$ –                | \$ –            | \$ 8,661   | \$ 85           |
| Total                     | \$ 8,661            | \$ 85           | \$ –                | \$ –            | \$ 8,661   | \$ 85           |
| As of December 31, 2010:  |                     |                 |                     |                 |            |                 |
| Available for Sale        |                     |                 |                     |                 |            |                 |
| State and Political       |                     |                 |                     |                 |            |                 |
| Subdivisions              | \$ 136,671          | \$ 6,501        | \$ 270              | \$ 39           | \$ 136,941 | \$ 6,540        |
| Other Stocks and Bonds    | –                   | –               | 189                 | 2,736           | 189        | 2,736           |
| Mortgage-Backed           |                     |                 |                     |                 |            |                 |
| Securities                | 312,985             | 2,475           | 21,779              | 165             | 334,764    | 2,640           |
| Total                     | \$ 449,656          | \$ 8,976        | \$ 22,238           | \$ 2,940        | \$ 471,894 | \$ 11,916       |
| Held to Maturity          |                     |                 |                     |                 |            |                 |
| Mortgage-Backed           |                     |                 |                     |                 |            |                 |
| Securities                | \$ 52,676           | \$ 644          | \$ 1,104            | \$ 20           | \$ 53,780  | \$ 664          |
| Total                     | \$ 52,676           | \$ 644          | \$ 1,104            | \$ 20           | \$ 53,780  | \$ 664          |

When it is determined that a decline in fair value of Held to Maturity (“HTM”) and Available for Sale (“AFS”) securities is other-than-temporary, the carrying value of the security is reduced to its estimated fair value, with a corresponding charge to earnings for the credit portion and the noncredit portion to other comprehensive income. In estimating other-than-temporary impairment losses, management considers, among other things, the length of time and the extent to which the fair value has been less than cost and the financial condition and near-term prospects of the issuer. Additionally, we do not currently intend to sell the securities and it is not more likely than not that we will be required to sell the security before the anticipated recovery of its amortized cost basis.

The turmoil in the capital markets had a significant impact on our estimate of fair value for certain of our securities. We believe the market values are reflective of illiquidity and credit impairment. At September 30, 2011, we have in AFS Other Stocks and Bonds, \$2.9 million amortized cost basis in pooled trust preferred securities

("TRUPs"). Those securities are structured products with cash flows dependent upon securities issued by U.S. financial institutions, including banks and insurance companies. Our estimate of fair value at September 30, 2011 for the TRUPs is approximately \$947,000 and reflects the market illiquidity. With the exception of the TRUPs, to the best of management's knowledge and based on our consideration of the qualitative factors associated with each security, there were no securities in our investment and mortgage-backed securities portfolio at September 30, 2011 with an other-than-temporary impairment.

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Given the facts and circumstances associated with the TRUPs we performed detailed cash flow modeling for each TRUP using an industry-accepted cash flow model. Prior to loading the required assumptions into the model we reviewed the financial condition of each of the underlying issuing banks within the TRUP collateral pool that had not deferred or defaulted as of September 30, 2011. Management's best estimate of a deferral assumption was assigned to each issuing bank based on the category in which it fell. Our analysis of the underlying cash flows contemplated various default, deferral and recovery scenarios to arrive at our best estimate of cash flows. Based on that detailed analysis, we have concluded that the other-than-temporary impairment, which captures the credit component in compliance with FASB ASC Topic 320, "Investments – Debt and Equity Securities," was estimated at \$3.1 million at both September 30, 2011 and December 31, 2010. The noncredit charge to other comprehensive income was estimated at \$2.0 million and \$2.7 million at September 30, 2011 and December 31, 2010, respectively. The carrying amount of the TRUPs was written down with \$75,000 and \$3.0 million recognized in earnings for the nine months ended September 30, 2010 and for the year ended December 31, 2009, respectively. There was no additional write-down of the TRUPs recognized in earnings for the nine months ended September 30, 2011. The cash flow model assumptions represent management's best estimate and consider a variety of qualitative factors, which include, among others, the credit rating downgrades, the severity and duration of the mark-to-market loss, and the structural nuances of each TRUP. Management believes that the detailed review of the collateral and cash flow modeling support the conclusion that the TRUPs had an other-than-temporary impairment at September 30, 2011. We will continue to update our assumptions and the resulting analysis each reporting period to reflect changing market conditions. Additionally, we do not currently intend to sell the TRUPs and it is not more likely than not that we will be required to sell the TRUPs before the anticipated recovery of their amortized cost basis.

The table below provides more detail on the TRUPs at September 30, 2011 (in thousands).

| TRUP | Par      | Credit Loss | Amortized Cost | Fair Value | Tranche | Credit Rating |
|------|----------|-------------|----------------|------------|---------|---------------|
| 1    | \$ 2,000 | \$ 1,075    | \$ 925         | \$ 300     | C1      | Ca            |
| 2    | 2,000    | 550         | 1,450          | 348        | B1      | C             |
| 3    | 2,000    | 1,450       | 550            | 299        | B2      | C             |
|      | \$ 6,000 | \$ 3,075    | \$ 2,925       | \$ 947     |         |               |

The following table presents the impairment activity related to credit loss, which is recognized in earnings, and the impairment activity related to all other factors, which are recognized in other comprehensive income (in thousands).

|   | Nine Months Ended September 30, 2011 |   |                  |
|---|--------------------------------------|---|------------------|
|   | Impairment Related to Credit Loss    | Impairment Related to All Other Factors | Total Impairment |
| Balance, beginning of the period  | \$3,075                              | \$2,694                                 | \$ 5,769         |
| Charges on securities for which other-than-temporary impairment charges were not previously recognized        | –                                    | –                                       | –                |
| Additional charges on securities for which other-than-temporary impairment charges were previously recognized | –                                    | –                                       | –                |
| Balance, end of the period  | \$3,075                              | \$2,694                                 | \$ 5,769         |

Three Months Ended September 30,  
2011

|   | Impairment<br>Related to<br>Credit Loss | Impairment<br>Related to<br>All Other<br>Factors | Total<br>Impairment |
|---|---|--|---------------------|
| Balance, beginning of the period  | \$3,075                                 | \$2,694  | \$5,769             |
| Charges on securities for which other-than-temporary impairment charges were not previously recognized        | –                                       | –  | –                   |
| Additional charges on securities for which other-than-temporary impairment charges were previously recognized | –                                       | –  | –                   |
| Balance, end of the period  | \$3,075                                 | \$2,694  | \$5,769             |



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Interest income recognized on AFS and HTM securities for the periods presented (in thousands):

|                                     | Nine Months Ended  |                    |
|-------------------------------------|--------------------|--------------------|
|                                     | September 30, 2011 | September 30, 2010 |
| U.S. Treasury                       | \$6                | \$ 7               |
| State and Political Subdivisions    | 9,525              | 8,239              |
| Other Stocks and Bonds              | 25                 | 35                 |
| Mortgage-backed Securities          | 37,899             | 37,937             |
| Total interest income on securities | \$47,455           | \$ 46,218          |

|                                     | Three Months Ended |                    |
|-------------------------------------|--------------------|--------------------|
|                                     | September 30, 2011 | September 30, 2010 |
| U.S. Treasury                       | \$-                | \$ 3               |
| State and Political Subdivisions    | 3,073              | 2,375              |
| Other Stocks and Bonds              | 7                  | 8                  |
| Mortgage-backed Securities          | 13,292             | 13,378             |
| Total interest income on securities | \$16,372           | \$ 15,764          |

There were no securities transferred from AFS to HTM during the nine months ended September 30, 2011 or 2010. There were no sales from the HTM portfolio during the nine months ended September 30, 2011 or 2010. There were \$390.7 million of securities classified as HTM at September 30, 2011 compared to \$419.4 million of securities classified as HTM at December 31, 2010.

Of the \$9.7 million in net securities gains from the AFS portfolio for the nine months ended September 30, 2011, there were \$10.2 million in realized gains and \$486,000 in realized losses. Of the \$23.0 million in net securities gains from the AFS portfolio for the nine months ended September 30, 2010, there were \$25.5 million in realized gains and \$2.5 million in realized losses.

The amortized cost and fair value of securities at September 30, 2011 are presented below by contractual maturity. Expected maturities may differ from contractual maturities because issuers may have the right to call or prepay obligations. Mortgage-backed securities are presented in total by category due to the fact that mortgage-backed securities typically are issued with stated principal amounts, and the securities are backed by pools of mortgages that have loans with varying maturities. The characteristics of the underlying pool of mortgages, such as fixed-rate or adjustable-rate, as well as prepayment risk, are passed on to the certificate holder. The term of a mortgage-backed pass-through security thus approximates the term of the underlying mortgages and can vary significantly due to prepayments.

| Available for sale securities:         | September 30, 2011 |            |
|--|--------------------|------------|
|  | Amortized Cost     | Fair Value |
|  | (in thousands)     |            |
| Investment Securities                  |                    |            |
| Due in one year or less                | \$1,968            | \$1,989    |
| Due after one year through five years  | 6,929              | 7,196      |
| Due after five years through ten years | 27,988             | 30,455     |
| Due after ten years                    | 241,210            | 265,354    |

|                            |             |             |
|----------------------------|-------------|-------------|
|                            | 278,095     | 304,994     |
| Mortgage-backed securities | 1,240,664   | 1,263,528   |
| Total                      | \$1,518,759 | \$1,568,522 |

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|  | September 30, 2011 |                              |
|--|--------------------|------------------------------|
|  | Amortized<br>Cost  | Fair Value<br>(in thousands) |
| Held to maturity securities:           |                    |                              |
| Investment Securities                  |                    |                              |
| Due in one year or less                | \$-                | \$-                          |
| Due after one year through five years  | -                  | -                            |
| Due after five years through ten years | 485                | 503                          |
| Due after ten years                    | 1,011              | 1,199                        |
|  | 1,496              | 1,702                        |
| Mortgage-backed securities             | 389,178            | 404,879                      |
| Total                                  | \$390,674          | \$406,581                    |

Investment and mortgage-backed securities with book values of \$999.8 million at September 30, 2011 and \$977.4 million at December 31, 2010 were pledged to collateralize Federal Home Loan Bank (“FHLB”) advances, repurchase agreements, public funds and trust deposits or for other purposes as required by law.

Securities with limited marketability, such as FHLB stock and other investments, are carried at cost, which approximates its fair value and assessed for other-than-temporary impairment. These securities have no maturity date.

#### 5. Loans and Allowance for Probable Loan Losses

The following table sets forth loan totals for the periods presented (in thousands):

|                        | At<br>September 30,<br>2011 | At<br>December 31,<br>2010 |
|------------------------|-----------------------------|----------------------------|
| Real Estate Loans:     |                             |                            |
| Construction           | \$ 103,859                  | \$ 115,094                 |
| 1-4 Family residential | 228,248                     | 219,031                    |
| Other                  | 202,595                     | 200,723                    |
| Commercial loans       | 140,115                     | 148,761                    |
| Municipal loans        | 199,122                     | 196,594                    |
| Loans to individuals   | 166,532                     | 197,717                    |
| Total loans            | \$ 1,040,471                | \$ 1,077,920               |

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### Allowance for Loan Losses

The allowance for loan losses is based on the most current review of the loan portfolio and is validated by multiple processes. First, the bank utilizes historical data to establish general reserve amounts for each class of loans. While we track several years of data, we primarily review one year data because we found during the 1980's that longer periods would not respond quickly enough to market conditions. Second, our lenders have the primary responsibility for identifying problem loans and estimating necessary reserves based on customer financial stress and underlying collateral. These recommendations are reviewed by the Senior lender, the Special Assets department, and the Loan Review department and are signed off on by the President. Third, the Loan Review department does independent reviews of the portfolio on an annual basis. The Loan Review department follows a board-approved annual loan review scope. The loan review scope encompasses a number of metrics that takes into consideration the size of the loan, the type of credit extended, the seasoning of the loan and the performance of the loan. The loan review scope as it relates to size, focuses more on larger dollar loan relationships, typically, for example, aggregate debt of \$500,000 or greater. The Loan Review officer also tracks specific reserves for loans by type compared to general reserves to determine trends in comparative reserves as well as losses not reserved for prior to charge off to determine the efficiency of the specific reserve process.

At each review, a subjective analysis methodology is used to grade the respective loan. Categories of grading vary in severity from loans that do not appear to have a significant probability of loss at the time of review to loans that indicate a probability that the entire balance of the loan will be uncollectible. If full collection of the loan balance appears unlikely at the time of review, estimates of future expected cash flows or appraisals of the collateral securing the debt are used to allocate the necessary allowances. The internal loan review department maintains a list of all loans or loan relationships that are graded as having more than the normal degree of risk associated with them. In addition, a list of specifically reserved loans or loan relationships of \$50,000 or more is updated on a quarterly basis in order to properly allocate necessary allowances and keep management informed on the status of attempts to correct the deficiencies noted with respect to the loan.

For loans to individuals, the methodology associated with determining the appropriate allowance for losses on loans primarily consists of an evaluation of individual payment histories, remaining term to maturity and underlying collateral support.

Industry experience indicates that a portion of our loans will become delinquent and a portion of the loans will require partial or entire charge-off. Regardless of the underwriting criteria utilized, losses may be experienced as a result of various factors beyond our control, including, among other things, changes in market conditions affecting the value of properties used as collateral for loans and problems affecting the credit of the borrower and the ability of the borrower to make payments on the loan. Our determination of the adequacy of allowance for loan losses is based on various considerations, including an analysis of the risk characteristics of various classifications of loans, previous loan loss experience, specific loans which would have loan loss potential, delinquency trends, estimated fair value of the underlying collateral, current economic conditions, the views of the bank regulators (who have the authority to require additional allowances), and geographic and industry loan concentration.

Consumer loans at SFG are reserved for based on general estimates of loss at the time of purchase for current loans. SFG loans experiencing past due status or extension of maturity characteristics are reserved for at significantly higher levels based on the circumstances associated with each specific loan. In general the reserves for SFG are calculated based on the past due status of the loan. For reserve purposes, the portfolio has been segregated by past due status and by the remaining term variance from the original contract. During repayment, loans that pay late will take longer to pay out than the original contract. Additionally, some loans may be granted extensions for extenuating payment circumstances. The remaining term extensions increase the risk of collateral deterioration and accordingly, reserves are increased to recognize this risk.

For SFG automobile loan pools purchased after August 1, 2010, additional reserve methods have been added. New pools purchased are reserved at their estimated annual loss. Thereafter, the reserve is adjusted based on the actual performance versus projected performance. Additionally, during the fourth quarter of 2010, data mining measures were further enhanced to track migration within risk tranches. Reserves are adjusted quarterly to match the migration metrics.

#### Credit Quality Indicators

We categorize loans into risk categories based on relevant information about the ability of borrowers to service their debt such as: current financial information, historical payment experience, credit documentation, public information, and current economic trends, among other factors. We use the following definitions for risk ratings:

- Satisfactory (Rating 1 – 4) – This rating is assigned to all satisfactory loans. This category, by definition, should consist of completely acceptable credit. Credit and collateral exceptions should not be present, although their presence would not necessarily prohibit a loan from being rated Satisfactory, if deficiencies are in process of correction. These loans will not be included in the Watch List.

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- Satisfactory (Rating 5) – Special Treatment Required – (Pass Watch) – These loans require some degree of special treatment, but not due to credit quality. This category does not include loans specially mentioned or adversely classified by the Loan Review Officer or regulatory authorities; however, particular attention must be accorded such credits due to characteristics such as:
  - A lack of, or abnormally extended payment program;
  - A heavy degree of concentration of collateral without sufficient margin;
  - A vulnerability to competition through lesser or extensive financial leverage;
- A dependence on a single, or few customers, or sources of supply and materials without suitable substitutes or alternatives.
- Special Mention (Rating 6) – A Special Mention asset has potential weaknesses that deserve management’s close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the asset or in the institution’s credit position at some future date. Special Mention assets are not adversely classified and do not expose an institution to sufficient risk to warrant adverse classification.
- Substandard (Rating 7) – Substandard loans are inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Loans so classified must have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the Bank will sustain some loss if the deficiencies are not corrected.
- Doubtful (Rating 8) – Loans classified Doubtful have all the weaknesses inherent in those classified Substandard with the added characteristic that the weaknesses make collection or liquidation, in full, on the basis of currently known facts, conditions and values, highly questionable and improbable.
- Loss (Rating 9) – Loans classified Loss are considered uncollectible or of such little value that their continuance as bankable assets is not warranted. This classification does not mean that the loan has absolutely no recovery or salvage value but rather it is not practical or desirable to defer writing off this basically worthless asset even though partial recovery may be affected in the future.

Loans not meeting risk ratings six through nine are reserved for as a group of similar type pass rated credits and included in the general portion of the allowance for loan losses.

The general portion of the loan loss allowance is reflective of historical charge-off levels for similar loans adjusted for changes in current conditions and other relevant factors. These factors are likely to cause estimated losses to differ from historical loss experience and include:

- Changes in lending policies or procedures, including underwriting, collection, charge-off, and recovery procedures;
  - Changes in local, regional and national economic and business conditions including entry into new markets;
    - Changes in the volume or type of credit extended;
  - Changes in the experience, ability, and depth of lending management;
- Changes in the volume and severity of past due, nonaccrual, restructured, or classified loans;
  - Changes in loan review or Board oversight; and,
  - Changes in the level of concentrations of credit.

