

SOUTHSIDE BANCSHARES INC  
Form 10-K  
March 06, 2013

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

Form 10-K  
(Mark One)

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

For the fiscal year ended December 31, 2012  
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)

1201 S. Beckham Avenue, Tyler, Texas

(Address of Principal Executive Offices)

75-1848732

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

75701

(Zip Code)

Registrant's telephone number, including area code: (903) 531-7111

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

Title of each class

COMMON STOCK, \$1.25 PAR VALUE

Name of each exchange  
on which registered

NASDAQ Global Select Market

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

NONE

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

Yes  No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes  No

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

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See 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

Accelerated filer

Non-accelerated filer  (Do not check if a smaller reporting company)

Smaller reporting company

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

The aggregate market value of the common stock held by non-affiliates of the registrant as of June 30, 2012 was \$330,278,517.

As of February 28, 2013, 16,976,698 shares of common stock of Southside Bancshares, Inc. were outstanding.

**DOCUMENTS INCORPORATED BY REFERENCE**

Certain portions of the Registrant's proxy statement to be filed for the Annual Meeting of Shareholders to be held April 18, 2013 are incorporated by reference into Part III of this Annual Report on Form 10-K. Other than those portions of the proxy statement specifically incorporated by reference pursuant to Items 10-14 of Part III hereof, no other portions of the proxy statement shall be deemed so incorporated.

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## IMPORTANT INFORMATION ABOUT THIS REPORT

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 SFG Finance, LLC (formerly Southside Financial Group, LLC) which is a wholly-owned subsidiary of the Bank as of July 15, 2011. “SSI” refers to Southside Securities, Inc., which is a wholly-owned subsidiary of Southside Bancshares, Inc.

## PART I

### ITEM 1. BUSINESS

#### FORWARD-LOOKING INFORMATION

The disclosures set forth in this item are qualified by the section captioned “Cautionary Notice Regarding Forward-Looking Statements” in “Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations” of this Annual Report on Form 10-K and other cautionary statements set forth elsewhere in this report.

#### GENERAL

Southside Bancshares, Inc., incorporated in Texas in 1982, is a bank holding company for Southside Bank, a Texas state bank headquartered in Tyler, Texas that was formed in 1960. We operate through 48 banking centers, 19 of which are located in grocery stores, and 13 motor bank facilities.

At December 31, 2012, our total assets were \$3.24 billion, total loans were \$1.26 billion, deposits were \$2.35 billion, and total equity was \$257.8 million. For the years ended December 31, 2012 and 2011, our net income was \$34.7 million and \$39.1 million and diluted earnings per common share were \$2.00 and \$2.26, respectively. We have paid a cash dividend every year since 1970 (including dividends paid by Southside Bank prior to the incorporation of Southside Bancshares).

We are a community-focused financial institution that offers a full range of financial services to individuals, businesses, municipal entities, and nonprofit organizations in the communities that we serve. These services include consumer and commercial loans, deposit accounts, trust services, safe deposit services and brokerage services.

Our consumer loan services include 1-4 family residential mortgage loans, home equity loans, home improvement loans, automobile loans and other installment loans. Commercial loan services include short-term working capital loans for inventory and accounts receivable, short and medium-term loans for equipment or other business capital expansion, commercial real estate loans and municipal loans. We also offer construction loans for 1-4 family residential and commercial real estate.

We offer a variety of deposit accounts with a wide range of interest rates and terms, including savings, money market, interest and noninterest bearing checking accounts and certificates of deposit (“CDs”). Our trust services include investment management, administration and advisory services, primarily for individuals and, to a lesser extent, partnerships and corporations. At December 31, 2012, our trust department managed approximately \$758.3 million of trust assets.

We and our subsidiaries are subject to comprehensive regulation, examination and supervision by the Board of Governors of the Federal Reserve System (the “Federal Reserve”), the Texas Department of Banking (the “TDB”) and the Federal Deposit Insurance Corporation (the “FDIC”) and are subject to numerous laws and regulations relating to internal controls, the extension of credit, making of loans to individuals, deposits, and all other facets of our operations.

Our administrative offices are located at 1201 South Beckham Avenue, Tyler, Texas 75701, and our telephone number is 903-531-7111. Our website can be found at [www.southside.com](http://www.southside.com). Our public filings with the Securities and Exchange Commission (the “SEC”) may be obtained free of charge at either our website, under the “Investor Relations” tab, or the SEC’s website, [www.sec.gov](http://www.sec.gov), as soon as reasonably practicable after filing with the SEC.

## RECENT DEVELOPMENTS

Effective February 14, 2012, Southside Bank became a direct wholly-owned subsidiary of Southside Bancshares, Inc. as a result of the merger of Southside Delaware Financial Corporation with and into Southside Bancshares, Inc.

During the fourth quarter ended December 31, 2012, we received regulatory approval to open a second branch in Austin, Texas, which we anticipate will open during the first quarter of 2013.

Subsequent to December 31, 2012, we made a decision to close Southside Securities, Inc. It is our expectation that we will complete the closing in the first half of 2013.

## MARKET AREA

We are headquartered in Tyler, Texas. The Tyler metropolitan area has a population of approximately 207,000 and is located approximately 90 miles east of Dallas, Texas and 90 miles west of Shreveport, Louisiana.

We consider our primary market area to be all of Smith, Gregg, Tarrant, Travis, Cherokee, Anderson, Kaufman, Henderson and Wood Counties in Texas, and to a lesser extent, portions of adjoining counties. Our expectation is that our presence in all of the market areas we serve should grow in the future. In addition, we continue to explore new markets in which we believe we can expand successfully.

The principal economic activities in our market areas include retail, distribution, manufacturing, medical services, education and oil and gas industries. Additionally, the industry base includes conventions and tourism, as well as retirement relocation. These economic activities support a growing regional system of medical service, retail and education centers. Tyler, Longview, Fort Worth, Austin and Arlington are home to several nationally recognized health care systems that represent all major specialties.

Our 48 branches and 13 motor bank facilities are located in and around Tyler, Longview, Lindale, Gresham, Jacksonville, Bullard, Chandler, Hawkins, Seven Points, Palestine, Forney, Gun Barrel City, Athens, Whitehouse, Fort Worth, Arlington and Austin. Our advertising is designed to target the market areas we serve. The type and amount of advertising done in each market area is directly attributable to our market share in that market area combined with overall cost.

Additionally, our customers may access various banking services through our 48 automated teller machines (“ATMs”) and ATMs owned by others, through debit cards, and through our automated telephone, internet and electronic banking products. These products allow our customers to apply for loans from their computers, access account information and conduct various other transactions from their telephones, smart phones and computers.

## THE BANKING INDUSTRY IN TEXAS

The banking industry is affected by general economic conditions such as interest rates, inflation, recession, unemployment and other factors beyond our control. During the last twenty years the Texas economy has continued to diversify, decreasing the overall impact of fluctuations in oil and gas prices; however, the oil and gas industry is still a significant component of the Texas economy. Beginning in the fourth quarter of 2008, as oil prices declined significantly and consumers all across the United States were impacted even more severely by the economic slowdown, our market areas began to experience a greater slowdown in economic activity. During 2009 and continuing throughout 2010, our market areas experienced the effects of the housing-led slowdown that impacted the other regions of the United States. During 2011, our markets appeared to partially strengthen economically,

exhibiting a combination of both modest growth in certain sectors as well as continued effects of the housing and unemployment downturn. During 2012 our market exhibited further strengthening both economically and in the housing sector. Many economists predict growth for the U.S. economy during 2013; however, we are well aware that any economic growth could be uneven. We cannot predict whether current economic conditions will improve, remain the same or decline.

#### COMPETITION

The activities we are engaged in are highly competitive. Financial institutions such as savings and loan associations, credit unions, consumer finance companies, insurance companies, brokerage companies and other financial institutions with varying degrees of regulatory restrictions compete vigorously for a share of the financial services market. During 2012, the number of financial institutions in our market areas increased, a trend that we expect will continue. Brokerage and insurance companies continue to become more competitive in the financial services arena and pose an ever-increasing challenge to banks. Legislative

changes also greatly affect the level of competition we face. Federal legislation allows credit unions to use their expanded membership capabilities, combined with tax-free status, to compete more fiercely for traditional bank business. The tax-free status granted to credit unions provides them with a significant competitive advantage. Many of the largest banks operating in Texas, including some of the largest banks in the country, have offices in our market areas with capital resources, broader geographic markets, and legal lending limits substantially in excess of those available to us. We face competition from institutions that offer products and services we do not or cannot currently offer. Some institutions we compete with offer interest rate levels on loan and deposit products that we are unwilling to offer due to interest rate risk and overall profitability concerns. We expect the level of competition to continue to increase.

## EMPLOYEES

At February 28, 2013, we employed approximately 574 full time equivalent persons. None of our employees are represented by any unions or similar groups, and we have not experienced any type of strike or labor dispute. We consider the relationship with our employees to be good.

## EXECUTIVE OFFICERS OF THE REGISTRANT

Our executive officers as of February 28, 2013 were as follows:

Sam Dawson (Age 65), was elected Chief Executive Officer of both Southside Bancshares, Inc. and Southside Bank on January 5, 2012. He has also served as President and Director of Southside Bancshares, Inc. since 1998 and served as Secretary from 1998 to February 2012. In addition, he also has served as President, Chief Operations Officer and Director of Southside Bank since 1996. He became an officer of Southside Bancshares, Inc. in 1982 and of Southside Bank in 1975.

Robbie N. Edmonson (Age 81), has served as Vice Chairman of the Board of Southside Bancshares, Inc. and Southside Bank since 1998. He joined Southside Bank as a vice president in 1968.

Jeryl Story (Age 61), has served as Senior Executive Vice President of Southside Bancshares, Inc. since 2000, and Senior Executive Vice President - Loan Administration, Senior Lending Officer and Director of Southside Bank since 1996. He joined Southside Bank in 1979 as an officer in Loan Documentation.

Lee R. Gibson (Age 56), has served as Senior Executive Vice President and Chief Financial Officer of Southside Bancshares, Inc. and of Southside Bank since 2000. He is also a Director of Southside Bank. He became an officer of Southside Bancshares, Inc. in 1985 and Southside Bank in 1984.

Michael L. Coogan (Age 53), has served as Executive Vice President and Treasurer of Southside Bank since 2009. He joined Southside Bank in 2009 and became an advisory director of Southside Bank in 2012. He is the President of the Company's subsidiary, Southside Securities, Inc., a broker-dealer.

All the individuals named above serve in their capacity as officers of Southside Bancshares, Inc. and Southside Bank and are appointed annually by the board of directors of each entity.

## SUPERVISION AND REGULATION

General



Banking is a complex, highly regulated industry. As a bank holding company under federal law, the Company is subject to regulation, supervision and examination by the Federal Reserve. In addition, under state law, as the parent company of a Texas-chartered state bank, the Company is subject to supervision and examination by the TDB. As a Texas-chartered state bank, Southside Bank is subject to regulation, supervision and examination by the TDB, as its chartering authority, and by the FDIC, as its primary federal regulator and deposit insurer. This system of regulation and supervision applicable to us establishes a comprehensive framework for our operations and is intended primarily for the protection of the FDIC's Deposit Insurance Fund ("DIF") and the public rather than our shareholders and creditors.

In addition to the system of regulation and supervision outlined above, the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), which is discussed in greater detail below, created the Consumer Financial Protection Bureau (the "Bureau"), a new federal regulatory body with broad authority to regulate the offering and provision of consumer financial products. The Bureau officially came into being on July 21, 2011, and rulemaking authority for a range of consumer

financial protection laws (such as the Truth in Lending Act, the Electronic Funds Transfer Act and the Real Estate Settlement Procedures Act, among others) transferred from the federal prudential banking regulators to the Bureau on that date. The Dodd-Frank Act gives the Bureau authority to supervise and examine depository institutions with more than \$10 billion in assets for compliance with these federal consumer laws. The authority to supervise and examine depository institutions with \$10 billion or less in assets for compliance with federal consumer laws will remain largely with those institutions' primary regulators. However, the Bureau may participate in examinations of these smaller institutions on a "sampling basis" and may refer potential enforcement actions against such institutions to their primary regulators. The Bureau will also have supervisory and examination authority over certain nonbank institutions that offer consumer financial products. The Dodd-Frank Act identifies a number of covered nonbank institutions, and also authorizes the Bureau to identify additional institutions that will be subject to its jurisdiction. Accordingly, the Bureau may participate in examinations of Southside Bank, and could supervise and examine other direct or indirect subsidiaries of the Company that offer consumer financial products.

The earnings of Southside Bank and, therefore, the earnings of the Company, are affected by general economic conditions, changes in federal and state laws and regulations and actions of various regulatory authorities, including those referenced above. Additional changes to the laws and regulations applicable to us are frequently proposed at both the federal and state levels. As a result of the Dodd-Frank Act, which was enacted on July 21, 2010, the regulatory framework under which we operate has changed and will continue to change substantially over the next several years. The Dodd-Frank Act represents a significant overhaul of many aspects of the regulation of the financial services industry, addressing, among other things, systemic risk, capital adequacy, deposit insurance assessments, consumer financial protection, interchange fees, derivatives, lending limits, mortgage lending practices, registration of investment advisors and changes among the bank regulatory agencies. Among the provisions that may affect the operations of the Company and Southside Bank are the following:

- Creation of the Bureau with centralized authority, including supervisory, examination and enforcement authority, for consumer protection in the banking industry;
- New limitations on federal preemption;
- New prohibitions and restrictions on the ability of a banking entity and nonbank financial company to engage in proprietary trading and have certain interests in, or relationships with, a hedge fund or private equity fund, which have been proposed but not yet finalized;
- Application of new regulatory capital requirements, including changes to leverage and risk-based capital standards and changes to the components of permissible tiered capital;
  - Requirement that holding companies and their subsidiary banks be well capitalized and well managed in order to engage in activities permitted for financial holding companies;
- Changes to the assessment base for deposit insurance premiums;
- Permanently raising the FDIC's standard maximum deposit insurance amount to \$250,000;
- Repeal of the prohibition on the payment of interest on demand deposits, thereby permitting depository institutions to pay interest on business transaction and other accounts;
- Restrictions on compensation, including a prohibition on incentive-based compensation arrangements that encourage inappropriate risk taking by covered financial institutions and are deemed to be excessive, or that may lead to material losses;
- Requirement that sponsors of asset-backed securities retain a percentage of the credit risk underlying the securities; and
- Requirement that banking regulators remove references to and requirements of reliance upon credit ratings from their regulations and replace them with appropriate alternatives for evaluating creditworthiness.

Some of these and other major changes could materially impact the profitability of our business, the value of assets we hold or the collateral available for our loans, require changes to business practices, or force us to discontinue businesses and expose us to additional costs, taxes, liabilities, enforcement actions and reputational risk. Many of

these provisions became effective upon enactment of the Dodd-Frank Act, while others are subject to further study, rulemaking, and the discretion of regulatory bodies. In light of these significant changes and the discretion afforded to federal regulators, we cannot fully predict the effect that compliance with the Dodd-Frank Act or any implementing regulations will have on the Company or Southside Bank's businesses or their ability to pursue future business opportunities. Additional regulations resulting from the Dodd-Frank Act may materially adversely affect the Company's business, financial condition or results of operations.

The likelihood, timing, and scope of any such change and the impact any such change may have on us are impossible to determine with any certainty. Also, additional changes to the laws and regulations applicable to us are frequently proposed at both the federal and state levels. We cannot predict whether new legislation or regulations will be enacted and, if enacted, the effect that it, or any regulations, would have on our business, financial condition or results of operations. Set forth below is a brief description of the significant federal and state laws and regulations to which we are currently subject. These descriptions do not purport to be complete and are qualified in their entirety by reference to the particular statutory or regulatory provision.

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## Holding Company Regulation

As a bank holding company regulated under the Bank Holding Company Act of 1956 (“BHCA”), as amended, the Company is registered with and subject to regulation, supervision and examination by the Federal Reserve. The Company is required to file annual and other reports with, and furnish information to, the Federal Reserve, which makes periodic inspections of the Company.

Permitted Activities. Under the BHCA, a bank holding company is generally permitted to engage in, or acquire direct or indirect control of more than five percent of the voting shares of any company engaged in, the following activities:

banking or managing or controlling banks;

furnishing services to or performing services for our subsidiaries; and

any activity that the Federal Reserve determines to be so closely related to banking as to be a proper incident to the business of banking, including:

factoring accounts receivable;

making, acquiring, brokering or servicing loans and usual related activities;

leasing personal or real property;

operating a nonbank depository institution, such as savings association;

performing trust company functions;

conducting financial and investment advisory activities;

conducting discount securities brokerage activities;

underwriting and dealing in government obligations and money market instruments;

providing specified management consulting and counseling activities;

performing selected data processing services and support services;

acting as agent or broker in selling credit life insurance and other types of insurance in connection with credit transactions;

performing selected insurance underwriting activities;

providing certain community development activities (such as making investments in projects designed primarily to promote community welfare); and

issuing and selling money orders and similar consumer-type payment instruments.

The Federal Reserve has the authority to order a bank holding company or its subsidiaries to terminate any of these activities or to terminate its ownership or control of any subsidiary when it has reasonable cause to believe that the bank holding company's continued ownership, activity or control constitutes a serious risk to the financial safety, soundness or stability of it or any of its bank subsidiaries.

Under the BHCA, a bank holding company meeting certain eligibility requirements may elect to become a "financial holding company," which is a form of bank holding company with authority to engage in additional activities. Specifically, a financial holding company and companies under its control may engage in activities that are "financial in nature," as defined by the Gramm-Leach-Bliley Act ("GLBA") and Federal Reserve interpretations, and therefore may engage in a broader range of activities than those permitted for bank holding companies and their subsidiaries. Financial activities specifically include insurance brokerage and underwriting, securities underwriting and dealing, merchant banking, investment advisory and lending activities. Financial

holding companies and their subsidiaries also may engage in additional activities that are determined by the Federal Reserve, in consultation with the Treasury Department, to be “financial in nature or incidental to” a financial activity or are determined by the Federal Reserve unilaterally to be “complementary” to financial activities.

In order to offer broker-dealer services through our subsidiary, Southside Securities, Inc., on February 8, 2011, we filed with the Federal Reserve Bank of Dallas a declaration of financial holding company status and were granted financial holding company status on March 22, 2011. Election of financial holding company status is not automatic and it was granted based upon consideration of a number of factors, including that all of our depository institution subsidiaries satisfy the Federal Reserve’s “well capitalized” and “well managed” standards and have at least a satisfactory rating under the Community Reinvestment Act (discussed below). Now that we have succeeded in attaining financial holding company status, that status could be impacted by the condition of Southside Bank and/or other factors. For example, if Southside Bank ceases to be “well capitalized” or “well managed” under applicable regulatory standards, the Federal Reserve Board may, among other things, place limitations on our ability to conduct broader financial activities or, if the deficiencies persist, require us to divest Southside Bank. In addition, if Southside Bank were to receive a rating of less than satisfactory under the Community Reinvestment Act, we would be prohibited from engaging in any additional activities other than those permissible for bank holding companies that are not financial holding companies. If we undertake expanded financial activities (that are not permissible for a bank holding company) and we fail to continue to meet any of the prerequisites for “financial holding company” status, including those described above, the financial holding company would be required to enter into an agreement with the Federal Reserve Board to comply with all applicable capital and management requirements. If we do not return to compliance within 180 days, the Federal Reserve may order the financial holding company to divest its bank or the company may discontinue or divest investments in companies engaged in, activities permissible only for a bank holding company that has elected to be treated as a financial holding company. We began engaging in broker-dealer activities through Southside Securities, Inc. on June 16, 2011.

**Capital Adequacy.** Each of the federal banking agencies, including the Federal Reserve and the FDIC, has issued substantially similar risk-based and leverage capital guidelines applicable to the banking organizations they supervise.

The agencies’ risk-based guidelines define a three-tier capital framework. Tier 1 capital principally consists of shareholders’ equity less any amounts of goodwill, other intangible assets, interest-only strips receivables, deferred tax assets, nonfinancial equity investments and other items that are required to be deducted by the Federal Reserve. Perpetual, non-cumulative preferred stock, certain amounts of trust-preferred securities and minority interests in consolidated subsidiaries also may be included in Tier 1 capital, but the Federal Reserve requires that common stock be the predominant form of Tier 1 capital. It is also important to note that the Dodd-Frank Act eliminates Tier 1 capital treatment for trust preferred securities for bank and thrift holding companies with assets of \$15 billion and more after a three-year period that begins January 1, 2013. Bank and thrift holding companies with assets of less than \$15 billion will be permitted to include trust preferred securities issued before May 19, 2010, as Tier 1 capital. Tier 2 capital principally consists of perpetual and trust preferred stock not qualifying as Tier 1 capital, mandatorily convertible debt, limited amounts of term-subordinated debt, intermediate-term preferred stock, and, subject to limitations, general allowances for loan and lease losses, and other adjustments. Tier 3 capital includes subordinated debt that is unsecured, fully paid, has an original maturity of at least two years, is not redeemable before maturity without prior approval by the Federal Reserve and includes a lock-in clause precluding payment of either interest or principal if the payment would cause the issuing bank’s risk-based capital ratio to fall or remain below the requirement minimum. The sum of Tier 1 and Tier 2 capital less investments in unconsolidated subsidiaries represents qualifying total capital.

Risk-based capital ratios are calculated by dividing, as appropriate, total capital and Tier 1 capital by risk-weighted assets. Assets and off-balance sheet exposures are assigned to one of four categories of risk weights, based primarily on relative credit risk. Under the existing risk-based capital requirements, the Company and Southside Bank are each

generally required to maintain a minimum ratio of total capital to risk-weighted assets of at least 8% and a minimum ratio of Tier 1 capital to risk-weighted assets of at least 4%. To the extent we engage in trading activities, we are required to adjust our risk-based capital ratios to take into consideration market risks that may result from movements in market prices of covered trading positions in trading accounts, or from foreign exchange or commodity positions, whether or not in trading accounts, including changes in interest rates, equity prices, foreign exchange rates or commodity prices. Any capital required to be maintained under these provisions may consist of Tier 3 capital.

Each of the federal bank regulatory agencies, including the Federal Reserve and the FDIC, also have established minimum leverage capital requirements for the banking organizations they supervise. These requirements provide that banking organizations that meet certain criteria, including excellent asset quality, high liquidity, low interest rate exposure and good earnings, and that have received the highest regulatory rating must maintain a ratio of Tier 1 capital to total adjusted average assets of at least 3%. Institutions not meeting these criteria, as well as institutions with supervisory, financial or operational weaknesses, are expected to maintain a minimum Tier 1 capital to total adjusted average assets ratio equal to 100 to 200 basis points above this stated

minimum. Holding companies experiencing internal growth or making acquisitions are expected to maintain strong capital positions substantially above the minimum supervisory levels without significant reliance on intangible assets. The Federal Reserve also continues to consider a “tangible Tier 1 capital leverage ratio” (deducting all intangibles) and other indicators of capital strength in evaluating proposals for expansion or new activity.

The ratios of Tier 1 capital and total capital to risk-weighted assets, and the leverage ratios of the Company and Southside Bank as of December 31, 2012, are shown in the following table.

|                              | Capital Adequacy Ratios |   |                                  |                   |  |   |
|------------------------------|-------------------------|---|----------------------------------|-------------------|--|---|
|                              | Regulatory<br>Minimums  | Regulatory<br>Minimums<br>to be Well<br>Capitalized | Southside<br>Bancshares,<br>Inc. | Southside<br>Bank |  |   |
| Risk-based capital ratios:   |                         |   |                                  |                   |  |   |
| Tier 1 capital (1)           | 4.00                    | % 6.00  | % 21.16                          | % 20.60           |  | % |
| Total risk-based capital (2) | 8.00                    | % 10.00   | % 22.42                          | % 21.86           |  | % |
| Tier 1 leverage ratio (3)    | 4.00                    | % 5.00  | % 9.11                           | % 8.87            |  | % |

Common shareholders’ equity excluding unrealized gains or losses on debt securities available for sale, unrealized gains on equity securities available for sale and unrealized gains or losses on cash flow hedges, net of deferred (1) income taxes; plus certain mandatorily redeemable capital securities, less nonqualifying intangible assets net of applicable deferred income taxes, and certain nonfinancial equity investments; computed as a ratio of risk-weighted assets, as defined in the risk-based capital guidelines.

The sum of Tier 1 capital, a qualifying portion of the allowance for credit losses, qualifying subordinated debt and (2) qualifying unrealized gains on available for sale equity securities; computed as a ratio of risk-weighted assets, as defined in the risk-based capital guidelines.

Tier 1 capital computed as a percentage of fourth quarter average assets less nonqualifying intangibles and certain (3) nonfinancial equity investments.

The capital requirements applicable to the Company and Southside Bank are subject to change because, over the coming years, the regulatory capital framework is expected to change in important respects as a result of the Dodd-Frank Act and as a result of a separate, international regulatory capital initiative known as “Basel III.” In particular, as noted above, the Dodd-Frank Act eliminates Tier 1 capital treatment for most trust preferred securities for holding companies with assets that exceed \$15 billion after a three-year period that begins January 1, 2013. Furthermore, the current risk-based capital guidelines that apply to the banks and bank holding companies are based upon the 1988 capital accord of the Basel Committee on Banking Supervision (“BCBS”), a committee of central banks and bank supervisors. The Basel I standards to which U.S. banks and bank and financial holding companies are subject were implemented by the Federal Reserve. In 2008, the Federal Reserve began to phase-in capital standards based on the BCBS’ second capital accord, referred to as Basel II, for large or “core” international banks (total assets of \$250 billion or more or consolidated foreign exposures of \$10 billion or more). Basel II emphasizes internal assessment of credit, market and operational risk, as well as supervisory assessment and market discipline in determining minimum capital requirements. In December 2010, BCBS finalized the Basel III regulatory capital standards and it was anticipated that U.S. regulators would adopt new regulatory capital requirements similar to those proposed by the BCBS to be phased in for U.S. financial institutions beginning in 2013. In June of 2012, U.S. banking regulators proposed new standards to implement these capital requirements. However, on November 9, 2012, regulators announced that the implementation of these rules would be delayed and did not provide a specific timeframe for their implementation. These standards, which are aimed at capital reform, seek to further strengthen financial institutions’ capital positions by mandating a higher minimum level of common equity to be held, along with a capital conservation buffer to withstand future periods of stress. The Basel III regime does not supplant Basel II,



however. The Basel II requirements focus on the appropriate allocation of capital to bank assets based on credit risk. Basel III addresses the quality of capital and introduces new capital requirements but does not purport to overrule the credit risk-based standards of Basel II.

In addition, reflecting the importance that regulators place on managing capital and other risks, on June 16, 2011, the banking agencies also issued proposed guidance on stress testing for banking organizations with more than \$10 billion in total consolidated assets. This guidance, which was finalized on May 14, 2012, outlines four “high-level” principles for stress testing practices that should be a part of a banking organization’s stress-testing framework. Specifically, the guidance calls for the framework to (i) include activities and exercises that are tailored to and sufficiently capture the banking organization's exposures, activities and risks; (ii) employ multiple conceptually sound stress testing activities and approaches; (iii) be forward-looking and flexible; and

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(iv) be clear, actionable, well-supported, and used in the decision-making process. Moreover, the federal bank regulators have issued a series of guidance and rulemakings applicable to “large banks.” While many of these do not currently apply to us due to our asset size, these issuances could impact industry capital standards and practices in many, potentially unforeseeable ways.

Complying with the new Basel III capital requirements will likely affect our operations, and the extent to which we will be affected will be known with more certainty once additional clarity is provided on the underlying details of these new requirements. These new requirements have been endorsed by the U.S. banking regulators, but have not yet been translated by the regulators into official, final regulations for U.S. financial institutions. It is anticipated that the regulators will adopt new regulatory capital requirements similar to those proposed by the BCBS, and, as noted above, it was anticipated that the new requirements would be phased-in for U.S. financial institutions beginning in 2013. However, on November 9, 2012, U.S. regulators announced that the implementation of rules implementing Basel III would be delayed and regulators have not provided a specific timeframe for their implementation of these requirements. Furthermore, it is widely anticipated that the capital requirements for most bank and financial holding companies, as well as for most insured depository institutions, will increase, although the nature and amounts of the increase have not yet been specified.

**Source of Strength.** Federal Reserve policy requires a bank holding company to act as a source of financial strength and to take measures to preserve and protect bank subsidiaries in situations where additional investments in a troubled bank may not otherwise be warranted. As a result, a bank holding company may be required to contribute additional capital to its subsidiaries in the form of capital notes or other instruments which qualify as capital under regulatory rules. Any loans from the holding company to its subsidiary banks likely will be unsecured and subordinated to the bank’s depositors and perhaps to other creditors of the bank. Notably, the Dodd-Frank Act codified the Federal Reserve’s “source of strength” policy; this statutory change became effective July 21, 2011. In addition to the foregoing requirements, the Dodd-Frank Act’s provisions authorize the Federal Reserve and other federal banking regulators to require a company that directly or indirectly controls a bank to submit reports that are designed both to assess the ability of such company to comply with its “source of strength” obligations and to enforce the company’s compliance with these obligations. As of December 31, 2012 the Federal Reserve and other federal banking regulators have not yet issued rules implementing this requirement.

In addition, if a bank holding company enters into bankruptcy or becomes subject to the orderly liquidation process established by the Dodd-Frank Act, any commitment by the bank holding company to a federal bank regulatory agency to maintain the capital of a subsidiary bank would be assumed by the bankruptcy trustee or the FDIC, as appropriate, and entitled to a priority of payment. In addition, the FDIC provides that any insured depository institution generally will be liable for any loss incurred by the FDIC in connection with the default of, or any assistance provided by the FDIC to, a commonly controlled insured depository institution. Southside Bank is an FDIC-insured depository institution and thus subject to these requirements. See also Bank Regulation – Prompt Corrective Action and Undercapitalization.

**Dividends.** The principal source of our liquidity at the parent company level is dividends from Southside Bank. Southside Bank is subject to federal and state restrictions on its ability to pay dividends to the Company. We must pay essentially all of our operating expenses from funds we receive from Southside Bank. Therefore, shareholders may receive dividends from us only to the extent that funds are available after payment of our operating expenses. Consistent with its “source of strength” policy, the Federal Reserve discourages bank holding companies from paying dividends except out of operating earnings and prefers that dividends be paid only if, after the payment, the prospective rate of earnings retention appears consistent with the bank holding company’s capital needs, asset quality and overall financial condition.

Among other things, the ability of banks and bank holding companies to pay dividends, and the contents of their respective dividend policies, could be impacted by a range of changes imposed by the Dodd-Frank Act, many of

which will require implementing rules to become effective. See also Bank Regulation – Dividends for additional information.

**Change in Control.** Subject to certain exceptions, under the BHCA and the Change in Bank Control Act (“CBCA”), and the regulations promulgated thereunder, persons who intend to acquire direct or indirect control of a depository institution or a bank holding company are required to obtain the approval of the Federal Reserve Board prior to acquiring control. With respect to the Company, “control” is conclusively presumed to exist where an acquiring party directly or indirectly owns, controls or has the power to vote at least 25% of our voting securities. Under the Federal Reserve’s CBCA regulations, a rebuttable presumption of control would arise with respect to an acquisition where, after the transaction, the acquiring party owns, controls or has the power to vote at least 10% (but less than 25%) of our voting securities. In certain cases, a company may also be presumed to have control under the Bank Holding Company Act if it acquires five percent or more of any class of voting securities.

On September 22, 2008, the Federal Reserve issued a policy statement on minority equity investments in banks and bank holding companies, that permits investors to (1) acquire up to 33 percent of the total equity of a target bank or bank holding company, subject to certain conditions, including that the acquiring investor does not acquire 15 percent or more of any class of

voting securities, and (2) designate at least one director, without triggering the various regulatory requirements associated with control.

**Acquisitions.** The BHCA provides that a bank holding company must obtain the prior approval of the Federal Reserve (i) for the acquisition of more than five percent of the voting stock in any bank or bank holding company, (ii) for the acquisition of substantially all the assets of any bank or bank holding company, or (iii) in order to merge or consolidate with another bank holding company.

**Regulatory Examination.** Federal and state banking agencies require the Company and Southside Bank to prepare annual reports on financial condition and to conduct an annual audit of financial affairs in compliance with minimum standards and procedures. Southside Bank, and in some cases the Company and any nonbank affiliates, must undergo regular on-site examinations by the appropriate regulatory agency, which will examine for adherence to a range of legal and regulatory compliance responsibilities. A bank regulator conducting an examination has complete access to the books and records of the examined institution, and the results of the examination are confidential. The cost of examinations may be assessed against the examined organization as the agency deems necessary or appropriate. The FDIC has developed a method for insured depository institutions to provide supplemental disclosure of the estimated fair value of assets and liabilities, to the extent feasible and practicable, in any balance sheet, financial statement, report of condition or any other report.

**Enforcement Authority.** The Federal Reserve has broad enforcement powers over bank holding companies and their nonbank subsidiaries, as well as “institution-affiliated parties,” including management, employees, agents, independent contractors and consultants, such as attorneys and accountants and others who participate in the conduct of the institution’s affairs, and has authority to prohibit activities that represent unsafe or unsound banking practices or constitute knowing or reckless violations of laws or regulations. These powers may be exercised through the issuance of cease and desist orders, civil money penalties or other actions. Civil money penalties can be as high as \$1,000,000 for each day the activity continues and criminal penalties for some financial institution crimes may include imprisonment for 20 years. Regulators have flexibility to commence enforcement actions against institutions and institution-affiliated parties, and the FDIC has the authority to terminate deposit insurance. When issued by a banking agency, cease-and-desist and similar orders may, among other things, require affirmative action to correct any harm resulting from a violation or practice, including restitution, reimbursement, indemnifications or guarantees against loss. A financial institution may also be ordered to restrict its growth, dispose of certain assets, rescind agreements or contracts, or take other actions determined to be appropriate by the ordering agency. The federal banking agencies also may remove a director or officer from an insured depository institution (or bar them from the industry) if a violation is willful or reckless.

#### Bank Regulation

Southside Bank is a Texas-chartered commercial bank, the deposits of which are insured up to the applicable limits by the DIF of the FDIC. It is not a member of the Federal Reserve System. The Bank is subject to extensive regulation, examination and supervision by the TDB, as its chartering authority, and by the FDIC, as its primary federal regulator and deposit insurer. In addition, the Bureau could participate in examinations of the Bank (as described above) in the near term regarding the Bank’s offering of consumer financial products and services. The federal and state laws applicable to banks regulate, among other things, the scope of their business and investments, lending and deposit-taking activities, borrowings, maintenance of retained earnings and reserve accounts, distribution of earnings and payment of dividends.

**Permitted Activities and Investments.** Under the Federal Deposit Insurance Act (“FDIA”), the activities and investments of state nonmember banks are generally limited to those permissible for national banks, notwithstanding state law. With FDIC approval, a state nonmember bank may engage in activities not permissible for a national bank if the

FDIC determines that the activity does not pose a significant risk to the DIF and that the bank meets its minimum capital requirements. Similarly, under Texas law, a state bank may engage in those activities permissible for national banks domiciled in Texas. The TDB may permit a Texas state bank to engage in additional activities so long as the performance of the activity by the bank would not adversely affect the safety and soundness of the bank.

Brokered Deposits. Southside Bank also may be restricted in its ability to accept, renew or roll over brokered deposits, depending on its capital classification. Only “well capitalized” banks are permitted to accept, renew or roll over brokered deposits. The FDIC may, on a case-by-case basis, permit banks that are adequately capitalized to accept brokered deposits if the FDIC determines that acceptance of such deposits would not constitute an unsafe or unsound banking practice with respect to the bank. Undercapitalized banks generally may not accept, renew or roll over brokered deposits.

Loans to One Borrower. Under Texas law, without the approval of the TDB and subject to certain limited exceptions, the maximum aggregate amount of loans that Southside Bank is permitted to make to any one borrower is 25% of Tier 1 capital.

**Insider Loans.** Under Regulation O of the Federal Reserve, as made applicable to state nonmember banks by section 18(j)(2) of the FDIA, Southside Bank is subject to quantitative restrictions on extensions of credit to its executive officers and directors, the executive officers and directors of the Company, any owner of 10% or more of its stock or the stock of Southside Bancshares, Inc., and certain entities affiliated with any such persons. In general, any such extensions of credit must (i) not exceed certain dollar limitations, (ii) be made on substantially the same terms, including interest rates and collateral, as those prevailing at the time for comparable transactions with third parties, and (iii) not involve more than the normal risk of repayment or present other unfavorable features. Additional restrictions are imposed on extensions of credit to executive officers. Certain extensions of credit also require the approval of a bank's board of directors.

**Deposit Insurance and Assessments.** The deposits of Southside Bank are insured by the DIF of the FDIC, up to the applicable limits established by law and are subject to the deposit insurance premium assessments of the DIF. The Dodd-Frank Act amended the statutory regime governing the DIF. Among other things, the Dodd-Frank Act established a minimum designated reserve ratio ("DRR") of 1.35 percent of estimated insured deposits, required that the fund reserve ratio reach 1.35 percent by September 30, 2020 and directed the FDIC to amend its regulations to redefine the assessment base used for calculating deposit insurance assessments. Specifically, the Dodd-Frank Act requires the assessment base to be an amount equal to the average consolidated total assets of the insured depository institution during the assessment period, minus the sum of the average tangible equity of the insured depository institution during the assessment period and an amount the FDIC determines is necessary to establish assessments consistent with the risk-based assessment system found in the FDIA.

In December of 2010, the FDIC adopted a final rule setting the DRR at 2.0 percent. Furthermore, on February 7, 2011, the FDIC issued a final rule changing its assessment system from one based on domestic deposits to one based on the average consolidated total assets of a bank minus its average tangible equity during each quarter. The February 7, 2011 final rule modifies two adjustments added to the risk-based pricing system in 2009 (an unsecured debt adjustment and a brokered deposit adjustment), discontinues a third adjustment added in 2009 (the secured liability adjustment), and adds an adjustment for long-term debt held by an insured depository institution where the debt is issued by another insured depository institution. Under the February 7, 2011 final rule, the total base assessment rates will vary depending on the DIF reserve ratio. For example, for banks in the best risk category, the initial total base assessment rates will be between 2.5 and 9 basis points when the DIF reserve ratio is below 1.15 percent, between 1.5 and 7 basis points when the DIF reserve ratio is between 1.15 percent and 2 percent, between 1 and 6 basis points when the DIF reserve ratio is between 2 percent and 2.5 percent and between 0.5 and 5 basis points when the DIF reserve ratio is 2.5 percent or higher.

In November 2009, the FDIC issued a rule that required all insured depository institutions, with limited exceptions, to prepay their estimated quarterly risk-based assessments for the fourth quarter of 2009 and for all of 2010, 2011 and 2012. In December 2009, we paid \$9.9 million in prepaid risk-based assessments, which included \$625,000 related to the fourth quarter of 2009 that would have otherwise been payable in the first quarter of 2010 and was included in deposit insurance expense for 2009. The remaining \$9.3 million in prepaid deposit insurance was included in other assets in our consolidated balance sheet as of December 31, 2009. As of December 31, 2012, 2011, and 2010, \$3.6 million, \$5.2 million and \$6.7 million, respectively, remained of the prepaid deposit insurance.

In addition, all FDIC-insured institutions are required to pay a pro rata portion of the interest due on bonds issued by the Financing Corporation ("FICO") to fund the closing and disposal of failed thrift institutions by the Resolution Trust Corporation. FICO assessments, which are calculated off the new assessment base established by the Dodd-Frank Act, are set quarterly, and was .660 (annual) basis points for all four quarters of 2012. These assessments will continue until the FICO bonds mature in 2017 through 2019.

Notably, the Dodd-Frank Act provided temporary, unlimited deposit insurance for all noninterest-bearing transaction accounts through December 31, 2012. However, as of January 1, 2013 when this provision of the Dodd-Frank Act expired, all of a depositor's accounts at an insured depository institution, including all noninterest-bearing transaction accounts, are insured by the FDIC up to the standard maximum deposit insurance amount (\$250,000), for each deposit insurance ownership category.

Capital Adequacy. See Holding Company Regulation – Capital Adequacy.

Prompt Corrective Action and Undercapitalization. The Federal Deposit Insurance Corporation Improvement Act (the “FDICIA”) established a system of prompt corrective action to resolve the problems of undercapitalized insured depository institutions. Under this system, the federal banking regulators are required to rate insured depository institutions on the basis of five capital categories as described below. The federal banking regulators are also required to take mandatory supervisory actions and are authorized to take other discretionary actions, with respect to insured depository institutions in the three undercapitalized

categories, the severity of which will depend upon the capital category in which the insured depository institution is assigned. Generally, subject to a narrow exception, the FDICIA requires the banking regulator to appoint a receiver or conservator for an insured depository institution that is critically undercapitalized. The federal banking agencies have specified by regulation the relevant capital level for each category. Under the regulations, all insured depository institutions are assigned to one of the following capital categories:

**Well Capitalized** – The insured depository institution exceeds the required minimum level for each relevant capital measure. A well capitalized insured depository institution is one (1) having a total risk-based capital ratio of 10 percent or greater, (2) having a Tier 1 risk-based capital ratio of 6 percent or greater, (3) having a leverage capital ratio of 5 percent or greater, and (4) that is not subject to any order or written directive to meet and maintain a specific capital level for any capital measure.

**Adequately Capitalized** – The insured depository institution meets the required minimum level for each relevant capital measure. An adequately capitalized insured depository institution is one (1) having a total risk-based capital ratio of 8 percent or greater, (2) having a Tier 1 risk-based capital ratio of 4 percent or greater, and (3) having a leverage capital ratio of 4 percent or greater, or a leverage capital ratio of 3 percent or greater if the institution is rated composite 1 under the CAMELS (Capital, Assets, Management, Earnings, Liquidity and Sensitivity to market risk) rating system, and (4) failing to meet the definition of a well capitalized bank.

**Undercapitalized** – The insured depository institution fails to meet the required minimum level for any relevant capital measure. An undercapitalized insured depository institution is one (1) having a total risk-based capital ratio of less than 8 percent, (2) having a Tier 1 risk-based capital ratio of less than 4 percent, or (3) a leverage capital ratio of less than 4 percent, or if the institution is rated a composite 1 under the CAMELS rating system, a leverage capital ratio of less than 3 percent.

**Significantly Undercapitalized** – The insured depository institution is significantly below the required minimum level for any relevant capital measure. A significantly undercapitalized insured depository institution is one (1) having a total risk-based capital ratio of less than 6 percent, (2) a Tier 1 risk-based capital ratio of less than 3 percent, or (3) a leverage capital ratio of less than 3 percent.

**Critically Undercapitalized** – The insured depository institution fails to meet a critical capital level set by the appropriate federal banking agency. A critically undercapitalized institution is one having a ratio of tangible equity to total assets that is equal to or less than 2 percent.

The regulations permit the appropriate federal banking regulator to downgrade an institution to the next lower category if the regulator determines after notice and opportunity for hearing or response that the institution (1) after notice and opportunity for hearing or response, that the institution is in an unsafe or unsound condition or (2) that the institution has received and not corrected a less-than-satisfactory rating for any of the categories of asset quality, management, earnings or liquidity in its most recent examination. Supervisory actions by the appropriate federal banking regulator depend upon an institution's classification within the five categories. Our management believes that we and our bank subsidiary have the requisite capital levels to qualify as well capitalized institutions under the FDICIA regulations.

If an institution fails to remain well capitalized, it will be subject to a variety of enforcement remedies that increase as the capital condition worsens. For instance, the FDICIA generally prohibits a depository institution from making any capital distribution, including payment of a dividend, or paying any management fee to its holding company if the depository institution would thereafter be undercapitalized as a result. Undercapitalized depository institutions are subject to restrictions on borrowing from the Federal Reserve System. In addition, undercapitalized depository institutions may not accept brokered deposits absent a waiver from the FDIC, are subject to growth limitations and are



required to submit capital restoration plans for regulatory approval. A depository institution's holding company must guarantee that any required capital restoration plan, up to an amount equal to the lesser of 5 percent of the depository institution's assets at the time it becomes undercapitalized or the amount of the capital deficiency when the institution fails to comply with the plan. Federal banking agencies may not accept a capital plan without determining, among other things, that the plan is based on realistic assumptions and is likely to succeed in restoring the depository institution's capital. If a depository institution fails to submit an acceptable plan, it is treated as if it is significantly undercapitalized.

Significantly undercapitalized depository institutions may be subject to a number of requirements and restrictions, including orders to sell sufficient voting stock to become adequately capitalized, requirements to reduce total assets and cessation of receipt

of deposits from correspondent banks. Critically undercapitalized depository institutions are subject to appointment of a receiver or conservator.

In addition to the “prompt corrective action” directives, failure to meet capital guidelines may subject a banking organization to a variety of other enforcement remedies, including additional substantial restrictions on its operations and activities, termination of deposit insurance by the FDIC and, under certain conditions, the appointment of a conservator or receiver.

**Standards for Safety and Soundness.** The FDIA also requires the federal banking regulatory agencies to prescribe, by regulation or guideline, operational and managerial standards for all insured depository institutions relating to: (i) internal controls; (ii) information systems and internal audit systems; (iii) loan documentation; (iv) credit underwriting; (v) interest rate risk exposure; and (vi) asset quality. The agencies also must prescribe standards for asset quality, earnings, and stock valuation, as well as standards for compensation, fees and benefits. The federal banking agencies have adopted regulations and Interagency Guidelines Prescribing Standards for Safety and Soundness (“Guidelines”) to implement these required standards. The Guidelines set forth the safety and soundness standards that the federal banking agencies use to identify and address problems at insured depository institutions before capital becomes impaired. Under the regulations, if the FDIC determines that Southside Bank fails to meet any standards prescribed by the Guidelines, it may require Southside Bank to submit an acceptable plan to achieve compliance, consistent with deadlines for the submission and review of such safety and soundness compliance plans. Notably, the Dodd-Frank Act contains separate requirements relating to compensation arrangement. Specifically, the Act requires banking regulators to issue regulations or guidelines to prohibit incentive-based compensation arrangements that encourage inappropriate risk taking by providing excessive compensation or that may lead to material loss at certain financial institutions with \$1 billion or more in assets. A proposed rule was published in the Federal Register on April 14, 2011; however, regulators have yet to issue final rules on the topic.

**Dividends.** All dividends paid by Southside Bank are paid to the Company, as the sole shareholder of Southside Bank. The ability of Southside Bank, as a Texas state bank, to pay dividends is restricted under federal and state law and regulations. As an initial matter, the FDICIA and the regulations of the FDIC generally prohibit an insured depository institution from making a capital distribution (including payment of dividend) if, thereafter, the institution would not be at least adequately capitalized. Under Texas law, Southside Bank generally may not pay a dividend reducing its capital and surplus without the prior approval of the Texas Banking Commissioner. All dividends must be paid out of net profits then on hand, after deducting expenses, including losses and provisions for loan losses.

Southside Bank’s general dividend policy is to pay dividends at levels consistent with maintaining liquidity and preserving applicable capital ratios and servicing obligations. Southside Bank’s dividend policies are subject to the discretion of its board of directors and will depend upon such factors as future earnings, financial conditions, cash needs, capital adequacy, compliance with applicable statutory and regulatory requirements and general business conditions. The exact amount of future dividends paid by Southside Bank will be a function of its general profitability (which cannot be accurately estimated or assured), applicable tax rates in effect from year to year and the discretion of its board of directors.

As described above under Holding Company Regulation - Dividends, the ability of banks and bank holding companies to pay dividends, and the contents of their respective dividend policies, could be impacted by a range of changes imposed by the Dodd-Frank Act, many of which will require implementing rules to become effective.

**Transactions with Affiliates.** Southside Bank is subject to sections 23A and 23B of the Federal Reserve Act (“FRA”) and the Federal Reserve’s Regulation W, as made applicable to state nonmember banks by section 18(j) of the FDIA. Sections 23A and 23B of the FRA restrict a bank’s ability to engage in certain transactions with its

affiliates. An affiliate of a bank is any company or entity that controls, is controlled by or is under common control with the bank. In a holding company context, the parent bank holding company and any companies controlled by such parent holding company are generally affiliates of the bank.

Specifically, section 23A places limits on the amount of “covered transactions,” which include loans or extensions of credit to, and investments in or certain other transactions with, affiliates. It also limits the amount of any advances to third parties that are collateralized by the securities or obligations of affiliates. The aggregate of all covered transactions is limited to 10 percent of the bank’s capital and surplus for any one affiliate and 20 percent for all affiliates. Additionally, within the foregoing limitations, each covered transaction must meet specified collateral requirements ranging from 100 to 130 percent of the loan amount, depending on the type of collateral. Further, banks are prohibited from purchasing low quality assets from an affiliate. Section 608 of the Dodd-Frank Act broadens the definition of “covered transactions” to include derivative transactions and the borrowing or lending of securities if the transaction will cause a bank to have credit exposure to an affiliate. The revised definition also includes the acceptance of debt obligations of an affiliate as collateral for a loan or extension of credit to a third party. Furthermore, reverse

repurchase transactions will be viewed as extensions of credit (instead of asset purchases) and thus become subject to collateral requirements. These expanded definitions took effect on July 21, 2012.

Section 23B, among other things, prohibits a bank from engaging in certain transactions with affiliates unless the transactions are on terms substantially the same, or at least as favorable to the bank, as those prevailing at the time for comparable transactions with non-affiliated companies. Except for limitations on low quality asset purchases and transactions that are deemed to be unsafe or unsound, Regulation W generally excludes affiliated depository institutions from treatment as affiliates.

**Anti-Tying Regulations.** Under the BHCA and Federal Reserve's regulations, a bank is prohibited from engaging in certain tying or reciprocity arrangements with its customers. In general, a bank may not extend credit, lease, sell property, or furnish any services or fix or vary the consideration for these products or services on the condition that either: (i) the customer obtain or provide some additional credit, property, or services from or to the bank, the bank holding company or subsidiaries thereof or (ii) the customer not obtain credit, property, or service from a competitor, except to the extent reasonable conditions are imposed to assure the soundness of the credit extended. A bank may, however, offer combined-balance products and may otherwise offer more favorable terms if a customer obtains two or more traditional bank products. Also, certain foreign transactions are exempt from the general rule.

**Community Reinvestment Act.** Under the Community Reinvestment Act ("CRA"), Southside Bank has a continuing and affirmative obligation, consistent with safe and sound banking practices, to help meet the needs of our entire community, including low- and moderate-income neighborhoods. The CRA does not establish specific lending requirements or programs for banks nor does it limit a bank's discretion to develop the types of products and services that it believes are best suited to its particular community.

On a periodic basis, the FDIC is charged with preparing a written evaluation of our record of meeting the credit needs of the entire community and assigning a rating – outstanding, satisfactory, needs to improve or substantial noncompliance. Banks are rated based on their actual performance in meeting community credit needs. The FDIC will take that rating into account in its evaluation of any application made by the bank for, among other things, approval of the acquisition or establishment of a branch or other deposit facility, an office relocation, a merger or the acquisition of shares of capital stock of another financial institution. A bank's CRA rating may be used as the basis to deny or condition an application. In addition, as discussed above, a bank holding company may not become a financial holding company unless each of its subsidiary banks has a CRA rating of at least "Satisfactory." Southside Bank was last examined for compliance with the CRA and received a rating of "Outstanding" on April 26, 2010.

**Branch Banking.** Pursuant to the Texas Finance Code, all banks located in Texas are authorized to branch statewide. Accordingly, a bank located anywhere in Texas has the ability, subject to regulatory approval, to establish branch facilities near any of our facilities and within our market area. If other banks were to establish branch facilities near our facilities, it is uncertain whether these branch facilities would have a material adverse effect on our business.

The Dodd-Frank Act substantially amended the legal framework that had previously governed interstate branching activities. Formerly, under the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994, a bank's ability to branch into a particular state was largely dependent upon whether the state "opted in" to de novo interstate branching. Many states did not "opt-in," which resulted in branching restrictions in those states. The Dodd-Frank Act removed the "opt-in" concept and permits banks to engage in de novo branching outside of their home states, provided that the laws of the target state permit banks chartered in that state to branch within that state. Accordingly, de novo interstate branching by Southside Bank is subject to these new standards. All branching in which Southside Bank may engage remains subject to regulatory approval and adherence to applicable legal and regulatory requirements.

Consumer Protection Regulation. The activities of Southside Bank are subject to a variety of statutes and regulations designed to protect consumers. Interest and other charges collected or contracted for by the banks are subject to state usury laws and federal laws concerning interest rates. Loan operations are also subject to federal laws applicable to credit transactions, such as:

the federal Truth-In-Lending Act and Regulation Z issued by the Federal Reserve, governing disclosures of credit terms to consumer borrowers;

the Home Mortgage Disclosure Act and Regulation C issued by the Federal Reserve, requiring financial institutions to provide information to enable the public and public officials to determine whether a financial institution is fulfilling its obligation to help meet the housing needs of the community it serves;

the Equal Credit Opportunity Act and Regulation B issued by the Federal Reserve, prohibiting discrimination on the basis of race, creed or other prohibited factors in extending credit;

the Fair Credit Reporting Act and Regulation V issued by the Federal Reserve, governing the use and provision of information to consumer reporting agencies;

the Fair Debt Collection Act, governing the manner in which consumer debts may be collected by collection agencies; and

the guidance of the various federal agencies charged with the responsibility of implementing such federal laws.