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The following table details activity in the Allowance for Loan Losses by portfolio segment for the periods presented (in thousands):

|                                      | Nine Months Ended September 30, 2011 |   |         |                     |                    |                         |             | Total    |
|--------------------------------------|--------------------------------------|---|---------|---------------------|--------------------|-------------------------|-------------|----------|
|                                      | Construction                         | Real Estate<br>1-4<br>Family<br>Residential | Other   | Commercial<br>Loans | Municipal<br>Loans | Loans to<br>Individuals | Unallocated |          |
| Balance at beginning of period       | \$2,585                              | \$ 1,988                                    | \$3,354 | \$ 3,746            | \$ 607             | \$ 7,978                | \$ 453      | \$20,711 |
| Provision (reversal) for loan losses | (25 )                                | 397   | (318 )  | (65 )               | (9 )               | 4,628                   | 844         | 5,452    |
| Loans charged off                    | (9 )                                 | (654 )                                      | (271 )  | (1,231 )            | –                  | (8,085 )                | –           | (10,250) |
| Recoveries of loans charged off      | 38                                   | 96  | 274     | 397                 | –                  | 1,471                   | –           | 2,276    |
| Balance at end of period             | \$2,589                              | \$ 1,827                                    | \$3,039 | \$ 2,847            | \$ 598             | \$ 5,992                | \$ 1,297    | \$18,189 |

|                                      | Three Months Ended September 30, 2011 |   |         |                     |                    |                         |             | Total    |
|--------------------------------------|---------------------------------------|---|---------|---------------------|--------------------|-------------------------|-------------|----------|
|                                      | Construction                          | Real Estate<br>1-4<br>Family<br>Residential | Other   | Commercial<br>Loans | Municipal<br>Loans | Loans to<br>Individuals | Unallocated |          |
| Balance at beginning of period       | \$2,800                               | \$ 1,879                                    | \$3,023 | \$ 2,916            | \$ 610             | \$ 6,657                | \$ 1,524    | \$19,409 |
| Provision (reversal) for loan losses | (235 )                                | 216   | 206     | 166                 | (12 )              | 1,340                   | (227 )      | 1,454    |
| Loans charged off                    | –                                     | (271 )                                      | (191 )  | (304 )              | –                  | (2,413 )                | –           | (3,179 ) |
| Recoveries of loans charged off      | 24                                    | 3   | 1       | 69                  | –                  | 408                     | –           | 505      |
| Balance at end of period             | \$2,589                               | \$ 1,827                                    | \$3,039 | \$ 2,847            | \$ 598             | \$ 5,992                | \$ 1,297    | \$18,189 |

|                                      | Nine Months Ended September 30, 2010 |   |         |                     |                    |                         |             | Total    |
|--------------------------------------|--------------------------------------|---|---------|---------------------|--------------------|-------------------------|-------------|----------|
|                                      | Construction                         | Real Estate<br>1-4<br>Family<br>Residential | Other   | Commercial<br>Loans | Municipal<br>Loans | Loans to<br>Individuals | Unallocated |          |
| Balance at beginning of period       | \$3,080                              | \$ 1,460                                    | \$3,175 | \$ 3,184            | \$ 400             | \$ 7,321                | \$ 1,276    | \$19,896 |
| Provision (reversal) for loan losses | 36                                   | 585   | 640     | 2,233               | 151                | 6,483                   | (800 )      | 9,328    |
| Loans charged off                    | (873 )                               | (236 )                                      | (519 )  | (2,023 )            | –                  | (9,165 )                | –           | (12,816) |
| Recoveries of loans charged off      | 165                                  | 12  | –       | 202                 | –                  | 1,944                   | –           | 2,323    |
|                                      | \$2,408                              | \$ 1,821                                    | \$3,296 | \$ 3,596            | \$ 551             | \$ 6,583                | \$ 476      | \$18,731 |

Balance at end of  
period

Three Months Ended September 30, 2010

|                                      | Construction | Real Estate<br>1-4<br>Family<br>Residential | Other   | Commercial<br>Loans | Municipal<br>Loans | Loans to<br>Individuals | Unallocated | Total    |
|--------------------------------------|--------------|---|---------|---------------------|--------------------|-------------------------|-------------|----------|
| Balance at beginning of period       | \$2,180      | \$ 1,820                                    | \$3,334 | \$ 3,367            | \$ 514             | \$ 6,804                | \$ 1,264    | \$19,283 |
| Provision (reversal) for loan losses | 228          | 114   | 281     | 1,242               | 37                 | 2,087                   | (788 )      | 3,201    |
| Loans charged off                    | –            | (120 )                                      | (319 )  | (1,058 )            | –                  | (2,844 )                | –           | (4,341 ) |
| Recoveries of loans charged off      | –            | 7   | –       | 45                  | –                  | 536                     | –           | 588      |
| Balance at end of period             | \$2,408      | \$ 1,821                                    | \$3,296 | \$ 3,596            | \$ 551             | \$ 6,583                | \$ 476      | \$18,731 |

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|  | Nine Months Ended September 30, 2011 |   |          |                     |                    |                         |             | Total     |
|--|--------------------------------------|---|----------|---------------------|--------------------|-------------------------|-------------|-----------|
|  | Construction                         | Real Estate<br>1-4<br>Family<br>Residential | Other    | Commercial<br>Loans | Municipal<br>Loans | Loans to<br>Individuals | Unallocated |           |
| Ending balance – individually evaluated for impairment | \$ 1,015                             | \$ 746                                      | \$ 527   | \$ 1,129            | \$ 110             | \$ 396                  | \$ –        | \$ 3,923  |
| Ending balance – collectively evaluated for impairment | 1,574                                | 1,081                                       | 2,512    | 1,718               | 488                | 5,596                   | 1,297       | 14,266    |
| Balance at end of period                               | \$ 2,589                             | \$ 1,827                                    | \$ 3,039 | \$ 2,847            | \$ 598             | \$ 5,992                | \$ 1,297    | \$ 18,189 |

|  | Nine Months Ended September 30, 2010 |   |          |                     |                    |                         |             | Total     |
|--|--------------------------------------|---|----------|---------------------|--------------------|-------------------------|-------------|-----------|
|  | Construction                         | Real Estate<br>1-4<br>Family<br>Residential | Other    | Commercial<br>Loans | Municipal<br>Loans | Loans to<br>Individuals | Unallocated |           |
| Ending balance – individually evaluated for impairment | \$ 1,088                             | \$ 673                                      | \$ 836   | \$ 1,752            | \$ 125             | \$ 580                  | \$ –        | \$ 5,054  |
| Ending balance – collectively evaluated for impairment | 1,320                                | 1,148                                       | 2,460    | 1,844               | 426                | 6,003                   | 476         | 13,677    |
| Balance at end of period                               | \$ 2,408                             | \$ 1,821                                    | \$ 3,296 | \$ 3,596            | \$ 551             | \$ 6,583                | \$ 476      | \$ 18,731 |

The following table details activity of the Reserve for Unfunded Loan Commitments for the periods presented (in thousands):

|  | Nine Months Ended<br>September 30, |       |
|--|------------------------------------|-------|
|  | 2011                               | 2010  |
| Reserve For Unfunded Loan Commitments:                       |                                    |       |
| Balance at beginning of period                               | \$ 30                              | \$ 5  |
| Provision (reversal) for losses on unfunded loan commitments | (8)                                | 15    |
| Balance at end of period                                     | \$ 22                              | \$ 20 |

|  | Three Months Ended<br>September 30, |      |
|--|-------------------------------------|------|
|  | 2011                                | 2010 |
| Reserve For Unfunded Loan Commitments: |                                     |      |

|  |    |    |    |      |
|--|----|----|----|------|
| Balance at beginning of period                               | \$ | 22 | \$ | 40   |
| Provision (reversal) for losses on unfunded loan commitments |    |    | -  | (20) |
| Balance at end of period                                     | \$ | 22 | \$ | 20   |

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The following table sets forth the balance in the recorded investment in loans by portfolio segment based on impairment method as described in the allowance for loan losses methodology discussion for the periods presented (in thousands):

| September 30, 2011                          | Construction | Real Estate<br>1-4 Family<br>Residential | Other      | Commercial<br>Loans | Municipal<br>Loans | Loans to<br>Individuals | Total        |
|---|--------------|--|------------|---------------------|--------------------|-------------------------|--------------|
| Loans individually evaluated for impairment | \$ 7,869     | \$ 11,059                                | \$ 7,271   | \$ 6,245            | \$ 651             | \$ 1,317                | \$ 34,412    |
| Loans collectively evaluated for impairment | 95,990       | 217,189                                  | 195,324    | 133,870             | 198,471            | 165,215                 | 1,006,059    |
| Total ending loans balance                  | \$ 103,859   | \$ 228,248                               | \$ 202,595 | \$ 140,115          | \$ 199,122         | \$ 166,532              | \$ 1,040,471 |

| December 31, 2010                           | Construction | Real Estate<br>1-4 Family<br>Residential | Other      | Commercial<br>Loans | Municipal<br>Loans | Loans to<br>Individuals | Total        |
|---|--------------|--|------------|---------------------|--------------------|-------------------------|--------------|
| Loans individually evaluated for impairment | \$ 10,355    | \$ 8,331                                 | \$ 10,688  | \$ 12,144           | \$ 738             | \$ 1,625                | \$ 43,881    |
| Loans collectively evaluated for impairment | 104,739      | 210,700                                  | 190,035    | 136,617             | 195,856            | 196,092                 | 1,034,039    |
| Total ending loans balance                  | \$ 115,094   | \$ 219,031                               | \$ 200,723 | \$ 148,761          | \$ 196,594         | \$ 197,717              | \$ 1,077,920 |

The following table sets forth loans by credit quality indicator for the periods presented (in thousands):

| September 30, 2011     | Pass       | Pass<br>Watch | Special<br>Mention | Substandard | Doubtful | Loss  | Total        |
|------------------------|------------|---------------|--------------------|-------------|----------|-------|--------------|
| Real Estate Loans:     |            |               |                    |             |          |       |              |
| Construction           | \$ 95,990  | \$ 1,237      | \$ 449             | \$ 6,041    | \$ 142   | \$ –  | \$ 103,859   |
| 1-4 Family residential | 217,188    | 640           | 5,242              | 4,313       | 865      | –     | 228,248      |
| Other                  | 195,324    | 94            | 3,270              | 3,869       | 38       | –     | 202,595      |
| Commercial loans       | 133,871    | 904           | 246                | 5,015       | 68       | 11    | 140,115      |
| Municipal loans        | 198,471    | 231           | –                  | 420         | –        | –     | 199,122      |
| Loans to individuals   | 155,590    | 7,306         | –                  | 2,564       | 1,040    | 32    | 166,532      |
| Total                  | \$ 996,434 | \$ 10,412     | \$ 9,207           | \$ 22,222   | \$ 2,153 | \$ 43 | \$ 1,040,471 |

| December 31, 2010  | Pass       | Pass<br>Watch | Special<br>Mention | Substandard | Doubtful | Loss | Total      |
|--------------------|------------|---------------|--------------------|-------------|----------|------|------------|
| Real Estate Loans: |            |               |                    |             |          |      |            |
| Construction       | \$ 104,739 | \$ 761        | \$ 1,420           | \$ 8,174    | \$ –     | \$ – | \$ 115,094 |

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|                        |              |           |          |           |          |        |              |
|------------------------|--------------|-----------|----------|-----------|----------|--------|--------------|
| 1-4 Family residential | 210,699      | 812       | 1,379    | 5,332     | 809      | –      | 219,031      |
| Other                  | 190,036      | 102       | 4,784    | 5,418     | 298      | 85     | 200,723      |
| Commercial loans       | 136,617      | 2,273     | 1,224    | 8,403     | 199      | 45     | 148,761      |
| Municipal loans        | 195,856      | 258       | –        | 480       | –        | –      | 196,594      |
| Loans to individuals   | 182,174      | 8,766     | 27       | 4,564     | 2,175    | 11     | 197,717      |
| Total                  | \$ 1,020,121 | \$ 12,972 | \$ 8,834 | \$ 32,371 | \$ 3,481 | \$ 141 | \$ 1,077,920 |

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The following table sets forth nonperforming assets for the periods presented:

|   | At<br>September 30,<br>2011 | At<br>December 31,<br>2010 |
|---|-----------------------------|----------------------------|
|   | (in thousands)              |                            |
| Nonaccrual loans                          | \$ 10,634                   | \$ 14,524                  |
| Accruing loans past due more than 90 days | 21                          | 7                          |
| Restructured loans                        | 1,486                       | 2,320                      |
| Other real estate owned                   | 831                         | 220                        |
| Reposessed assets                         | 188                         | 638                        |
| Total Nonperforming Assets                | \$ 13,160                   | \$ 17,709                  |

## Nonaccrual and Past Due Loans

Nonaccrual loans are those loans which are 90 days or more delinquent and collection in full of both the principal and interest is in doubt. Additionally, some loans that are not delinquent may be placed on nonaccrual status due to doubts about full collection of principal or interest. When a loan is categorized as nonaccrual, the accrual of interest is discontinued and the accrued balance is reversed for financial statement purposes. Payments of contractual interest are recognized as income only to the extent that full recovery of the principal balance of the loan is reasonably certain. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured. Other factors, such as the value of collateral securing the loan and the financial condition of the borrower must be considered in judgments as to potential loan loss.

Loans are considered impaired if, based on current information and events, it is probable that we will be unable to collect the scheduled payments of principal and interest when due according to the contractual terms of the loan agreement. The measurement of impaired loans is generally based on the present value of the expected future cash flows discounted at the historical effective interest rate stipulated in the loan agreement, except that all collateral-dependent loans are measured for impairment based on the fair value of the collateral. In measuring the fair value of the collateral, in addition to relying on third party appraisals, we use assumptions such as discount rates, and methodologies, such as comparison to the recent selling price of similar assets, consistent with those that would be utilized by unrelated third parties performing a valuation.

Nonaccrual loans and accruing loans past due more than 90 days include both smaller balance homogeneous loans that are collectively evaluated for impairment and individually classified impaired loans.

The following table sets forth the recorded investment in nonaccrual and accruing loans past due more than 90 days by class of loans for the periods presented (in thousands):

|                        | September 30, 2011 |   | December 31, 2010 |   |
|------------------------|--------------------|---|-------------------|---|
|                        | Nonaccrual         | Accruing<br>Loans Past<br>Due More<br>Than 90<br>Days | Nonaccrual        | Accruing<br>Loans Past<br>Due More<br>Than 90<br>Days |
| Real Estate Loans:     |                    |   |                   |   |
| Construction           | \$3,838            | \$-   | \$4,730           | \$-   |
| 1-4 Family residential | 1,863              | -   | 2,353             | -   |

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|                      |          |      |          |     |
|----------------------|----------|------|----------|-----|
| Other                | 1,291    | –    | 1,428    | –   |
| Commercial loans     | 1,495    | –    | 1,799    | –   |
| Loans to individuals | 2,147    | 21   | 4,214    | 7   |
| Total                | \$10,634 | \$21 | \$14,524 | \$7 |

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The following table presents the aging of the recorded investment in past due loans as of September 30, 2011 by class of loans (in thousands):

|                        | 30-59 Days<br>Past Due | 60-89 Days<br>Past Due | Greater<br>than 90<br>Days<br>Past Due | Total Past<br>Due | Loans Not<br>Past Due | Total       |
|------------------------|------------------------|------------------------|--|-------------------|-----------------------|-------------|
| Real Estate Loans:     |                        |                        |  |                   |                       |             |
| Construction           | \$448                  | \$370                  | \$3,838                                | \$4,656           | \$99,203              | \$103,859   |
| 1-4 Family residential | 3,720                  | 723                    | 1,863                                  | 6,306             | 221,942               | 228,248     |
| Other                  | 364                    | 31                     | 1,291                                  | 1,686             | 200,909               | 202,595     |
| Commercial loans       | 1,097                  | 343                    | 1,495                                  | 2,935             | 137,180               | 140,115     |
| Municipal loans        | –                      | –                      | –                                      | –                 | 199,122               | 199,122     |
| Loans to individuals   | 2,705                  | 713                    | 2,168                                  | 5,586             | 160,946               | 166,532     |
| Total                  | \$8,334                | \$2,180                | \$10,655                               | \$21,169          | \$1,019,302           | \$1,040,471 |

Impaired loans, primarily nonaccrual loans, were as follows (in thousands):

|   | September 30,<br>2011 | December 31,<br>2010 |
|---|-----------------------|----------------------|
| Loans with no allocated allowance for loan losses | \$ 5                  | \$ 69                |
| Loans with allocated allowance for loan losses    | 12,080                | 16,699               |
| Total   | \$ 12,085             | \$ 16,768            |
| Amount of the allowance for loan losses allocated | \$ 2,512              | \$ 3,864             |

At any time a potential loss is recognized in the collection of principal, proper reserves should be allocated. Loans are charged off when deemed uncollectible. Loans are charged down as soon as collection by liquidation is evident to the liquidation value of the collateral net of liquidation costs, if any, and placed in nonaccrual status.

Interest income recognized on nonaccrual and restructured loans by class of loans for the period presented (in thousands):

|                        | September 30, 2011<br>Accruing<br>Interest<br>at Original<br>Contracted<br>Rate | Interest<br>Income<br>Recognized |
|------------------------|---|----------------------------------|
| Real Estate Loans:     |   |                                  |
| Construction           | \$209   | \$9                              |
| 1-4 Family residential | 89  | 60                               |
| Other                  | 99  | 19                               |
| Commercial loans       | 54  | 4                                |
| Municipal loans        | –   | –                                |
| Loans to individuals   | 578   | 363                              |
| Total                  | \$1,029   | \$455                            |

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The following table sets forth impaired loans by class of loans for the periods presented (in thousands). Average recorded investment is reported on a year-to-date basis.

| September 30, 2011     | Unpaid<br>Contractual<br>Principal<br>Balance | Recorded<br>Investment<br>With No<br>Allowance | Recorded<br>Investment<br>With<br>Allowance | Total<br>Recorded<br>Investment | Loan<br>Losses<br>Allocated | Average<br>Recorded<br>Investment |
|------------------------|---|--|---|---------------------------------|-----------------------------|-----------------------------------|
| Real Estate Loans:     |   |  |   |                                 |                             |                                   |
| Construction           | \$ 4,750                                      | \$-  | \$ 3,838                                    | \$ 3,838                        | \$ 633                      | \$ 4,083                          |
| 1-4 Family residential | 1,927   | -  | 1,863                                       | 1,863                           | 277                         | 2,386                             |
| Other                  | 1,890   | -  | 1,290                                       | 1,290                           | 125                         | 1,830                             |
| Commercial loans       | 1,564   | -  | 1,495                                       | 1,495                           | 477                         | 1,832                             |
| Municipal loans        | -   | -  | -   | -                               | -                           | -                                 |
| Loans to individuals   | 3,886   | 5  | 3,594                                       | 3,599                           | 1,000                       | 4,888                             |
| Total                  | \$ 14,017                                     | \$ 5   | \$ 12,080                                   | \$ 12,085                       | \$ 2,512                    | \$ 15,019                         |



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| December 31, 2010      | Unpaid<br>Contractual<br>Principal<br>Balance | Recorded<br>Investment<br>With No<br>Allowance | Recorded<br>Investment<br>With<br>Allowance | Total<br>Recorded<br>Investment | Loan<br>Losses<br>Allocated | Average<br>Recorded<br>Investment |
|------------------------|---|--|---|---------------------------------|-----------------------------|-----------------------------------|
| Real Estate Loans:     |   |  |   |                                 |                             |                                   |
| Construction           | \$ 6,045                                      | \$—  | \$4,730                                     | \$4,730                         | \$562                       | \$6,013                           |
| 1-4 Family residential | 2,453   | —  | 2,354                                       | 2,354                           | 426                         | 1,250                             |
| Other                  | 1,807   | —  | 1,428                                       | 1,428                           | 179                         | 1,445                             |
| Commercial loans       | 1,826   | —  | 1,799                                       | 1,799                           | 719                         | 1,950                             |
| Municipal loans        | —   | —  | —   | —                               | —                           | —                                 |
| Loans to individuals   | 6,854   | 69   | 6,388                                       | 6,457                           | 1,978                       | 7,904                             |
| Total                  | \$ 18,985                                     | \$69   | \$16,699                                    | \$16,768                        | \$3,864                     | \$18,562                          |

## Troubled Debt Restructurings

The restructuring of a loan is considered a “troubled debt restructuring” if both (i) the borrower is experiencing financial difficulties and (ii) the creditor has granted a concession. Concessions may include interest rate reductions or below market interest rates, principal forgiveness, restructuring amortization schedules and other actions intended to minimize potential losses. Effective July 1, 2011, we adopted the provisions of Accounting Standards Update (“ASU”) No. 2011-02, “Receivables (Topic 310) – A Creditor’s Determination of Whether a Restructuring Is a Troubled Debt Restructuring.” We reassessed all loan modifications occurring since January 1, 2011 for identification as troubled debt restructurings.