Deposit and other operations also are subject to:

the Truth in Savings Act and Regulation DD issued by the Federal Reserve, governing disclosure of deposit account terms to consumers;

the Right to Financial Privacy Act, which imposes a duty to maintain confidentiality of consumer financial records and prescribes procedures for complying with administrative subpoenas of financial records; and

the Electronic Funds Transfer Act and Regulation E issued by the Federal Reserve, which governs automatic deposits to and withdrawals from deposit accounts and customers' rights and liabilities arising from the use of ATMs and other electronic banking services, which the Bureau is in the process of expanding to include a new compliance regime that will govern consumer-initiated cross border electronic transfers.

Many of the foregoing laws and regulations are subject to change resulting from the provisions in the Dodd-Frank Act and other developments, which in many cases call for revisions to implementing regulations. In addition to numerous new disclosure requirements, the Dodd-Frank Act imposes new standards for mortgage loan originations on all lenders, including banks, in an effort to encourage lenders to verify a borrower's ability to repay. The Bureau recently issued rules that implement this "ability-to-repay" requirement and provide lenders with protection from liability for "qualified mortgages," as required by the Dodd-Frank Act. Most significantly, the new "qualified mortgage" standards generally limit the total points and fees that financial institutions and/or a broker may charge on conforming and jumbo loans to 3 percent of the total loan amount. Also, the Dodd-Frank Act, in conjunction with the Federal Reserve's final rule on loan originator compensation issued August 16, 2010 and effective April 1, 2011, prohibits certain compensation payments to loan originators and steering consumers to loans not in their interest because it will result in greater compensation for a loan originator. In addition, the Bureau recently issued additional rules pertaining to loan originator compensation, and that established qualification, registration and licensing requirements for loan originators. These standards will result in a myriad of new system, pricing, and compensation controls in order to ensure compliance and to decrease repurchase requests and foreclosure defenses. In addition, the Dodd-Frank Act generally requires lenders or securitizers to retain an economic interest in the credit risk relating to loans the lender sells and other asset-backed securities that the securitizer issues if the loans have not complied with the ability to repay standards. The risk retention requirement generally will be 5 percent, but could be increased or decreased by regulation.

Moreover, the Bureau has republished the transferred regulations in a new section of the Code of Federal Regulations and has requested comments regarding an effort to "streamline" these regulations. It is also anticipated that the Bureau will be making substantive changes to a number of consumer protection regulations and associated disclosures in the near term including significant changes to a number of requirements related to lending. The Bureau is also in the process of establishing a series of mechanisms to collect, track and make public consumer complaints, including complaints against individual financial institutions.

We cannot predict the effect that being regulated by a new, additional regulatory authority focused on consumer financial protection, or any new implementing regulations or revisions to existing regulations that may result from the establishment of this new authority, will have on our businesses. Additional regulations resulting from the Dodd-Frank Act may materially adversely affect our business, financial condition or results of operations. In addition, Southside Bank also may be subject to certain state laws and regulations designed to protect consumers.

**Commercial Real Estate Lending.** Lending operations that involve concentration of commercial real estate loans are subject to enhanced scrutiny by federal banking regulators. The regulators have issued guidance with respect to the risks posed by commercial real estate lending concentrations. Real estate loans generally include land development, construction loans, land and lot loans to individuals, loans secured by multi-family property and nonfarm nonresidential real property where the primary source of repayment is derived from rental income associated with the property. The guidance prescribes the following guidelines for

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examiners to help identify institutions that are potentially exposed to concentration risk and may warrant greater supervisory scrutiny:

total reported loans for construction, land development and other land represent 100 percent or more of the institution's total capital, or

total commercial real estate loans represent 300 percent or more of the institution's total capital and the outstanding balance of the institution's commercial real estate loan portfolio has increased by 50 percent or more during the prior 36 months.

In October 2009, the federal banking agencies issued additional guidance on real estate lending that emphasizes these considerations.

In addition, the Dodd-Frank Act contains provisions that may impact our business by reducing the amount of our commercial real estate lending and increasing the cost of borrowing, including rules relating to risk retention of securitized assets. Section 941 of the Dodd-Frank Act requires, among other things, a loan originator or a securitizer of asset-backed securities to retain a percentage of the credit risk of securitized assets. The banking agencies have jointly issued a proposed rule to implement these requirements but have yet to issue final rules.

**Anti-Money Laundering.** Southside Bank is subject to the regulations of the Financial Crimes Enforcement Network ("FinCEN"), which implement the Bank Secrecy Act, as amended by the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001, or the "USA Patriot Act." The USA Patriot Act gives the federal government the power to address terrorist threats through enhanced domestic security measures, expanded surveillance powers, increased information sharing, and broadened anti-money laundering requirements. Title III of the USA Patriot Act includes measures intended to encourage information sharing among banks, regulatory agencies and law enforcement bodies. Further, certain provisions of Title III impose affirmative obligations on a broad range of financial institutions, including state-chartered banks like Southside Bank.

The USA Patriot Act and the related FinCEN regulations impose certain requirements with respect to financial institutions, including the following:

establishment of anti-money laundering programs, including adoption of written procedures and an ongoing employee training program, designation of a compliance officer and auditing of the program;

establishment of a program specifying procedures for obtaining information from customers seeking to open new accounts, including verifying the identity of customers within a reasonable period of time;

establishment of enhanced due diligence policies, procedures and controls designed to detect and report money laundering, and for financial institutions that administer, maintain or manage private bank accounts or correspondent accounts for non-U.S. persons;

prohibitions on correspondent accounts for foreign shell banks and compliance with recordkeeping obligations with respect to correspondent accounts of foreign banks;

filing of suspicious activities reports if a bank believes a customer may be violating U.S. laws and regulations; and

requirements that bank regulators consider bank holding company or bank compliance in connection with merger or acquisition transactions.



Bank regulators routinely examine institutions for compliance with these obligations and have been active in imposing “cease and desist” and other regulatory orders and money penalty sanctions against institutions found to be violating these obligations. In addition, FinCEN is in the process of establishing new regulations that would require financial institutions to obtain beneficial ownership information for certain accounts, however, it has yet to establish final regulations on this topic.

The Federal Bureau of Investigation can send bank regulatory agencies lists of the names of persons suspected of involvement in terrorist activities. Southside Bank can be requested to search its records for any relationships or transactions with persons on those lists and required to report any identified relationships or transactions.

OFAC. The Office of Foreign Assets Control (“OFAC”) is responsible for helping to insure that U.S. entities do not engage in transactions with certain prohibited parties, as defined by various Executive Orders and Acts of Congress. OFAC publishes, and routinely updates, lists of names of persons and organizations suspected of aiding, harboring or engaging in terrorist acts, including the Specially Designated Nationals List. If we find a name on any transaction, account or wire transfer that is on an OFAC list, we must undertake certain specified activities, which could include blocking or freezing the account or transaction requested, and we must notify the appropriate authorities.

Privacy and Data Security. Under federal law, financial institutions are generally prohibited from disclosing consumer information to non-affiliated third parties unless the consumer has been given the opportunity to object and has not objected to such disclosure. Financial institutions are further required to disclose their privacy policies to consumers annually. To the extent state laws are more protective of consumer privacy, financial institutions must comply with state law privacy provisions.

In addition, federal and state banking agencies have prescribed standards for maintaining the security and confidentiality of consumer information. Southside Bank is subject to such standards, as well as standards for notifying consumers in the event of a security breach. Under federal law, Southside Bank must disclose its privacy policy for collecting and protecting confidential customer information to consumers, permit consumers to “opt out” of having nonpublic customer information disclosed to non-affiliated third parties, with some exceptions, and allow customers to opt out of receiving marketing solicitations based on information about the customer received from another subsidiary. States may adopt more extensive privacy protections. Southside Bank is similarly required to have an information security program to safeguard the confidentiality and security of customer information and to ensure proper disposal. Customers must be notified when unauthorized disclosure involves sensitive customer information that may be misused.

Regulatory Examination. See Holding Company Regulation – Regulatory Examination.

Enforcement Authority. Southside Bank and its “institution-affiliated parties,” including management, employees, agents, independent contractors and consultants, such as attorneys and accountants and others who participate in the conduct of the institution’s affairs, are subject to potential civil and criminal penalties for violations of law, regulations or written orders of a government agency. Violations can include failure to timely file required reports, filing false or misleading information or submitting inaccurate reports. Civil penalties may be as high as \$1,000,000 a day for such violations, and criminal penalties for some financial institution crimes may include imprisonment for 20 years. Regulators have flexibility to commence enforcement actions against institutions and institution-affiliated parties, and the FDIC has the authority to terminate deposit insurance. When issued by a banking agency, cease-and-desist orders may, among other things, require affirmative action to correct any harm resulting from a violation or practice, including restitution, reimbursement, indemnifications or guarantees against loss. A financial institution may also be ordered to restrict its growth, dispose of certain assets, rescind agreements or contracts, or take other actions determined to be appropriate by the ordering agency. The federal banking agencies also may remove a director or officer from an insured depository institution (or bar them from the industry) if a violation is willful or reckless.

Governmental Monetary Policies. The commercial banking business is affected not only by general economic conditions but also by the monetary policies of the Federal Reserve. Changes in the discount rate on member bank borrowings, control of borrowings, open market operations, the imposition of and changes in reserve requirements against member banks, deposits and assets of foreign branches, the imposition of and changes in reserve requirements against certain borrowings by banks and their affiliates and the placing of limits on interest rates which member banks may pay on time and savings deposits are some of the instruments of monetary policy available to the Federal Reserve. These monetary policies influence to a significant extent the overall growth of all bank loans, investments

and deposits and the interest rates charged on loans or paid on time and savings deposits. Recently, in response to the financial crisis, the Federal Reserve has established several innovative programs to stabilize certain financial institutions and to ensure the availability of credit. The nature of future monetary policies and the effect of such policies on Southside Bank's future business and earnings, therefore, cannot be predicted accurately.

**Evolving Legislation and Regulatory Action.** Proposals for new statutes and regulations are frequently circulated at both the federal and state levels, and may include wide-ranging changes to the structures, regulations and competitive relationships of financial institutions. We cannot predict whether new legislation or regulations will be enacted and, if enacted, the effect that it, or any regulations, would have on our business, financial condition or results of operations.

**Other Regulatory Matters.** The Company and its subsidiary, Southside Securities, Inc., and their affiliates are subject to oversight by the SEC, the Financial Industry Regulatory Authority, the New York Stock Exchange, the NASDAQ Stock Market and various state securities regulators. The Company and its subsidiaries have from time to time received requests for information from regulatory authorities in various states, including state attorneys general, securities regulators and other regulatory authorities, concerning their business practices. Such requests are considered incidental to the normal conduct of business.

## ITEM 1A. RISK FACTORS

An investment in our common stock is subject to risks inherent to our business. The material risks and uncertainties that management believes affect us are described below. Before making an investment decision, you should carefully consider the risks and uncertainties described below together with all of the other information included or incorporated by reference in this report. The risks and uncertainties described below are not the only ones facing us. Additional risks and uncertainties that management is not aware of or focused on or that management currently deems immaterial may also impair our business operations. This report is qualified in its entirety by these risk factors.

If any of the following risks actually occur, our financial condition and results of operations could be materially and adversely affected. If this were to happen, the value of our common stock could decline significantly, and you could lose all or part of your investment.

### RISKS RELATED TO OUR BUSINESS

We are subject to an economic environment that continues to pose significant challenges for us and could adversely affect our financial condition and results of operations.

We continue to operate in a challenging and uncertain economic environment. Financial institutions continue to be affected by declines in the real estate market and constrained financial markets. We retain direct exposure to the residential and commercial real estate markets, and we could be affected by these events. Declines in real estate values, home sales volumes and financial stress on borrowers as a result of the uncertain economic environment, including unemployment and new job losses, could have an adverse effect on our borrowers or their customers, which could adversely affect our financial condition and results of operations. In addition, should we see a renewed national economic recession, the residual deterioration in local economic conditions in our markets could drive losses beyond those which are provided for in our allowance for loan losses and result in the following consequences:

• increases in loan delinquencies;

• increases in nonperforming assets and foreclosures;

• decreases in demand for our products and services, which could adversely affect our liquidity position;

• decreases in the value of the collateral securing our loans, especially real estate, which could reduce customers' borrowing power;

• decreases in the credit quality of our non-U.S. Government and non-U.S. agency investment securities, especially our trust preferred, corporate and municipal securities;

• an adverse or unfavorable resolution of the Fannie Mae or Freddie Mac receivership; and

• decreases in the real estate values subject to ad-valorem taxes by municipalities that impact such municipalities' ability to repay their debt, which could adversely affect our municipal loans or debt securities.

Any of the foregoing could adversely affect our financial condition and results of operation.



We continue to face market volatility, which could adversely impact our results of operations and access to capital.

The capital and credit markets experienced volatility and disruption from 2008 to 2010. While volatility in, and disruption of, these markets no longer remain at unprecedented levels, any future escalated levels of market volatility and disruption could produce downward pressure on stock prices and credit capacity without regard to an issuer's underlying financial strength. If levels of market disruption and volatility worsen, there can be no assurance that we will not experience adverse effects, which may be material, on our ability to access capital and on our results of operations and financial condition, including our liquidity position.

Current market developments may adversely affect our industry, business and results of operations.

Dramatic declines in the housing market during the past few years, with falling home prices and increased foreclosures and high levels of unemployment, have resulted in significant write-downs of asset values by financial institutions, including government-sponsored entities and major commercial and investment banks. These write-downs, initially of mortgage-backed securities but spreading to credit default swaps and other derivative securities, have caused many financial institutions to seek additional capital, to merge with larger and stronger institutions and, in some cases, to fail. Reflecting concern about the stability of the financial markets generally and the strength of counterparties, many lenders and institutional investors reduced, and in some cases, ceased to provide funding to borrowers including other financial institutions. In the past two years availability of credit has increased. Should conditions deteriorate the resulting lack of available credit, lack of confidence in the financial sector, increased volatility in the financial markets and reduced business activity could materially and adversely affect our business, financial condition and results of operations.

Emergency measures designed to stabilize the U.S. financial system are beginning to wind down.

Since 2008, various legislative and regulatory actions have been implemented in response to the financial crises affecting the banking system and financial markets and to the recession. Many of these programs have expired. The wind-down of these programs may have a direct adverse effect on us or a broader adverse impact on the financial sector. TARP was established pursuant to EESA, as amended by ARRA, whereby the Treasury has the authority to, among other things, spend up to \$700 billion to purchase equity in financial institutions, purchase mortgages, mortgage-backed securities and certain other financial instruments from financial institutions for the purpose of stabilizing and providing liquidity to the U.S. financial markets. Though TARP was scheduled to expire on December 31, 2009, the Treasury extended TARP until October 3, 2010, in order to retain an adequate financial stability reserve if financial conditions worsen and threaten the economy. On October 21, 2009, the FDIC voted to end the Debt Guarantee Program portion of the Temporary Liquidity Guarantee Program, which guarantees certain "newly-issued unsecured debt" of banks and certain holding companies. The Debt Guarantee Program expired on October 31, 2009, with the guarantee period on such debt expiring on December 30, 2012. The Transaction Account Guarantee portion of the program, which guarantees noninterest bearing bank transaction accounts on an unlimited basis expired December 31, 2010. However, provisions in the Dodd-Frank Act that amend the FDIA provide temporary unlimited deposit insurance coverage for noninterest-bearing transaction accounts (including Interest on Lawyer Trust Accounts or IOLTAs) beginning December 31, 2010, for a two-year period. This program expired on December 31, 2012.

The Transaction Account Guarantee program was utilized by a number of our customers and we anticipate some deposit rolloff with expiration of this program. To date, we have not experienced significant outflows of deposits as a result of the Transaction Account Guarantee program expiring. We did not utilize the other programs and as such we believe the expiration of these programs will have significantly less, if any, direct impact. However, we cannot predict any future effect that the wind-down of these various governmental programs will have on current financial market conditions, or on our business, financial condition, results of operations, access to credit and the trading price

of our common stock.

We are subject to interest rate risk.

Our earnings and cash flows are largely dependent upon our net interest income. Net interest income is the difference between interest income earned on interest earning assets such as loans and securities and interest expense paid on interest bearing liabilities such as deposits and borrowed funds. Interest rates are highly sensitive to many factors that are beyond our control, including general economic conditions and policies of various governmental and regulatory agencies and, in particular, the Board of Governors of the Federal Reserve System. Changes in monetary policy, changes in interest rates, changes in the yield curve, changes in market risk spreads, or a prolonged inverted yield curve could influence not only the interest we receive on loans and securities and the amount of interest we pay on deposits and borrowings, but such changes could also affect:

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- our ability to originate loans and obtain deposits;
- our ability to retain deposits in a rising rate environment;
- net interest rate spreads and net interest rate margins;
- our ability to enter into instruments to hedge against interest rate risk;
- the fair value of our financial assets and liabilities; and
- the average duration of our loan and mortgage-backed securities portfolio.

If the interest rates paid on deposits and other borrowings increase at a faster rate than the interest rates received on loans and other investments, our net interest income, and therefore earnings, could be adversely affected. Earnings could also be adversely affected if the interest rates received on loans and other investments fall more quickly than the interest rates paid on deposits and other borrowings.

Any substantial, unexpected or prolonged change in market interest rates could have a material adverse effect on our financial condition and results of operations. See the section captioned “Net Interest Income” in “Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations” for further discussion related to our management of interest rate risk.

We are subject to the risk that our U.S. agency mortgage-backed securities (“MBS”) could prepay faster than we have projected.

We have and continue to purchase MBS at significant premiums due to the low interest rate environment. Our prepayment assumptions take into account Bloomberg consensus speeds, current trends and past experience. On October 24, 2011, the Federal Housing Finance Agency (the “FHFA”) announced expanded initiatives to assist homeowners that might not otherwise have been able to qualify for a new mortgage to refinance their mortgage. The FHFA announced changes to the guidelines related to loan-to-value, appraisals, and certain fees, among other things, subject to a variety of qualifications and the extension of the end date for the Home Affordable Refinance Program (“HARP”) until December 31, 2013. It does not change the time period which these loans were originated, maintaining the requirement that the loans must have been guaranteed by Fannie Mae or Freddie Mac on or before May 31, 2009. These changes could cause MBS prepayments to significantly exceed our projections. If actual prepayments exceed our projections, the amortization expense associated with these MBS will increase, thereby decreasing our net income. The increase in amortization expense and the corresponding decrease in net income could have a material adverse effect on our financial condition and results of operations.

We are subject to credit quality risks and our credit policies may not be sufficient to avoid losses.

We are subject to the risk of losses resulting from the failure of borrowers, guarantors and related parties to pay interest and principal amounts on their loans. Although we maintain credit policies and credit underwriting and monitoring and collection procedures, these policies and procedures may not prevent losses, particularly during periods in which the local, regional or national economy suffers a general decline. If borrowers fail to repay their loans, our financial condition and results of operations would be adversely affected.

Our interest rate risk, liquidity, fair value of securities and profitability are subject to risks associated with the successful management of our balance sheet strategy.



We implemented a balance sheet strategy for the purpose of enhancing overall profitability by maximizing the use of our capital. The effectiveness of our balance sheet strategy, and therefore our profitability, may be adversely affected by a number of factors, including reduced net interest margin and spread, adverse fair value changes to the investment securities and U.S. agency mortgage-backed and related securities, adverse changes in the market liquidity of our investment securities and U.S. agency mortgage-backed and related securities, incorrect modeling results 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. In addition, we may not be able to obtain wholesale funding to profitably and properly fund the balance sheet strategy. If our balance sheet strategy is flawed or poorly implemented, we may incur significant losses. See the section captioned “Balance Sheet Strategy” in “Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations.”

We have a high concentration of loans secured by real estate and a further decline in the real estate market, for any reason, could result in losses and materially and adversely affect our business, financial condition, results of operations and future prospects.

A significant portion of our loan portfolio is dependent on real estate. In addition to the financial strength and cash flow characteristics of the borrower in each case, often loans are secured with real estate collateral. At December 31, 2012, approximately 57.0% of our loans have real estate as a primary or secondary component of collateral. The real estate in each case provides an alternate source of repayment in the event of default by the borrower and may deteriorate in value during the time the credit is extended. Beginning in the third quarter of 2007 and continuing throughout 2008, 2009 and 2010, there were well-publicized developments in the credit markets, beginning with a decline in the sub-prime mortgage lending market, which later extended to the markets for collateralized mortgage obligations, mortgage-backed securities and the lending markets generally. This decline has continued to result in restrictions in the resale markets during 2011 and 2012 for non-conforming loans and has had an adverse effect on retail mortgage lending operations in many markets. A further decline in the credit markets generally could adversely affect our financial condition and results of operations if we are unable to extend credit or sell loans in the secondary market. An adverse change in the economy affecting values of real estate generally or in our primary markets specifically could significantly impair the value of collateral and our ability to sell the collateral upon foreclosure. Furthermore, it is likely that, in a declining real estate market, we would be required to further increase our allowance for loan losses. If we are required to liquidate the collateral securing a loan to satisfy the debt during a period of reduced real estate values or to increase our allowance for loan losses, our profitability and financial condition could be adversely impacted.

We have a high concentration of loans directly related to the medical community in our market area, primarily in Smith and Gregg counties. A negative change adversely impacting the medical community, for any reason, could result in losses and materially and adversely affect our business, financial condition, results of operations and future prospects.

A significant portion of our loan portfolio is dependent on the medical community. The primary source of repayment for loans in the medical community is cash flow from continuing operations. However, changes in the amount the government pays the medical community through the various government health insurance programs could adversely impact the medical community, which in turn could result in higher default rates by borrowers in the medical industry. Healthcare reform or increased regulation of the medical community could also negatively impact profitability and cash flow in the medical community. It is likely that, should there be any significant adverse impact to the medical community, our profitability and financial condition would also be adversely impacted.

Our allowance for probable loan losses may be insufficient.

We maintain an allowance for probable loan losses, which is a reserve established through a provision for probable loan losses charged to expense. This allowance represents management's best estimate of probable losses that may exist within the existing portfolio of loans. The allowance, in the judgment of management, is necessary to reserve for estimated loan losses and risks inherent in the loan portfolio. The level of the allowance reflects management's continuing evaluation of industry concentrations; specific credit risks; loan loss experience; current loan portfolio quality; present economic, political and regulatory conditions; and unidentified losses inherent in the current loan portfolio. The determination of the appropriate level of the allowance for probable loan losses inherently involves a high degree of subjectivity and requires us to make significant estimates and assumptions regarding current credit risks and future trends, all of which may undergo material changes. Changes in economic conditions affecting the value of properties used as collateral for loans, problems affecting the credit of borrowers, new information regarding existing loans, identification of additional problem loans and other factors, both within and outside our control, may

require an increase in the allowance for probable loan losses. In addition, bank regulatory agencies periodically review our allowance for loan losses and may require an increase in the provision for probable loan losses or the recognition of further loan charge-offs, based on judgments different than those of management. In addition, if charge-offs in future periods exceed the allowance for probable loan losses, we will need additional provisions to increase the allowance for probable loan losses. Any increases in the allowance for probable loan losses will result in a decrease in net income and, possibly, capital, and may have a material adverse effect on our financial condition and results of operations. See the section captioned “Loan Loss Experience and Allowance for Loan Losses” in “Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations” for further discussion related to our process for determining the appropriate level of the allowance for probable loan losses.

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If we fail to maintain an effective system of disclosure controls and procedures, including internal control over financial reporting, we may not be able to accurately report our financial results or prevent fraud, which could have a material adverse effect on our business, results of operation and financial condition. In addition, current and potential shareholders could lose confidence in our financial reporting, which could harm the trading price of our common stock.

Management regularly reviews and updates our disclosure controls and procedures, including our internal control over financial reporting. Any system of controls, however well designed and operated, is based in part on certain assumptions and can provide only reasonable, not absolute, assurances that the objectives of the system are met. Any failure or circumvention of our controls and procedures or failure to comply with regulations related to controls and procedures could have a material adverse effect on our business, results of operations and financial condition.

Based on management's assessment of the effectiveness of our internal controls over financial reporting as of December 31, 2011, management decided that our disclosure controls and procedures were not effective as of that date due to the following control deficiencies:

We did not adequately design security price verification controls. Specifically, we did not perform adequate price verification procedures to determine that security prices obtained from the third party pricing service, which are utilized to record securities at fair value, were accurate. The control deficiency resulted in certain pricing errors, including for certain securities which were purchased at a significant premium that required specific accounting in accordance with generally accepted accounting principles. The errors resulted in our audit committee determining that the Company's financial statements as of and for the quarters and year to date periods ended March 31, June 30, and September 30, 2011 could no longer be relied upon and were required to be restated and that revisions to the Company's consolidated financial statements for the year ended December 31, 2010 and adjustments to the consolidated financial statements for the year ended December 31, 2011 were required. Management concluded that the identified control deficiency constituted a material weakness.

Controls designed to evaluate the impairment of FHLB advance option fees did not operate effectively. Specifically, we failed to execute the control to assess the probability of exercise for the FHLB advance option fees. This control deficiency resulted in accounting errors for the FHLB options. The errors resulted in our audit committee determining that the Company's financial statements as of and for the quarter and year to date period ended September 30, 2011 could no longer be relied upon and were required to be restated and that adjustments to the Company's consolidated financial statements for the year ended December 31, 2011 were required. Management concluded that the identified control deficiency constituted a material weakness.

A material weakness is a deficiency, or combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented or detected and corrected on a timely basis. Although management had taken actions to remediate the material weaknesses identified, management was unable to conclude that our disclosure controls and procedures were effective as of March 31, 2012 or June 30, 2012.

Although management believes that the actions it has taken remediated these material weaknesses as of September 30, 2012, we cannot assure you that they have been remediated. If the security price verification control deficiency has not been remediated, it could result in future material misstatements of the available for sale or held to maturity securities and related disclosures. Additionally, if the Company were to purchase additional options from the FHLB where the advance option fee paid was material and if the FHLB advance option fee control deficiency has not been remediated,

it could result in future material misstatements of other assets and impairment charges. These control deficiencies could result in material misstatements of related disclosures that would result in a material misstatement of the consolidated financial statements that would not be prevented or detected assuming the FHLB advance option fee once again became a material amount in the future. In addition, we cannot assure you that additional control deficiencies or material weaknesses will not be identified in the future.

Failure to achieve and maintain an effective internal control environment could result in us not being able to accurately report our financial results, prevent or detect fraud, or provide timely and reliable financial information pursuant to our reporting obligations, which could have a material adverse effect on our business, financial condition, and results of operations. Further, it could cause our investors to lose confidence in the financial information we report, which could affect the trading price of our common stock.

We are subject to environmental liability risk associated with lending activities.

A significant portion of our loan portfolio is secured by real property. During the ordinary course of business, we may foreclose on and take title to properties securing certain loans. There is a risk that hazardous or toxic substances could be found on these properties. If hazardous or toxic substances are found, we may be liable for remediation costs, as well as for personal injury and property damage. Environmental laws may require us to incur substantial expenses and may materially reduce the affected property's value or limit our ability to use or sell the affected property. In addition, future laws or more stringent interpretations or enforcement policies with respect to existing laws may increase our exposure to environmental liability. Although we have policies and procedures to perform an environmental review before initiating any foreclosure action on nonresidential real property, these reviews may not be sufficient to detect all potential environmental hazards. The remediation costs and any other financial liabilities associated with an environmental hazard could have a material adverse effect on our financial condition and results of operations.

Our profitability depends significantly on economic conditions in the State of Texas.

Our success depends primarily on the general economic conditions of the State of Texas and the specific local markets in which we operate. Unlike larger national or other regional banks that are more geographically diversified, we provide banking and financial services to customers primarily in the Texas areas of Tyler, Longview, Lindale, Whitehouse, Chandler, Gresham, Athens, Palestine, Jacksonville, Hawkins, Bullard, Forney, Seven Points, Gun Barrel City, Fort Worth, Austin and Arlington. The local economic conditions in these areas have a significant impact on the demand for our products and services, as well as the ability of our customers to repay loans, the value of the collateral securing loans and the stability of our deposit funding sources. A significant decline in general economic conditions, caused by inflation, recession, acts of terrorism, outbreak of hostilities or other international or domestic occurrences, unemployment, plant or business closings or downsizing, changes in securities markets or other factors could impact these local economic conditions and, in turn, have a material adverse effect on our financial condition and results of operations.

We operate in a highly competitive industry and market area.

We face substantial competition in all areas of our operations from a variety of different competitors, many of which are larger and may have more financial resources. Such competitors primarily include national, regional, and community banks within the various markets we operate. Additionally, various out-of-state banks have entered or have announced plans to enter the market areas in which we currently operate. We also face competition from many other types of financial institutions, including, without limitation, savings and loans, credit unions, finance companies, brokerage firms, insurance companies, factoring companies and other financial intermediaries. The financial services industry could become even more competitive as a result of legislative, regulatory and technological changes, continued consolidation and recent trends in the credit and mortgage lending markets. Banks, securities firms and insurance companies can merge under the umbrella of a financial holding company, which can offer virtually any type of financial service, including banking, securities underwriting, insurance (both agency and underwriting) and merchant banking. Also, technology has lowered barriers to entry and made it possible for nonbanks to offer products and services traditionally provided by banks, such as automatic transfer and automatic payment systems. Many of our competitors have fewer regulatory constraints and may have lower cost structures. Additionally, due to their size, many competitors may be able to achieve economies of scale and, as a result, may offer a broader range of products and services as well as better pricing for those products and services than we can.

Our ability to compete successfully depends on a number of factors, including, among other things:

the ability to develop, maintain and build upon long-term customer relationships based on top quality service, high ethical standards and safe, sound assets;

the ability to expand our market position;

the scope, relevance and pricing of products and services offered to meet customer needs and demands;

the rate at which we introduce new products and services relative to our competitors;

customer satisfaction with our level of service; and

industry and general economic trends.

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Failure to perform in any of these areas could significantly weaken our competitive position, which could adversely affect our growth and profitability, which, in turn, could have a material adverse effect on our financial condition and results of operations.

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

From time to time, we may implement new delivery systems, such as internet banking, or offer new products and services within existing lines of business. In developing and marketing new delivery systems and/or new products and services, we may invest significant time and resources. Initial timetables for the introduction and development of new lines of business and/or new products or services may not be achieved and price and profitability targets may not prove feasible. External factors, such as compliance with regulations, competitive alternatives, and shifting market preferences, may also impact the successful implementation of a new line of business or a new product or service. Furthermore, any new line of business and/or new product or service could have a significant impact on the effectiveness of our system of internal controls. Failure to successfully manage these risks in the development and implementation of new lines of business or new products or services could have a material adverse effect on our business, results of operations and financial condition. During 2011 Southside Securities, Inc., which is a wholly-owned subsidiary of Southside Bancshares, Inc., began doing business as a broker-dealer. Southside Securities concentrates on fixed income products primarily for financial institutions. This subsidiary is subject to significant regulations that, if we do not implement properly, could add additional risks.

We rely on dividends from our subsidiaries for most of our revenue.

Southside Bancshares, Inc. is a separate and distinct legal entity from our subsidiaries. We receive substantially all of our revenue from dividends from our subsidiaries. These dividends are the principal source of funds to pay dividends on our common stock and interest and principal on our debt. Various federal and/or state laws and regulations limit the amount of dividends that Southside Bank, and certain nonbank subsidiaries may pay to Southside Bancshares, Inc. Also, Southside Bancshares, Inc.'s right to participate in a distribution of assets upon a subsidiary's liquidation or reorganization is subject to the prior claims of the subsidiary's creditors. In the event Southside Bank is unable to pay dividends to Southside Bancshares, Inc., Southside Bancshares, Inc. may not be able to service debt, pay obligations or pay dividends on common stock. The inability to receive dividends from Southside Bank could have a material adverse effect on Southside Bancshares, Inc.'s business, financial condition and results of operations. See the section captioned "Supervision and Regulation" in "Item 1. Business" and "Note 13 – Shareholders' Equity" to our consolidated financial statements included in this report.

Funding to provide liquidity may not be available to us on favorable terms or at all.

Liquidity is the ability to meet cash flow needs on a timely basis at a reasonable cost. The liquidity of Southside Bank is used to make loans and leases, to repay deposit liabilities as they become due or are demanded by customers. Liquidity policies and limits are established by the board of directors. Management and our asset liability committee regularly monitor the overall liquidity position of Southside Bank and the Company to ensure that various alternative strategies exist to cover unanticipated events that could affect liquidity. Management and our asset liability committee also establish policies and monitor guidelines to diversify Southside Bank's funding sources to avoid concentrations in excess of board-approved policies in any one market source. Funding sources include federal funds purchased, securities sold under repurchase agreements, noncore deposits, and short- and long-term debt. Southside Bank is also a member of the Federal Home Loan Bank ("FHLB") System, which provides funding through advances to members that are collateralized with mortgage-related assets.

We maintain a portfolio of securities that can be used as a secondary source of liquidity. There are other sources of liquidity available to us should they be needed. These sources include sales or securitizations of loans, our ability to



acquire additional national market, noncore deposits, additional collateralized borrowings such as Federal Home Loan Bank advances, the issuance and sale of debt securities, and the issuance and sale of preferred or common securities in public or private transactions. Southside Bank also can borrow from the Federal Reserve's discount window.

We have historically had access to a number of alternative sources of liquidity, but if there is an increase in volatility in the credit and liquidity markets similar to 2008, there is no assurance that we will be able to obtain such liquidity on terms that are favorable to us, or at all. For example, the cost of out-of-market deposits may exceed the cost of deposits of similar maturity in our local market area, making them unattractive sources of funding; financial institutions may be unwilling to extend credit to banks because of concerns about the banking industry and the economy generally; and, given previous downturns in the economy, there may not be a viable market for raising equity capital.

If we were unable to access any of these funding sources when needed, we might be unable to meet customers' needs, which could adversely impact our financial condition, results of operations, cash flows and liquidity, and level of regulatory-qualifying capital.

Acquisitions and potential acquisitions may disrupt our business and dilute shareholder value.

During 2007, we completed the acquisition of FWBS. This was our first acquisition. Aside from this acquisition, we occasionally investigate potential merger or acquisition partners that appear to be culturally similar, have experienced management and possess either significant or attractive market presence or have potential for improved profitability through financial management, economies of scale or expanded services. Acquiring other banks, businesses or branches involves various risks commonly associated with acquisitions, including, among other things:

- potential exposure to unknown or contingent liabilities of the target company;
- exposure to potential asset quality issues of the target company;
- difficulty and expense of integrating the operations and personnel of the target company;
- potential disruption to our business;
- potential diversion of our management's time and attention;
- the possible loss of key employees and customers of the target company;
- difficulty in estimating the value of the target company; and
- potential changes in banking or tax laws or regulations that may affect the target company.

We occasionally evaluate merger and acquisition opportunities and conduct due diligence activities related to possible transactions with other financial institutions and financial services companies. As a result, merger or acquisition discussions and, in some cases, negotiations may take place and future mergers or acquisitions involving cash, debt or equity securities may occur at any time. Acquisitions typically involve the payment of a premium over book and fair values, and, therefore, some dilution of our tangible book value and net income per common share may occur in connection with any future transaction. Furthermore, failure to realize the expected revenue increases, cost savings, increases in geographic or product presence, and/or other projected benefits and synergies from an acquisition could have a material adverse effect on our financial condition and results of operations.

We may not be able to attract and retain skilled people.

Our success depends, in large part, on our ability to attract and retain key people. Competition for the best people in most activities we engage in can be intense, and we may not be able to hire people or to retain them. The unexpected loss of services of one or more of our key personnel could have a material adverse impact on our business because of their skills, knowledge of our market, relationships in the communities we serve, years of industry experience and the difficulty of promptly finding qualified replacement personnel. Although we have employment agreements with certain of our executive officers, there is no guarantee that these officers will remain employed with the Company.

Our information systems may experience an interruption or breach in security.

We rely heavily on communications and information systems to conduct our business. Any failure, interruption or breach in security of these systems could result in failures or disruptions in our customer relationship management, general ledger, deposit, loan and other systems. While we have policies and procedures designed to prevent or limit the effect of the failure, interruption or security breach of our information systems, there can be no assurance that we

can prevent any such failures, interruptions or security breaches or, if they do occur, that they will be adequately addressed. The occurrence of any failures, interruptions or security breaches of our information systems could damage our reputation, result in a loss of customer business, subject us to additional regulatory scrutiny, or expose us to civil litigation and possible financial liability, any of which could have a material adverse effect on our financial condition and results of operations.

We continually encounter technological change.

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

improvements. We may not be able to effectively implement new technology-driven products and services or be successful in marketing these products and services to our customers and even if we implement such products and services, we may incur substantial costs in doing so. Failure to successfully keep pace with technological change affecting the financial services industry could have a material adverse impact on our business, financial condition and results of operations.

Severe weather, natural disasters, climate change, acts of war or terrorism and other external events could significantly impact our business.

Severe weather, natural disasters, climate change, acts of war or terrorism and other adverse external events could have a significant impact on our ability to conduct business. Such events could affect the stability of our deposit base, impair the ability of borrowers to repay outstanding loans, impair the value of collateral securing loans, cause significant property damage, result in loss of revenue and/or cause us to incur additional expenses. For example, because of our location and the location of the market areas we serve, severe weather is more likely than in other areas of the country. Although management has established disaster recovery policies and procedures, there can be no assurance of the effectiveness of such policies and procedures, and the occurrence of any such event could have a material adverse effect on our business, financial condition and results of operations.

#### RISKS ASSOCIATED WITH THE BANKING INDUSTRY

We are subject or may become subject to extensive government regulation and supervision.

Southside Bancshares, Inc., primarily through Southside Bank, and certain nonbank subsidiaries, is subject to extensive federal and state regulation and supervision. Banking regulations are primarily intended to protect depositors' funds, federal deposit insurance funds and the banking system as a whole, not shareholders. These regulations affect our lending practices, capital structure, investment practices and dividend policy and growth, among other things. The statutory and regulatory framework under which we operate will change substantially over the next several years as the result of the enactment of the Dodd-Frank Act. The Dodd-Frank Act represents a significant overhaul of many aspects of the regulation of the financial services industry, addressing, among other things, systemic risk, capital adequacy, deposit insurance assessments, consumer financial protection, as implemented through the Bureau, interchange fees, derivatives, lending limits, mortgage lending practices, registration of investment advisors and changes among bank regulatory authorities. To date, there are a number of provisions of the Dodd-Frank Act that have not taken effect and many important provisions require implementing rules to become effective. In addition to these developments, Congress and federal and state regulatory agencies continually review banking laws, regulations and policies for possible changes. Changes to statutes, regulations or regulatory policies, including changes in interpretation or implementation of statutes, regulations or policies, could affect us in substantial and unpredictable ways. Such changes could subject us to additional costs, limit deposit fees and other types of fees we charge, limit the types of financial services and products we may offer and/or increase the ability of nonbanks to offer competing financial services and products, among other things. While we cannot predict the impact caused by the Dodd-Frank Act and forthcoming implementing rules, or the impact of any additional regulatory changes that may arise out of the current financial and economic environment, any regulatory changes or increased regulatory scrutiny could increase costs directly related to complying with new regulatory requirements. Failure to comply with laws, regulations or policies could result in sanctions by regulatory agencies, civil money penalties and/or reputation damage, which could have a material adverse effect on our business, financial condition and results of operations. While our policies and procedures are designed to prevent any such violations, there can be no assurance that such violations will not occur. See the section captioned "Supervision and Regulation" in "Item 1. Business" and "Note 13 – Shareholders' Equity" to our consolidated financial statements included in this report.

We may become subject to increased regulatory capital requirements.

The capital requirements applicable to Southside Bancshares, Inc. and Southside Bank are subject to change as a result of the Dodd-Frank Act, the international regulatory capital initiative known as Basel III and any other future government actions. In particular, the Dodd-Frank Act eliminates Tier 1 capital treatment for most trust preferred securities after a three-year phase-in period that begins January 1, 2013 for institutions that exceed \$15 billion in assets. Furthermore, in December 2010, the BCBS finalized the Basel III regulatory capital standards. The standards, which mandate a higher minimum level of common equity to be held by financial institutions, along with a capital conservation buffer to withstand future periods of stress, are subject to individual adoption by member nations, including the United States. During 2012, U.S. regulators proposed Basel III regulatory capital standards that were to be phased in beginning January 2013. During the comment period, U.S. regulators received over 1,000 comment letters. As a result U.S. regulators were asked to testify before Congress. U.S. regulators agreed to reconsider some of the proposed Basel III standards and are expected to propose or issue revised Basel III standards during 2013. It is widely anticipated that the capital requirements for most bank and financial holding companies, as well as for most insured depository institutions, will increase, although the nature and amounts of the increase have not yet been specified. Complying with any higher

capital requirements mandated by the Dodd-Frank Act and new capital standards brought about by Basel III implementation may affect our operations, including our asset portfolios and financial performance.

The earnings of financial services companies are significantly affected by general business and economic conditions.

Our operations and profitability are impacted by general business and economic conditions in the United States and abroad. These conditions include short-term and long-term interest rates, inflation, money supply, political issues, legislative and regulatory changes, fluctuations in both debt and equity capital markets, broad trends in industry and finance, and the strength of the U.S. economy and the local economies in which we operate, all of which are beyond our control. A deterioration in economic conditions could result in an increase in loan delinquencies and nonperforming assets, decreases in loan collateral values and a decrease in demand for our products and services, among other things, any of which could have a material adverse impact on our financial condition and results of operations.

Financial services companies depend on the accuracy and completeness of information about customers and counterparties.

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

Consumers may decide not to use banks to complete their financial transactions.

Technology and other changes are allowing parties to complete financial transactions that historically have involved banks through alternative methods. For example, consumers can now maintain funds that would have historically been held as bank deposits in brokerage accounts or mutual funds. Consumers can also complete transactions such as paying bills and/or transferring funds directly without the assistance of banks. The process of eliminating banks as intermediaries could result in the loss of fee income, as well as the loss of customer deposits and the related income generated from those deposits. The loss of these revenue streams and the lower cost deposits as a source of funds could have a material adverse effect on our financial condition and results of operations.

The soundness of other financial institutions could adversely affect us.

Financial services institutions are interrelated as a result of trading, clearing, counterparty or other relationships. We have exposure to many different industries and counterparties, and we routinely execute transactions with counterparties in the financial services industry, including brokers and dealers, commercial banks, investment banks, mutual and hedge funds, and other institutional clients. Many of these transactions expose us to credit risk in the event of default of our counterparty or client. In addition, our credit risk may be exacerbated when the collateral held by us cannot be realized or is liquidated at prices not sufficient to recover the full amount of the loan or derivative exposure due us. There is no assurance that any such losses would not materially and adversely affect our results of operations or earnings.

We are subject to claims and litigation pertaining to fiduciary responsibility.

From time to time, customers make claims and take legal action pertaining to our performance of our fiduciary responsibilities. Whether customer claims and legal action related to our performance of our fiduciary responsibilities

are founded or unfounded, defending claims is costly and diverts management's attention, and if such claims and legal actions are not resolved in a manner favorable to us, they may result in significant financial liability and/or adversely affect our market perception and products and services as well as impact customer demand for those products and services. Any financial liability or reputation damage could have a material adverse effect on our business, financial condition and results of operations.

#### RISKS ASSOCIATED WITH OUR COMMON STOCK

Our stock price can be volatile.

Stock price volatility may make it more difficult for you to resell your common stock when you want and at prices you find attractive. Our stock price can fluctuate significantly in response to a variety of factors including, among other things:

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

General market fluctuations, industry factors and general economic and political conditions and events, such as economic slowdowns or recessions, interest rate changes or credit loss trends, could also cause our stock price to decrease regardless of operating results.

The trading volume in our common stock is less than that of other larger financial services companies.

Although our common stock is listed for trading on the NASDAQ Global Select Market, the trading volume is low, and you are not assured liquidity with respect to transactions in our common stock. A public trading market having the desired characteristics of depth, liquidity and orderliness depends on the presence in the marketplace of willing buyers and sellers of our common stock at any given time. This presence depends on the individual decisions of investors and general economic and market conditions over which we have no control. Given the lower trading volume of our common stock, significant sales of our common stock, or the expectation of these sales, could cause our stock price to fall.

The holders of our junior subordinated debentures have rights that are senior to those of our shareholders.

On September 4, 2003, we issued \$20.6 million of floating rate junior subordinated debentures in connection with a \$20.0 million trust preferred securities issuance by our subsidiary, Southside Statutory Trust III. These junior subordinated debentures mature in September 2033. On August 8 and 10, 2007, we issued \$23.2 million and \$12.9 million, respectively, of five-year fixed rate converting to floating rate thereafter, junior subordinated debentures in connection with \$22.5 million and \$12.5 million, respectively, trust preferred securities issuances by our subsidiaries Southside Statutory Trust IV and V, respectively. Trust IV matures October 2037 and Trust V matures September 2037. As part of the acquisition of FWBS on October 10, 2007, we assumed \$3.6 million of floating rate junior subordinated debentures issued to Magnolia Trust Company I in connection with \$3.5 million of trust preferred securities issued in 2005 that matures in 2035.



We conditionally guarantee payments of the principal and interest on the trust preferred securities. Our junior subordinated debentures are senior to our shares of common stock. As a result, we must make payments on the junior subordinated debentures (and the related trust preferred securities) before any dividends can be paid on our common stock and, in the event of bankruptcy, dissolution or liquidation, the holders of the debentures must be satisfied before any distributions can be made to the holders of common stock. We have the right to defer distributions on our junior subordinated debentures (and the related trust preferred securities) for up to five years, during which time no dividends may be paid to holders of common stock.

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

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

Provisions of our articles of incorporation bylaws, as well as state and federal banking regulations, could delay or prevent a takeover of us by a third party.

Our articles of incorporation and bylaws could delay, defer or prevent a third party from acquiring us, despite the possible benefit to our shareholders, or otherwise adversely affect the price of our common stock. These provisions include, among others, requiring advance notice for raising business matters or nominating directors at shareholders' meetings and staggered board elections.

Any individual, acting alone or with other individuals, who are seeking to acquire, directly or indirectly, 10.0% or more of our outstanding common stock must comply with the Change in Bank Control Act, which requires prior notice to the Federal Reserve for any acquisition. Additionally, any entity that wants to acquire 5.0% or more of our outstanding common stock, or otherwise control us, may need to obtain the prior approval of the Federal Reserve under the BHCA of 1956, as amended. As a result, prospective investors in our common stock need to be aware of and comply with those requirements, to the extent applicable.

We may issue additional securities, which could dilute your ownership percentage.

In certain situations, our board of directors has the authority, without any vote of our shareholders, to issue shares of our authorized but unissued stock. In the future, we may issue additional securities, through public or private offerings, to raise additional capital or finance acquisitions. Any such issuance would dilute the ownership of current holders of our common stock.

ITEM 1B. UNRESOLVED STAFF COMMENTS

None

ITEM 2. PROPERTIES

Southside Bank owns and operates the following properties:

Southside Bank main branch at 1201 South Beckham Avenue, Tyler, Texas. The executive offices of Southside Bancshares, Inc. are located at this location;

Southside Bank Annex at 1211 South Beckham Avenue, Tyler, Texas. The Southside Bank Annex is directly adjacent to the main bank building. Human Resources, and other support areas are located in this building;

Operations Annex at 1221 South Beckham Avenue, Tyler, Texas. Various back office, lending and training facilities and other support areas are located in this building;

Southside Bank Trust at 1305 South Beckham Avenue, Tyler, Texas. The Trust Department is located in this building;

Southside Bank main branch motor bank facility at 1010 East First Street, Tyler, Texas;

South Broadway branch at 6201 South Broadway, Tyler, Texas;

South Broadway branch motor bank facility at 6019 South Broadway, Tyler, Texas;

Downtown branch at 113 West Ferguson Street, Tyler, Texas;

Gentry Parkway branch and motor bank facility at 2121 West Gentry Parkway, Tyler, Texas;

Highway 64 West branch and motor bank facility at 3815 State Highway 64 West, Tyler, Texas;

Longview main branch and motor bank facility at 2001 Judson Road, Longview, Texas;

Lindale main branch and motor bank facility at 2510 South Main Street, Lindale, Texas;

Whitehouse main branch and motor bank facility at 901 Highway 110 North, Whitehouse, Texas;

Jacksonville main branch and motor bank at 1015 South Jackson Street, Jacksonville, Texas;

Gresham main branch and motor bank at 16691 FM 2493, Tyler, Texas;

Gun Barrel City main branch and motor bank facility at 901 West Main, Gun Barrel City, Texas;

Arlington branch and motor bank facility at 2831 West Park Row, Arlington, Texas;

• Fort Worth branch and motor bank facility at 9516 Clifford Street, Fort Worth, Texas;  
and

48 ATM's located throughout our market areas.

Southside Bank currently operates full service banks in leased space in 19 grocery stores and four full service branches in leased office space in the following locations:

•one in Bullard, Texas;

•one in Lindale, Texas;

•one in Flint, Texas;

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one in Whitehouse, Texas;

one in Chandler, Texas;

one in Seven Points, Texas;

one in Palestine, Texas;

one in Athens, Texas;

one in Hawkins, Texas;

three in Longview, Texas;

seven in Tyler, Texas;

Fort Worth branch and motor bank facility at 701 West Magnolia, Fort Worth, Texas;

Fort Worth branch at 707 West Magnolia, Fort Worth, Texas;

Forney branch at 413 North McGraw, Forney, Texas; and

Austin branch at 8200 North Mopac, Suite 130, Austin, Texas.

SFG currently operates its business in leased office space in the following location:

700 West Arkansas Lane, Arlington, Texas.

SSI currently operates its business in the Southside Bank Annex at 1211 South Beckham Avenue, Tyler, Texas.

All of the properties detailed above are suitable and adequate to provide the banking services intended based on the type of property described. In addition, the properties for the most part are fully utilized but designed with productivity in mind and can handle the additional business volume we anticipate they will generate. As additional potential needs are identified, individual property enhancements or the need to add properties will be evaluated.

### ITEM 3. LEGAL PROCEEDINGS

We are party to legal proceedings arising in the normal conduct of business. Management believes that such litigation is not material to our financial position, results of operations or cash flows.

### ITEM 4. MINE SAFETY DISCLOSURES

Not applicable.

## PART II

## ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

## MARKET INFORMATION

Our common stock trades on the NASDAQ Global Select Market under the symbol "SBSI." Set forth below are the high and low sales prices on the NASDAQ Global Select Market for each full quarterly period from January 1, 2011 to December 31, 2012. During 2012 and 2011, we declared and paid a 5% stock dividend. Stock prices listed below have been adjusted to give retroactive recognition to such stock dividends.

| Year Ended   |                  |                  |                  |                  |
|--------------|------------------|------------------|------------------|------------------|
| December 31, | 1st Quarter      | 2nd Quarter      | 3rd Quarter      | 4th Quarter      |
| 2012         | \$ 21.42 – 19.78 | \$ 22.48 – 19.89 | \$ 23.05 – 20.41 | \$ 22.00 – 20.12 |
| 2011         | \$ 20.69 – 18.02 | \$ 20.99 – 17.68 | \$ 19.66 – 17.15 | \$ 21.45 – 16.95 |

See "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations – Capital Resources" for a discussion of our common stock repurchase program.

## SHAREHOLDERS

There were approximately 1,000 holders of record of our common stock, the only class of equity securities currently issued and outstanding, as of February 28, 2013.

## DIVIDENDS

Cash dividends declared and paid were \$1.11 and \$0.90 per share for the years ended December 31, 2012 and 2011, respectively. Stock dividends of 5% were also declared and paid during each of the years ended December 31, 2012 and 2011. We have paid a cash dividend at least once every year since 1970 (including dividends paid by Southside Bank prior to the incorporation of Southside Bancshares). Future dividends will depend on our earnings, financial condition and other factors that our board of directors considers to be relevant. In addition, we must make payments on our junior subordinated debentures before any dividends can be paid on the common stock. For additional discussion relating to restrictions that limit our ability to pay dividends refer to "Item 1. Business – Supervision and Regulation" and "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations – Capital Resources." The cash dividends were paid quarterly each year as listed below.

## Quarterly Cash Dividends Paid

| Year Ended   |             |             |             |             |
|--------------|-------------|-------------|-------------|-------------|
| December 31, | 1st Quarter | 2nd Quarter | 3rd Quarter | 4th Quarter |
| 2012         | \$0.18      | \$0.20      | \$0.20      | \$0.53      |
| 2011         | \$0.17      | \$0.17      | \$0.18      | \$0.38      |



## ISSUER SECURITY REPURCHASES

The following table provides information with respect to purchases made by or on behalf of any “affiliated purchaser” (as defined in Rule 10b-18(a)(3) under the Exchange Act), of our common stock during the three and twelve months ended December 31, 2012.

| Period                             | Total Number of Shares Purchased | Average Price Paid Per Share | Total Number of Shares Purchased as Part of Publicly Announced Plan | Maximum Dollar Value of Shares That May Yet Be Purchased Under the Plan at the End of the Period |
|------------------------------------|----------------------------------|------------------------------|---|--|
| November 8, 2012                   | —                                | \$—                          | —   | \$ 10,000,000  |
| November 9, 2012-November 30, 2012 | 198,400                          | 20.89                        | 198,400   | 5,855,440  |
| December 1, 2012-December 31, 2012 | 157,100                          | 20.82                        | 157,100   | 2,583,877  |
| Total                              | 355,500                          | \$ 20.86                     | 355,500   |  |

On November 8, 2012, our board of directors approved the continuation of our stock repurchase plan, committing \$10.0 million to repurchase common stock with a re-evaluation of such plan by the board of directors to occur on a quarterly basis. During the year ended December 31, 2012, we purchased 355,500 shares of common stock at an average price of \$20.86.