The following table sets forth troubled debt restructurings for the periods presented:

|                        | Three<br>Months<br>Ended<br>September 30,<br>2011 | Nine Months<br>Ended<br>September 30,<br>2011 |
|------------------------|---|---|
| Real Estate Loans:     |   |   |
| Construction           | \$ —  | \$ 54   |
| 1-4 Family residential | —   | 284   |
| Other                  | —   | —   |
| Commercial loans       | —   | —   |
| Loans to individuals   | 57  | 78  |
| Total                  | \$ 57   | \$ 416  |

The loans indentified as troubled debt restructurings were previously reported as impaired loans prior to restructuring. The modifications related to extending the amortization periods, lowering interest rates and principal forgiveness of the loans. Of the loans restructured during the nine months ended September 30, 2011, \$406,000 were on nonaccrual status as of September 30, 2011. Because the loans were classified and on nonaccrual status both before and after restructuring, the modifications did not impact our determination of the allowance for loan losses. For the three and nine months ended September 30, 2011, there have been no defaults on any loans that were modified as troubled debt restructurings during the preceding twelve months.



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## 6. Long-term Obligations

Long-term obligations are summarized as follows (in thousands):

|  | September 30,<br>2011 | December 31,<br>2010 |
|--|-----------------------|----------------------|
| FHLB Advances (1)                          | \$ 275,458            | \$ 373,479           |
| Long-term Debt (2)                         |                       |                      |
| Southside Statutory Trust III Due 2033 (3) | 20,619                | 20,619               |
| Southside Statutory Trust IV Due 2037 (4)  | 23,196                | 23,196               |
| Southside Statutory Trust V Due 2037 (5)   | 12,887                | 12,887               |
| Magnolia Trust Company I Due 2035 (6)      | 3,609                 | 3,609                |
| Total Long-term Debt                       | 60,311                | 60,311               |
| Total Long-term Obligations                | \$ 335,769            | \$ 433,790           |

(1) At September 30, 2011, the weighted average cost of these advances was 3.27%. FHLB Advances have maturities ranging from October 2012 through July 2028.

(2) This long-term debt consists of trust preferred securities that qualify under the risk-based capital guidelines as Tier 1 capital, subject to certain limitations.

(3) This debt carries an adjustable rate of 3.30856% through December 30, 2011 and adjusts quarterly at a rate equal to three-month LIBOR plus 294 basis points.

(4) This debt carries a fixed rate of 6.518% through October 30, 2012 and thereafter, adjusts quarterly at a rate equal to three-month LIBOR plus 130 basis points.

(5) This debt carries a fixed rate of 7.48% through December 15, 2012 and thereafter, adjusts quarterly at a rate equal to three-month LIBOR plus 225 basis points.

(6) This debt carries an adjustable rate of 2.103% through November 22, 2011 and thereafter, adjusts quarterly at a rate equal to three-month LIBOR plus 180 basis points.

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Beginning in September 2010 and continuing into the first quarter of 2011, we entered into the option to fund between one and a half and two years forward from the advance commitment date \$200 million par in long-term advance commitments from the FHLB at the rates on the date the option was purchased. The fee, included in other assets in our consolidated balance sheet, will be amortized over the term of the advance as long as it is probable we will exercise the advance commitments. Should we determine the advance commitments will not be exercised, the fee will be expensed in the period determination is made.

Below is a table detailing the optional advance commitment terms (dollars in thousands):

| Advance Commitment | Option Expiration Date | Advance Commitment Term at Exercise Date | Advance Commitment |   | Option Fee Paid |
|--------------------|------------------------|--|--------------------|---|-----------------|
|                    |                        |  | Rate               | % |                 |
| \$ 25,000          | 09/20/12               | 36 months                                | 1.325              | % | \$ 1,105        |
| 25,000             | 09/20/12               | 48 months                                | 1.674              | % | 1,410           |
| 20,000             | 10/09/12               | 36 months                                | 1.153              | % | 789             |
| 20,000             | 10/09/12               | 48 months                                | 1.466              | % | 1,042           |
| 20,000             | 10/09/12               | 60 months                                | 1.807              | % | 1,216           |
| 20,000             | 05/17/12               | 48 months                                | 1.710              | % | 917             |
| 20,000             | 05/17/12               | 60 months                                | 2.085              | % | 1,102           |
| 20,000             | 03/18/13               | 60 months                                | 2.510              | % | 1,528           |
| 15,000             | 03/18/13               | 36 months                                | 1.622              | % | 828             |
| 15,000             | 03/18/13               | 48 months                                | 2.086              | % | 1,017           |
| \$ 200,000         |                        |  |                    |   | \$ 10,954       |

## 7. Employee Benefit Plans

The components of net periodic benefit cost are as follows (in thousands):

|                                   | Nine Months Ended September 30, |          |                  |        |
|-----------------------------------|---------------------------------|----------|------------------|--------|
|                                   | Defined Benefit Pension Plan    |          | Restoration Plan |        |
|                                   | 2011                            | 2010     | 2011             | 2010   |
| Service cost                      | \$ 1,152                        | \$ 1,022 | \$ 130           | \$ 115 |
| Interest cost                     | 2,235                           | 2,124    | 297              | 288    |
| Expected return on assets         | (2,912)                         | (2,739)  | –                | –      |
| Net loss recognition              | 872                             | 754      | 227              | 218    |
| Prior service credit amortization | (31)                            | (31)     | (2)              | (2)    |
| Net periodic benefit cost         | \$ 1,316                        | \$ 1,130 | \$ 652           | \$ 619 |

|                           | Three Months Ended September 30, |        |                  |       |
|---------------------------|----------------------------------|--------|------------------|-------|
|                           | Defined Benefit Pension Plan     |        | Restoration Plan |       |
|                           | 2011                             | 2010   | 2011             | 2010  |
| Service cost              | \$ 384                           | \$ 341 | \$ 43            | \$ 38 |
| Interest cost             | 745                              | 708    | 99               | 96    |
| Expected return on assets | (971)                            | (913)  | –                | –     |
| Net loss recognition      | 291                              | 251    | 76               | 73    |

|                                   |    |      |    |      |    |     |    |     |
|-----------------------------------|----|------|----|------|----|-----|----|-----|
| Prior service credit amortization |    | (10) |    | (10) |    | (1) |    | (1) |
| Net periodic benefit cost         | \$ | 439  | \$ | 377  | \$ | 217 | \$ | 206 |

Employer Contributions. We previously disclosed in our financial statements for the year ended December 31, 2010, that we expected to contribute \$2.0 million to our defined benefit pension plan and \$80,000 to our restoration plan in 2011. As of September 30, 2011, we had contributed \$2.0 million to our defined benefit plan, and contributions of \$60,000 had been made to our restoration plan.

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8. Share-based Incentive Plans

2009 Incentive Plan (the "2009 Incentive Plan")

On April 16, 2009, our shareholders approved the Southside Bancshares, Inc. 2009 Incentive Plan (the "2009 Incentive Plan"), which is a stock-based incentive compensation plan. A total of 1,157,625 shares of our common stock were reserved and available for issuance pursuant to awards granted under the 2009 Incentive Plan. Under the 2009 Incentive Plan, we were authorized to grant nonqualified stock options ("NQSOs"), restricted stock units ("RSUs") or any combination thereof to certain officers. During the three months ended June 30, 2011, we granted RSUs and NQSOs pursuant to the 2009 Incentive Plan.

As of September 30, 2011, there were 204,202 nonvested awards outstanding. For the three and nine months ended September 30, 2011, there was \$117,000 and \$143,000, respectively, share-based compensation expense related to the 2009 Incentive Plan. As of September 30, 2010, there were no awards granted or nonvested. There was no share-based compensation expense for the three and nine months ended September 30, 2010.

As of September 30, 2011, there was \$1.5 million of unrecognized compensation cost related to the 2009 Incentive Plan for the nonvested awards granted in June 2011. The cost is expected to be recognized over a weighted-average period of 3.24 years.

The fair value of each NQSO granted is estimated on the date of grant using the Black-Scholes method of option pricing with the following weighted-average assumptions for grants in 2011: dividend yield of 3.54%; risk-free interest rate of 2.30%; expected life of 6.5 and 7.0 years for the three-year and four-year vesting schedule, respectively; and expected volatility of 42.07% and 41.50% for the three-year and four-year vesting schedule, respectively.

The NQSOs which have contractual terms of 10 years and vest in equal annual installments over either a three- or four-year period.

The fair value of each RSU is the ending stock price on the date of grant. The RSUs vest in equal annual installments over either a three- or four-year period.

Each award is evidenced by an award agreement that specifies the option price, if applicable, the duration of the award, the number of shares to which the award pertains, and such other provisions as the Board determines.

1993 Incentive Stock Option Plan ("the ISO Plan")

In April 1993, we adopted the Southside Bancshares, Inc. 1993 Incentive Stock Option Plan ("the ISO Plan"), a stock-based incentive compensation plan. The ISO Plan expired March 31, 2003.

As of September 30, 2011 and 2010, there were no nonvested shares for the ISO Plan. For the nine months ended September 30, 2011 and 2010, there was no stock-based compensation expense related to the ISO Plan.

As of September 30, 2011 and 2010, there was no unrecognized compensation cost related to the ISO Plan for nonvested options granted in March 2003.

The fair value of each stock option granted is estimated on the date of grant using the Black-Scholes method of option pricing with the following weighted-average assumptions for grants in 2003: dividend yield of 1.93%; risk-free interest rate of 4.93%; expected life of six years; and expected volatility of 28.90%.

Under the ISO Plan, we were authorized to issue shares of common stock pursuant to "Awards" granted in the form of incentive stock options (intended to qualify under Section 422 of the Internal Revenue Code of 1986, as amended). Before the ISO Plan expired, awards were granted to selected employees and directors. No stock options have been available for grant under the ISO Plan since its expiration in March 2003.

The ISO Plan provided that the exercise price of any stock option not be less than the fair market value of the common stock on the date of grant. The outstanding stock options have contractual terms of 10 years. All options vest on a graded schedule, 20% per year for five years, beginning on the first anniversary date of the grant date.

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A combined summary of activity in our share-based plans as of September 30, 2011 is presented below:

|                             | Shares<br>Available<br>for Grant | Restricted Stock Units<br>Outstanding |  | Stock Options<br>Outstanding |                                    |
|-----------------------------|----------------------------------|---------------------------------------|--|------------------------------|------------------------------------|
|                             |                                  | Number<br>of Shares                   | Weighted-Average<br>Grant-Date Fair<br>Value | Number<br>of Shares          | Weighted-Average<br>Exercise Price |
| Balance, January 1, 2011    | 1,157,625                        | –                                     | \$ –   | 10,825                       | \$ 10.38                           |
| Granted                     | (204,202 )                       | 33,392                                | 19.19  | 170,810                      | 19.19                              |
| Stock options exercised     | –                                | –                                     | –  | (838 )                       | 10.38                              |
| Stock awards vested         | –                                | –                                     | –  | –                            | –                                  |
| Forfeited                   | –                                | –                                     | –  | –                            | –                                  |
| Canceled/expired            | –                                | –                                     | –  | –                            | –                                  |
| Balance, September 30, 2011 | 953,423                          | 33,392                                | \$ 19.19                                     | 180,797                      | \$ 18.70                           |

Other information regarding options outstanding and exercisable as of September 30, 2011 is as follows:

| Range of Exercise Prices | Options Outstanding |   |  | Options Exercisable |   |  |
|--------------------------|---------------------|---|--|---------------------|---|--|
|                          | Number<br>of Shares | Weighted-<br>Average<br>Exercise<br>Price | Weighted-<br>Average<br>Remaining<br>Contractual<br>Life in<br>Years | Number<br>of Shares | Weighted-<br>Average<br>Exercise<br>Price |  |
| \$ 10.38– 10.38          | 9,987               | \$ 10.38                                  | 1.50   | 9,987               | \$ 10.38                                  |  |
| 19.19 – 19.19            | 170,810             | 19.19                                     | 9.69   | –                   | –   |  |
| Total                    | 180,797             | \$ 18.70                                  | 9.24   | 9,987               | \$ 10.38                                  |  |

The total intrinsic value (i.e., the amount by which the fair value of the underlying common stock exceeds the exercise price of a stock option on exercise date) of outstanding stock options and exercisable stock options was zero and \$76,000 at September 30, 2011, respectively.

The total intrinsic value of stock options exercised during the nine months ended September 30, 2011 and 2010 was \$7,000 and \$1.5 million, respectively.

Cash received from stock option exercises for the nine months ended September 30, 2011 and 2010 was \$9,000 and \$419,000, respectively. The tax benefit realized for the deductions related to the stock option exercises was \$2,000 and \$328,000 for the nine months ended September 30, 2011 and 2010, respectively.

## 9. Fair Value Measurement

Fair value is 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.

Valuation techniques including the market approach, the income approach and/or the cost approach are utilized to determine fair value. Inputs to valuation techniques refer to the assumptions that market participants would use in pricing the asset or liability. An entity must consider all aspects of nonperforming risk, including the entity's own credit standing when measuring fair value of a 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. A fair value hierarchy for valuation inputs 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:

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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 might 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 (such as interest rates, volatilities, prepayment speeds, credit risks, etc.) or inputs that are derived principally from or corroborated by market data by correlation or other means.

Level 3 Inputs - Unobservable inputs for determining the fair values of assets or liabilities that reflect an entity's own assumptions about the 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.

Securities Available for Sale - Securities classified as AFS primarily consist of U.S. Treasuries, government-sponsored enterprise debentures, mortgage-backed securities, municipal bonds, and, to a lesser extent, TRUPs and equity securities. We use quoted market prices of identical assets on active exchanges, or Level 1 measurements, where possible. Where such quoted market prices are not available, we typically employ quoted market prices of similar instruments (including matrix pricing), or Level 2 measurements. Level 3 measurements include a range of fair value estimates in the marketplace as a result of the illiquid market specific to the type of security or discounted cash flow analyses based on assumptions that are not readily observable in the market place. Such assumptions include projections of future cash flows, including loss assumptions and discount rates.

Certain financial assets are measured at fair value in accordance with GAAP. Adjustments to the fair value of these assets usually result from the application of fair value accounting or write-downs of individual assets. Transfers between levels of the fair value hierarchy are recognized on the actual date of the event or circumstances that caused the transfer, which generally coincides with our monthly and/or quarterly valuation process. There were no transfers between Level 1 and Level 2 during the nine months ended September 30, 2011.

Loans Held for Sale - These loans are reported at the lower of cost or fair value. Fair value is determined based on expected proceeds, which are based on sales contracts and commitments and are considered Level 2 inputs. At September 30, 2011, based on our estimates of fair value, no valuation allowance was recognized.

Impaired Loans – Certain impaired loans may be reported at the fair value of the underlying collateral if repayment is expected solely from the collateral. Collateral values are estimated using Level 3 inputs based on customized discounting criteria or appraisals. At September 30, 2011, the impact of loans with specific reserves based on the fair value of the collateral was reflected in our allowance for loans losses.

The following table summarizes impaired loans measured at fair value through a specific valuation allowance allocation of the allowance for possible loan losses based upon fair value of the underlying collateral utilizing Level 3 valuation inputs as follows (in thousands):

|                           | At<br>September 30,<br>2011 | At<br>December 31,<br>2010 | At<br>September 30,<br>2010 |
|---------------------------|-----------------------------|----------------------------|-----------------------------|
| Carrying Value            | \$ 12,085                   | \$ 16,768                  | \$ 17,110                   |
| Valuation Allowance       | 2,512                       | 3,864                      | 3,405                       |
| Total Reported Fair Value | \$ 9,573                    | \$ 12,904                  | \$ 13,705                   |

Certain nonfinancial assets and nonfinancial liabilities measured at fair value on a recurring basis include reporting units measured at fair value in the first step of a goodwill impairment test. Certain nonfinancial assets measured at fair value on a nonrecurring basis include nonfinancial assets and nonfinancial liabilities measured at fair value in the second step of a goodwill impairment test, as well as intangible assets and other nonfinancial long-lived assets (such as real estate owned) that are measured at fair value in the event of an impairment.

The following tables summarize financial assets and financial liabilities measured at fair value on a recurring basis as of September 30, 2011 and December 31, 2010, segregated by the level of the valuation inputs within the fair value hierarchy utilized to measure fair value (in thousands):

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| Securities Available For Sale      | As of September 30, 2011 |                    |                  |                     |
|------------------------------------|--------------------------|--------------------|------------------|---------------------|
|                                    | Level 1<br>Input         | Level 2<br>Input   | Level 3<br>Input | Total<br>Fair Value |
| <b>Investment Securities:</b>      |                          |                    |                  |                     |
| State and Political Subdivisions   | \$-                      | \$304,047          | \$-              | \$304,047           |
| Other Stocks and Bonds             | -                        | -                  | 947              | 947                 |
| <b>Mortgage-backed Securities:</b> |                          |                    |                  |                     |
| U.S. Government Agencies           | -                        | 152,416            | -                | 152,416             |
| Government-Sponsored Enterprise    | -                        | 1,111,112          | -                | 1,111,112           |
| <b>Total</b>                       | <b>\$-</b>               | <b>\$1,567,575</b> | <b>\$947</b>     | <b>\$1,568,522</b>  |
| Securities Available For Sale      | As of December 31, 2010  |                    |                  |                     |
|                                    | Level 1<br>Input         | Level 2<br>Input   | Level 3<br>Input | Total<br>Fair Value |
| <b>Investment Securities:</b>      |                          |                    |                  |                     |
| U.S. Treasury                      | \$4,700                  | \$-                | \$-              | \$4,700             |
| State and Political Subdivisions   | -                        | 294,262            | -                | 294,262             |
| Other Stocks and Bonds             | 193                      | -                  | 189              | 382                 |
| <b>Mortgage-backed Securities:</b> |                          |                    |                  |                     |
| U.S. Government Agencies           | -                        | 154,534            | -                | 154,534             |
| Government-Sponsored Enterprise    | -                        | 791,509            | -                | 791,509             |
| <b>Total</b>                       | <b>\$4,893</b>           | <b>\$1,240,305</b> | <b>\$189</b>     | <b>\$1,245,387</b>  |

The following tables present additional information about financial assets and liabilities measured at fair value on a recurring basis and for which we have utilized Level 3 inputs to determine fair value (in thousands):

| Other Stocks and Bonds                              | Nine Months Ended<br>September 30, |       |
|---|------------------------------------|-------|
|   | 2011                               | 2010  |
| Balance at Beginning of Period                      | \$189                              | \$270 |
| <b>Total gains or losses (realized/unrealized):</b> |                                    |       |
| Included in earnings (or changes in net assets)     | -                                  | (75 ) |
| Included in other comprehensive income (loss)       | 758                                | (7 )  |
| Purchases   | -                                  | -     |
| Issuances   | -                                  | -     |
| Settlements   | -                                  | -     |
| Transfers in and/or out of Level 3                  | -                                  | -     |
| Balance at End of Period                            | \$947                              | \$188 |

The amount of total gains or losses for the periods included in earnings (or changes in net assets) attributable to the change in unrealized gains or losses relating to assets still held at reporting date

\$- (75 )



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|  | Three Months Ended<br>September 30, |       |
|--|-------------------------------------|-------|
|  | 2011                                | 2010  |
| Other Stocks and Bonds   |                                     |       |
| Balance at Beginning of Period   | \$957                               | \$187 |
| Total gains or losses (realized/unrealized):   |                                     |       |
| Included in earnings (or changes in net assets)  | -                                   | -     |
| Included in other comprehensive income (loss)  | (10 )                               | 1     |
| Purchases  | -                                   | -     |
| Issuances  | -                                   | -     |
| Settlements  | -                                   | -     |
| Transfers in and/or out of Level 3   | -                                   | -     |
| Balance at End of Period   | \$947                               | \$188 |
| The amount of total gains or losses for the periods included in earnings (or changes in net assets) attributable to the change in unrealized gains or losses relating to assets still held at reporting date | \$-                                 | \$-   |

Disclosure of fair value information about financial instruments, whether or not recognized in the balance sheet is required, for which it is practicable to estimate that value. In cases where quoted market prices are not available, fair values are based on estimates using present value or other estimation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. Such techniques and assumptions, as they apply to individual categories of our financial instruments, are as follows:

Cash and cash equivalents - The carrying amounts for cash and cash equivalents is a reasonable estimate of those assets' fair value.

Investment and mortgage-backed and related securities - Fair values for these securities are based on quoted market prices, where available. If quoted market prices are not available, fair values are based on quoted market prices for similar securities or estimates from independent pricing services.

FHLB stock and other investments - The carrying amount of FHLB stock is a reasonable estimate of those assets' fair value.

Loans receivable - For adjustable rate loans that reprice frequently and with no significant change in credit risk, the carrying amounts are a reasonable estimate of those assets' fair value. The fair value of fixed rate loans is estimated by discounting the future cash flows using the current rates at which similar loans would be made to borrowers with similar credit ratings and for the same remaining maturities. Nonperforming loans are estimated using discounted cash flow analyses or the underlying value of the collateral where applicable.

Deposit liabilities - The fair value of demand deposits, savings accounts, and certain money market deposits is the amount on demand at the reporting date, that is, the carrying value. Fair values for fixed rate certificates of deposits are estimated using a discounted cash flow calculation that applies interest rates currently being offered for deposits of similar remaining maturities.

Federal funds purchased and repurchase agreements - Federal funds purchased and repurchase agreements generally have an original term to maturity of one day and thus are considered short-term borrowings. Consequently, their

carrying value is a reasonable estimate of fair value.

FHLB advances - The fair value of these advances is estimated by discounting the future cash flows using rates at which advances would be made to borrowers with similar credit ratings and for the same remaining maturities.

Long-term debt - The carrying amount for the long-term debt is estimated by discounting future cash flows using estimated rates at which long-term debt would be made to borrowers with similar credit ratings and for the remaining maturities. This type of debt is issued much less frequently since the economic crisis beginning in 2007. Therefore, the discount rate is a best estimate.

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The following table presents our financial assets, financial liabilities, and unrecognized financial instruments at both their respective carrying amounts and fair value:

|   | At September 30, 2011 |             | At December 31, 2010 |             |
|---|-----------------------|-------------|----------------------|-------------|
|   | Carrying<br>Amount    | Fair Value  | Carrying<br>Amount   | Fair Value  |
|   | (in thousands)        |             |                      |             |
| Financial assets:                                 |                       |             |                      |             |
| Cash and cash equivalents                         | \$47,131              | \$47,131    | \$79,073             | \$79,073    |
| Investment securities:                            |                       |             |                      |             |
| Available for sale, at estimated fair value       | 304,994               | 304,994     | 299,344              | 299,344     |
| Held to maturity, at amortized cost               | 1,496                 | 1,702       | 1,495                | 1,553       |
| Mortgage-backed and related securities:           |                       |             |                      |             |
| Available for sale, at estimated fair value       | 1,263,528             | 1,263,528   | 946,043              | 946,043     |
| Held to maturity, at amortized cost               | 389,178               | 404,879     | 417,862              | 426,572     |
| FHLB stock and other investments, at cost         | 31,121                | 31,121      | 36,776               | 36,776      |
| Loans, net of allowance for loan losses           | 1,022,282             | 1,032,092   | 1,057,209            | 1,066,125   |
| Loans held for sale                               | 5,491                 | 5,491       | 6,583                | 6,583       |
| Financial liabilities:                            |                       |             |                      |             |
| Retail deposits                                   | \$2,293,760           | \$2,298,118 | \$2,134,428          | \$2,138,587 |
| Federal funds purchased and repurchase agreements | 2,997                 | 2,997       | 3,844                | 3,844       |
| FHLB advances                                     | 562,662               | 578,417     | 562,573              | 578,561     |
| Long-term debt                                    | 60,311                | 45,620      | 60,311               | 50,673      |

As discussed earlier, the fair value estimate of financial instruments for which quoted market prices are unavailable is dependent upon the assumptions used. Consequently, those estimates cannot be substantiated by comparison to independent markets and, in many cases, could not be realized in immediate settlement of the instruments. Accordingly, the aggregate fair value amounts presented in the above fair value table do not necessarily represent their underlying value.

The estimated fair value of our commitments to extend credit, credit card arrangements and letters of credit, was not material at September 30, 2011 or December 31, 2010.



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## 10. Off-Balance-Sheet Arrangements, Commitments and Contingencies

Financial Instruments with Off-Balance-Sheet-Risk. In the normal course of business, we are a party to certain financial instruments, with off-balance-sheet risk, to meet the financing needs of our customers. These off-balance-sheet instruments include commitments to extend credit and standby letters of credit. These instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount reflected in the financial statements. The contract or notional amounts of these instruments reflect the extent of involvement and exposure to credit loss that we have in these particular classes of financial instruments.

Commitments to extend credit are agreements to lend to a customer provided that the terms established in the contract are met. Commitments generally have fixed expiration dates and may require payment of fees. Since some commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. Standby letters of credit are conditional commitments issued to guarantee the performance of a customer to a third party. These guarantees are primarily issued to support public and private borrowing arrangements. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan commitments to customers.

We had outstanding unused commitments to extend credit of \$128.3 million and \$113.3 million at September 30, 2011 and December 31, 2010, respectively. Each commitment has a maturity date and the commitment expires on that date with the exception of credit card and ready reserve commitments, which have no stated maturity date. Unused commitments for credit card and ready reserve at September 30, 2011 and December 31, 2010 were \$11.9 million and \$11.5 million, respectively, and are reflected in the due after one year category. We had outstanding standby letters of credit of \$5.9 million and \$5.0 million at September 30, 2011 and December 31, 2010, respectively.

The scheduled maturities of unused commitments as of September 30, 2011 and December 31, 2010 were as follows (in thousands):

|                         | September 30,<br>2011 | December 31,<br>2010 |
|-------------------------|-----------------------|----------------------|
| Unused commitments:     |                       |                      |
| Due in one year or less | \$ 96,379             | \$ 64,984            |
| Due after one year      | 31,944                | 48,267               |
| Total                   | \$ 128,323            | \$ 113,251           |

We apply the same credit policies in making commitments and standby letters of credit as we do for on-balance-sheet instruments. We evaluate each customer's credit worthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary, upon extension of credit is based on management's credit evaluation of the borrower. Collateral held varies but may include cash or cash equivalents, negotiable instruments, real estate, accounts receivable, inventory, oil, gas and mineral interests, property, plant and equipment.

Lease Commitments. We lease certain branch facilities and office equipment under operating leases. It is expected that certain leases will be renewed, or equipment replaced with new leased equipment, as these leases expire.

Securities. In the normal course of business we buy and sell securities. There were no unsettled trades to purchase or sell securities at September 30, 2011. There were no unsettled trades to sell securities at December 31, 2010. There were \$145,000 of unsettled trades to purchase securities at December 31, 2010.

Deposits. There were no unsettled issuances of brokered CDs at September 30, 2011. There were \$5.0 million of unsettled issuances of brokered CDs at December 31, 2010.

Litigation. We are involved with various litigation in the normal course of business. Management, after consulting with our legal counsel, believes that any liability resulting from litigation will not have a material effect on the financial position and results of operations and our liquidity.

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

The following is a discussion of the consolidated financial condition, changes in financial condition, and results of our operations, and should be read and reviewed in conjunction with the financial statements, and the notes thereto, in this Quarterly Report on Form 10-Q and in our Annual Report on Form 10-K for the year ended December 31, 2010.

We reported an increase in net income for the three months and a decrease for the nine months ended September 30, 2011 compared to the same periods in 2010. Net income attributable to Southside Bancshares, Inc. for the three and nine months ended September 30, 2011 was \$11.5 million and \$29.9 million, respectively, compared to \$11.0 million and \$31.9 million, respectively, for the same periods in 2010.

Forward Looking Statements

Certain statements of other than historical fact that are contained in this document and in written material, press releases and oral statements issued by or on behalf of Southside Bancshares, Inc., a bank holding company, may be considered to be "forward-looking statements" within the meaning of and subject to the protections of the Private Securities Litigation Reform Act of 1995. These forward-looking statements are not guarantees of future performance, nor should they be relied upon as representing management's views as of any subsequent date. These statements may include words such as "expect," "estimate," "project," "anticipate," "appear," "believe," "could," "should," "may," "intend," "probability," "risk," "target," "objective," "plans," "potential," and similar expressions. Forward-looking statements are statements with respect to our beliefs, plans, expectations, objectives, goals, anticipations, assumptions, estimates, intentions and future performance, and are subject to significant known and unknown risks and uncertainties, which could cause our actual results to differ materially from the results discussed in the forward-looking statements. For example, discussions of the effect of our expansion, trends in asset quality and earnings from growth, and certain market risk disclosures are based upon information presently available to management and are dependent on choices about key model characteristics and assumptions and are subject to various limitations. By their nature, certain of the market risk disclosures are only estimates and could be materially different from what actually occurs in the future. As a result, actual income gains and losses could materially differ from those that have been estimated. Other factors that could cause actual results to differ materially from forward-looking statements include, but are not limited to, the following:

- general economic conditions, either globally, nationally, in the State of Texas, or in the specific markets in which we operate, including, without limitation, the deterioration of the commercial real estate, residential real estate, construction and development, credit and liquidity markets, which could cause an adverse change in our net interest margin, or a decline in the value of our assets, which could result in realized losses;
- legislation, regulatory changes or changes in monetary or fiscal policy that adversely affect the businesses in which we are engaged, including the impact of the Dodd-Frank Act, the Federal Reserve's actions with respect to interest rates and other regulatory responses to current economic conditions;
- adverse changes in the status or financial stability or credit rating of the U.S. Treasury-issued securities impacting the U.S. Treasury's guarantees or ability to pay or issue debt;
  - adverse changes in the status or financial condition of the Government-Sponsored Enterprises (the "GSEs") impacting the GSEs' guarantees or ability to pay or issue debt;
- adverse changes in GSE mortgage-backed securities or the prepayments received on these securities as a result of government changes to refinancing and modification programs that would allow individuals previously unable to refinance or modify their loan;
- adverse changes in the credit portfolio of other U.S. financial institutions relative to the performance of certain of our investment securities;
  - economic or other disruptions caused by acts of terrorism in the United States, Europe or other areas;

- changes in the interest rate yield curve such as flat, inverted or steep yield curves, or changes in the interest rate environment that impact interest margins and may impact prepayments on the mortgage-backed securities portfolio;
  - increases in our nonperforming assets;
  - our ability to maintain adequate liquidity to fund operations and growth;
  - the failure of our assumptions underlying allowance for loan losses and other estimates;
  - unexpected outcomes of, and the costs associated with, existing or new litigation involving us;
    - changes impacting our balance sheet and leverage strategy;
    - our ability to monitor interest rate risk;
  - significant increases in competition in the banking and financial services industry;
    - changes in consumer spending, borrowing and saving habits;
    - technological changes;
    - our ability to increase market share and control expenses;
    - the effect of changes in federal or state tax laws;

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- the effect of compliance with legislation or regulatory changes;
- the effect of changes in accounting policies and practices;
- risks of mergers and acquisitions including the related time and cost of implementing transactions and the potential failure to achieve expected gains, revenue growth or expense savings;
  - credit risks of borrowers, including any increase in those risks due to changing economic conditions; and
- risks related to loans secured by real estate, including the risk that the value and marketability of collateral could decline.

All written or oral forward-looking statements made by us or attributable to us are expressly qualified by this cautionary notice. We disclaim any obligation to update any factors or to announce publicly the result of revisions to any of the forward-looking statements included herein to reflect future events or developments.

### Impact of Dodd-Frank Act

On July 21, 2010, the Dodd-Frank Act was signed into law. The Dodd-Frank Act represents a significant overhaul of many aspects of the regulation of the financial services industry, although some of its provisions apply to companies that are significantly larger than us. The Dodd-Frank Act directs applicable regulatory authorities to promulgate regulations implementing its provisions, and its effect on us and on the financial services industry as a whole will be clarified as those regulations are issued. Major elements of the Dodd-Frank Act include:

- A permanent increase in deposit insurance coverage to \$250,000 per account, unlimited deposit insurance on noninterest bearing transaction accounts beginning December 31, 2010 through December 31, 2012, and an increase in the minimum Deposit Insurance Fund reserve requirement from 1.15% to 1.35%, with assessments to be based on assets as opposed to deposits.
- New disclosure and other requirements relating to executive compensation and corporate governance.
- Amendments to the Truth in Lending Act aimed at improving consumer protections with respect to mortgage originations, including originator compensation, minimum repayment standards, and prepayment considerations.
- The establishment of the Financial Stability Oversight Council, which will be responsible for identifying and monitoring systemic risks posed by financial firms, activities, and practices.
  - The development of regulations to limit debit card interchange fees.
- The future elimination of newly issued trust preferred securities as a permitted element of Tier 1 capital.
- The creation of a special regime to allow for the orderly liquidation of systemically important financial companies, including the establishment of an orderly liquidation fund.
- The development of regulations to address derivatives markets, including clearing and exchange trading requirements and a framework for regulating derivatives-market participants.
  - Enhanced supervision of credit rating agencies through the Office of Credit Ratings within the SEC.
- Increased regulation of asset-backed securities, including a requirement that issuers of asset-backed securities retain at least 5% of the risk of the asset-backed securities.
- The establishment of a Bureau of Consumer Financial Protection, within the Federal Reserve, to serve as a dedicated consumer-protection regulatory body.

We continue to evaluate the potential impact of the Dodd-Frank Act on our business, financial condition and results of operations and expect that some provisions may have adverse effects on us, such as the cost of complying with the numerous new regulations and reporting requirements mandated by the Dodd-Frank Act.

### Critical Accounting Estimates

Our accounting and reporting estimates conform with U.S. generally accepted accounting principles (“GAAP”) and general practices within the financial services industry. The preparation of financial statements in conformity with

GAAP requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates. We consider our critical accounting policies to include the following:

**Allowance for Losses on Loans.** The allowance for losses on loans represents our best estimate of probable losses inherent in the existing loan portfolio. The allowance for losses on loans is increased by the provision for losses on loans charged to expense and reduced by loans charged-off, net of recoveries. The provision for losses on loans is determined based on our assessment of several factors: reviews and evaluations of specific loans, changes in the nature and volume of the loan portfolio, current economic conditions and the related impact on specific borrowers and industry groups, historical loan loss experience, the level of classified and nonperforming loans and the results of regulatory examinations.