Subsequent to December 31, 2012 through February 15, 2013, we purchased 90,300 shares of common stock at an average price of \$21.03.



## FINANCIAL PERFORMANCE

The following performance graph does not constitute soliciting material and should not be deemed filed or incorporated by reference into any other Company under the Securities Act of 1933 or the Securities Exchange Act of 1934, except to the extent the filing Company specifically incorporates the performance graph by reference therein.

Southside Bancshares, Inc.

| Index                       | Period Ending |            |            |            |            |            |
|-----------------------------|---------------|------------|------------|------------|------------|------------|
|                             | 12/31/2007    | 12/31/2008 | 12/31/2009 | 12/31/2010 | 12/31/2011 | 12/31/2012 |
| Southside Bancshares, Inc.  | 100.00        | 123.98     | 112.72     | 132.62     | 149.52     | 160.81     |
| Russell 2000                | 100.00        | 66.21      | 84.20      | 106.82     | 102.36     | 119.09     |
| SBSI Peer Group 2011 Index* | 100.00        | 104.54     | 109.75     | 125.45     | 126.05     | 143.62     |
| SBSI Peer Group 2012 Index* | 100.00        | 105.96     | 111.76     | 127.58     | 127.65     | 144.51     |

\*SBSI 2011 Peer Group consist of Cullen/Frost Bankers, Inc. (CFR), First Financial Bankshares, Inc. (FFIN), International Bancshares Corporation (IBOC), MetroCorp Bancshares, Inc. (MCBI), Prosperity Bancshares, Inc. (PB), Texas Capital Bancshares, Inc. (TCBI), Encore Bancshares, Inc. (EBTX - This is now historical)

\*SBSI 2012 Peer Group consist of Cullen/Frost Bankers, Inc. (CFR), First Financial Bankshares, Inc. (FFIN), International Bancshares Corporation (IBOC), MetroCorp Bancshares, Inc. (MCBI), Prosperity Bancshares, Inc. (PB), Texas Capital Bancshares, Inc. (TCBI).

Source : SNL Financial LC,  
Charlottesville, VA  
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www.snl.com

## ITEM 6. SELECTED FINANCIAL DATA

The following table sets forth selected financial data regarding our results of operations and financial position for, and as of the end of, each of the fiscal years in the five-year period ended December 31, 2012. This information should be read in conjunction with "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations" and "Item 8. Financial Statements and Supplementary Data," as set forth in this report.

|   | As of and For the Years Ended December 31, |             |             |             |             |
|---|--|-------------|-------------|-------------|-------------|
|   | 2012                                       | 2011        | 2010        | 2009        | 2008        |
|   | (in thousands, except per share data)      |             |             |             |             |
| <b>Balance Sheet Data:</b>                            |  |             |             |             |             |
| Investment Securities                                 | \$618,716                                  | \$284,452   | \$300,839   | \$266,553   | \$278,856   |
| Mortgage-backed and Related Securities                | \$1,051,898                                | \$1,729,516 | \$1,364,117 | \$1,480,847 | \$1,183,800 |
| Loans, Net of Allowance for Loan Losses               | \$1,242,392                                | \$1,068,690 | \$1,057,209 | \$1,013,680 | \$1,006,437 |
| Total Assets  | \$3,237,403                                | \$3,303,817 | \$2,999,759 | \$3,024,288 | \$2,700,238 |
| Deposits  | \$2,351,897                                | \$2,321,671 | \$2,134,428 | \$1,870,421 | \$1,556,131 |
| Long-term Obligations                                 | \$429,408                                  | \$321,035   | \$433,790   | \$592,830   | \$715,800   |
| Shareholders' Equity                                  | \$257,763                                  | \$258,927   | \$214,461   | \$201,781   | \$160,617   |
| <b>Income Statement Data:</b>                         |  |             |             |             |             |
| Interest Income                                       | \$116,020                                  | \$131,038   | \$131,374   | \$145,193   | \$136,176   |
| Interest Expense                                      | \$26,895                                   | \$35,631    | \$45,307    | \$52,672    | \$60,363    |
| Deposit Service Income                                | \$15,433                                   | \$15,943    | \$16,819    | \$17,629    | \$18,395    |
| Gain on Sale of Securities Available for Sale         | \$17,966                                   | \$11,795    | \$25,789    | \$33,446    | \$12,334    |
| Noninterest Income                                    | \$40,021                                   | \$35,322    | \$50,798    | \$56,674    | \$40,302    |
| Noninterest Expense                                   | \$76,107                                   | \$72,348    | \$71,314    | \$71,630    | \$60,352    |
| Net Income Attributable to Southside Bancshares, Inc. | \$34,695                                   | \$39,133    | \$39,103    | \$44,396    | \$30,696    |
| <b>Per Share Data:</b>                                |  |             |             |             |             |
| <b>Earnings Per Common Share:</b>                     |  |             |             |             |             |
| Basic   | \$2.00                                     | \$2.26      | \$2.25      | \$2.58      | \$1.82      |
| Diluted   | \$2.00                                     | \$2.26      | \$2.25      | \$2.55      | \$1.78      |
| Cash Dividends Paid Per Common Share                  | \$1.11                                     | \$0.90      | \$0.85      | \$0.75      | \$0.60      |

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

The following discussion and analysis provides a comparison of our results of operations for the years ended December 31, 2012, 2011, and 2010 and financial condition as of December 31, 2012 and 2011. This discussion should be read in conjunction with the financial statements and related notes included elsewhere in this report. All share data has been adjusted to give retroactive recognition to stock splits and stock dividends.

### CAUTIONARY NOTICE REGARDING 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. See "Item 1. Business" and this "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations." 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 condition of the Government-Sponsored Enterprises (the "GSEs") impacting the GSEs' guarantees or ability to pay or issue debt;

- 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;
- risks related to actual U.S. agency mortgage-backed securities prepayments exceeding projected prepayment levels;

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risks related to U.S. agency mortgage-backed securities prepayments increasing due to U.S. Government programs designed to assist homeowners to refinance their mortgage that might not otherwise have qualified;

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;

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 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;

New prohibitions and restrictions on the ability of a banking entity and nonbank financial company to engage in proprietary trading and have certain interests in, or relationships with, a hedge fund or private equity fund;

• 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; and

The establishment of a Bureau of Consumer Financial Protection with centralized authority, including examination and enforcement authority, for consumer protection in the banking industry.

Regulatory agencies are still in the process of issuing regulations, rules and reporting requirements as mandated by the Dodd-Frank Act. As a result, we are continuing 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.

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 the 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 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 December 31, 2012, our review of the loan portfolio indicated that a loan loss allowance of \$20.6 million was appropriate to cover probable losses in the portfolio.

Refer to “Loan Loss Experience and Allowance for Loan Losses” and “Note 5 – Loans and Allowance for Probable Loan Losses” to our consolidated financial statements included in this report 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. In addition, 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 estimates from independent pricing services. Where there are price variances outside certain ranges from different pricing services for specific securities, those pricing variances are reviewed with other market data to determine which of the price estimates is appropriate for that period. For securities carried at fair value through income, the change in fair value from the prior period is recorded on our income statement as fair value gain (loss) – securities.

At September 30, 2008 and continuing at December 31, 2012, the valuation inputs for our available for sale (“AFS”) trust preferred securities (“TRUPs”) became unobservable as a result of the significant market dislocation and illiquidity in the marketplace. We continue to rely on nonbinding prices compiled by third party vendors, which we have verified to be an appropriate measure of fair value. However, the significant illiquidity in this market results in a fair value not clearly based on observable market data but rather a range of fair value data points from the market place. 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 held to maturity (“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 to other comprehensive income for the noncredit portion. For certain assets we consider expected cash flows of the investment in determining if impairment exists.

The turmoil in the capital markets had a significant impact on our estimate of fair value for certain of our securities. We believe the fair values are reflective of a combination of illiquidity and credit impairment. At December 31, 2012 we have in AFS Other Stocks and Bonds \$2.7 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 December 31, 2012 for the TRUPs is approximately \$990,000 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 December 31, 2012 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 December 31, 2012.

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 estimated the credit component at \$3.3 million and \$3.1 million at December 31, 2012 and 2011, respectively. The noncredit charge to other comprehensive income was estimated at \$1.8 million, and \$2.4 million at December 31, 2012 and 2011, respectively. The carrying amount of the TRUPs was written down with \$181,000 recognized in earnings for the year ended December 31, 2012. There was no write-down required during the year ended December 31, 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 December 31, 2012. 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 11 – Employee Benefits” to our consolidated financial statements included in this report. 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, 2012. 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 December 31, 2012, the weighted-average actuarial assumptions of the Plan were: a discount rate of 4.08%; 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.

**Long-term Advance Commitments.** During 2011 and 2010, we entered into the option to fund between one and a half years and two years forward from the advance commitment date, \$200 million par in long-term advance commitments from the FHLB at the FHLB rates on the date the option was purchased. A table detailing the optional advance commitment terms is presented in “Note 10 – Long-Term Obligations” to our consolidated financial statements included in this report. In order to obtain these commitments from the FHLB we paid fees of \$10.95 million, which at December 31, 2012 were fully impaired. In determining if it is probable that we will exercise the advance commitments quarterly, we compare all the 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. If the current rate is less and the forward yield curve does not support our assumption that it is probable we will exercise the advance commitments, then we value the option to determine if it is impaired and if so record the impairment in that period.

## OVERVIEW

## OPERATING RESULTS

During the year ended December 31, 2012, net income attributable to Southside Bancshares, Inc. decreased \$4.4 million, or 11.3%, to \$34.7 million, from \$39.1 million for the same period in 2011. The decrease in net income was

primarily attributable to the decrease in net interest income, an increase in the provision for loan losses, a reduction in fair value gain-securities, and an increase in noninterest expense. These items were partially offset by an increase in the gain on sale of securities available for sale and a reduction in the FHLB advance option fee charges. Noninterest expense increased primarily due to an increase in salaries and employee benefits. Earnings per diluted share decreased \$0.26, or 11.5%, to \$2.00 for the year ended December 31, 2012, from \$2.26 for the same period in 2011.

During the year ended December 31, 2011, net income attributable to Southside Bancshares, Inc. increased \$30,000, or 0.1%, to \$39.1 million, from \$39.1 million for the same period in 2010. The increase in net income was primarily attributable to the increase in net interest income, a decrease in the provision for loan losses and an increase in fair value gain-securities. These items were partially offset by a decrease in the gain on sale of securities available for sale and an impairment charge of \$8.9 million to our FHLB advance option fee. Noninterest expense increased primarily due to an increase in salaries and employee benefits due to our overall growth and expansion while offset by a decrease in FDIC insurance. Earnings per diluted share increased to \$2.26 for the year ended December 31, 2011, from \$2.25 for the same period in 2010.

## FINANCIAL CONDITION

Our total assets decreased \$66.4 million, or 2.0%, to \$3.24 billion at December 31, 2012 from \$3.30 billion at December 31, 2011. This decrease was attributable to a decrease in our mortgage-backed securities and was partially offset by an increase in loans and investment securities. Our securities portfolio decreased by \$343.4 million, or 17.0%, to \$1.67 billion compared to \$2.01 billion at December 31, 2011. At December 31, 2012, loans were \$1.26 billion compared to \$1.09 billion at December 31, 2011. The decrease in our securities was comprised entirely of mortgage-backed and related securities. The increase in loans was funded by cashflow from the decrease in the securities portfolio.

Our nonperforming assets at December 31, 2012 increased to \$14.7 million, and represented 0.45% of total assets, compared to \$13.2 million, or 0.40% of total assets at December 31, 2011. Nonaccruing loans were unchanged at \$10.3 million and the ratio of nonaccruing loans to total loans decreased to 0.82% at December 31, 2012 compared to 0.95% at December 31, 2011. Other Real Estate Owned (“OREO”) increased to \$686,000 at December 31, 2012 from \$453,000 at December 31, 2011. Accruing loans past due more than 90 days at December 31, 2012 increased to \$15,000 compared to \$5,000 at December 31, 2011. Repossessed assets increased to \$704,000 at December 31, 2012 from \$322,000 at December 31, 2011. Restructured performing loans at December 31, 2012 increased to \$3.0 million compared to \$2.1 million at December 31, 2011.

Our deposits increased \$30.2 million to \$2.35 billion at December 31, 2012 from \$2.32 billion at December 31, 2011. Our deposits, net of brokered deposits, increased \$174.6 million. The increase in our deposits during 2012 was primarily due to an increase in public fund deposits and to a lesser extent an increase in deposits from branch expansion and increased market penetration. During 2012, our public fund deposits increased \$112.2 million while our brokered deposits decreased \$144.4 million. Total FHLB advances decreased \$102.5 million to \$520.1 million at December 31, 2012, from \$622.5 million at December 31, 2011. Short-term FHLB advances decreased \$210.8 million to \$151.0 million at December 31, 2012 from \$361.8 million at December 31, 2011. Long-term FHLB advances increased \$108.4 million to \$369.1 million at December 31, 2012 from \$260.7 million at December 31, 2011. During 2010 and 2011, we entered into the option to purchase, between one and a half years and two years forward from the advance commitment date \$200 million par in long-term advance commitments from FHLB at the FHLB rates on the date the option was purchased. During the year ended December 31, 2012, \$150 million par of long-term commitments expired unexercised. Other borrowings at December 31, 2012 and 2011 totaled \$61.5 million and \$63.5 million, respectively, and at December 31, 2012 consisted of \$1.2 million of short-term borrowings and \$60.3 million of long-term debt.

Assets under management in our trust department increased during 2012 and were approximately \$758.3 million at December 31, 2012 compared to \$718.5 million at December 31, 2011.

Shareholders’ equity at December 31, 2012 totaled \$257.8 million compared to \$258.9 million at December 31, 2011. The decrease primarily reflects cash dividends paid of \$19.1 million, a decrease in accumulated other comprehensive income of \$11.8 million and the purchase of treasury stock of \$7.4 million. This was partially offset by the net income of \$34.7 million recorded for the year ended December 31, 2012 and the common stock issued of \$1.9 million as a result of our dividend reinvestment plan. The decrease in accumulated other comprehensive income is comprised primarily of a decrease of \$6.3 million, net of tax, in the unrealized gain on securities, net of reclassification adjustment and a decrease of \$5.5 million, net of tax, related to the change in the unfunded status of our defined benefit plan. See “Note 3 – Comprehensive Income (Loss)” to our consolidated financial statements included in this report.

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 did experience some weakening conditions associated with the real estate led downturn during 2008 through 2011. Many economists predict growth for the economy during 2013, however we are well aware that any economic recovery could be uneven. We cannot predict whether current economic conditions will improve, remain the same or decline.

Key financial indicators management follows include, but are not limited to, numerous interest rate sensitivity and interest rate risk indicators, credit risk, operations risk, liquidity risk, capital risk, regulatory risk, competition risk, yield curve risk, U.S. agency mortgage-backed securities prepayment risk, and economic risk indicators.

#### 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 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 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” 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 fair 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 fair 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 ALCO and described under “Item 7A. 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. The current low interest rate environment and investment and economic landscape make it unlikely that we will experience asset growth driven by an increase in the securities portfolio until one or more of these conditions change.

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 year ended December 31, 2012 was marked by proactive management of the securities portfolio which included restructuring a portion of the portfolio. During the year ended December 31, 2012, interest rates remained low and prepayments on our mortgage-backed securities increased, so we continued to sell primarily longer duration municipal securities and more prepayment volatile mortgage-backed securities and replaced a portion of them with primarily shorter duration municipal securities, U.S Government agency debentures and fixed and floating rate U.S. agency mortgage-backed securities. The sale of these securities resulted in a gain on the sale of available for sale securities of \$4.4 million during the three months ended December 31, 2012. During the quarter we purchased fewer fixed rate mortgage-backed securities because the risk/reward of this class of securities decreased due to increased prepayment speeds and continued high purchase prices. During the quarter ended December 31, 2012, our investment securities

and U.S. agency mortgage-backed securities decreased from \$1.72 billion at September 30, 2012, to \$1.67 billion at December 31, 2012. The average coupon of the mortgage-backed securities portfolio decreased to 5.11% at December 31, 2012 from 6.12% at December 31, 2011, primarily as a result of the sale of the securities carried at fair value through income combined with reinvestment into coupons on average below 6.00% and the purchase of some lower coupon floating rate U.S. agency mortgage-backed securities. At December 31, 2012, securities as a percentage of assets decreased to 51.6%, when compared to 53.4% at September 30, 2012 and 61.0% at December 31, 2011 primarily as a result of the increase in loans and the reduced risk/reward opportunities in mortgage-backed securities as prepayments have increased during 2012. 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 purchasing securities remain the same or decrease, we will likely allow this part of the balance sheet to shrink through run-off or security sales. However, should the economics become more attractive, we might strategically increase the securities portfolio and 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 is the primary wholesale funding source we are currently utilizing. Our FHLB borrowings at December 31, 2012 decreased 2.5%, or \$13.1 million, to \$520.1 million from \$533.2 million at September 30, 2012 primarily as a result of a decrease in the securities portfolio. During 2010 and 2011 we entered into the option to purchase, between one and a half and two years forward from the advance commitment date, \$200 million par in long-term advance commitments from FHLB at the FHLB rates on the date the option was purchased. During the year ended December 31, 2012, \$150 million par of long-term commitments expired unexercised. As of December 31, 2012, we had \$19.5 million in brokered CDs of which all were long-term. All of the long-term brokered CDs, except for one \$5.0 million CD, 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. We are actively evaluating the callable brokered CDs and may exercise the call option if there is an economic benefit. Our wholesale funding policy currently allows maximum brokered CDs of \$180 million; however, this amount could be increased to match changes in ALCO objectives. The potential higher interest expense and lack of customer loyalty are risks associated with the use of brokered CDs. During 2012, overall growth in deposits, not including brokered CDs, combined with a decrease in wholesale funding resulted in a decrease in our total wholesale funding as a percentage of deposits, not including brokered CDs, to 23.1% at December 31, 2012, from 36.4% at December 31, 2011. The decrease in wholesale funding at December 31, 2012, when compared to 2011 is the result of the decrease in total assets and the increase in deposits not including brokered CDs.

## RESULTS OF OPERATIONS

Our results of operations are dependent primarily on net interest income, which is the difference between the interest income earned on assets (loans and investments) and interest expense due on our funding sources (deposits and borrowings) during a particular period. Results of operations are also affected by our noninterest income, provision for loan losses, noninterest expenses and income tax expense. General economic and competitive conditions, particularly changes in interest rates, changes in interest rate yield curves, prepayment rates of mortgage-backed securities and loans, repricing of loan relationships, government policies and actions of regulatory authorities, also significantly affect our results of operations. Future changes in applicable law, regulations or government policies may also have a material impact on us.

## 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.

|  | Years ended December 31, |          |          |
|--|--------------------------|----------|----------|
|  | 2012                     | 2011     | 2010     |
|  | (in thousands)           |          |          |
| Interest income                        |                          |          |          |
| Loans                                  | \$69,462                 | \$66,736 | \$69,973 |
| Investment securities – taxable        | 519                      | 64       | 91       |
| Investment securities – tax-exempt     | 13,644                   | 12,520   | 10,889   |
| Mortgage-backed and related securities | 32,118                   | 51,467   | 50,130   |
| FHLB stock and other investments       | 240                      | 233      | 259      |
| Other interest earning assets          | 37                       | 18       | 32       |
| Total interest income                  | 116,020                  | 131,038  | 131,374  |
| Interest expense                       |                          |          |          |
| Deposits                               | 10,841                   | 15,647   | 18,969   |
| Short-term obligations                 | 6,340                    | 6,577    | 7,563    |
| Long-term obligations                  | 9,714                    | 13,407   | 18,775   |
| Total interest expense                 | 26,895                   | 35,631   | 45,307   |
| Net interest income                    | \$89,125                 | \$95,407 | \$86,067 |

Net interest income for the year ended December 31, 2012 decreased \$6.3 million, or 6.6%, compared to the same period in 2011 and increased \$9.3 million, or 10.9%, for the year ended December 31, 2011 compared to the same period in 2010. The overall decrease in net interest income during 2012, was primarily the result of a decrease in interest income from mortgage-backed and related securities due to an increase in prepayments which increased our amortization expense combined with a decrease in the average balance of these securities. This was partially offset by an increase in interest income from loans, an increase in interest income from tax-exempt investment securities and a decrease in interest expense on deposits, short-term and long-term obligations. The overall increase in net interest income during 2011 was primarily the result of a decrease in total interest expense and increases in interest income from tax-exempt investment securities and mortgage-backed and related securities. This was partially offset by a decrease in interest income from loans.



During the year ended December 31, 2012, total interest income decreased \$15.0 million, or 11.5%, when compared to the same period in 2011, and during the year ended December 31, 2011, decreased \$336,000, or 0.3%, when compared to 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 5.01% for the year ended December 31, 2010 to 4.82% for the year ended December 31, 2011 to 4.13% for the year ended December 31, 2012 which more than offset the increase in average interest earning assets of \$126.4 million, or 4.5%, from \$2.80 billion to \$2.93 billion from 2010 to 2011 and \$141.8 million, or 4.8%, from \$2.93 billion to \$3.07 billion from 2011 to 2012. The decrease in the yield on interest earning assets during the year ended December 31, 2012 is reflective of a 46 basis point decrease in the yield on loans and a 93 basis point decrease in the yield on our securities portfolio due to lower overall interest rates and increased amortization expense on our mortgage-backed securities as a result of increased prepayment speeds. The decrease in the yield on interest earning assets during the year ended December 31, 2011 is reflective of a 41 basis point decrease in the yield on loans and a 6 basis point decrease in the yield on our securities portfolio due to lower overall interest rates.

Total interest expense decreased \$8.7 million, or 24.5%, during the year ended December 31, 2012. The decrease was attributable to a decrease in the average yield on interest bearing liabilities for the year ended December 31, 2012, to 1.11% from 1.48% for the same period in 2011 which was partially offset by an increase in average interest bearing liabilities of \$23.4 million, or 1.0%, from \$2.40 billion to \$2.43 billion. The decrease in the average yield on interest bearing liabilities of 37 basis points is a result of overall lower interest rates. Total interest expense decreased \$9.7 million, or 21.4%, during the year ended December 31, 2011. The decrease was attributable to a decrease in the average yield on interest bearing liabilities for the year ended December 31, 2011, to 1.48% from 1.94% for the same period in 2010 which was partially offset by an increase in average interest bearing liabilities of \$64.1 million, or 2.7%, from \$2.34 billion to \$2.40 billion. The decrease in the average yield on interest bearing liabilities of 46 basis points is a result of overall lower interest rates. For the year ended December 31, 2012, our net interest spread decreased to 3.02% from 3.34%, and our net interest margin decreased to 3.26% from 3.60% when compared to the same period in 2011. For the year ended December 31, 2011, our net interest spread increased to 3.34% from 3.07%, and our net interest margin increased to 3.60% from 3.39% when compared to the same period in 2010.

During the year ended December 31, 2012, average loans increased \$125.2 million, or 11.9%, to \$1.18 billion from \$1.05 billion, compared to the same period in 2011. During the year ended December 31, 2011, average loans increased \$23.0 million, or 2.2%, from \$1.03 billion to \$1.05 billion, compared to the same period in 2010. Residential 1-4 family loans and municipal loans represent a large part of this increase for both years. The average yield on loans decreased from 6.69% for the year ended December 31, 2011 to 6.23% for the year ended December 31, 2012. The increase in interest income on loans of \$2.7 million, or 4.1%, for the year ended December 31, 2012 was the result of an increase in the average balance which more than offset the decrease in the average yield. The average yield on loans decreased from 7.10% for the year ended December 31, 2010 to 6.69% for the year ended December 31, 2011. The decrease in interest income on loans of \$3.2 million, or 4.6%, for the year ended December 31, 2011 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 for 2012 and 2011 was due to overall lower interest rates.

Average investment and mortgage-backed securities increased slightly \$2.1 million, or 0.1%, from \$1.83 billion to \$1.84 billion, for the year ended December 31, 2012 when compared to the same period in 2011 and increased \$118.1 million, or 6.9%, from \$1.72 billion to \$1.83 billion, for the year ended December 31, 2011 when compared to the same period in 2010. This increase was the result of securities purchased due to buying opportunities available throughout most of 2011. At December 31, 2012, most of our mortgage-backed securities were fixed rate securities and approximately eight percent were variable rate mortgage-backed securities compared to approximately one percent in 2011. The overall yield on average investment and mortgage-backed securities decreased to 2.90% during the year ended December 31, 2012 from 3.83% during the same period in 2011 and decreased to 3.83% during the

year ended December 31, 2011 from 3.89% during the same period in 2010. The decrease in the average yield during 2012 primarily reflects increased prepayment speeds on mortgage-backed securities that increased amortization expense combined with overall lower interest rates and the decrease in the average yield during 2011 primarily reflects tighter spreads on mortgage-backed and municipal securities and overall lower interest rates. Interest income on investment and mortgage-backed securities decreased \$17.8 million in 2012, or 27.7%, as the decrease in the average yield more than offset the increase in the average balance. A further decrease in long-term interest rate levels combined with lower credit spreads could negatively impact our net interest margin in the future due to increased prepayments and repricings. Interest income on investment and mortgage-backed securities increased \$2.9 million in 2011, or 4.8%, due to an increase in the average balance which was partially offset by a decrease in the average yield.

Average FHLB stock and other investments increased \$3.3 million, or 10.5%, to \$34.2 million, for the year ended December 31, 2012, when compared to \$30.9 million for 2011 due to the increase in average FHLB advances during 2012 and the corresponding requirement to hold stock associated with those advances. Average FHLB stock and other investments decreased \$7.0 million, or 18.5%, to \$30.9 million, for the year ended December 31, 2011, when compared to \$38.0 million for 2010 due to the decrease in average FHLB advances during 2011 and the corresponding requirement to hold stock associated with those

advances. Interest income from our FHLB stock and other investments increased \$7,000, or 3.0%, during 2012, due to an increase in the average balance which more than offset the decrease in the average yield from 0.75% for the year ended December 31, 2011 compared to 0.70% for the same period in 2012. Interest income from our FHLB stock and other investments decreased \$26,000, or 10.0%, during 2011, due to a decrease in the average balance while partially offset by an increase in the average yield from 0.68% for the year ended December 31, 2010 compared to 0.75% for the same period in 2011. 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.