The loan loss allowance is based on the most current review of the loan portfolio and is validated by multiple processes. The servicing officer has the primary responsibility for updating significant changes in a customer's financial position. Each officer prepares status updates on any credit deemed to be experiencing repayment difficulties which, in the officer's opinion, would place the collection of principal or interest in doubt. Our internal loan review department is responsible for an ongoing review of our loan portfolio with specific goals set for the loans to be reviewed on an annual basis.

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At each review, a subjective analysis methodology is used to grade the respective loan. Categories of grading vary in severity from loans that do not appear to have a significant probability of loss at the time of review to loans that indicate a probability that the entire balance of the loan will be uncollectible. If full collection of the loan balance appears unlikely at the time of review, estimates of future expected cash flows or appraisals of the collateral securing the debt are used to allocate the necessary allowances. The internal loan review department maintains a list of all loans or loan relationships that are graded as having more than the normal degree of risk associated with them. In addition, a list of specifically reserved loans or loan relationships of \$50,000 or more is updated on a quarterly basis in order to properly allocate necessary allowance and keep management informed on the status of attempts to correct the deficiencies noted with respect to the loan.

Loans are considered impaired if, based on current information and events, it is probable that we will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. The measurement of impaired loans is generally based on the present value of expected future cash flows discounted at the historical effective interest rate stipulated in the loan agreement, except that all collateral-dependent loans are measured for impairment based on the fair value of the collateral. In measuring the fair value of the collateral, in addition to relying on third party appraisals, we use assumptions such as discount rates, and methodologies, such as comparison to the recent selling price of similar assets, consistent with those that would be utilized by unrelated third parties performing a valuation.

Changes in the financial condition of individual borrowers, economic conditions, historical loss experience and the conditions of the various markets in which collateral may be sold all may affect the required level of the allowance for losses on loans and the associated provision for loan losses.

As of September 30, 2011, our review of the loan portfolio indicated that a loan loss allowance of \$18.2 million was adequate to cover probable losses in the portfolio.

Refer to “Part II - Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations - Loan Loss Experience and Allowance for Loan Losses” and “Note 6 – Loans and Allowance for Probable Loan Losses” of the Notes to Consolidated Financial Statements in our Annual Report on Form 10-K for the year ended December 31, 2010 for a detailed description of our estimation process and methodology related to the allowance for loan losses.

**Estimation of Fair Value.** The estimation of fair value is significant to a number of our assets and liabilities. GAAP requires disclosure of the fair value of financial instruments as a part of the notes to the consolidated financial statements. Fair values for securities are volatile and may be influenced by a number of factors, including market interest rates, prepayment speeds, discount rates and the shape of yield curves. Fair values for most investment and mortgage-backed securities are based on quoted market prices, where available. If quoted market prices are not available, fair values are based on the quoted prices of similar instruments or our estimate of fair value by using a range of fair value estimates in the market place as a result of the illiquid market specific to the type of security.

At September 30, 2008 and continuing at September 30, 2011, the valuation inputs for our AFS TRUPs became unobservable as a result of the significant market dislocation and illiquidity in the marketplace. Although we continue to rely on nonbinding prices compiled by third party vendors, the visibility of the observable market data (Level 2) to determine the values of these securities has become less clear. Fair values of financial assets are determined in an orderly transaction and not a forced liquidation or distressed sale at the measurement date. While we feel the financial market conditions at September 30, 2011 reflect the market illiquidity from forced liquidation or distressed sales for these TRUPs, we determined that the fair value provided by our pricing service continues to be an appropriate fair value for financial statement measurement and therefore, as we verified the reasonableness of that fair value, we have not otherwise adjusted the fair value provided by our vendor. However, the severe decline in estimated fair value is caused by the significant illiquidity in this market which contrasts sharply with our assessment of the fundamental

performance of these securities. Therefore, we believe the estimate of fair value is still not clearly based on observable market data and will be based on a range of fair value data points from the market place as a result of the illiquid market specific to this type of security. Accordingly, we determined that the TRUPs security valuation is based on Level 3 inputs.

Impairment of Investment Securities and Mortgage-backed Securities. Investment and mortgage-backed securities classified as AFS are carried at fair value and the impact of changes in fair value are recorded on our consolidated balance sheet as an unrealized gain or loss in "Accumulated other comprehensive income (loss)," a separate component of shareholders' equity. Securities classified as AFS or HTM are subject to our review to identify when a decline in value is other-than-temporary. Factors considered in determining whether a decline in value is other-than-temporary include: whether the decline is substantial; the duration of the decline; the reasons for the decline in value; whether the decline is related to a credit event, a change in interest rate or a change in the market discount rate; and the financial condition and near-term prospects of the issuer. Additionally, we do not currently intend to sell the security and it is not more likely than not that we will be required to sell the security before the anticipated recovery of its amortized cost basis. When it is determined that a decline in value is other-than-temporary, the carrying value of the security is reduced to its estimated fair value, with a corresponding charge to earnings for the credit portion and the noncredit portion to other comprehensive income. For certain assets we consider expected cash flows of the investment in determining if impairment exists.



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The turmoil in the capital markets had a significant impact on our estimate of fair value for certain of our securities. We believe the market values are reflective of a combination of illiquidity and credit impairment. At September 30, 2011 we have, in AFS Other Stocks and Bonds, \$2.9 million amortized cost basis in pooled TRUPs. Those securities are structured products with cash flows dependent upon securities issued by U.S. financial institutions, including banks and insurance companies. Our estimate of fair value at September 30, 2011 for the TRUPs is approximately \$947,000 and reflects the market illiquidity. With the exception of the TRUPs, to the best of management's knowledge and based on our consideration of the qualitative factors associated with each security, there were no securities in our investment and mortgage-backed securities portfolio at September 30, 2011 with an other-than-temporary impairment. Given the facts and circumstances associated with the TRUPs, we performed detailed cash flow modeling for each TRUP using an industry accepted model. Prior to loading the required assumptions into the model, we reviewed the financial condition of the underlying issuing banks within the TRUP collateral pool that had not deferred or defaulted as of September 30, 2011.

Management's best estimate of a default assumption, based on a third party method, was assigned to each issuing bank based on the category in which it fell. Our analysis of the underlying cash flows contemplated various default, deferral and recovery scenarios to arrive at our best estimate of cash flows. Based on that detailed analysis, we have concluded that the other-than-temporary impairment which captures the credit component in compliance with the FASB ASC Topic 320, "Investments – Debt and Equity Securities," was estimated at \$3.1 million at both September 30, 2011 and December 31, 2010. The noncredit charge to other comprehensive income was estimated at \$2.0 million and \$2.7 million at September 30, 2011 and December 31, 2010, respectively. The carrying amount of the TRUPs was written down with \$75,000 and \$3.0 million recognized in earnings for the nine months ended September 30, 2010 and for the year ended December 31, 2009, respectively. There was no additional write-down of the TRUPs recognized in earnings for the nine months ended September 30, 2011. The cash flow model assumptions represent management's best estimate and consider a variety of qualitative factors, which include, among others, the credit rating downgrades, severity and duration of the mark-to-market loss, and structural nuances of each TRUP. Management believes the detailed review of the collateral and cash flow modeling support the conclusion that the TRUPs had an other-than-temporary impairment at September 30, 2011. We will continue to update our assumptions and the resulting analysis each reporting period to reflect changing market conditions. Additionally, we do not currently intend to sell the TRUPs and it is not more likely than not that we will be required to sell the TRUPs before the anticipated recovery of their amortized cost basis.

**Defined Benefit Pension Plan.** The plan obligations and related assets of our defined benefit pension plan (the "Plan") are presented in "Note 12 – Employee Benefits" of the Notes to Consolidated Financial Statements in our Annual Report on Form 10-K for the year ended December 31, 2010. Entry into the Plan by new employees was frozen effective December 31, 2005. Plan assets, which consist primarily of marketable equity and debt instruments, are valued using observable market quotations. Plan obligations and the annual pension expense are determined by independent actuaries and through the use of a number of assumptions that are reviewed by management. Key assumptions in measuring the plan obligations include the discount rate, the rate of salary increases and the estimated future return on plan assets. In determining the discount rate, we utilized a cash flow matching analysis to determine a range of appropriate discount rates for our defined benefit pension and restoration plans. In developing the cash flow matching analysis, we constructed a portfolio of high quality noncallable bonds (rated AA- or better) to match as close as possible the timing of future benefit payments of the plans at December 31, 2010. Based on this cash flow matching analysis, we were able to determine an appropriate discount rate.

Salary increase assumptions are based upon historical experience and our anticipated future actions. The expected long-term rate of return assumption reflects the average return expected based on the investment strategies and asset allocation on the assets invested to provide for the Plan's liabilities. We considered broad equity and bond indices, long-term return projections, and actual long-term historical Plan performance when evaluating the expected long-term rate of return assumption. At September 30, 2011, the weighted-average actuarial assumptions of the Plan

were: a discount rate of 5.63%; a long-term rate of return on Plan assets of 7.25%; and assumed salary increases of 4.50%. Material changes in pension benefit costs may occur in the future due to changes in these assumptions. Future annual amounts could be impacted by changes in the number of Plan participants, changes in the level of benefits provided, changes in the discount rates, changes in the expected long-term rate of return, changes in the level of contributions to the Plan and other factors.

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Long-term Advance Commitments. During 2011, we entered into the option to purchase, two years forward from the advance commitment date, \$50 million par in long-term advance commitments from FHLB at the FHLB rates on the date the option was purchased. This increased to \$200 million the total amount of options of this type we have purchased. A table detailing the optional advance commitment terms is presented in “Note 6 – Long-Term Obligations” to our consolidated financial statements included in this report. In order to obtain these commitments from the FHLB we paid fees, which at September 30, 2011, were \$ 11.0 million. The fee, included in other assets in our consolidated balance sheet, will be amortized over the term of the advance as long as it is probable we will exercise the advance commitments. In determining quarterly, if it is still probable we will exercise the advance commitments we compare the all in costs of the advance commitment with the current advance rate available from the FHLB. If the current advance rate is reasonably close to or greater than the advance commitment rate then it is probable we will exercise our option. If the current rate is less, then we review the slope of the yield curve to determine if the forward yield curve supports our assumption that it is probable we will exercise the advance commitments.

## Off-Balance-Sheet Arrangements, Commitments and Contingencies

Details of our off-balance-sheet arrangements, commitments and contingencies as of September 30, 2011 and December 31, 2010, are included in “Note 10 – Off-Balance-Sheet Arrangements, Commitments and Contingencies” in the accompanying Notes to Financial Statements included in this report.

## Balance Sheet Strategy

We utilize wholesale funding and securities to enhance our profitability and balance sheet composition by determining acceptable levels of credit, interest rate and liquidity risk consistent with prudent capital management. This balance sheet strategy consists of borrowing a combination of long and short-term funds from the FHLB and, when determined appropriate, issuing brokered certificates of deposit (“CDs”). These funds are invested primarily in U.S. agency mortgage-backed securities, and to a lesser extent, long-term municipal securities. Although U.S. agency mortgage-backed securities often carry lower yields than traditional mortgage loans and other types of loans we make, these securities generally (i) increase the overall quality of our assets because of either the implicit or explicit guarantees of the U.S. government, (ii) are more liquid than individual loans and (iii) may be used to collateralize our borrowings or other obligations. While the strategy of investing a substantial portion of our assets in U.S. agency mortgage-backed securities and to a lesser extent municipal securities has historically resulted in lower interest rate spreads and margins, we believe that the lower operating expenses and reduced credit risk combined with the managed interest rate risk of this strategy have enhanced our overall profitability over the last several years. At this time, we utilize this balance sheet strategy with the goal of enhancing overall profitability by maximizing the use of our capital.

Risks associated with the asset structure we maintain include a lower net interest rate spread and margin when compared to our peers, changes in the slope of the yield curve, which can reduce our net interest rate spread and margin, increased interest rate risk, the length of interest rate cycles, changes in volatility spreads associated with the mortgage-backed securities and municipal securities, the unpredictable nature of mortgage-backed securities prepayments and credit risks associated with the municipal securities. See “Part I - Item 1A. Risk Factors – Risks Related to Our Business” in our Annual Report on Form 10-K for the year ended December 31, 2010 for a discussion of risks related to interest rates. Our asset structure, net interest spread and net interest margin require us to closely monitor our interest rate risk. An additional risk is the change in market value of the AFS securities portfolio as a result of changes in interest rates. Significant increases in interest rates, especially long-term interest rates, could adversely impact the market value of the AFS securities portfolio, which could also significantly impact our equity capital. Due to the unpredictable nature of mortgage-backed securities prepayments, the length of interest rate cycles, and the slope of the interest rate yield curve, net interest income could fluctuate more than simulated under the scenarios modeled by our Asset/Liability Committee (“ALCO”) and described under “Item 3. Quantitative and Qualitative Disclosures about Market Risk” in this report.

Determining the appropriate size of the balance sheet is one of the critical decisions any bank makes. Our balance sheet is not merely the result of a series of micro-decisions, but rather the size is controlled based on the economics of assets compared to the economics of funding. For several quarters up to and ending June 30, 2007, the size of our balance sheet was in a period of no growth or actual shrinkage due to the flat to inverted yield curve and tight volatility spreads during that time period. Beginning with the third quarter of 2007 we began deliberately increasing the size of our balance sheet taking advantage of the increasingly attractive economics of financial intermediation, due to the extraordinary volatility in the capital markets. While volatility in the capital markets has moderated since its high in 2008 and 2009, it increased some during the second and third quarters of 2011 due to concerns about the European debt crisis and the U.S. budget deficit. During the third quarter the Federal Reserve made two important announcements. They announced, first, that they believe shorter-term interest rates will remain low until mid 2013 and, second, that they would begin selling short-term treasury securities and begin purchasing long-term treasury securities in an effort to lower long-term interest rates. As a result, the current investment and economic landscape has changed, which resulted in a decision to grow our assets in the third quarter and which could result in future asset growth.

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The management of our securities portfolio as a percentage of earning assets is guided by changes in our overall loan and deposit levels, combined with changes in our wholesale funding levels. If adequate quality loan growth is not available to achieve our goal of enhancing profitability by maximizing the use of capital, as described above, then we could purchase additional securities, if appropriate, which could cause securities as a percentage of earning assets to increase. Should we determine that increasing the securities portfolio or replacing the current securities maturities and principal payments is not an efficient use of capital, we could decrease the level of securities through proceeds from maturities, principal payments on mortgage-backed securities or sales. Our balance sheet strategy is designed such that our securities portfolio should help mitigate financial performance associated with slower loan growth and higher credit costs.

The quarter ended September 30, 2011 was marked by proactive management of the investment portfolio which included continued restructuring of a portion of our investment portfolio. This restructuring resulted in a gain on the sale of AFS securities of \$3.9 million during the three months ended September 30, 2011. During the quarter ended September 30, 2011, as interest rates decreased, we continued to sell primarily lower yielding, longer duration municipal securities and lower coupon or more prepayment volatile mortgage-backed securities and replaced them with primarily shorter duration municipal securities and higher coupon and less prepayment volatile mortgage-backed securities that might perform better in both the current and potentially higher interest rate environment in the future. During the quarter ended September 30, 2011, we increased the size of the securities portfolio as long-term U.S. Treasury yields decreased due to increased global economic concerns and U.S. deficit concerns, the Federal Reserve signaling an extended period of low short-term interest rates, loans increasing only slightly and overall deposit growth. The net result was an increase of \$122.5 million in our investment and U.S. agency mortgage-backed securities from \$1.84 billion at June 30, 2011, to \$1.96 billion at September 30, 2011. The average coupon of the mortgage-backed securities portfolio increased from 5.90% at December 31, 2010 to 6.14% at September 30, 2011. At September 30, 2011, securities as a percentage of assets increased to 61.0%, when compared to 59.0% at June 30, 2011, 58.8% at March 31, 2011 and 55.5% at December 31, 2010. Our balance sheet management strategy is dynamic and will be continually reevaluated as market conditions warrant. As interest rates, yield curves, mortgage-backed securities prepayments, funding costs, security spreads and loan and deposit portfolios change, our determination of the proper types and maturities of securities to own, proper amount of securities to own and funding needs and funding sources will continue to be reevaluated. Should the economics of asset accumulation decrease, we might allow the balance sheet to shrink through run-off or asset sales. However, should the economics become more attractive, we will strategically increase the balance sheet.

With respect to liabilities, we will continue to utilize a combination of FHLB advances and deposits to achieve our strategy of minimizing cost while achieving overall interest rate risk objectives as well as the liability management objectives of the ALCO. FHLB funding and brokered CDs represent wholesale funding sources we are currently utilizing. Our FHLB borrowings at September 30, 2011 increased 5.6%, or \$29.9 million, to \$562.7 million from \$532.8 million at June 30, 2011. During 2011, we entered into the option to purchase, two years forward from the advance commitment date, \$50 million par in long-term advance commitments from FHLB at the FHLB rates on the date the option was purchased. This increased to \$200 million the total amount of options of this type we have purchased. As of September 30, 2011 we had \$166.3 million in long-term brokered CDs. All of the long-term brokered CDs have short-term calls that we control. We utilized long-term callable brokered CDs because the brokered CDs better matched overall ALCO objectives at the time of issuance by protecting us with fixed rates should interest rates increase, while providing us options to call the funding should interest rates decrease. Our wholesale funding policy currently allows maximum brokered CDs of \$180 million; however, this amount could be increased to match changes in ALCO objectives. We have been actively calling and reissuing our brokered CDs which has allowed us to both extend the maturities and lower the funding costs. The potential higher interest expense and lack of customer loyalty are risks associated with the use of brokered CDs. During the three months ended September 30, 2011, overall growth in our deposits, offset with a slight increase in FHLB borrowings, resulted in a decrease in our total wholesale funding as a percentage of deposits, not including brokered CDs, to 34.3% at September 30, 2011,

from 45.0% at September 30, 2010 and 36.7% at December 31, 2010.

#### Net Interest Income

Net interest income is one of the principal sources of a financial institution's earnings stream and represents the difference or spread between interest and fee income generated from interest earning assets and the interest expense paid on deposits and borrowed funds. Fluctuations in interest rates or interest rate yield curves, as well as repricing characteristics and volume and changes in the mix of interest earning assets and interest bearing liabilities, materially impact net interest income.