Average interest earning deposits increased \$13.0 million, or 165.7%, to \$20.8 million, for the year ended December 31, 2012, when compared to \$7.8 million for 2011. Interest income from interest earning deposits increased \$19,000, or 105.6%, for the year ended December 31, 2012, when compared to 2011, as a result of the increase in the average balance. Average interest earning deposits decreased \$6.0 million, or 43.6%, to \$7.8 million, for the year ended December 31, 2011, when compared to \$13.9 million for 2010. Interest income from interest earning deposits decreased \$14,000, or 43.8%, for the year ended December 31, 2011, when compared to 2010, as a result of the decrease in the average balance.

During the year ended December 31, 2012, our average loans increased more than our average securities compared to 2011 when average loans increased less than average securities. As a result, the mix of our average interest earning assets changed as our average total securities as a percentage of total average interest earning assets averaged 60.9% during 2012 compared to 63.6% during 2011 and 62.5% during 2010. Average loans were 38.4% of average total interest earning assets during 2012 compared to 36.1% during 2011 and 37.0% during 2010. Other interest earning asset categories averaged 0.7% of average interest earning assets during 2012 compared to 0.3% during 2011 and 0.5% during 2010.

Total interest expense decreased \$8.7 million, or 24.5%, during the year ended December 31, 2012 and \$9.7 million, or 21.4%, during the year ended December 31, 2011. The decreases were primarily attributable to decreased funding costs as the average yield on interest bearing liabilities decreased from 1.94% for 2010 to 1.48% for 2011 to 1.11% for the year ended December 31, 2012, which more than offset increases in average interest bearing liabilities in 2012 and 2011. The increase in average interest bearing liabilities included an increase in long-term FHLB advances of \$40.3 million, or 13.8%, that was partially offset by a decrease in interest bearing deposits of \$3.7 million, or 0.2%, and other short-term obligations of \$13.2 million, or 4.4%, during 2012. The increase in average interest bearing liabilities during the year ended December 31, 2011 included an increase in deposits of \$214.7 million, or 13.9%, that was partially offset by a decrease in long-term FHLB advances of \$138.9 million, or 32.3%, and other short-term obligations of \$11.7 million, or 3.8%.

The following table sets forth our deposit averages by category for the years ended December 31, 2012, 2011 and 2010:

## COMPOSITION OF DEPOSITS

|                                     | Years Ended December 31, |         | 2011          |         | 2010          |         |         |       |
|-------------------------------------|--------------------------|---------|---------------|---------|---------------|---------|---------|-------|
|                                     | 2012                     | Average | Average       | Average | Average       | Average | Average |       |
|                                     | Balance                  | Yield   | Balance       | Yield   | Balance       | Yield   | Balance | Yield |
|                                     | (dollars in thousands)   |         |               |         |               |         |         |       |
| Interest Bearing Demand Deposits    | \$892,798                | 0.39    | % \$807,344   | 0.52    | % \$723,315   | 0.71    | %       |       |
| Savings Deposits                    | 96,854                   | 0.15    | % 86,417      | 0.25    | % 74,668      | 0.43    | %       |       |
| Time Deposits                       | 761,030                  | 0.95    | % 860,614     | 1.30    | % 741,712     | 1.82    | %       |       |
| Total Interest Bearing Deposits     | 1,750,682                | 0.62    | % 1,754,375   | 0.89    | % 1,539,695   | 1.23    | %       |       |
| Noninterest Bearing Demand Deposits | 564,007                  | N/A     | 459,594       | N/A     | 415,162       | N/A     |         |       |
| Total Deposits                      | \$2,314,689              | 0.47    | % \$2,213,969 | 0.71    | % \$1,954,857 | 0.97    | %       |       |

Average interest bearing deposits decreased \$3.7 million, or 0.2%, and the average rate paid decreased from 0.89% for the year ended December 31, 2011 to 0.62% for the year ended December 31, 2012 and increased \$214.7 million, or 13.9%, while the average rate paid decreased from 1.23% for the year ended December 31, 2010 to 0.89% for the year ended December 31, 2011. Average time deposits decreased \$99.6 million, or 11.6%, and the average rate paid decreased 35 basis points for the year ended December 31, 2012 and increased \$118.9 million, or 16.0%, while the average rate paid decreased 52 basis points for the year ended December 31, 2011. Average interest bearing demand deposits increased \$85.5 million, or 10.6%, while the average rate paid decreased 13 basis points and increased \$84.0 million, or 11.6%, while the average rate paid decreased 19 basis points for the year ended December 31, 2011. Average savings deposits increased \$10.4 million, or 12.1%, while the average rate paid decreased 10 basis points and increased \$11.7 million, or 15.7%, while the average rate paid decreased 18 basis points for the year ended December 31, 2011. Average noninterest bearing demand deposits increased \$104.4 million, or 22.7%, during 2012 and increased \$44.4 million, or 10.7%, during 2011. Interest expense for interest bearing deposits for the year ended December 31, 2012 decreased \$4.8 million, or 30.7%, when compared to the same period in 2011 due to the decrease in the average yield and the decrease in the average balance. Interest expense for interest bearing deposits for the year ended December 31, 2011, decreased \$3.3 million, or 17.5%, 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. The latter three categories, which are considered the lowest cost deposits, comprised 67.1% of total average deposits during the year ended December 31, 2012 compared to 61.1% during 2011 and 62.1% during 2010. The increase in our average total deposits during 2012 and 2011 is primarily the result of an increase in deposits from municipalities and to a lesser extent, deposit growth due to branch expansion, and continued market penetration.

At December 31, 2012, total brokered CDs issued were \$19.5 million compared to \$163.8 million at December 31, 2011. This represented a decrease of \$144.4 million, or 88.1%, from 2011 and an increase of \$2.5 million, or 1.5%, from \$161.3 million at December 31, 2010, when compared to 2011. At December 31, 2012, all of the brokered CDs had maturities of one to five years. During 2012 we called brokered CDs and replaced them with lower cost longer duration FHLB advances. All of the long-term brokered CDs, except for one \$5.0 million CD, 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 December 31, 2012, brokered CDs represented 0.8% of deposits compared to 7.1% of deposits at December 31, 2011 and 7.6% at December 31, 2010. Our wholesale

funding policy currently allows maximum brokered CDs of \$180 million; however, this amount could be increased to match changes in ALCO objectives. The potential higher interest cost and lack of customer loyalty are risks associated with the use of brokered CDs.

Average short-term interest bearing liabilities, consisting primarily of FHLB advances and federal funds purchased and repurchase agreements, were \$284.7 million, a decrease of \$13.2 million, or 4.4%, for the year ended December 31, 2012 when compared to the same period in 2011. For the year ended 2011, the decrease was \$11.7 million, or 3.8% to \$298.0 million when compared to the same period in 2010. Interest expense associated with short-term interest bearing liabilities decreased \$237,000, or 3.6%, while the average rate paid increased 2 basis points to 2.23% for the year ended December 31, 2012, when compared to



2.21% for the same period in 2011. Interest expense associated with short-term interest bearing liabilities decreased \$986,000, or 13.0%, and the average rate paid decreased 23 basis points to 2.21% for the year ended December 31, 2011, when compared to 2.44% for the same period in 2010. The increase in the average rate paid during 2012 is due to higher priced long-term advances rolling into short-term. The decrease in the interest expense during 2012 was due to a decrease in the average balance which more than offset the increase in the average rate. The decrease in the interest expense during 2011 was due to a decrease in the average rate paid and the average balance.

Average long-term interest bearing liabilities consisting of FHLB advances increased \$40.3 million, or 13.8%, during the year ended December 31, 2012 to \$331.9 million as compared to \$291.6 million at December 31, 2011. The increase in the average long-term FHLB advances is due primarily to the purchase of long-term advances to replace brokered CDs that we called and advances purchased as interest rates decreased. Average long-term interest bearing liabilities consisting of FHLB advances decreased \$138.9 million, or 32.3%, during the year ended December 31, 2011 from \$430.5 million at December 31, 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, 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. In order to obtain these commitments from the FHLB we paid fees of \$10.95 million. At December 31, 2012, the remaining FHLB advance option fees recorded on the balance sheet were fully impaired. Interest expense associated with long-term FHLB advances decreased \$3.5 million, or 34.6%, and the average rate paid decreased 148 basis points to 2.00% for the year ended December 31, 2012 when compared to 3.48% for the same period in 2011. The decrease in interest expense was due to the decrease in the average rate paid, which more than offset the increase in the average balance. Interest expense associated with long-term FHLB advances decreased \$5.4 million, or 34.6%, and the average rate paid decreased 12 basis points to 3.48% for the year ended December 31, 2011 when compared to 3.60% for the same period in 2010. The decrease in interest expense was due to the decrease in the average balance of long-term interest bearing liabilities and the decrease in the average rate paid. 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 2007 and the junior subordinated debentures acquired in the purchase of FWBS, was \$60.3 million for the three years ended December 31, 2012, 2011, and 2010. Interest expense associated with long-term debt decreased \$181,000, or 5.5%, to \$3.1 million for the year ended December 31, 2012 when compared to \$3.3 million for the same period in 2011 as a result of the decrease in the average yield of 30 basis points. Interest expense associated with long-term debt decreased \$9,000, or 0.3%, to \$3.3 million for the year ended December 31, 2011 when compared to \$3.3 million for the same period in 2010 as a result of the decrease in the average yield of one basis point. 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 interest rate on the \$23.2 million of long-term debentures issued to Southside Statutory Trust IV adjusts quarterly at a rate equal to three-month LIBOR plus 130 basis points. The interest rate on the \$12.9 million of long-term debentures issued to Southside Statutory Trust V adjusts quarterly at a rate equal to three-month LIBOR plus 225 basis points. 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.

## AVERAGE BALANCES AND YIELDS

The following table presents average balance sheet amounts and average yields for the years ended December 31, 2012, 2011 and 2010. The information should be reviewed in conjunction with the consolidated financial statements for the same years then ended. Two major components affecting our earnings are the interest earning assets and interest bearing liabilities. A summary of average interest earning assets and interest bearing liabilities is set forth below, 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)

Years Ended

|   | December 31, 2012 |          |            | December 31, 2011 |          |            | December 31, 2010 |          |            |
|---|-------------------|----------|------------|-------------------|----------|------------|-------------------|----------|------------|
|   | Average Balance   | Interest | Avg. Yield | Average Balance   | Interest | Avg. Yield | Average Balance   | Interest | Avg. Yield |
| <b>ASSETS</b>                             |                   |          |            |                   |          |            |                   |          |            |
| <b>INTEREST EARNING ASSETS:</b>           |                   |          |            |                   |          |            |                   |          |            |
| Loans(1)(2)                               | \$1,180,095       | \$73,498 | 6.23 %     | \$1,054,882       | \$70,533 | 6.69 %     | \$1,031,858       | \$73,230 | 7.10 %     |
| Loans Held For Sale                       | 1,694             | 59       | 3.48 %     | 3,415             | 133      | 3.89 %     | 5,123             | 189      | 3.69 %     |
| Securities:                               |                   |          |            |                   |          |            |                   |          |            |
| Inv. Sec. (Taxable)(4)                    | 35,217            | 519      | 1.47 %     | 6,056             | 64       | 1.06 %     | 9,156             | 91       | 0.99 %     |
| Inv. Sec. (Tax Exempt)(3)(4)              | 387,284           | 20,552   | 5.31 %     | 293,044           | 18,776   | 6.41 %     | 245,874           | 16,515   | 6.72 %     |
| Mortgage-backed and related Sec.(4)       | 1,413,554         | 32,118   | 2.27 %     | 1,534,837         | 51,467   | 3.35 %     | 1,460,785         | 50,130   | 3.43 %     |
| Total Securities                          | 1,836,055         | 53,189   | 2.90 %     | 1,833,937         | 70,307   | 3.83 %     | 1,715,815         | 66,736   | 3.89 %     |
| FHLB stock and other investments, at cost | 34,191            | 240      | 0.70 %     | 30,937            | 233      | 0.75 %     | 37,973            | 259      | 0.68 %     |
| Interest Earning Deposits                 | 20,809            | 37       | 0.18 %     | 7,833             | 18       | 0.23 %     | 13,880            | 32       | 0.23 %     |
| Total Interest Earning Assets             | 3,072,844         | 127,023  | 4.13 %     | 2,931,004         | 141,224  | 4.82 %     | 2,804,649         | 140,446  | 5.01 %     |
| <b>NONINTEREST EARNING ASSETS:</b>        |                   |          |            |                   |          |            |                   |          |            |
| Cash and Due From Banks                   | 42,938            |          |            | 41,280            |          |            | 43,881            |          |            |
| Bank Premises and Equipment               | 50,392            |          |            | 50,627            |          |            | 48,709            |          |            |
| Other Assets                              | 163,402           |          |            | 137,166           |          |            | 124,052           |          |            |
| Less: Allowance for Loan Losses           | (19,922 )         |          |            | (18,965 )         |          |            | (19,135 )         |          |            |
| Total Assets                              | \$3,309,654       |          |            | \$3,141,112       |          |            | \$3,002,156       |          |            |

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

(2) Interest income includes taxable-equivalent adjustments of \$4,095, \$3,930 and \$3,446 for the years ended December 31, 2012, 2011, and 2010, respectively.

(3) Interest income includes taxable-equivalent adjustments of \$6,908, \$6,256 and \$5,626 for the years ended December 31, 2012, 2011, and 2010, respectively.

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

Note: As of December 31, 2012, 2011 and 2010, loans totaling \$10,314, \$10,299 and \$14,524, respectively, were on nonaccrual status. The policy is to reverse previously accrued but unpaid interest on nonaccrual loans; thereafter, interest income is recorded to the extent received when appropriate.

## AVERAGE BALANCES AND YIELDS

(dollars in thousands)

Years Ended

December 31, 2012

December 31, 2011

December 31, 2010

Average  
Balance

Interest

Avg.  
YieldAverage  
Balance

Interest

Avg.  
YieldAverage  
Balance

Interest

Avg.  
YieldLIABILITIES AND  
SHAREHOLDERS'  
EQUITY

## INTEREST

## BEARING

## LIABILITIES:

|   |           |        |        |           |        |        |           |        |        |
|---|-----------|--------|--------|-----------|--------|--------|-----------|--------|--------|
| Savings Deposits  | \$96,854  | \$145  | 0.15 % | \$86,417  | \$215  | 0.25 % | \$74,668  | \$324  | 0.43 % |
| Time Deposits   | 761,030   | 7,256  | 0.95 % | 860,614   | 11,229 | 1.30 % | 741,712   | 13,514 | 1.82 % |
| Interest Bearing<br>Demand Deposits                         | 892,798   | 3,440  | 0.39 % | 807,344   | 4,203  | 0.52 % | 723,315   | 5,131  | 0.71 % |
| Total Interest Bearing<br>Deposits                          | 1,750,682 | 10,841 | 0.62 % | 1,754,375 | 15,647 | 0.89 % | 1,539,695 | 18,969 | 1.23 % |
| Short-term Interest<br>Bearing Liabilities                  | 284,730   | 6,340  | 2.23 % | 297,960   | 6,577  | 2.21 % | 309,649   | 7,563  | 2.44 % |
| Long-term Interest<br>Bearing<br>Liabilities-FHLB<br>Dallas | 331,898   | 6,629  | 2.00 % | 291,586   | 10,141 | 3.48 % | 430,485   | 15,500 | 3.60 % |
| Long-term Debt (5)  | 60,311    | 3,085  | 5.12 % | 60,311    | 3,266  | 5.42 % | 60,311    | 3,275  | 5.43 % |
| Total Interest Bearing<br>Liabilities                       | 2,427,621 | 26,895 | 1.11 % | 2,404,232 | 35,631 | 1.48 % | 2,340,140 | 45,307 | 1.94 % |

## NONINTEREST

## BEARING

## LIABILITIES:

|                   |           |  |  |           |  |  |           |  |  |
|-------------------|-----------|--|--|-----------|--|--|-----------|--|--|
| Demand Deposits   | 564,007   |  |  | 459,594   |  |  | 415,162   |  |  |
| Other Liabilities | 47,668    |  |  | 34,614    |  |  | 28,132    |  |  |
| Total Liabilities | 3,039,296 |  |  | 2,898,440 |  |  | 2,783,434 |  |  |

SHAREHOLDERS'  
EQUITY (6)

270,358

242,672

218,722

## TOTAL

## LIABILITIES AND

## SHAREHOLDERS'

## EQUITY

\$3,309,654

\$3,141,112

\$3,002,156

## NET INTEREST

## INCOME

\$100,128

\$105,593

\$95,139

## NET INTEREST

## MARGIN ON

## AVERAGE

## EARNING ASSETS

3.26 %

3.60 %

3.39 %

## NET INTEREST

## SPREAD

3.02 %

3.34 %

3.07 %

- 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
- (5) 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 \$1,112 and \$1,248 for the years ended December 31, 2011 and 2010, respectively.

## ANALYSIS OF CHANGES IN INTEREST INCOME AND INTEREST EXPENSE

The following tables set forth the dollar amount of increase (decrease) in interest income and interest expense resulting from changes in the volume of interest earning assets and interest bearing liabilities and from changes in yields (in thousands):

|   | Years Ended December 31,<br>2012 Compared to 2011 |                  |                        |
|---|---|------------------|------------------------|
|   | Average<br>Volume                                 | Average<br>Yield | Increase<br>(Decrease) |
| <b>INTEREST INCOME:</b>                 |   |                  |                        |
| Loans (1)                               | \$8,008   | \$ (5,043 )      | \$ 2,965               |
| Loans Held For Sale                     | (61 )   | (13 )            | (74 )                  |
| Investment Securities (Taxable)         | 421   | 34               | 455                    |
| Investment Securities (Tax Exempt) (1)  | 5,362   | (3,586 )         | 1,776                  |
| Mortgage-backed and related Securities  | (3,809 )  | (15,540 )        | (19,349 )              |
| FHLB stock and other investments        | 23  | (16 )            | 7                      |
| Interest Earning Deposits               | 24  | (5 )             | 19                     |
| Total Interest Income                   | 9,968   | (24,169 )        | (14,201 )              |
| <b>INTEREST EXPENSE:</b>                |   |                  |                        |
| Savings Deposits                        | 24  | (94 )            | (70 )                  |
| Time Deposits                           | (1,194 )  | (2,779 )         | (3,973 )               |
| Interest Bearing Demand Deposits        | 411   | (1,174 )         | (763 )                 |
| Short-term Interest Bearing Liabilities | (294 )  | 57               | (237 )                 |
| Long-term FHLB Advances                 | 1,256   | (4,768 )         | (3,512 )               |
| Long-term Debt                          | —   | (181 )           | (181 )                 |
| Total Interest Expense                  | 203   | (8,939 )         | (8,736 )               |
| Net Interest Income                     | \$9,765   | \$ (15,230 )     | \$ (5,465 )            |

|   | Years Ended December 31,<br>2011 Compared to 2010 |                  |                        |
|---|---|------------------|------------------------|
|   | Average<br>Volume                                 | Average<br>Yield | Increase<br>(Decrease) |
| <b>INTEREST INCOME:</b>                 |   |                  |                        |
| Loans (1)                               | \$1,608   | \$ (4,305 )      | \$ (2,697 )            |
| Loans Held For Sale                     | (66 )   | 10               | (56 )                  |
| Investment Securities (Taxable)         | (32 )   | 5                | (27 )                  |
| Investment Securities (Tax Exempt) (1)  | 3,051   | (790 )           | 2,261                  |
| Mortgage-backed and related Securities  | 2,501   | (1,164 )         | 1,337                  |
| FHLB stock and other investments        | (51 )   | 25               | (26 )                  |
| Interest Earning Deposits               | (14 )   | —                | (14 )                  |
| Total Interest Income                   | 6,997   | (6,219 )         | 778                    |
| <b>INTEREST EXPENSE:</b>                |   |                  |                        |
| Savings Deposits                        | 45  | (154 )           | (109 )                 |
| Time Deposits                           | 1,944   | (4,229 )         | (2,285 )               |
| Interest Bearing Demand Deposits        | 548   | (1,476 )         | (928 )                 |
| Short-term Interest Bearing Liabilities | (278 )  | (708 )           | (986 )                 |
| Long-term FHLB Advances                 | (4,847 )  | (512 )           | (5,359 )               |
| Long-term Debt                          | —   | (9 )             | (9 )                   |

|                        |         |          |          |   |
|------------------------|---------|----------|----------|---|
| Total Interest Expense | (2,588  | ) (7,088 | ) (9,676 | ) |
| Net Interest Income    | \$9,585 | \$869    | \$10,454 |   |

(1) Interest yields on loans and securities that are nontaxable for federal income tax purposes are presented on a taxable equivalent basis.

Note: Volume/Yield variances (change in volume times change in yield) have been allocated to amounts attributable to changes in volumes and to changes in yields in proportion to the amounts directly attributable to those changes.

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## PROVISION FOR LOAN LOSSES

The provision for loan losses for the year ended December 31, 2012 was \$10.7 million compared to \$7.5 million for the year ended December 31, 2011 and \$13.7 million for the year ended December 31, 2010. For the year ended December 31, 2012, net charge-offs of loans decreased \$1.0 million, to \$8.7 million when compared to \$9.7 million for the same period in 2011 and decreased \$3.3 million from \$12.9 during 2010 when compared to 2011.

The decrease in net charge-offs for 2012 was due to a combination of a decrease in total charge-offs of \$1.4 million and a decrease in total recoveries of \$472,000. Net charge-offs for 1-4 family residential loans decreased \$510,000, to \$67,000. Net charge-offs for loans to individuals increased 1.9%, to \$8.5 million and net charge-offs for commercial loans decreased \$715,000, to \$90,000. Net recoveries of construction loans increased \$65,000, resulting in net recoveries of \$80,000. Net charge-offs of other real estate loans increased \$157,000, resulting in net charge-offs of \$153,000.

The decrease in net charge-offs for 2011 was due to a combination of a decrease in total charge-offs of \$3.9 million while partially offset by a decrease in total recoveries of \$681,000. Net charge-offs for loans to individuals decreased \$1.3 million, to \$8.3 million and net charge-offs for commercial loans decreased \$944,000, to \$805,000. Net charge-offs of construction loans decreased \$723,000, resulting in net recoveries of \$15,000. Net charge-offs of other real estate loans decreased \$581,000, resulting in net recoveries of \$4,000. Net charge-offs for 1-4 family residential loans increased \$302,000, to \$577,000.

As of December 31, 2012, and 2011, our reviews of the loan portfolio indicated that loan loss allowances of \$20.6 million and \$18.5 million, respectively, were appropriate to cover probable losses in the portfolio.

## NONINTEREST INCOME

Noninterest income consists of revenues generated from a broad range of financial services and activities including deposit related fee based services. The following schedule lists the accounts from which noninterest income was derived and gives totals for these accounts for the year ended December 31, 2012 and the comparable years ended December 31, 2011, and 2010:

|   | Years Ended December 31, |           |          |
|---|--------------------------|-----------|----------|
|   | 2012                     | 2011      | 2010     |
|   | (in thousands)           |           |          |
| Deposit services  | \$15,433                 | \$15,943  | \$16,819 |
| Gain on sale of securities available for sale                           | 17,966                   | 11,795    | 25,789   |
| (Loss) gain on sale of securities carried at fair value through income  | (498)                    | ) 937     | —        |
| Total other-than-temporary impairment losses                            | (21)                     | ) —       | (39)     |
| Portion of loss recognized in other comprehensive income (before taxes) | (160)                    | ) —       | (36)     |
| Net impairment losses recognized in earnings                            | (181)                    | ) —       | (75)     |
| Fair value gain (loss) – securities                                     | —                        | 6,693     | (598)    |
| FHLB advance option impairment charges                                  | (2,031)                  | ) (8,923) | ) —      |
| Gain on sale of loans   | 1,119                    | 1,230     | 1,751    |
| Trust income  | 2,794                    | 2,610     | 2,368    |
| Bank owned life insurance income  | 1,110                    | 1,087     | 1,155    |
| Other   | 4,309                    | 3,950     | 3,589    |



|                          |          |          |          |
|--------------------------|----------|----------|----------|
| Total noninterest income | \$40,021 | \$35,322 | \$50,798 |
|--------------------------|----------|----------|----------|

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Total noninterest income for the year ended December 31, 2012 increased 13.3%, or \$4.7 million, compared to 2011 and decreased 30.5%, or \$15.5 million during the year ended December 31, 2011, when compared to the same period in 2010. During the years ended December 31, 2012, 2011 and 2010, we had gains on sale of AFS securities of \$18.0 million, \$11.8 million, and \$25.8 million, respectively. The fair value of the AFS securities portfolio at December 31, 2012 was \$1.42 billion with a net unrealized gain on that date of \$45.3 million. The net unrealized gain is comprised of \$49.0 million in unrealized gains and \$3.7 million in unrealized losses. The fair value of the AFS securities portfolio at December 31, 2011 was \$999.1 million with a net unrealized gain on that date of \$55.2 million. The net unrealized gain is comprised of \$58.5 million in unrealized gains and \$3.3 million in unrealized losses. The fair value of HTM securities portfolio at December 31, 2012 was \$255.4 million with a net unrealized gain on that date of \$8.9 million. The net unrealized gain is comprised of \$8.9 million in unrealized gains and \$47,000 in unrealized losses. The fair value of HTM securities portfolio at December 31, 2011 was \$383.3 million with a net unrealized gain on that date of \$16.2 million. The net unrealized gain is comprised of \$16.2 million in unrealized gains and \$54,000 in unrealized losses. During the quarter ended December 31, 2012, as interest rates remained low, we sold some of our longer maturity general market tax-free municipal securities when the market pricing for these securities caused the economics of purchasing this sector to become unattractive. We also sold some of our mortgage-backed securities with more volatile prepays and some of our agency debentures. During the year ended December 31, 2012, the size of the securities portfolio decreased due to increased prepayments on our mortgage-backed securities, sales of prepayment volatile mortgage-backed securities and the significantly reduced attractiveness of purchasing additional fixed rate mortgage-backed securities. There can be no assurance that the level of security gains reported during the year ended December 31, 2012, will continue in future periods.

During the year ended December 31, 2011, we had a gain on the sale of AFS securities of \$11.8 million. During 2011, 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. During 2011, we increased the size of the securities portfolio due to increased global economic concerns, U.S. deficit concerns, and the Federal Reserve signaling an extended period of low short-term interest rates.

During 2012, we sold all of our securities carried at fair value through income. The sale of these securities resulted in a loss on sale of securities carried at fair value through income of \$498,000 compared to a \$937,000 gain on sale of securities carried at fair value during 2011. During 2011, the fair value of our securities carried at fair value through income increased to \$6.7 million from a fair value loss of \$598,000 during 2010, and was recorded in noninterest income.

During 2012, the FHLB advance option fees were further impaired and were completely written down for a total charge of \$2.0 million for the year ended December 31, 2012. During 2011, the value of the FHLB advance option fees became impaired resulting in a total impairment charge of \$8.9 million in 2011.

Deposit services income decreased \$510,000, or 3.2%, for the year ended December 31, 2012, as compared to the same period in 2011 and decreased \$876,000, or 5.2%, for the year ended December 31, 2011, as compared to the same period in 2010 primarily due to a decrease in overdraft income.

Gain on sale of loans decreased \$111,000, or 9.0%, for the year ended December 31, 2012, when compared to the same period in 2011. Gain on sale of loans decreased \$521,000, or 29.8%, for the year ended December 31, 2011, when compared to the same period in 2010. This is primarily a result of a decrease in the dollar amount of loans sold and the related servicing release and secondary market fees. The decrease in loans sold was due to a greater emphasis on retaining loans for our own portfolio.

Trust income increased \$184,000, or 7.0%, for the year ended December 31, 2012, as compared to the same period in 2011, and \$242,000, or 10.2% for the year ended December 31, 2011, as compared to the same period in 2010 primarily due to the addition of several new accounts.

Other income increased \$359,000, or 9.1%, for the year ended December 31, 2012, when compared to the same period in 2011, primarily as a result of increases in brokerage fee income, trading income and the fair value of written loan commitments. Other income increased \$361,000, or 10.1%, for the year ended December 31, 2011, when compared to the same period in 2010 as a result of increases in brokerage fee income, Southside Select fee income, Master Card income and credit card fee income while offset by a decrease in the fair value of written loan commitments.

## NONINTEREST EXPENSE

The following schedule lists the accounts which comprise noninterest expense, gives totals for these accounts for the years ended December 31, 2012, 2011 and 2010:

|                                       | Years Ended December 31, |          |          |
|---------------------------------------|--------------------------|----------|----------|
|                                       | 2012                     | 2011     | 2010     |
|                                       | (in thousands)           |          |          |
| Salaries and employee benefits        | \$48,084                 | \$45,421 | \$43,957 |
| Occupancy expense                     | 7,498                    | 7,205    | 6,780    |
| Equipment expense                     | 2,169                    | 2,055    | 1,899    |
| Advertising, travel and entertainment | 2,463                    | 2,414    | 2,319    |
| ATM and debit card expense            | 1,063                    | 987      | 825      |
| Director fees                         | 1,213                    | 914      | 950      |
| Supplies                              | 747                      | 746      | 902      |
| Professional fees                     | 2,034                    | 2,160    | 2,015    |
| Postage                               | 700                      | 725      | 800      |
| Telephone and communications          | 1,665                    | 1,325    | 1,443    |
| FDIC insurance                        | 1,744                    | 1,817    | 2,909    |
| Other                                 | 6,727                    | 6,579    | 6,515    |
| Total noninterest expense             | \$76,107                 | \$72,348 | \$71,314 |

Noninterest expense for the year ended December 31, 2012 increased \$3.8 million, or 5.2%, when compared to the year ended December 31, 2011 and increased \$1.0 million, or 1.4%, when compared to the year ended December 31, 2010.

Salaries and employee benefits expense increased \$2.7 million, or 5.9%, during the year ended December 31, 2012, when compared to the same period in 2011 and increased \$1.5 million, or 3.3% during the year ended December 31, 2011, when compared to the same period in 2010. These increases were the result of the increases in personnel associated with our overall growth and expansion, an increase in retirement expense, normal salary increases for existing personnel, increases in incentive pay associated with the increased loan production and share based payment compensation. Direct salary expense and payroll taxes increased \$1.2 million, or 3.0%, for the year ended December 31, 2012, when compared to the same period in 2011 and increased \$1.3 million, or 3.4%, for the year ended December 31, 2011, when compared to the same period in 2010.

Retirement expense, included in salary and benefits, increased \$863,000, or 24.8%, for the year ended December 31, 2012, when compared to the same period in 2011 and increased \$445,000, or 14.7%, for the year ended December 31, 2011, when compared to the same period in 2010. The increase was primarily related to the increase in the defined benefit and restoration plans. The defined benefit and restoration plan increased primarily due to the changes in the actuarial assumptions used to determine net periodic pension costs for 2012 when compared to 2011 and for 2011 when compared to 2010. Specifically, the assumed long-term rate of return was 7.25% for 2012 and 2011 and 7.50% for 2010 and the assumed discount rate was decreased to 4.84% for 2012 compared to 5.63% for 2011 and 6.10% for 2010. We will continue to evaluate the assumed long-term rate of return and the discount rate to determine if either should be changed in the future. If either of these assumptions decreased, the cost and funding required for the retirement plan could increase.

Health and life insurance expense, included in salary and benefits, increased \$636,000, or 17.6%, for the year ended December 31, 2012, when compared to the same period in 2011 due to increased health claims expense and plan administrative cost. Health and life insurance expense, included in salary and benefits, decreased \$249,000, or 6.5%,

for the year ended December 31, 2011, when compared to the same period in 2010 due to decreased health claims expense and plan administrative cost during 2011. 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 2013.

ATM and debit card expense increased \$76,000, or 7.7%, for the year ended December 31, 2012, compared to the same period in 2011 and increased \$162,000, or 19.6%, for the year ended December 31, 2011, compared to the same period in 2010 due to an increase in the volume of transactions and an increase in processing expenses.

Director fees increased \$299,000, or 32.7%, for the year ended December 31, 2012, compared to the same period in 2011. Effective January 5, 2012, Mr. B. G. Hartley retired as Chief Executive Officer of Southside Bancshares, Inc. and became a non-employee Chairman of the Board of Directors of the Company. The increase is due to the director fees Mr. Hartley received for serving as Chairman of the Board. Director fees decreased \$36,000, or 3.8%, for year ended December 31, 2011, compared to the same period in 2010.

Supplies increased \$1,000, or 0.1%, for the year ended December 31, 2012, compared to the same period in 2011 and decreased \$156,000, or 17.3%, for the year ended December 31, 2011, compared to the same period in 2010 due primarily to the printing of our 50<sup>th</sup> anniversary logo on supplies purchased during 2010.

Telephone and communications increased \$340,000, or 25.7%, for the year ended December 31, 2012, as compared to the same period in 2011 and decreased \$118,000, or 8.2%, for the year ended December 31, 2011, as compared to the same period in 2010. The increase during 2012 was due to bank growth and upgraded systems.

FDIC insurance decreased \$73,000, or 4.0%, for the year ended December 31, 2012, compared to the same period in 2011 and \$1.1 million, or 37.5%, for the year ended December 31, 2011, compared to the same period 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 year ended December 31, 2012 was \$42.3 million compared to \$50.9 million for the year ended December 31, 2011, and \$51.8 million for the year ended December 31, 2010.

Income tax expense was \$7.6 million for the year ended December 31, 2012 and represented a decrease of \$2.8 million, or 26.8%, when compared to the year ended December 31, 2011, and decreased \$1.4 million, or 11.6%, to \$10.4 million, when compared to the year ended December 31, 2010. The effective tax rate as a percentage of pre-tax income was 18.0% in 2012, 20.4% in 2011 and 22.7% in 2010. The decrease in the income tax expense and effective tax rate for the year ended December 31, 2012 and 2011 was due to an increase in tax exempt income as a percentage of taxable income as compared to the prior year and a decrease in income before tax expense for the year ended December 31, 2012, of \$8.6 million when compared to 2011. The net deferred tax asset totaled \$4.1 million at December 31, 2012 as compared to a net deferred tax liability of \$3.5 million in 2011.

## LENDING ACTIVITIES

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 December 31, 2012, the SFG loans totaled approximately \$69.8 million.

Total loans as of December 31, 2012 increased \$175.7 million, or 16.2%, and the average loan balance increased \$125.2 million, or 11.9%, when compared to 2011.

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 did experience weakening conditions associated with the real estate led downturn during 2008 through 2011 and 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.

1-4 family residential loans increased \$121.4 million, or 49.0%, from December 31, 2011. Other real estate loans increased \$30.2 million, or 14.6%, and commercial loans increased \$16.5 million, or 11.5%, from December 31, 2011 to December 31, 2012, respectively. Municipal loans as of December 31, 2012 increased \$13.7 million, or 6.6%, from December 31, 2011. The increase in municipal loans is due to continued demand which provided additional opportunities for us to lend to municipalities during 2012. Construction loans increased \$2.4 million, or 2.1%, from December 31, 2011. Loans to individuals decreased \$8.4 million, or 4.9%, from December 31, 2011.

The increase in 1-4 family residential loans is due to the low interest rate environment, our competitive pricing for this type of loan and our decision to portfolio more of our originations. The increase in our construction loans, commercial loans and other real estate loans is due to an increase in loan demand for this type of loan. The decrease in loans to individuals reflects a decrease in this type of loan as financing for automobiles and other consumer products are available from manufacturers at rates that we are unable to offer. In our loan portfolio, loans dependent upon private household income represent a significant concentration. Due to the number of customers involved who work in all sectors of the numerous local, state and national economies, we believe the risk in this portion of the portfolio is adequately spread throughout the economic communities we serve, which assists in mitigating this concentration.

A significant portion of our loan portfolio is dependent on the medical community. Medical loan types include commercial loans and commercial real estate loans. Collateral for these loans varies depending on the type of loan and financial strength of the borrower. The primary source of repayment for loans in the medical community is cash flow from continuing operations. The medical community represents a concentration of risk in our Commercial loan and Commercial Real Estate loan portfolio. See "Item 1. Business – Market Area." We believe that risk in the medical community is mitigated because it is spread among multiple practice types and multiple specialties. Should the government change the amount it pays the medical community through the various government health insurance programs or if new government regulation impacts the profitability of the medical community, the medical community could be adversely impacted which in turn could result in higher default rates by borrowers in the medical industry.

The aggregate amount of loans that we are permitted to make under applicable bank regulations to any one borrower, including non-affiliate related entities is 25% of Tier 1 capital. Our legal lending limit at December 31, 2012, was approximately \$70.7 million. Our largest loan relationship at December 31, 2012 was approximately \$23.4 million.

The average yield on loans for the year ended December 31, 2012, decreased to 6.23% from 6.69% for the year ended December 31, 2011. This decrease was reflective of the overall lower interest rate environment during 2012 and the lower rates associated with the new loans added and repriced during 2012.

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## LOAN PORTFOLIO COMPOSITION AND ASSOCIATED RISK

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

|                        | December 31, |              |              |              |              |
|------------------------|--------------|--------------|--------------|--------------|--------------|
|                        | 2012         | 2011         | 2010         | 2009         | 2008         |
| Real Estate Loans:     |              |              |              |              |              |
| Construction           | \$ 113,744   | \$ 111,361   | \$ 115,094   | \$ 105,268   | \$ 132,666   |
| 1-4 Family Residential | 368,845      | 247,479      | 219,031      | 217,677      | 226,180      |
| Other                  | 236,760      | 206,519      | 200,723      | 212,731      | 184,629      |
| Commercial Loans       | 160,058      | 143,552      | 148,761      | 159,529      | 165,558      |
| Municipal Loans        | 220,947      | 207,261      | 196,594      | 150,111      | 134,986      |
| Loans to Individuals   | 162,623      | 171,058      | 197,717      | 188,260      | 178,530      |
| Total Loans            | \$ 1,262,977 | \$ 1,087,230 | \$ 1,077,920 | \$ 1,033,576 | \$ 1,022,549 |

For purposes of this discussion, our loans are divided into Real Estate Loans, Commercial Loans, Municipal Loans and Loans to Individuals.

## REAL ESTATE LOANS

Real estate loans represent our greatest concentration of loans. We attempt to mitigate the amount of risk associated with this group of loans through the type of loans originated and geographic distribution. At December 31, 2012, the majority of our real estate loans were collateralized by properties located in our market areas. Of the \$719.3 million in real estate loans, \$368.8 million, or 51.3%, represent loans collateralized by residential dwellings that are primarily owner-occupied. Historically, the amount of losses suffered on this type of loan has been significantly less than those on other properties. Beginning in the third quarter of 2007, there were well-publicized developments in the credit markets, beginning with a decline in the sub-prime mortgage lending market, which later extended to the markets for collateralized mortgage obligations, mortgage-backed securities and the lending markets generally. Initially our markets appeared to have been relatively resilient, not experiencing the significant effects associated with these market trends; however, beginning in the later half of 2008 as consumers all across the United States were impacted by the economic slowdown, our market areas began to experience more of a slowdown in economic activity. From 2009 and continuing into 2011, our markets did experience a slowdown as a result of the real estate led downturn across the country. During 2012 our markets appear to have stabilized and in some cases strengthened. A more severe decline in credit markets generally could adversely affect our financial condition and results of operation if we are unable to extend credit or sell loans into the secondary market. Our loan policy requires an appraisal or evaluation on the property, based on the size and complexity of the transaction, prior to funding any real estate loan and also outlines the requirements for appraisals on renewals.

We pursue an aggressive policy of reappraisal on any real estate loan that is in the process of foreclosure and potential exposures are recognized and reserved for or charged off as soon as they are identified. Our ability to liquidate certain types of properties that may be obtained through foreclosure could adversely affect the volume of our nonperforming real estate loans.

Real estate loans are divided into 1-4 Family Residential Mortgage Loans, Construction Loans and Other. The Other real estate consists of \$230.4 million of commercial real estate loans, \$4.3 million of loans secured by multi-family properties and \$2.1 million of loans secured by farm land. The Commercial Real Estate portion of Other is discussed in more detail below.

## 1-4 Family Residential Mortgage Loans

Residential loan originations are generated by our loan officers, in-house origination staff, marketing efforts, present customers, walk-in customers and referrals from real estate agents and builders. We focus our lending efforts primarily on the origination of loans secured by first mortgages on owner-occupied, 1-4 family residences. Substantially all of our 1-4 family residential mortgage originations are secured by properties located in or near our market areas. Historically, we have originated a portion of our residential mortgage loans for sale into the secondary market. These loans are reflected on the balance sheet as loans held for sale. These secondary market investors typically pay us a service release premium in addition to a predetermined price based on the interest rate of the loan originated. We retain liabilities related to early prepayments, defaults, failure to adhere to origination and processing guidelines and other issues. We have internal controls in place to mitigate many of these liabilities and historically our realized liability has been extremely low. In addition, many of the retained liabilities expire inside of one year

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from the date a loan is sold. We warehouse these loans until they are transferred to the secondary market investor, which usually occurs within 45 days.

Our 1-4 family residential mortgage loans generally have maturities ranging from five to 30 years. These loans are typically fully amortizing with monthly payments sufficient to repay the total amount of the loan or amortizing with a balloon feature, typically due in fifteen years or less. Our 1-4 family residential mortgage loans are made at both fixed and adjustable interest rates.

We review information concerning the income, financial condition, employment and credit history when evaluating the creditworthiness of the applicant.

We also make home equity loans, which are included as part of the 1-4 family residential mortgage loans, and at December 31, 2012, these loans totaled \$82.3 million. Under Texas law, these loans, when combined with all other mortgage indebtedness for the property, are capped at 80% of appraised value.

#### Construction Loans

Our commercial construction loans and construction loans to individuals are collateralized by property located primarily in the market areas we serve. A majority of our construction loans are directed toward properties that will be owner-occupied. Construction loans for projects built on speculation are financed, but these typically have secondary sources of repayment and collateral. Our construction loans have both adjustable and fixed interest rates during the construction period. Construction loans to individuals are typically priced and made with the intention of granting the permanent loan on the property. During 2010 our construction loans experienced slight additional stress due to the general downturn in market conditions associated with this type of lending. During 2011, construction loans in our market areas stabilized and during 2012 they have rebounded and strengthened in many of our market areas.

#### Commercial Real Estate Loans

Commercial real estate loans primarily include commercial office buildings, retail, medical facilities and offices, warehouse facilities, hotels and churches. In determining whether to originate commercial real estate loans, we generally consider such factors as the financial condition of the borrower and the debt service coverage of the property. Commercial real estate loans are made at both fixed and adjustable interest rates for terms generally up to 20 years.

#### COMMERCIAL LOANS

Our commercial loans are diversified to meet most business needs. Loan types include short-term working capital loans for inventory and accounts receivable and short- and medium-term loans for equipment or other business capital expansion. Management does not consider there to be a concentration of risk in any one industry type, other than the medical industry. Loans to borrowers in the medical industry include all loan types listed above for commercial loans. Collateral for these loans varies depending on the type of loan and financial strength of the borrower. The primary source of repayment for loans in the medical community is cash flow from continuing operations.

In our commercial loan underwriting, we assess the creditworthiness, ability to repay, and the value and liquidity of the collateral being offered. Terms of commercial loans are generally commensurate with the useful life of the collateral offered.

#### MUNICIPAL LOANS

We have a specific lending department that makes loans to municipalities and school districts throughout the state of Texas. The majority of the loans to municipalities and school districts have tax or revenue pledges and in some cases are additionally supported by collateral. Municipal loans made without a direct pledge of taxes or revenues are usually made based on some type of collateral that represents an essential service. Lending money directly to these municipalities allows us to earn a higher yield for similar durations than we could if we purchased municipal securities. Total loans to municipalities and school districts as of December 31, 2012 increased \$13.7 million when compared to 2011. At December 31, 2012, we had total loans to municipalities and school districts of \$220.9 million.

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## LOANS TO INDIVIDUALS

Substantially all of our consumer loan originations are made to consumers in our market areas. The majority of loans to individuals outstanding are collateralized by titled equipment, which are primarily vehicles, and automobile loans purchased by SFG. At December 31, 2012, these types of loans accounted for approximately \$133.7 million, or 82.2%, of total loans to individuals.

The total of SFG automobile loans included in loans to individuals at December 31, 2012 was \$69.8 million. These high yield loans represent existing subprime automobile loans with payment histories that are primarily collateralized by used automobiles. Loan pools purchased through SFG are subjected to a modeling system to determine the risk associated with the expected defaults. Among other things, the model takes into consideration credit scores and estimated collateral values to determine the risk inherent in each pool.

Home equity loans, which are included in 1-4 family residential loans, have replaced some of the traditional loans to individuals. In addition, we make loans for a full range of other consumer purposes, which may be secured or unsecured depending on the credit quality and purpose of the loan.

Consumer loan terms vary according to the type and value of collateral, length of contract and creditworthiness of the borrower. The underwriting standards we employ for consumer loans include an application, a determination of the applicant's payment history on other debts, with the greatest weight being given to payment history with us, and an assessment of the borrower's ability to meet existing obligations and payments on the proposed loan. Although creditworthiness of the applicant is a primary consideration, the underwriting process also includes a comparison of the value of the collateral, if any, in relation to the proposed loan amount. Most of our loans to individuals are collateralized, which management believes should assist in limiting our exposure.

## LOAN MATURITIES AND SENSITIVITY TO CHANGES IN INTEREST RATES

The following table represents loan maturities and sensitivity to changes in interest rates for our real estate construction, commercial and municipal loans. The amounts of these loans outstanding at December 31, 2012, which, based on remaining scheduled repayments of principal, are due in (1) one year or less, (2) more than one year but less than five years, and (3) more than five years, are shown in the following table. The amounts due after one year are classified according to the sensitivity to changes in interest rates.

|                                  | Due in One<br>Year or<br>Less* | After One<br>but<br>Within Five<br>Years | After Five<br>Years |
|----------------------------------|--------------------------------|--|---------------------|
|                                  | (in thousands)                 |  |                     |
| Real Estate Loans – Construction | \$48,908                       | \$36,367                                 | \$28,469            |
| Commercial Loans                 | 61,894                         | 86,411                                   | 11,753              |
| Municipal Loans                  | 21,710                         | 71,442                                   | 127,795             |
| Total                            | \$132,512                      | \$194,220                                | \$168,017           |

Loans with Maturities After  
One Year for Which:

|   |           |
|---|-----------|
| Interest Rates are Fixed or Predetermined | \$230,629 |
| Interest Rates are Floating or Adjustable | \$131,608 |

\* The volume of commercial loans due within one year reflects our general policy of attempting to limit these loans to a short-term maturity. Nonaccrual loans totaling \$4.2 million are reflected in the due after five years column.

## LOANS TO AFFILIATED PARTIES

In the normal course of business, we make loans to certain of our own executive officers and directors and their related interests. As of December 31, 2012 and 2011, these loans totaled \$4.3 million and \$4.1 million, respectively. These loans represented 1.7% and 1.6% of shareholders' equity as of December 31, 2012 and 2011, respectively. Such loans are made in the normal course of business at normal credit terms, including interest rate and collateral requirements and do not represent more than normal credit risks contained in the rest of the loan portfolio for loans of similar types.

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## LOAN LOSS EXPERIENCE AND ALLOWANCE FOR LOAN LOSSES

Our allowance for loan losses was \$20.6 million at December 31, 2012, or 1.6% of loans. The increase in the allowance for loan losses is due primarily to an 11.6% increase in nonperforming assets and a change in the loan mix as SFG, commercial and construction loans which require larger allowance for loan loss accruals, increased. The increase in loans during 2012 occurred primarily in 1-4 family residential and other real estate loans which require smaller allowance for loan loss accruals.

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. Previously, a review of data for one year was used to establish a general reserve. Beginning in the fourth quarter of 2012, an average three year history of annualized net charge-offs against the average portfolio balance for that time period is utilized. The historical charge off figure is further adjusted through qualitative factors that include six month general trends in past dues, nonaccruals and classified loans to more effectively and promptly react to both positive and negative movements. Management feels this change in methodology is appropriate to accurately estimate the bank's inherent losses in the current fragile economic climate. 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. 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 along with 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 effectiveness 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 determine 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 determine 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 and our own experience indicates that a portion of our loans will become delinquent and a portion of the loans will require partial or full 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 appropriateness of the 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 in accordance with GAAP), 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 and evaluated for troubled debt classification. The remaining term extensions increase the risk of collateral deterioration and accordingly, reserves are increased to recognize this risk.

New pools purchased are reserved at their estimated annual loss. Thereafter, the reserve is adjusted based on the actual performance versus projected performance. Additionally, we use data mining measures 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 detailed in the table below. At December 31, 2012, the unallocated portion of the allowance for loan loss was \$1.2 million, or 0.1% of loans.

As of December 31, 2012, our review of the loan portfolio indicated that a loan loss allowance of \$20.6 million was appropriate to cover probable losses in the portfolio. Changes in economic and other conditions may require future adjustments to the allowance for loan losses.

The following table presents information regarding the average amount of net loans outstanding, changes in the allowance for loan losses, selected asset quality ratios and an allocation of the allowance for loan losses (dollars in thousands).

#### LOAN LOSS EXPERIENCE AND ALLOWANCE FOR LOAN LOSSES

|  | Years Ended December 31, |              |              |              |            |   |
|--|--------------------------|--------------|--------------|--------------|------------|---|
|  | 2012                     | 2011         | 2010         | 2009         | 2008       |   |
| Average Net Loans Outstanding                                | \$ 1,180,095             | \$ 1,054,882 | \$ 1,031,858 | \$ 1,021,770 | \$ 983,336 |   |
| Balance of Allowance for Loan Losses at Beginning of Period  | \$ 18,540                | \$ 20,711    | \$ 19,896    | \$ 16,112    | \$ 9,753   |   |
| Loan Charge-Offs:  |                          |              |              |              |            |   |
| Real Estate-Construction                                     | (41 )                    | (46 )        | (873 )       | (932 )       | (111 )     |   |
| Real Estate-1-4 Family Residential                           | (239 )                   | (675 )       | (288 )       | (267 )       | (11 )      |   |
| Real Estate-Other  | (159 )                   | (271 )       | (577 )       | (322 )       | —          |   |
| Commercial Loans   | (402 )                   | (1,254 )     | (2,603 )     | (2,037 )     | (505 )     |   |
| Loans to Individuals   | (10,188 )                | (10,231 )    | (12,072 )    | (9,589 )     | (8,570 )   |   |
| Total Loan Charge-Offs                                       | (11,029 )                | (12,477 )    | (16,413 )    | (13,147 )    | (9,197 )   |   |
| Recovery of Loans Previously Charged-off:                    |                          |              |              |              |            |   |
| Real Estate-Construction                                     | 121                      | 61           | 165          | 2            | —          |   |
| Real Estate-1-4 Family Residential                           | 172                      | 98           | 13           | 5            | 1          |   |
| Real Estate-Other  | 6                        | 275          | —            | —            | 6          |   |
| Commercial Loans   | 312                      | 449          | 854          | 104          | 32         |   |
| Loans to Individuals   | 1,727                    | 1,927        | 2,459        | 1,727        | 1,842      |   |
| Total Recovery of Loans Previously Charged-Off               | 2,338                    | 2,810        | 3,491        | 1,838        | 1,881      |   |
| Net Loan Charge-Offs   | (8,691 )                 | (9,667 )     | (12,922 )    | (11,309 )    | (7,316 )   |   |
| Provision for Loan Losses                                    | 10,736                   | 7,496        | 13,737       | 15,093       | 13,675     |   |
| Balance of Allowance for Loan Losses at End of Period        | \$ 20,585                | \$ 18,540    | \$ 20,711    | \$ 19,896    | \$ 16,112  |   |
| Reserve for Unfunded Loan Commitments at Beginning of Period | \$ 26                    | \$ 30        | \$ 5         | \$ 7         | \$ 50      |   |
| Provision for Losses on Unfunded Loan Commitments            | (21 )                    | (4 )         | 25           | (2 )         | (43 )      |   |
| Reserve for Unfunded Loan Commitments at End of Period       | \$ 5                     | \$ 26        | \$ 30        | \$ 5         | \$ 7       |   |
| Net Charge-Offs to Average Net Loans Outstanding             | 0.74                     | % 0.92       | % 1.25       | % 1.11       | % 0.74     | % |
| Allowance for Loan Losses to Nonaccruing Loans               | 199.58                   | 180.02       | 142.60       | 106.80       | 112.76     |   |
|  | 139.87                   | 140.58       | 116.95       | 84.83        | 102.10     |   |

Allowance for Loan Losses to  
Nonperforming Assets

|  |      |      |      |      |      |
|--|------|------|------|------|------|
| Allowance for Loan Losses to Total Loans | 1.63 | 1.71 | 1.92 | 1.92 | 1.58 |
|--|------|------|------|------|------|

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## Allocation of Allowance for Loan Losses (dollars in thousands):

|                        | Years Ended December 31, |                                 | 2011     |                                 | 2010     |                                 | 2009     |                                 | 2008     |                                 |
|------------------------|--------------------------|---------------------------------|----------|---------------------------------|----------|---------------------------------|----------|---------------------------------|----------|---------------------------------|
|                        | 2012                     | 2011                            | 2011     | 2010                            | 2010     | 2009                            | 2008     | 2008                            | 2007     |                                 |
|                        | Amount                   | Percent of Loans To Total Loans | Amount   | Percent of Loans To Total Loans | Amount   | Percent of Loans To Total Loans | Amount   | Percent of Loans To Total Loans | Amount   | Percent of Loans To Total Loans |
| Real Estate            |                          |                                 |          |                                 |          |                                 |          |                                 |          |                                 |
| Construction           | \$2,355                  | 9.0 %                           | \$2,620  | 10.2 %                          | \$2,585  | 10.7 %                          | \$3,080  | 10.2 %                          | \$2,757  | 12.9 %                          |
| 1-4 Family Residential | 3,545                    | 29.2 %                          | 1,957    | 22.8 %                          | 1,988    | 20.3 %                          | 1,460    | 21.1 %                          | 1,567    | 22.1 %                          |
| Other                  | 2,290                    | 18.7 %                          | 3,051    | 19.0 %                          | 3,354    | 18.6 %                          | 3,175    | 20.6 %                          | 2,701    | 18.1 %                          |
| Commercial Loans       | 3,158                    | 12.7 %                          | 2,877    | 13.2 %                          | 3,746    | 13.8 %                          | 3,184    | 15.4 %                          | 2,496    | 16.2 %                          |
| Municipal Loans        | 633                      | 17.5 %                          | 619      | 19.1 %                          | 607      | 18.3 %                          | 400      | 14.5 %                          | 341      | 13.2 %                          |
| Loans to Individuals   | 7,373                    | 12.9 %                          | 6,244    | 15.7 %                          | 7,978    | 18.3 %                          | 7,321    | 18.2 %                          | 6,206    | 17.5 %                          |
| Unallocated            | 1,231                    | 0.0 %                           | 1,172    | 0.0 %                           | 453      | 0.0 %                           | 1,276    | 0.0 %                           | 44       | 0.0 %                           |
| Ending Balance         | \$20,585                 | 100.0 %                         | \$18,540 | 100.0 %                         | \$20,711 | 100.0 %                         | \$19,896 | 100.0 %                         | \$16,112 | 100.0 %                         |

See "Consolidated Financial Statements - Note 5 – Loans and Allowance for Probable Loan Losses."