Net interest income for the nine months ended September 30, 2011 was \$70.8 million, an increase of \$7.1 million, or 11.2%, compared to the same period in 2010. The overall increase in net interest income was the result of the decrease in interest expense.

During the nine months ended September 30, 2011, total interest income decreased \$283,000, or 0.3%, to \$98.3 million compared to \$98.6 million for the same period in 2010. The decrease in total interest income was the result of a decrease in the average yield on average interest earning assets from 5.07% for the nine months ended September 30, 2010 to 4.93% for the nine months ended September 30, 2011 which more than offset the increase in average interest earning assets of \$95.9 million, or 3.5%, from \$2.77 billion to \$2.87 billion. Total interest expense decreased \$7.4 million, or 21.2%, to \$27.4 million during the nine months ended September 30, 2011 as compared to \$34.8 million during the same period in 2010. The decrease was attributable to a decrease in the average yield on interest bearing liabilities for the nine months ended September 30, 2011, to 1.56% from 2.01% for the same period in 2010, which was partially offset by an increase in average interest bearing liabilities of \$38.0 million, or 1.6%, from \$2.32 billion for the nine months ended September 30, 2010 to \$2.36 billion for the same period in 2011.

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Net interest income increased during the three months ended September 30, 2011 when compared to the same period in 2010 primarily as a result of a decrease in interest expense. Our average interest earning assets increased \$153.6 million, or 5.6%. The decrease in the average yield on interest bearing liabilities of 55 basis points is a result of an overall decrease in interest rates compared to the same period in 2010. For the three months ended September 30, 2011, our net interest spread and net interest margin increased to 3.35% and 3.61%, respectively, from 3.02% and 3.35% when compared to the same period in 2010.

During the nine months ended September 30, 2011, average loans increased \$27.9 million, or 2.7%, compared to the same period in 2010. Municipal loans represent a large part of this increase. The average yield on loans decreased from 7.13% for the nine months ended September 30, 2010 to 6.81% for the nine months ended September 30, 2011. The decrease in interest income on loans of \$1.5 million, or 2.9%, to \$50.6 million for the nine months ended September 30, 2011, when compared to \$52.1 million for the same period in 2010 was the result of a decrease in the average yield which more than offset the increase in the average balance. The decrease in the yield on loans was due to overall lower interest rates. For the three months ended September 30, 2011, average loans increased \$7.3 million, or 0.7%, to \$1.03 billion, when compared to \$1.02 billion for the same period in 2010. The average yield on loans decreased from 6.87% for the three months ended September 30, 2010 to 6.60% for the three months ended September 30, 2011. Due to the competitive loan pricing environment, we anticipate that we may be required to continue to offer lower interest rate loans that compete with those offered by other financial institutions in order to retain quality loan relationships. Offering lower interest rate loans could impact the overall loans yield and, therefore, profitability.

Average investment and mortgage-backed securities increased \$83.7 million, or 4.9%, from \$1.69 billion to \$1.78 billion, for the nine months ended September 30, 2011 when compared to the same period in 2010. This increase was the result of securities purchased due primarily to buying opportunities available throughout early 2011 and increased volatility during the second and third quarters. At September 30, 2011, virtually all of our mortgage-backed securities were fixed rate securities with less than one percent variable rate mortgage-backed securities. The overall yield on average investment and mortgage-backed securities decreased to 3.92% during the nine months ended September 30, 2011, from 3.97% during the same period in 2010. The decrease in the average yield primarily reflects the purchase of lower yielding securities when compared to both those securities paying off and securities in the current securities portfolio due to the lower interest rate environment during 2011 when compared to 2010. During the first six months of 2010, prepayments on our mortgage-backed securities increased significantly due to a one time prepayment event caused by a Fannie Mae and Freddie Mac announcement that they had not repurchased delinquent mortgage loans from mortgage pools for several months and would be repurchasing those loans primarily during the first six months of 2010. This caused a significant one time prepayment event that increased our amortization expense significantly during the first six months of 2010. Interest income on investment and mortgage-backed securities increased \$1.2 million during the nine months ended September 30, 2011, or 2.7%, compared to the same period in 2010 due to an increase in the average balance which more than offset the decrease in the yield. For the three months ended September 30, 2011, average investment and mortgage-backed securities increased \$169.8 million, or 10.1%, to \$1.85 billion, when compared to \$1.68 billion for the same period in 2010. The overall yield on average investment and mortgage-backed securities decreased to 3.85% during the three months ended September 30, 2011, from 4.01% during the same period in 2010. Interest income from investment and mortgage-backed securities increased \$608,000, or 3.9%, to \$16.4 million for the three months ended September 30, 2011, compared to \$15.8 million for the same period in 2010. The decrease in the average yield primarily reflects the purchase of lower yielding securities when compared to both those securities paying off and securities in the current securities portfolio due to the overall lower interest rate environment in 2011 when compared to 2010. The increase in interest income for the three months is due to the increase in the average balance which more than offset the decrease in the average yield.

Average FHLB stock and other investments decreased \$8.3 million, or 21.6%, to \$30.1 million, for the nine months ended September 30, 2011, when compared to \$38.5 million for the same period in 2010 due to the decrease in FHLB

advances during 2011 and the corresponding requirement to hold stock associated with those advances. Interest income from our FHLB stock and other investments decreased \$18,000, or 9.0%, during the nine months ended September 30, 2011, when compared to the same period in 2010 due to the decrease in the average balance which more than offset the increase in the average yield from 0.70% for the nine months ended September 30, 2010 compared to 0.81% for the same period in 2011. For the three months ended September 30, 2011, average FHLB stock and other investments decreased \$8.5 million, or 22.3%, to \$29.7 million, when compared to \$38.2 million for the same period in 2010. The FHLB stock is a variable instrument with the rate typically tied to the federal funds rate. We are required as a member of FHLB to own a specific amount of stock that changes as the level of our FHLB advances and asset size change. For the three months ended September 30, 2011, interest income from FHLB stock and other investments decreased \$9,000, or 15.3%, to \$50,000, when compared to \$59,000 for the same period in 2010 as a result of the decrease in the average balance which more than offset the increase in the average yield from 0.61% in 2010 to 0.67% in 2011.



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Average interest earning deposits decreased \$6.3 million, or 40.9%, to \$9.2 million, for the nine months ended September 30, 2011, when compared to \$15.5 million for the same period in 2010. Interest income from interest earning deposits decreased \$4,000, or 21.1%, for the nine months ended September 30, 2011, when compared to the same period in 2010, as a result of the decrease in the average balance which more than offset the increase in the average yield from 0.16% in 2010 to 0.22% in 2011. Average interest earning deposits decreased \$13.1 million, or 70.6%, to \$5.4 million, for the three months ended September 30, 2011, when compared to \$18.5 million for the same period in 2010. Interest income from interest earning deposits decreased \$2,000, or 50.0%, for the three months ended September 30, 2011, when compared to the same period in 2010, as a result of the decrease in the average balance while offset by an increase in the average yield from 0.09% in 2010 to 0.15% in 2011.

During the nine months ended September 30, 2011, our average securities increased more than our average loans compared to the same period in 2010. The mix of our average interest earning assets changed as average total securities as a percentage of total average interest earning assets increased to 61.9% during the nine months ended September 30, 2011 compared to 61.0% during the same period in 2010. Average loans decreased to 36.7% of average total interest earning assets and other interest earning asset categories averaged 1.4% for the nine months ended September 30, 2011. During 2010, the comparable mix was 37.0% in loans and 2.0% in the other interest earning asset categories.

Total interest expense decreased \$7.4 million, or 21.2%, to \$27.4 million during the nine months ended September 30, 2011 as compared to \$34.8 million during the same period in 2010. The decrease was primarily attributable to decreased funding costs as the average yield on interest bearing liabilities decreased from 2.01% for 2010 to 1.56% for the nine months ended September 30, 2011, which more than offset an increase in average interest bearing liabilities. The increase in average interest bearing liabilities of \$38.0 million, or 1.6% included an increase in deposits of \$224.1 million, or 14.9% that was offset by a decrease in FHLB advances and other short-term obligations of \$186.1 million, or 24.7%. For the three months ended September 30, 2011, total interest expense decreased \$2.8 million, or 24.7%, to \$8.6 million, compared to \$11.5 million for the same period in 2010 as a result of a decrease in the average yield while partially offset by an increase in the average balance on interest bearing liabilities. Average interest bearing liabilities increased \$92.9 million, or 4.0%, while the average yield decreased from 1.98% for the three months ended September 30, 2010 to 1.43% for the three months ended September 30, 2011.

Average interest bearing deposits increased \$224.1 million, or 14.9%, from \$1.51 billion to \$1.73 billion, while the average rate paid decreased from 1.30% for the nine months ended September 30, 2010 to 0.92% for the nine months ended September 30, 2011. For the three months ended September 30, 2011, average interest bearing deposits increased \$231.3 million, or 15.3%, to \$1.75 billion, when compared to \$1.51 billion for the same period in 2010 while the average rate paid decreased from 1.28% for the three month period ended September 30, 2010 to 0.88% for the three month period ended September 30, 2011. Average time deposits increased \$140.3 million, or 19.6%, from \$715.7 million to \$856.1 million while the average rate paid decreased to 1.34% for the nine months ended September 30, 2011 as compared to 1.95% for the same period in 2010. Average interest bearing demand deposits increased \$72.5 million, or 10.1%, while the average rate paid decreased to 0.55% for the nine months ended September 30, 2011 as compared to 0.73% for the same period in 2010. Average savings deposits increased \$11.2 million, or 15.2%, while the average rate paid decreased to 0.26% for the nine months ended September 30, 2011 as compared to 0.46% for the same period in 2010. Interest expense for interest bearing deposits for the nine months ended September 30, 2011, decreased \$2.6 million, or 18.1%, when compared to the same period in 2010 due to the decrease in the average yield which more than offset the increase in the average balance. Average noninterest bearing demand deposits increased \$46.8 million, or 11.5%, during the nine months ended September 30, 2011. The latter three categories, which are considered the lowest cost deposits, comprised 60.8% of total average deposits during the nine months ended September 30, 2011 compared to 62.6% during the same period in 2010. The increase in our average total deposits is primarily the result of an increase in deposits from municipalities and, to a lesser extent, deposit growth due to branch expansion, continued market penetration, and an increase in brokered CDs issued.

During the nine months ended September 30, 2011, we issued \$112.6 million of long-term brokered CDs. All of the long-term brokered CDs have short-term calls that we control. We utilize long-term callable brokered CDs because the brokered CDs better match overall ALCO objectives at the time of issuance by protecting us with fixed rates should interest rates increase, while providing us options to call the funding should interest rates decrease. At September 30, 2011, we had \$166.3 million in brokered CDs that represented 7.2% of deposits compared to \$161.3 million, or 7.6% of deposits, at December 31, 2010. At September 30, 2011 and December 31, 2010, all of the brokered CDs had maturities of less than six years. Our wholesale funding policy currently allows maximum brokered CDs of \$180 million; however, this amount could be increased to match changes in ALCO objectives. We have been actively calling and reissuing our brokered CDs which has allowed us to both extend the maturities and lower the funding costs. This was the primary reason for the issuance of \$112.6 million of brokered CDs during 2011. The potential higher interest cost and lack of customer loyalty are risks associated with the use of brokered CDs.

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Average short-term interest bearing liabilities, consisting primarily of FHLB advances, federal funds purchased and repurchase agreements, were \$266.7 million, a decrease of \$38.1 million, or 12.5%, for the nine months ended September 30, 2011 when compared to the same period in 2010. Interest expense associated with short-term interest bearing liabilities decreased \$556,000, or 9.9%, while the average rate paid increased seven basis points to 2.54% for the nine months ended September 30, 2011, when compared to 2.47% for the same period in 2010. The increase in the average rate paid was due to the higher rate long-term FHLB advances rolling into the short-term FHLB advances category. For the three months ended September 30, 2011, average short-term interest bearing liabilities increased \$8.8 million, or 2.8%, when compared to the same period in 2010. Interest expense associated with short-term interest bearing liabilities decreased \$443,000, or 21.2%, and the average rate paid decreased to 2.03% for the three month period ended September 30, 2011 when compared to 2.65% for the same period in 2010. The decrease in the average rate paid reflects the use of more low cost short-term FHLB advances in 2011 when compared to 2010. The decrease in the interest expense was due to a decrease in the average rate paid while offset by an increase in the average balance.

Average long-term interest bearing liabilities consisting of FHLB advances decreased \$148.0 million, or 33.0%, during the nine months ended September 30, 2011 to \$300.2 million as compared to \$448.2 million for the nine months ended September 30, 2010. Interest expense associated with long-term FHLB advances decreased \$4.2 million, or 34.4%, and the average rate paid decreased eight basis points for the nine months ended September 30, 2011 when compared to the same period in 2010. For the three months ended September 30, 2011, long-term interest bearing liabilities decreased \$147.2 million, or 35.7%, when compared to the same period in 2010. Interest expense associated with long-term FHLB advances decreased \$1.4 million, or 37.4%, and the average rate paid decreased to 3.43% for the three months ended September 30, 2011 when compared to 3.53% for the same period in 2010. The decrease in the average long-term FHLB advances is due primarily to advances classified as long-term at December 31, 2010 rolling into the short-term category, an increase in the issuance of long-term callable brokered CDs, the use of more short-term FHLB advances during the period and the decision to enter into \$200 million par in long-term advance commitments from the FHLB. During the second half of 2010, we entered into the option to fund between one and a half years and two years forward from the advance commitment date, \$150 million par in long-term advance commitments from the FHLB at the FHLB rates on the date the option was purchased. During the first quarter of 2011 we entered into an additional \$50 million of these options to fund two years forward from the advance commitment date, for a total of \$200 million. In order to obtain these commitments from the FHLB, we paid fees, which at September 30, 2011, were \$11.0 million. The fee, included in other assets in our consolidated balance sheet, will be amortized over the term of the advance as long as it is probable we will exercise the advance commitments. Should we determine the advance commitments will not be exercised, the fee will be expensed in the period determination is made. FHLB advances are collateralized by FHLB stock, securities and nonspecific real estate loans.

Average long-term debt, consisting of our junior subordinated debentures issued in 2003 and August 2007 and junior subordinated debentures acquired in the purchase of FWBS, was \$60.3 million for the three and nine months ended September 30, 2011 and 2010. During the third quarter ended September 30, 2007, we issued \$36.1 million of junior subordinated debentures in connection with the issuance of trust preferred securities by our subsidiaries Southside Statutory Trusts IV and V. The \$36.1 million in debentures were issued to fund the purchase of FWBS, which occurred on October 10, 2007. Interest expense associated with long-term debt decreased \$13,000, or 0.5% to \$2.4 million for the nine months ended September 30, 2011, when compared to the same period in 2010, as a result of a decrease in the average yield of three basis points during the nine months ended September 30, 2011 when compared to the same period in 2010. Interest expense was \$820,000 for the three month periods ended September 30, 2011, a decrease of \$16,000, or 1.9%, when compared to the same period in 2010, as a result of a decrease in the average yield of 11 basis points. The interest rate on the \$20.6 million of long-term debentures issued to Southside Statutory Trust III adjusts quarterly at a rate equal to three-month LIBOR plus 294 basis points. The \$23.2 million of long-term debentures issued to Southside Statutory Trust IV and the \$12.9 million of long-term debentures issued to Southside

Statutory Trust V have fixed rates of 6.518% through October 30, 2012 and 7.48% through December 15, 2012, respectively, and thereafter, adjust quarterly. The interest rate on the \$3.6 million of long-term debentures issued to Magnolia Trust Company I, assumed in the purchase of FWBS, adjusts quarterly at a rate equal to three-month LIBOR plus 180 basis points.

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## RESULTS OF OPERATIONS

The analysis below shows average interest earning assets and interest bearing liabilities together with the average yield on the interest earning assets and the average cost of the interest bearing liabilities.

## AVERAGE BALANCES AND YIELDS

(dollars in thousands)

(unaudited)

Nine Months Ended

|   | September 30, 2011 |           |              | September 30, 2010 |           |              |
|---|--------------------|-----------|--------------|--------------------|-----------|--------------|
|   | AVG<br>BALANCE     | INTEREST  | AVG<br>YIELD | AVG<br>BALANCE     | INTEREST  | AVG<br>YIELD |
| <b>ASSETS</b>                               |                    |           |              |                    |           |              |
| <b>INTEREST EARNING ASSETS:</b>             |                    |           |              |                    |           |              |
| Loans (1) (2)                               | \$ 1,049,918       | \$ 53,443 | 6.81 %       | \$ 1,022,003       | \$ 54,521 | 7.13 %       |
| Loans Held For Sale                         | 3,414              | 100       | 3.92 %       | 4,509              | 125       | 3.71 %       |
| <b>Securities:</b>                          |                    |           |              |                    |           |              |
| Investment Securities (Taxable)(4)          | 6,040              | 49        | 1.08 %       | 9,271              | 72        | 1.04 %       |
| Investment Securities (Tax-Exempt)(3)(4)    | 296,752            | 14,198    | 6.40 %       | 240,434            | 12,276    | 6.83 %       |
| Mortgage-backed and Related Securities (4)  | 1,474,104          | 37,899    | 3.44 %       | 1,443,459          | 37,937    | 3.51 %       |
| Total Securities                            | 1,776,896          | 52,146    | 3.92 %       | 1,693,164          | 50,285    | 3.97 %       |
| FHLB stock and other investments, at cost   | 30,146             | 182       | 0.81 %       | 38,471             | 200       | 0.70 %       |
| Interest Earning Deposits                   | 9,164              | 15        | 0.22 %       | 15,502             | 19        | 0.16 %       |
| Total Interest Earning Assets               | 2,869,538          | 105,886   | 4.93 %       | 2,773,649          | 105,150   | 5.07 %       |
| <b>NONINTEREST EARNING ASSETS:</b>          |                    |           |              |                    |           |              |
| Cash and Due From Banks                     | 42,069             |           |              | 43,723             |           |              |
| Bank Premises and Equipment                 | 50,570             |           |              | 48,233             |           |              |
| Other Assets                                | 137,774            |           |              | 124,201            |           |              |
| Less: Allowance for Loan Loss               | (19,258 )          |           |              | (19,079 )          |           |              |
| Total Assets                                | \$ 3,080,693       |           |              | \$ 2,970,727       |           |              |
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b> |                    |           |              |                    |           |              |
| <b>INTEREST BEARING LIABILITIES:</b>        |                    |           |              |                    |           |              |
| Savings Deposits                            | \$ 84,899          | 168       | 0.26 %       | \$ 73,725          | 251       | 0.46 %       |
| Time Deposits                               | 856,059            | 8,554     | 1.34 %       | 715,716            | 10,462    | 1.95 %       |
| Interest Bearing Demand Deposits            | 790,608            | 3,244     | 0.55 %       | 718,067            | 3,899     | 0.73 %       |
|   | 1,731,566          | 11,966    | 0.92 %       | 1,507,508          | 14,612    | 1.30 %       |

|   |              |           |        |              |           |        |  |
|---|--------------|-----------|--------|--------------|-----------|--------|--|
| Total Interest Bearing                        |              |           |        |              |           |        |  |
| Deposits                                      |              |           |        |              |           |        |  |
| Short-term Interest Bearing                   |              |           |        |              |           |        |  |
| Liabilities                                   | 266,730      | 5,077     | 2.54 % | 304,811      | 5,633     | 2.47 % |  |
| Long-term Interest Bearing                    |              |           |        |              |           |        |  |
| Liabilities – FHLB Dallas                     | 300,184      | 7,958     | 3.54 % | 448,156      | 12,133    | 3.62 % |  |
| Long-term Debt (5)                            | 60,311       | 2,439     | 5.41 % | 60,311       | 2,452     | 5.44 % |  |
| Total Interest Bearing                        |              |           |        |              |           |        |  |
| Liabilities                                   | 2,358,791    | 27,440    | 1.56 % | 2,320,786    | 34,830    | 2.01 % |  |
| NONINTEREST BEARING LIABILITIES:              |              |           |        |              |           |        |  |
| Demand Deposits                               | 454,454      |           |        | 407,659      |           |        |  |
| Other Liabilities                             | 34,089       |           |        | 25,775       |           |        |  |
| Total Liabilities                             | 2,847,334    |           |        | 2,754,220    |           |        |  |
| SHAREHOLDERS' EQUITY (6)                      |              |           |        |              |           |        |  |
|   | 233,359      |           |        | 216,507      |           |        |  |
| Total Liabilities and Shareholders' Equity    | \$ 3,080,693 |           |        | \$ 2,970,727 |           |        |  |
| NET INTEREST INCOME                           |              | \$ 78,446 |        |              | \$ 70,320 |        |  |
| NET INTEREST MARGIN ON AVERAGE EARNING ASSETS |              |           |        |              |           |        |  |
|   |              |           | 3.66 % |              |           | 3.39 % |  |
| NET INTEREST SPREAD                           |              |           |        |              |           |        |  |
|   |              |           | 3.37 % |              |           | 3.06 % |  |

(1) Interest on loans includes fees on loans that are not material in amount.

(2) Interest income includes taxable-equivalent adjustments of \$2,913 and \$2,518 for the nine months ended September 30, 2011 and 2010, respectively.

(3) Interest income includes taxable-equivalent adjustments of \$4,691 and \$4,067 for the nine months ended September 30, 2011 and 2010, respectively.

(4) For the purpose of calculating the average yield, the average balance of securities is presented at historical cost.

(5) Represents junior subordinated debentures issued by us to Southside Statutory Trust III, IV, and V in connection with the issuance by Southside Statutory Trust III of \$20 million of trust preferred securities, Southside Statutory Trust IV of \$22.5 million of trust preferred securities, Southside Statutory Trust V of \$12.5 million of trust preferred securities and junior subordinated debentures issued by FWBS to Magnolia Trust Company I in connection with the issuance by Magnolia Trust Company I of \$3.5 million of trust preferred securities.

(6) Includes average equity of noncontrolling interest of \$1,487 and \$1,195 for the nine months ended September 30, 2011 and 2010, respectively.

Note: As of September 30, 2011 and 2010, loans totaling \$10,634 and \$14,631, respectively, were on nonaccrual status. Our policy is to reverse previously accrued but unpaid interest on nonaccrual loans; thereafter, interest income is recorded to the extent received when appropriate.

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## AVERAGE BALANCES AND YIELDS

(dollars in thousands)

(unaudited)

Three Months Ended

|  | September 30, 2011 |           |              | September 30, 2010 |           |              |
|--|--------------------|-----------|--------------|--------------------|-----------|--------------|
|  | AVG<br>BALANCE     | INTEREST  | AVG<br>YIELD | AVG<br>BALANCE     | INTEREST  | AVG<br>YIELD |
| <b>ASSETS</b>  |                    |           |              |                    |           |              |
| <b>INTEREST EARNING ASSETS:</b>                      |                    |           |              |                    |           |              |
| Loans (1) (2)  | \$ 1,031,435       | \$ 17,162 | 6.60 %       | \$ 1,024,157       | \$ 17,742 | 6.87 %       |
| Loans Held For Sale                                  | 4,019              | 32        | 3.16 %       | 6,032              | 54        | 3.55 %       |
| <b>Securities:</b>                                   |                    |           |              |                    |           |              |
| Investment Securities (Taxable)(4)                   | 4,037              | 11        | 1.08 %       | 9,070              | 20        | 0.87 %       |
| Investment Securities (Tax-Exempt)(3)(4)             | 285,598            | 4,634     | 6.44 %       | 209,727            | 3,574     | 6.76 %       |
| Mortgage-backed and Related Securities (4)           | 1,558,141          | 13,292    | 3.38 %       | 1,459,132          | 13,378    | 3.64 %       |
| Total Securities                                     | 1,847,776          | 17,937    | 3.85 %       | 1,677,929          | 16,972    | 4.01 %       |
| FHLB stock and other investments, at cost            | 29,665             | 50        | 0.67 %       | 38,161             | 59        | 0.61 %       |
| Interest Earning Deposits                            | 5,440              | 2         | 0.15 %       | 18,503             | 4         | 0.09 %       |
| Total Interest Earning Assets                        | 2,918,335          | 35,183    | 4.78 %       | 2,764,782          | 34,831    | 5.00 %       |
| <b>NONINTEREST EARNING ASSETS:</b>                   |                    |           |              |                    |           |              |
| Cash and Due From Banks                              | 37,269             |           |              | 41,202             |           |              |
| Bank Premises and Equipment                          | 50,681             |           |              | 49,267             |           |              |
| Other Assets   | 175,659            |           |              | 130,860            |           |              |
| Less: Allowance for Loan Loss                        | (18,474 )          |           |              | (18,789 )          |           |              |
| Total Assets   | \$ 3,163,470       |           |              | \$ 2,967,322       |           |              |
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>          |                    |           |              |                    |           |              |
| <b>INTEREST BEARING LIABILITIES:</b>                 |                    |           |              |                    |           |              |
| Savings Deposits                                     | \$ 87,960          | 50        | 0.23 %       | \$ 74,620          | 84        | 0.45 %       |
| Time Deposits  | 854,485            | 2,810     | 1.30 %       | 720,737            | 3,508     | 1.93 %       |
| Interest Bearing Demand Deposits                     | 803,159            | 1,019     | 0.50 %       | 718,910            | 1,282     | 0.71 %       |
| Total Interest Bearing Deposits                      | 1,745,604          | 3,879     | 0.88 %       | 1,514,267          | 4,874     | 1.28 %       |
| Short-term Interest Bearing Liabilities              | 320,934            | 1,643     | 2.03 %       | 312,182            | 2,086     | 2.65 %       |
| Long-term Interest Bearing Liabilities – FHLB Dallas | 265,162            | 2,295     | 3.43 %       | 412,356            | 3,668     | 3.53 %       |

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|   |              |           |        |              |           |        |
|---|--------------|-----------|--------|--------------|-----------|--------|
| Long-term Debt (5)                            | 60,311       | 820       | 5.39 % | 60,311       | 836       | 5.50 % |
| Total Interest Bearing Liabilities            | 2,392,011    | 8,637     | 1.43 % | 2,299,116    | 11,464    | 1.98 % |
| <b>NONINTEREST BEARING LIABILITIES:</b>       |              |           |        |              |           |        |
| Demand Deposits                               | 467,008      |           |        | 418,344      |           |        |
| Other Liabilities                             | 53,688       |           |        | 23,924       |           |        |
| Total Liabilities                             | 2,912,707    |           |        | 2,741,384    |           |        |
| <b>SHAREHOLDERS' EQUITY (6)</b>               |              |           |        |              |           |        |
| Total Liabilities and Shareholders' Equity    | \$ 3,163,470 |           |        | \$ 2,967,322 |           |        |
| NET INTEREST INCOME                           |              | \$ 26,546 |        |              | \$ 23,367 |        |
| NET INTEREST MARGIN ON AVERAGE EARNING ASSETS |              |           | 3.61 % |              |           | 3.35 % |
| NET INTEREST SPREAD                           |              |           | 3.35 % |              |           | 3.02 % |

- (1) Interest on loans includes fees on loans that are not material in amount.
- (2) Interest income includes taxable-equivalent adjustments of \$965 and \$870 for the three months ended September 30, 2011 and 2010, respectively.
- (3) Interest income includes taxable-equivalent adjustments of \$1,565 and \$1,208 for the three months ended September 30, 2011 and 2010, respectively.
- (4) For the purpose of calculating the average yield, the average balance of securities is presented at historical cost.
- (5) Represents junior subordinated debentures issued by us to Southside Statutory Trust III, IV, and V in connection with the issuance by Southside Statutory Trust III of \$20 million of trust preferred securities, Southside Statutory Trust IV of \$22.5 million of trust preferred securities, Southside Statutory Trust V of \$12.5 million of trust preferred securities and junior subordinated debentures issued by FWBS to Magnolia Trust Company I in connection with the issuance by Magnolia Trust Company I of \$3.5 million of trust preferred securities.
- (6) Includes average equity of noncontrolling interest of \$405 and \$1,495 for the three months ended September 30, 2011 and 2010, respectively.

Note: As of September 30, 2011 and 2010, loans totaling \$10,634 and \$14,631, respectively, were on nonaccrual status. Our policy is to reverse previously accrued but unpaid interest on nonaccrual loans; thereafter, interest income is recorded to the extent received when appropriate.



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## Noninterest Income

Noninterest income consists of revenue generated from a broad range of financial services and activities including deposit related fee based services such as ATM, overdraft, and check processing fees. In addition, we earn income from the sale of loans and securities, trust services, bank owned life insurance (“BOLI”), brokerage services, and other fee generating programs that we either provide or in which we participate.

Noninterest income was \$10.3 million and \$28.5 million for the three and nine months ended September 30, 2011, respectively, compared to \$14.7 million and \$42.2 million for the same periods in 2010, a decrease of \$4.4 million, or 30.0%, and \$13.8 million, or 32.6%, respectively. The primary reason for the decrease in noninterest income was due to the decrease in gains on the sales of AFS securities during the three and nine months ended September 30, 2011 when compared to the same periods in 2010. During the nine months ended September 30, 2011, we had gains on sale of AFS securities of \$9.7 million compared to gains of \$23.0 million for the same period in 2010. Gains on AFS securities for the three months ended September 30, 2011 were \$3.9 million compared to \$8.0 million for the same period in 2010. The market value of the AFS securities portfolio at September 30, 2011 was \$1.57 billion with a net unrealized gain on that date of \$49.8 million. The net unrealized gain is comprised of \$57.1 million in unrealized gains and \$7.4 million in unrealized losses. The market value of the HTM securities portfolio at September 30, 2011 was \$406.6 million with a net unrealized gain on that date of \$15.9 million. The net unrealized gain is comprised of \$16.0 million in unrealized gains and \$85,000 in unrealized losses. During the nine months ended September 30, 2011, we proactively managed the investment portfolio which included restructuring a portion of our investment portfolio. This restructuring resulted in a gain on the sale of AFS securities of \$3.9 million during the three months ended September 30, 2011. As interest rates decreased during the third quarter of 2011, we continued to sell selected primarily low coupon or long duration municipal securities and low coupon or potentially more prepay volatile mortgage-backed securities. The securities sold were replaced with primarily shorter duration municipal securities and higher coupon and less prepayment volatile mortgage-backed securities that might perform better in both the current environment and in a potentially higher future interest rate environment. There can be no assurance that the level of security gains reported during the three and nine months ended September 30, 2011, will continue in future periods.

Deposit services income decreased \$182,000, or 4.3%, and \$739,000, or 5.8%, for the three and nine months ended September 30, 2011, respectively, when compared to the same periods in 2010 primarily due to a decrease in overdraft income.

Gain on sale of loans decreased \$115,000, or 22.2%, and \$230,000, or 19.2%, for the three and nine months ended September 30, 2011, respectively, when compared to the same periods in 2010 due primarily to a decrease in the dollar amount of loans sold and the related servicing release and secondary market fees.

Trust income increased \$27,000, or 4.2%, and \$232,000, or 13.4%, for the three and nine months ended September 30, 2011, respectively, when compared to the same periods in 2010 due to growth experienced in our trust department.

Other income increased \$26,000, or 2.8%, and \$293,000, or 10.7%, for the three and nine months ended September 30, 2011, respectively, when compared to the same periods in 2010 as a result of increases in other fee income, Southside Select fee income, MasterCard income and credit card fee income.

## Noninterest Expense

We incur numerous types of noninterest expenses associated with the operation of our various business activities, the largest of which are salaries and employee benefits. In addition, we incur numerous other expenses, the largest of which are detailed in the consolidated statements of income.

Noninterest expense was \$17.7 million and \$54.5 million for the three and nine months ended September 30, 2011, respectively, compared to \$17.7 million and \$53.1 million for the same periods in 2010, respectively, representing an increase of \$41,000, or 0.2%, and \$1.5 million, or 2.7%, for the three and nine months ended September 30, 2011, respectively.

Salaries and employee benefits expense increased \$389,000, or 3.6%, and \$1.5 million, or 4.7%, during the three and nine months ended September 30, 2011, respectively, when compared to the same periods in 2010. The increase for the three and nine months ended September 30, 2011, was primarily the result of increases in personnel associated with our overall growth and expansion, an increase in retirement expense and normal salary increases for existing personnel. Direct salary expense and payroll taxes increased \$468,000, or 5.2%, and \$1.7 million, or 6.0%, during the three and nine months ended September 30, 2011 when compared to the same periods in 2010.

Retirement expense, included in salary and benefits, increased \$9,000, or 1.0%, and \$185,000, or 7.7%, for the three and nine months ended September 30, 2011, respectively, when compared to the same periods in 2010. The increase was primarily related to the increase in the expense of the defined benefit and restoration plans that were partially offset by a decrease in the post retirement expense and split dollar expense for 2011 when compared to 2010.

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Health and life insurance expense, included in salary and benefits, decreased \$88,000, or 8.6%, and \$304,000, or 10.0%, for the three and nine months ended September 30, 2011 when compared to the same periods in 2010, respectively, due to decreased health claims expense and plan administrative cost for the comparable periods of time. We have a self-insured health plan which is supplemented with stop loss insurance policies. Health insurance costs are rising nationwide and these costs may increase during the remainder of 2011.

ATM and debit card expense increased \$12,000, or 5.4%, and \$114,000, or 18.9%, for the three and nine months ended September 30, 2011, respectively, when compared to the same periods in 2010 due to an increase in processing expenses.

Supplies decreased \$3,000, or 1.6%, and \$94,000, or 14.1%, for the three and nine months ended September 30, 2011, respectively, when compared to the same periods in 2010 due primarily to the printing of our 50th anniversary logo on supplies purchased for the three and six months ended June 30, 2010.

Professional fees increased \$153,000, or 36.6%, and \$220,000, or 16.1%, for the three and nine months ended September 30, 2011 as compared to the same periods in 2010 due to legal fees and consulting fees associated with the acquisition of SFG.

Postage expense decreased \$17,000, or 8.7%, and \$69,000, or 11.3%, for the three and nine months ended September 30, 2011, respectively, when compared to the same periods in 2010 due to a new contract with United States Postal Service and growing electronic delivery of our monthly bank statements.

Telephone and communications decreased \$64,000, or 18.3%, and \$101,000, or 9.5%, for the three and nine months ended September 30, 2011 as compared to the same periods in 2010 due to decreases in communications expense.

FDIC insurance decreased \$592,000, or 73.6%, and \$462,000, or 21.3%, for the three and nine months ended September 30, 2011, respectively, when compared to the same periods in 2010 due to a change in the FDIC assessment calculation effective for the second quarter of 2011.

## Income Taxes

Pre-tax income for the three and nine months ended September 30, 2011 was \$15.1 million and \$39.3 million, respectively, compared to \$15.1 million and \$43.5 million, respectively, for the same periods in 2010. Income tax expense was \$3.6 million and \$8.1 million, respectively, for the three and nine months ended September 30, 2011 compared to \$3.8 million and \$10.3 million, respectively, for the three and nine months ended September 30, 2010. The effective tax rate as a percentage of pre-tax income was 24.0% and 20.6% for the three and nine months ended September 30, 2011, compared to 25.2% and 23.6% for the three and nine months ended September 30, 2010. The decrease in the effective tax rate and income tax expense for the nine months ended September 30, 2011 was due to an increase in tax-exempt income as a percentage of taxable income as compared to the same period in 2010.

## Capital Resources

Our total shareholders' equity at September 30, 2011, was \$258.1 million, representing an increase of 20.4%, or \$43.8 million from December 31, 2010 and represented 8.0% of total assets at September 30, 2011 compared to 7.1% of total assets at December 31, 2010.

Increases to our shareholders' equity consisted of net income of \$29.9 million, the issuance of \$860,000 in common stock (44,352 shares) through our incentive stock option and dividend reinvestment plans, an increase in accumulated

other comprehensive income of \$24.1 million, which was partially offset by \$8.4 million in dividends paid and the decrease of approximately \$2.8 million associated with the purchase of the remaining 50% interest in SFG, increasing our ownership to 100%.

On March 31, 2011, our board of directors declared a 5% stock dividend to common stock shareholders of record as of April 20, 2011, and payable on May 11, 2011.

Under the Federal Reserve Board's risk-based capital guidelines for bank holding companies, the minimum ratio of total capital to risk-adjusted assets (including certain off-balance sheet items, such as standby letters of credit) is currently 8%. The minimum Tier 1 capital to risk-adjusted assets is 4%. Our \$20 million, \$22.5 million, \$12.5 million and \$3.5 million of trust preferred securities issued by our subsidiaries, Southside Statutory Trust III, IV, V and Magnolia Trust Company I, respectively, are considered Tier 1 capital by the Federal Reserve Board and will continue to be under the Dodd-Frank Act. Any trust preferred securities that are issued by our subsidiaries in the future will be considered Tier 2 capital. The Federal Reserve Board also requires bank holding companies to comply with the minimum leverage ratio guidelines. The leverage ratio is the ratio of bank holding company's Tier 1 capital to its total consolidated quarterly average assets, less goodwill and certain other intangible assets. The guidelines require a minimum leverage ratio of 4% for bank holding companies that meet certain specified criteria. Failure to meet minimum capital requirements can initiate certain mandatory and possibly additional discretionary actions by regulators that, if undertaken, could have a direct material effect on our financial statements. Management believes that, as of September 30, 2011, we met all capital adequacy requirements to which we were subject.

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The Federal Deposit Insurance Act requires bank regulatory agencies to take "prompt corrective action" with respect to FDIC-insured depository institutions that do not meet minimum capital requirements. A depository institution's treatment for purposes of the prompt corrective action provisions will depend on how its capital levels compare to various capital measures and certain other factors, as established by regulation. Prompt corrective action and other discretionary actions could have a direct material effect on our financial statements.

It is management's intention to maintain our capital at a level acceptable to all regulatory authorities and future dividend payments will be determined accordingly. Regulatory authorities require that any dividend payments made by either us or the Bank, not exceed earnings for that year. Shareholders should not anticipate a continuation of the cash dividend simply because of the existence of a dividend reinvestment program. The payment of dividends will depend upon future earnings, our financial condition, and other related factors including the discretion of the board of directors.

To be categorized as well capitalized, we must maintain minimum Total risk-based, Tier 1 risk-based, and Tier 1 leverage ratios as set forth in the following table:

|  | Actual     |        | For Capital Adequacy Purposes |       | To Be Well Capitalized Under Prompt Corrective Actions Provisions |        |
|--|------------|--------|-------------------------------|-------|---|--------|
|  | Amount     | Ratio  | Amount                        | Ratio | Amount  | Ratio  |
| As of September 30, 2011:                |            |        |                               |       |   |        |
| (dollars in thousands)                   |            |        |                               |       |   |        |
| Total Capital (to Risk Weighted Assets)  |            |        |                               |       |   |        |
| Consolidated                             | \$ 292,919 | 22.59% | \$ 103,731                    | 8.00% | N/A   | N/A    |
| Bank Only                                | \$ 284,073 | 21.91% | \$ 103,726                    | 8.00% | \$ 129,657  | 10.00% |
| Tier 1 Capital (to Risk Weighted Assets) |            |        |                               |       |   |        |
| Consolidated                             | \$ 276,633 | 21.33% | \$ 51,866                     | 4.00% | N/A   | N/A    |
| Bank Only                                | \$ 267,787 | 20.65% | \$ 51,863                     | 4.00% | \$ 77,794   | 6.00%  |
| Tier 1 Capital (to Average Assets) (1)   |            |        |                               |       |   |        |
| Consolidated                             | \$ 276,633 | 8.92%  | \$ 124,017                    | 4.00% | N/A   | N/A    |
| Bank Only                                | \$ 267,787 | 8.64%  | \$ 123,915                    | 4.00% | \$ 154,894  | 5.00%  |
| As of December 31, 2010:                 |            |        |                               |       |   |        |
| Total Capital (to Risk Weighted Assets)  |            |        |                               |       |   |        |
| Consolidated                             | \$ 274,175 | 21.09% | \$ 103,981                    | 8.00% | N/A   | N/A    |
| Bank Only                                | \$ 263,186 | 20.27% | \$ 103,882                    | 8.00% | \$ 129,853  | 10.00% |
| Tier 1 Capital (to Risk Weighted Assets) |            |        |                               |       |   |        |

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|              |            |        |           |       |           |       |
|--------------|------------|--------|-----------|-------|-----------|-------|
| Consolidated | \$ 257,837 | 19.84% | \$ 51,991 | 4.00% | N/A       | N/A   |
| Bank Only    | \$ 246,848 | 19.01% | \$ 51,941 | 4.00% | \$ 77,912 | 6.00% |

Tier 1 Capital (to  
Average Assets) (1)

|              |            |       |            |       |            |       |
|--------------|------------|-------|------------|-------|------------|-------|
| Consolidated | \$ 257,837 | 8.45% | \$ 122,026 | 4.00% | N/A        | N/A   |
| Bank Only    | \$ 246,848 | 8.10% | \$ 121,893 | 4.00% | \$ 152,367 | 5.00% |

(1) Refers to quarterly average assets as calculated by bank regulatory agencies.

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### Liquidity and Interest Rate Sensitivity

Liquidity management involves our ability to convert assets to cash with a minimum of loss to enable us to meet our obligations to our customers at any time. This means addressing (1) the immediate cash withdrawal requirements of depositors and other funds providers; (2) the funding requirements of all lines and letters of credit; and (3) the short-term credit needs of customers. Liquidity is provided by short-term investments that can be readily liquidated with a minimum risk of loss. Cash, interest earning deposits, federal funds sold and short-term investments with maturities or repricing characteristics of one year or less continue to be a substantial percentage of total assets. At September 30, 2011, these investments were 18.9% of total assets as compared to 16.8% at December 31, 2010 and 18.6% at September 30, 2010. The increase to 18.9% at September 30, 2011 is primarily reflective of changes in the investment portfolio. Liquidity is further provided through the matching, by time period, of rate sensitive interest earning assets with rate sensitive interest bearing liabilities. Southside Bank has four lines of credit for the purchase of overnight federal funds at prevailing rates. Three \$15.0 million and one \$10.0 million unsecured lines of credit have been established with Bank of America, Frost Bank, Sterling Bank and TIB - The Independent Bankers Bank, respectively. There were no federal funds purchased at September 30, 2011. At September 30, 2011, the amount of additional funding Southside Bank could obtain from FHLB using unpledged securities at FHLB was approximately \$606.3 million, net of FHLB stock purchases required. Southside Bank obtained \$10.0 million letters of credit from FHLB as collateral for a portion of its public fund deposits.

Interest rate sensitivity management seeks to avoid fluctuating net interest margins and to enhance consistent growth of net interest income through periods of changing interest rates. The ALCO closely monitors various liquidity ratios, interest rate spreads and margins. The ALCO performs interest rate simulation tests that apply various interest rate scenarios including immediate shocks and market value of portfolio equity ("MVPE") with interest rates immediately shocked plus and minus 200 basis points to assist in determining our overall interest rate risk and adequacy of the liquidity position. In addition, the ALCO utilizes a simulation model to determine the impact on net interest income of several different interest rate scenarios. By utilizing this technology, we can determine changes that need to be made to the asset and liability mixes to minimize the change in net interest income under these various interest rate scenarios.

### Composition of Loans

One of our main objectives is to seek attractive lending opportunities in Texas, primarily in the counties in which we operate. Substantially all of our loan originations are made to borrowers who live in and conduct business in the counties in Texas in which we operate, with the exception of municipal loans which are made almost entirely in Texas, and purchases of automobile loan portfolios throughout the United States. Municipal loans are made to municipalities, counties, school districts and colleges primarily throughout the state of Texas. Through SFG, we purchase portfolios of automobile loans from a variety of lenders throughout the United States. These high yield loans represent existing subprime automobile loans with payment histories that are collateralized by new and used automobiles. At September 30, 2011, the SFG loans totaled approximately \$61.1 million. We look forward to the possibility that our loan growth will accelerate in the future when the economy in the markets we serve improve and as we work to identify and develop additional markets and strategies that will allow us to expand our lending territory. Total loans decreased \$37.4 million, or 3.5%, to \$1.04 billion for the nine month period ended September 30, 2011 from \$1.08 billion at December 31, 2010, and increased \$3.3 million, or 0.3%, from \$1.04 billion at September 30, 2010. Average loans increased \$27.9 million, or 2.7%, when compared to the same period in 2010.

Our market areas to date have not experienced the level of downturn in the economy and real estate prices that some of the harder hit areas of the country have experienced. However, we have experienced weakening conditions associated with the real estate led downturn and have strengthened our underwriting standards, especially related to all aspects of real estate lending. Our real estate loan portfolio does not have Alt-A or subprime mortgage exposure.





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The following table sets forth loan totals for the periods presented:

|                        | At<br>September 30,<br>2011 | At<br>December 31,<br>2010 | At<br>September 30,<br>2010 |
|------------------------|-----------------------------|----------------------------|-----------------------------|
|                        | (in thousands)              |                            |                             |
| Real Estate Loans:     |                             |                            |                             |
| Construction           | \$ 103,859                  | \$ 115,094                 | \$ 111,121                  |
| 1-4 Family Residential | 228,248                     | 219,031                    | 216,972                     |
| Other                  | 202,595                     | 200,723                    | 202,497                     |
| Commercial Loans       | 140,115                     | 148,761                    | 156,635                     |
| Municipal Loans        | 199,122                     | 196,594                    | 173,314                     |
| Loans to Individuals   | 166,532                     | 197,717                    | 176,669                     |
| Total Loans            | \$ 1,040,471                | \$ 1,077,920               | \$ 1,037,208                |

Our 1-4 family residential mortgage loans increased \$9.2 million, or 4.2%, to \$228.2 million for the nine month period ended September 30, 2011 from \$219.0 million at December 31, 2010, and \$11.3 million, or 5.2%, from \$217.0 million at September 30, 2010.

Municipal loans increased \$2.5 million, or 1.3%, to \$199.1 million for the nine month period ended September 30, 2011 from \$196.6 million at December 31, 2010, and \$25.8 million, or 14.9%, from \$173.3 million at September 30, 2010. The increase in municipal loans is due to overall market volatility related to credit markets, including municipal credits. This provided additional opportunities for us to lend to municipalities.

Construction loans decreased \$11.2 million, or 9.8%, to \$103.9 million for the nine month period ended September 30, 2011 from \$115.1 million at December 31, 2010, and \$7.3 million, or 6.5%, from \$111.1 million at September 30, 2010.

Other real estate loans, which are comprised primarily of commercial real estate loans, increased \$1.9 million, or 0.9%, to \$202.6 million for the nine month period ended September 30, 2011 from \$200.7 million at December 31, 2010, and \$98,000 from \$202.5 million at September 30, 2010.

Commercial loans decreased \$8.6 million, or 5.8%, to \$140.1 million for the nine month period ended September 30, 2011 from \$148.8 million at December 31, 2010, and \$16.5 million, or 10.5%, from \$156.6 million at September 30, 2010. The decrease in commercial loans is reflective of decreased loan demand for this type of loan in our market area.

Loans to individuals, which includes SFG loans, decreased \$31.2 million, or 15.8%, to \$166.5 million for the nine month period ended September 30, 2011 from \$197.7 million at December 31, 2010, and \$10.1 million, or 5.7%, from \$176.7 million at September 30, 2010. Most of the decrease is due to a decrease of SFG loans due to normal paydowns, the inability to find a sufficient supply of automobile loan pools to purchase and a sale of \$6.2 million of SFG loans due to the implementation of Dodd Frank.

#### Loan Loss Experience and Allowance for Loan Losses

The allowance for loan losses is based on the most current review of the loan portfolio and is validated by multiple processes. First, the bank utilizes historical data to establish general reserve amounts for each class of loans. While we track several years of data, we primarily review one year data because we found during the 1980's that longer periods would not respond quickly enough to market conditions. Second, our lenders have the primary responsibility

for identifying problem loans and estimating necessary reserves based on customer financial stress and underlying collateral. These recommendations are reviewed by the Senior lender, the Special Assets department, and the Loan Review department and are signed off on by the President. Third, the Loan Review department does independent reviews of the portfolio on an annual basis. The Loan Review department follows a board-approved annual loan review scope. The loan review scope encompasses a number of metrics that takes into consideration the size of the loan, the type of credit extended, the seasoning of the loan and the performance of the loan. The loan review scope as it relates to size, focuses more on larger dollar loan relationships, typically, for example, aggregate debt of \$500,000 or greater. The Loan Review officer also tracks specific reserves for loans by type compared to general reserves to determine trends in comparative reserves as well as losses not reserved for prior to charge off to determine the efficiency of the specific reserve process.

At each review, a subjective analysis methodology is used to grade the respective loan. Categories of grading vary in severity from loans that do not appear to have a significant probability of loss at the time of review to loans that indicate a probability that the entire balance of the loan will be uncollectible. If full collection of the loan balance appears unlikely at the time of review, estimates of future expected cash flows or appraisals of the collateral securing the debt are used to allocate the necessary allowances. The internal loan review department maintains a list of all loans or loan relationships that are graded as having more than the normal degree of risk associated with them. In addition, a list of specifically reserved loans or loan relationships of \$50,000 or more is updated on a quarterly basis in order to properly allocate necessary allowances and keep management informed on the status of attempts to correct the deficiencies noted with respect to the loan.

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For loans to individuals the methodology associated with determining the appropriate allowance for losses on loans primarily consists of an evaluation of individual payment histories, remaining term to maturity and underlying collateral support.

Industry experience indicates that a portion of our loans will become delinquent and a portion of the loans will require partial or entire charge-off. Regardless of the underwriting criteria utilized, losses may be experienced as a result of various factors beyond our control, including, among other things, changes in market conditions affecting the value of properties used as collateral for loans and problems affecting the credit of the borrower and the ability of the borrower to make payments on the loan. Our determination of the adequacy of allowance for loan losses is based on various considerations, including an analysis of the risk characteristics of various classifications of loans, previous loan loss experience, specific loans which would have loan loss potential, delinquency trends, estimated fair value of the underlying collateral, current economic conditions, the views of the bank regulators (who have the authority to require additional allowances), and geographic and industry loan concentration.

Consumer loans at SFG are reserved for based on general estimates of loss at the time of purchase for current loans. SFG loans experiencing past due status or extension of maturity characteristics are reserved for at significantly higher levels based on the circumstances associated with each specific loan. In general the reserves for SFG are calculated based on the past due status of the loan. For reserve purposes, the portfolio has been segregated by past due status and by the remaining term variance from the original contract. During repayment, loans that pay late will take longer to pay out than the original contract. Additionally, some loans may be granted extensions for extenuating payment circumstances. The remaining term extensions increase the risk of collateral deterioration and accordingly, reserves are increased to recognize this risk.

For SFG automobile loan pools purchased after August 1, 2010, additional reserve methods have been added. New pools purchased are reserved at their estimated annual loss. Thereafter, the reserve is adjusted based on the actual performance versus projected performance. Additionally, during the fourth quarter of 2010, data mining measures were further enhanced to track migration within risk tranches. Reserves are adjusted quarterly to match the migration metrics.

After all of the data in the loan portfolio is accumulated, the reserve allocations are separated into various loan classes. At September 30, 2011, the unallocated portion of the allowance for loan loss increased to \$1.3 million or 0.1% of loans.

As of September 30, 2011, our review of the loan portfolio indicated that a loan loss allowance of \$18.2 million was adequate to cover probable losses in the portfolio. Changes in economic and other conditions may require future adjustments to the allowance for loan losses.

For the three and nine months ended September 30, 2011, loan charge-offs were \$3.2 million and \$10.3 million and recoveries were \$505,000 and \$2.3 million, resulting in net charge-offs of \$2.7 million and \$8.0 million, respectively. For the three and nine months ended September 30, 2010, loan charge-offs were \$4.3 million and \$12.8 million and recoveries were \$588,000 and \$2.3 million, resulting in net charge-offs of \$3.8 million and \$10.5 million, respectively. The decrease in net charge-offs for the three and nine months ended September 30, 2011 was primarily related to economic conditions requiring the write-down of nonperforming loans in the previous year. The necessary provision expense was estimated at \$1.5 million and \$5.5 million for the three and nine months ended September 30, 2011, compared to \$3.2 million and \$9.3 million for the comparable periods in 2010, respectively. The decrease in provision expense for the three and nine months ended September 30, 2011 compared to the same periods in 2010 was primarily a result of the decrease in nonperforming loans.

## Nonperforming Assets

Nonperforming assets consist of delinquent loans 90 days or more past due, nonaccrual loans, other real estate owned (“OREO”), repossessed assets and restructured loans. Nonaccrual loans are those loans which are 90 days or more delinquent and collection in full of both the principal and interest is in doubt. Additionally, some loans that are not delinquent may be placed on nonaccrual status due to doubts about full collection of principal or interest. When a loan is categorized as nonaccrual, the accrual of interest is discontinued and the accrued balance is reversed for financial statement purposes. Restructured loans represent loans that have been renegotiated to provide a reduction or deferral of interest or principal because of deterioration in the financial position of the borrowers. Categorization of a loan as nonperforming is not in itself a reliable indicator of potential loan loss. Other factors, such as the value of collateral securing the loan and the financial condition of the borrower must be considered in judgments as to potential loan loss. OREO represents real estate taken in full or partial satisfaction of debts previously contracted. The dollar amount of OREO is based on a current evaluation of the OREO at the time it is recorded on our books, net of estimated selling costs. Updated valuations are obtained as needed and any additional impairments are recognized.

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The following table sets forth nonperforming assets for the periods presented:

|   | At<br>September 30,<br>2011 | At<br>December 31,<br>2010 | At<br>December 31,<br>2010 |
|---|-----------------------------|----------------------------|----------------------------|
|   | (in thousands)              |                            |                            |
| Nonaccrual loans                          | \$10,634                    | \$ 14,524                  | \$ 14,631                  |
| Accruing loans past due more than 90 days | 21                          | 7                          | 7                          |
| Restructured loans                        | 1,486                       | 2,320                      | 2,516                      |
| Other real estate owned                   | 831                         | 220                        | 1,100                      |
| Reposessed assets                         | 188                         | 638                        | 445                        |
| Total Nonperforming Assets                | \$13,160                    | \$ 17,709                  | \$ 18,699                  |