## NONPERFORMING ASSETS

Nonperforming assets consist of delinquent loans 90 days or more past due, nonaccrual loans, 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 any 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. 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. 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.

Total nonperforming assets at December 31, 2012 were \$14.7 million representing an increase of \$1.5 million, or 11.6%, from \$13.2 million at December 31, 2011. From December 31, 2011 to December 31, 2012, nonaccrual loans increased \$15,000, or 0.1%, to \$10.3 million. Of this total, 19.4% are residential real estate loans, 13.2% are commercial real estate loans, 17.6% are commercial loans, 26.4% are loans to individuals, primarily SFG automobile loans, and 23.4% are construction loans. OREO increased \$233,000, or 51.4%, to \$686,000 from December 31, 2011

to December 31, 2012. We are actively marketing all properties and none are being held for investment purposes. Accruing loans past due more than 90 days increased \$10,000, or 200.0% to \$15,000 at December 31, 2012 from \$5,000 at December 31, 2011. Restructured loans increased \$889,000, or 42.2%, to \$3.0 million. Repossessed assets increased \$382,000, or 118.6%, to \$704,000 at December 31, 2012 from \$322,000 at December 31, 2011. Included in total nonperforming assets are \$4.1 million loans classified as troubled debt restructurings at December 31, 2012 and \$1.4 million at December 31, 2011.

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The following table presents information on nonperforming assets (dollars in thousands):

|  | NONPERFORMING ASSETS     |          |          |          |          |   |
|--|--------------------------|----------|----------|----------|----------|---|
|  | Years Ended December 31, |          |          |          |          |   |
|  | 2012                     | 2011     | 2010     | 2009     | 2008     |   |
| Accruing Loans Past Due More Than 90 Days: |                          |          |          |          |          |   |
| Real Estate                                | \$—                      | \$—      | \$—      | \$289    | \$404    |   |
| Loans to Individuals                       | 15                       | 5        | 7        | 34       | 53       |   |
| Commercial                                 | —                        | —        | —        | —        | 136      |   |
|  | 15                       | 5        | 7        | 323      | 593      |   |
| Loans on Nonaccrual:                       |                          |          |          |          |          |   |
| Real Estate                                | 5,774                    | 7,037    | 8,511    | 8,930    | 7,469    |   |
| Loans to Individuals                       | 2,728                    | 1,909    | 4,214    | 7,461    | 5,976    |   |
| Commercial                                 | 1,812                    | 1,353    | 1,799    | 2,238    | 844      |   |
|  | 10,314                   | 10,299   | 14,524   | 18,629   | 14,289   |   |
| Restructured Loans:                        |                          |          |          |          |          |   |
| Real Estate                                | 2,135                    | 762      | 36       | 87       | 91       |   |
| Loans to Individuals                       | 632                      | 1,206    | 2,243    | 1,831    | 39       |   |
| Commercial                                 | 231                      | 141      | 41       | 54       | 18       |   |
|  | 2,998                    | 2,109    | 2,320    | 1,972    | 148      |   |
| Total Nonperforming Loans                  | 13,327                   | 12,413   | 16,851   | 20,924   | 15,030   |   |
| Other Real Estate Owned                    | 686                      | 453      | 220      | 1,875    | 318      |   |
| Reposessed Assets                          | 704                      | 322      | 638      | 654      | 433      |   |
| Total Nonperforming Assets                 | \$14,717                 | \$13,188 | \$17,709 | \$23,453 | \$15,781 |   |
| Nonperforming Assets to Total Assets       | 0.45                     | % 0.40   | % 0.59   | % 0.78   | % 0.58   | % |
| Nonperforming Assets to Total Loans        | 1.17                     | 1.21     | 1.64     | 2.27     | 1.54     |   |
| Nonaccrual Loans to Total Loans            | 0.82                     | 0.95     | 1.35     | 1.80     | 1.40     |   |
| Loans 90 Days Past Due to Total Loans      | —                        | —        | —        | 0.03     | 0.06     |   |

Nonperforming assets at December 31, 2012, as a percentage of total assets increased to 0.45% from the previous year and as a percentage of loans decreased to 1.17%. Nonperforming assets hinder our ability to earn money. Decreases in earnings can result from both the loss of interest income and the costs associated with maintaining the OREO, for taxes, insurance and other operating expenses. In addition to the nonperforming assets, at December 31, 2012, in the opinion of management, we had \$652,000 of loans identified as potential problem loans. A potential problem loan is a loan where information about possible credit problems of the borrower is known, causing management to have serious doubts about the ability of the borrower to comply with the present loan repayment terms and which may result in a future classification of the loan in one of the nonperforming asset categories.

The restructured loans to individuals referred to in the preceding table are primarily SFG loans which have had payment extensions or whose maturity has extended due to late payments on the contract. These loans continue to accrue interest on the principal balance.

The following is a summary of our recorded investment in loans (primarily nonaccrual loans) for which impairment has been recognized (in thousands):

|                      | December 31, 2012 |                     |                |
|----------------------|-------------------|---------------------|----------------|
|                      | Total             | Valuation Allowance | Carrying Value |
| Real Estate Loans    | \$7,877           | \$665               | \$7,212        |
| Loans to Individuals | 3,360             | 1,428               | 1,932          |
| Commercial Loans     | 2,043             | 630                 | 1,413          |
| Total                | \$13,280          | \$2,723             | \$10,557       |

  

|                      | December 31, 2011 |                     |                |
|----------------------|-------------------|---------------------|----------------|
|                      | Total             | Valuation Allowance | Carrying Value |
| Real Estate Loans    | \$7,765           | \$1,297             | \$6,468        |
| Loans to Individuals | 3,112             | 857                 | 2,255          |
| Commercial Loans     | 1,493             | 485                 | 1,008          |
| Total                | \$12,370          | \$2,639             | \$9,731        |

The balances of impaired loans included above with no valuation allowances were approximately \$1,000 and \$4,000 at December 31, 2012 and 2011, respectively.

For the years ended December 31, 2012 and 2011, the average recorded investment in impaired loans was approximately \$13.2 million and \$14.4 million, respectively.

The amount of interest recognized on loans that were nonaccruing or restructured during the year was \$572,000, \$943,000 and \$1.1 million for the years ended December 31, 2012, 2011 and 2010, respectively. If these loans had been accruing interest at their original contracted rates, related income would have been \$1.3 million, \$1.8 million and \$2.2 million for the years ended December 31, 2012, 2011 and 2010, respectively.

## SECURITIES ACTIVITY

Our securities portfolio plays a primary role in management of our interest rate sensitivity and, therefore, is managed in the context of the overall balance sheet. The securities portfolio generates a substantial percentage of our interest income and serves as a necessary source of liquidity.

We account for debt and equity securities as follows:

**Held to Maturity (“HTM”).** Debt securities that management has the current intent and ability to hold until maturity are classified as HTM and are carried at their remaining unpaid principal balance, net of unamortized premiums or unaccreted discounts. Premiums are amortized and discounts are accreted using the level interest yield method over the estimated remaining term of the underlying security.

**Available for Sale (“AFS”).** Debt and equity securities that will be held for indefinite periods of time, including securities that may be sold in response to changes in market interest or prepayment rates, needs for liquidity and changes in the availability of and the yield of alternative investments are classified as AFS. These assets are carried at fair value. Fair value is determined using 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. Unrealized gains and losses on AFS securities are excluded from earnings and reported net of tax as a

separate component of shareholders' equity until realized.

Securities Carried at Fair Value through Income. Debt securities purchased at significant premiums that contain an embedded derivative where the embedded derivative is not readily identifiable and measurable and as such cannot be bifurcated, are classified as securities carried at fair value through income. Fair value is determined using quoted market prices. If quoted market prices are not available, fair values are based on quoted market prices for similar

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securities or estimates from independent pricing services. Changes in fair value are reported through the income statement as fair value gain (loss) – securities.

Purchase of premiums and discounts are recognized in interest income using the interest method over the terms of the securities. Declines in the fair value of HTM and AFS securities below their cost that are deemed to be other-than-temporary are reflected in earnings as realized losses. In estimating other-than-temporary impairment losses, management considers (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, and (3) our intent and ability to retain our investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value. Gains and losses on the sale of securities are recorded on the trade date and are determined using the specific identification method.

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.

Management attempts to deploy investable funds into instruments that are expected to provide a reasonable overall return on the portfolio given the current assessment of economic and financial conditions, while maintaining acceptable levels of capital, interest rate and liquidity risk. At December 31, 2012, the securities portfolio as a percentage of total assets was 52.5% and was larger than loans, which were 39.0% of total assets. For a discussion of our strategy in relation to the securities portfolio, see “Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations – Balance Sheet Strategy.”

The following tables set forth the carrying amount of investment securities and mortgage-backed securities at December 31, 2012, 2011 and 2010 (in thousands):

|  | December 31, |           |             |
|--|--------------|-----------|-------------|
|  | 2012         | 2011      | 2010        |
| Available for Sale:                              |              |           |             |
| Investment Securities:                           |              |           |             |
| U.S. Treasury                                    | \$—          | \$—       | \$4,700     |
| U.S. Government Agency Debentures                | 60,863       | —         | —           |
| State and Political Subdivisions                 | 545,688      | 282,457   | 294,262     |
| Other Stocks and Bonds                           | 11,156       | 499       | 382         |
| Mortgage-backed Securities:                      |              |           |             |
| U.S. Government Agencies                         | 89,803       | 107,052   | 150,273     |
| Government-Sponsored Enterprises                 | 716,557      | 609,074   | 736,301     |
| Total  | \$1,424,067  | \$999,082 | \$1,185,918 |
|  |              |           |             |
|  | December 31, |           |             |
|  | 2012         | 2011      | 2010        |
| Securities Carried at Fair Value through Income: |              |           |             |
| Mortgage-backed Securities:                      |              |           |             |
| U.S. Government Agencies                         | \$—          | \$30,413  | \$5,392     |
| Government-Sponsored Enterprises                 | —            | 617,346   | 66,784      |
| Total  | \$—          | \$647,759 | \$72,176    |
|  |              |           |             |
|  | December 31, |           |             |
|  | 2012         | 2011      | 2010        |
| Held to Maturity:                                |              |           |             |
| Investment Securities:                           |              |           |             |
| State and Political Subdivisions                 | \$1,009      | \$1,010   | \$1,012     |
| Other Stocks and Bonds                           | —            | 486       | 483         |
| Mortgage-backed Securities:                      |              |           |             |
| U.S. Government Agencies                         | 20,135       | 22,999    | 20,821      |



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|                                  |           |           |           |
|----------------------------------|-----------|-----------|-----------|
| Government-Sponsored Enterprises | 225,403   | 342,632   | 384,546   |
| Total                            | \$246,547 | \$367,127 | \$406,862 |

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We invest in mortgage-backed and related securities, including mortgage participation certificates, which are insured or guaranteed by U.S. Government agencies and GSEs and Collateralized Mortgage Obligation (“CMOs”) and real estate mortgage investment conduits (“REMICs”). Mortgage-backed securities (which also are known as mortgage participation certificates or pass-through certificates) represent a participation interest in a pool of single-family or multi-family mortgages, the principal and interest payments on which are passed from the mortgage originators, through intermediaries (generally U.S. Government agencies and GSEs) that pool and re-package the participation interests in the form of securities, to investors such as us. U.S. Government agencies, primarily Government National Mortgage Association (“GNMA”) and GSEs, primarily Freddie Mac, and Fannie Mae guarantee the payment of principal and interest to investors. GSEs are not backed by the full faith and credit of the U.S. Government. Freddie Mac, Fannie Mae and FHLB are the primary GSEs from which we purchase securities. At December 31, 2012, all of our mortgage-backed securities were collateralized by U.S. Government agencies or GSEs.

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.

Our mortgage-backed securities include CMOs, which include securities issued by entities that have qualified under the Internal Revenue Code of 1986, as amended, as REMICs. CMOs and REMICs (collectively CMOs) were developed in response to investor concerns regarding the uncertainty of cash flows associated with the prepayment option of the underlying mortgagor and are typically issued by governmental agencies, GSEs and special purpose entities, such as trusts, corporations or partnerships, established by financial institutions or other similar institutions. A CMO can be collateralized by loans or securities which are insured or guaranteed by Fannie Mae, Freddie Mac or GNMA. In contrast to pass-through mortgage-backed securities, in which cash flow is received pro rata by all security holders, the cash flow from the mortgages underlying a CMO is segmented and paid in accordance with a predetermined priority to investors holding various CMO classes. By allocating the principal and interest cash flows from the underlying collateral among the separate CMO classes, different classes of bonds are created, each with its own stated maturity, estimated average life, coupon rate and prepayment characteristics.

On October 24, 2011 the President of the United States and the FHFA announced programs designed to assist homeowners with refinancing their mortgage. These programs target homeowners that might not otherwise qualify for a new mortgage loan as a result of either loan-to-value issues or past due loan payment status or history. The FHFA is the agency responsible for Fannie Mae and Freddie Mac. Should these programs be successful in reaching borrowers targeted in large numbers, our MBS could see increased prepayment levels that we did not project at purchase.

Like most fixed income securities, mortgage-backed and related securities are subject to interest rate risk. However, unlike most fixed income securities, the mortgage loans underlying a mortgage-backed or related security generally may be prepaid at any time without penalty. The ability to prepay a mortgage loan generally results in significantly increased price and yield volatility (with respect to mortgage-backed and related securities) than is the case with noncallable fixed income securities. Most of our mortgage-backed securities were purchased at a premium. As these mortgage-backed securities prepay at a faster rate our yield on these securities will decrease. Conversely, as prepayments slow the yield on these mortgage-backed securities will increase.

Debt securities purchased at a significant premium that contain an embedded derivative where the embedded derivative is not readily identifiable and measurable and as such cannot be bifurcated, are classified as securities carried at fair value through income. As such, mortgage-backed securities purchased at a significant premium, which

we describe as any mortgage-backed security purchase at a price in excess of 111.111%, are classified as securities carried at fair value through income unless they are in a trading account. At December 31, 2012, we had no securities carried at fair value through income compared to \$647.8 million at December 31, 2011. During 2012, we sold all of our securities carried at fair value through income as management determined it did not want additional, potentially significant, swings in net income associated with fair value changes for these securities. The sale of these securities resulted in a loss on sale of securities carried at fair value through income of \$498,000. During 2012, as interest rates remained low, we continued to sell primarily lower yielding, longer duration municipal securities and more prepayment volatile mortgage-backed securities and replaced them with primarily shorter duration municipal securities. The sale of these securities resulted in a gain on the sale of available for sale securities of \$18.0 million. There can be no assurance that the level of security gains reported during the year ended December 31, 2012, will continue in future periods.

The combined investment securities, mortgage-backed securities, and FHLB stock and other investments portfolio decreased to \$1.70 billion at December 31, 2012, compared to \$2.05 billion at December 31, 2011, a decrease of \$349.3 million, or 17.0%. This is primarily a result of a decrease in mortgage-backed securities of \$677.6 million, or 39.2%, which was partially offset by a \$263.2 million, or 92.9%, increase in our ownership of securities issued by state and political subdivisions during 2012 when compared to 2011.

During 2012, the interest rate yield curve remained steep while at the same time credit and volatility spreads continued to tighten. We used this environment to reposition a portion of the securities portfolio. The decrease in mortgage-backed securities is due to sales of more prepay volatile securities, principal payments due primarily to prepayments and reduced purchases of fixed rate mortgage-backed securities as the risk/reward profile of these securities became less favorable. The addition of the Federal Reserve purchasing \$40 billion of mortgage-backed securities per month will likely limit purchases until the economics in this sector change. To offset the decrease of the mortgage-backed securities portfolio we significantly increased our tax-free municipal security portfolio. Most of our purchases were in Texas with only limited purchases in other states. As we increased the municipal portfolio we sold some of our longer maturity lower coupon municipal securities to lower the overall duration of this portfolio.

The combined fair value of the AFS and HTM securities portfolio at December 31, 2012 was \$1.68 billion, which represented a net unrealized gain as of that date of \$54.2 million. The net unrealized gain was comprised of \$57.9 million in unrealized gains and \$3.7 million of unrealized losses. The fair value of the AFS securities portfolio at December 31, 2012 was \$1.42 billion, which represented a net unrealized gain as of that date of \$45.3 million. The net unrealized gain was comprised of \$49.0 million of unrealized gains and \$3.7 million of unrealized losses. The \$3.7 million of unrealized losses is primarily resulting from our investment in three tranches of TRUPS and securities issued by government-sponsored enterprises. Net unrealized gains and losses on AFS securities, which is a component of shareholders' equity on the consolidated balance sheet, can fluctuate significantly as a result of changes in interest rates. Because management cannot predict the future direction of interest rates, the effect on shareholders' equity in the future cannot be determined; however, this risk is monitored through the use of shock tests on the AFS securities portfolio using an array of interest rate assumptions.

There were no securities transferred from AFS to HTM during 2012, 2011 and 2010. There were no sales from the HTM portfolio during the years ended December 31, 2012, 2011 or 2010. There were \$246.5 million and \$367.1 million of securities classified as HTM at December 31, 2012 and 2011, respectively. In conjunction with correcting errors in the first three quarters of 2011 that were restated related to securities carried at fair value through income, on October 1, 2010 we corrected \$13.9 million in HTM securities which should have been originally classified as securities carried at fair value through income.

The maturities classified according to the sensitivity to changes in interest rates of the December 31, 2012 securities portfolio and the weighted yields are presented below. Tax-exempt obligations are shown on a taxable equivalent basis. Mortgage-backed securities are included in maturity categories based on their stated maturity date. Expected maturities may differ from contractual maturities because issuers may have the right to call or prepay obligations.

| Available For Sale:                  | MATURING               |        |                               |        |                                |        |                |        |
|--------------------------------------|------------------------|--------|-------------------------------|--------|--------------------------------|--------|----------------|--------|
|                                      | Within 1 Year          |        | After 1 But<br>Within 5 Years |        | After 5 But<br>Within 10 Years |        | After 10 Years |        |
|                                      | Amount                 | Yield  | Amount                        | Yield  | Amount                         | Yield  | Amount         | Yield  |
|                                      | (dollars in thousands) |        |                               |        |                                |        |                |        |
| Investment Securities:               |                        |        |                               |        |                                |        |                |        |
| U.S. Government Agency<br>Debentures | \$—                    | —      | \$—                           | —      | \$38,554                       | 1.30 % | \$22,309       | 2.06 % |
| State and Political<br>Subdivisions  | 4,473                  | 5.15 % | 14,337                        | 3.69 % | 111,493                        | 3.27 % | 415,385        | 4.66 % |
| Other Stocks and Bonds               | —                      | —      | 7,791                         | 1.62 % | 2,375                          | 2.03 % | 990            | —      |
| Mortgage-backed<br>Securities:       |                        |        |                               |        |                                |        |                |        |
| U.S. Government Agencies             | —                      | —      | 747                           | 4.76 % | 2,743                          | 3.95 % | 86,313         | 2.22 % |
| Government-Sponsored<br>Enterprises  | 64                     | 5.57 % | 4,403                         | 3.52 % | 12,709                         | 3.73 % | 699,381        | 1.70 % |
| Total                                | \$4,537                | 5.16 % | \$27,278                      | 3.10 % | \$167,874                      | 2.85 % | \$1,224,378    | 2.75 % |

| Held to Maturity:                   | MATURING               |        |                               |        |                                |        |                |        |
|-------------------------------------|------------------------|--------|-------------------------------|--------|--------------------------------|--------|----------------|--------|
|                                     | Within 1 Year          |        | After 1 But<br>Within 5 Years |        | After 5 But<br>Within 10 Years |        | After 10 Years |        |
|                                     | Amount                 | Yield  | Amount                        | Yield  | Amount                         | Yield  | Amount         | Yield  |
|                                     | (dollars in thousands) |        |                               |        |                                |        |                |        |
| Investment Securities:              |                        |        |                               |        |                                |        |                |        |
| State and Political<br>Subdivisions | \$—                    | —      | \$—                           | —      | \$—                            | —      | \$1,009        | 8.09 % |
| Mortgage-backed<br>Securities:      |                        |        |                               |        |                                |        |                |        |
| U.S. Government Agencies            | —                      | —      | 248                           | 4.59 % | 12,112                         | 2.98 % | 7,775          | 0.19 % |
| Government-Sponsored<br>Enterprises | 519                    | 3.96 % | 17,032                        | 3.12 % | 113,253                        | 1.70 % | 94,599         | 3.44 % |
| Total                               | \$519                  | 3.96 % | \$17,280                      | 3.14 % | \$125,365                      | 1.82 % | \$103,383      | 3.24 % |

At December 31, 2012, there were no holdings of any one issuer, other than the U.S. Government, its agencies and its GSEs, in an amount greater than 10% of our shareholders' equity.

## DEPOSITS AND BORROWED FUNDS

Deposits provide us with our primary source of funds. The increase of \$30.2 million, or 1.3%, in total deposits during 2012 partially contributed to the decrease in FHLB advances. Deposits increased during 2012 primarily due to an increase in public funds, and to a lesser extent branch expansion and increased market penetration. During 2012, our public fund deposits increased \$112.2 million to \$713.4 million at December 31, 2012 from \$601.1 million at December 31, 2011. At December 31, 2012, brokered CDs reflected a decrease of approximately \$144.4 million when compared to December 31, 2011. Deposits, net of brokered deposits, at December 31, 2012, increased \$174.6 million, or 8.1%, when compared to December 31, 2011. Time deposits, including brokered CDs issued decreased a total of \$237.3 million, or 26.9%, during 2012 when compared to 2011. Noninterest bearing demand deposits increased \$89.5 million, or 17.7%, during 2012. Interest bearing demand deposits increased \$165.4 million, or 19.6%, and saving deposits increased \$12.6 million, or 13.9%, during 2012. The latter three categories, which are considered the lowest cost deposits, comprised 72.6% of total deposits at December 31, 2012 compared to 62.0% at December 31, 2011.

The following table sets forth deposits by category at December 31, 2012, 2011, and 2010 (in thousands):

|                                     | Years Ended December 31, |             |             |
|-------------------------------------|--------------------------|-------------|-------------|
|                                     | 2012                     | 2011        | 2010        |
| Noninterest Bearing Demand Deposits | \$595,093                | \$505,594   | \$423,304   |
| Interest Bearing Demand Deposits    | 1,008,348                | 842,970     | 786,552     |
| Savings Deposits                    | 103,839                  | 91,203      | 79,472      |
| Time Deposits                       | 644,617                  | 881,904     | 845,100     |
| Total Deposits                      | \$2,351,897              | \$2,321,671 | \$2,134,428 |

During the year ended December 31, 2012, total time deposits of \$100,000 or more decreased \$71.2 million, or 12.9%, to \$481.7 million from \$552.9 million at December 31, 2011.

The table below sets forth the maturity distribution of time deposits of \$100,000 or more at December 31, 2012 and 2011 (in thousands):

|                           | December 31, 2012                  |                           |           | December 31, 2011                  |                           |           |
|---------------------------|------------------------------------|---------------------------|-----------|------------------------------------|---------------------------|-----------|
|                           | Time<br>Certificates<br>Of Deposit | Other<br>Time<br>Deposits | Total     | Time<br>Certificates<br>Of Deposit | Other<br>Time<br>Deposits | Total     |
| Three months or less      | \$95,548                           | \$28,000                  | \$123,548 | \$80,226                           | \$28,000                  | \$108,226 |
| Over three to six months  | 53,279                             | 21,000                    | 74,279    | 86,138                             | 21,000                    | 107,138   |
| Over six to twelve months | 106,818                            | 7,000                     | 113,818   | 197,911                            | 7,000                     | 204,911   |
| Over twelve months        | 170,065                            | —                         | 170,065   | 132,644                            | —                         | 132,644   |
| Total                     | \$425,710                          | \$56,000                  | \$481,710 | \$496,919                          | \$56,000                  | \$552,919 |

At December 31, 2012, we had \$19.5 million in long-term brokered CDs that represented 0.8% of our deposits. Our brokered CDs at December 31, 2012 have maturities of less than five years and are reflected in the CDs under \$100,000 category. At December 31, 2011, we had \$163.8 million in brokered CDs and at December 31, 2010, we had \$161.3 million in brokered CDs. Our current policy allows for a maximum of \$180 million in brokered CDs. The potential higher interest cost and lack of customer loyalty are risks associated with the use of brokered CDs.



Short-term obligations, consisting primarily of FHLB advances and federal funds purchased and repurchase agreements, decreased \$212.8 million, or 58.3%, during 2012 when compared to 2011. FHLB advances are collateralized by FHLB stock, nonspecified loans and securities. Short-term obligations are summarized as follows (dollars in thousands):

|  | Years Ended December 31, |           |           |   |
|--|--------------------------|-----------|-----------|---|
|  | 2012                     | 2011      | 2010      |   |
| Federal funds purchased and repurchase agreements    |                          |           |           |   |
| Balance at end of period                             | \$984                    | \$2,945   | \$3,844   |   |
| Average amount outstanding during the period (1)     | 1,770                    | 3,137     | 6,699     |   |
| Maximum amount outstanding during the period (2)     | 2,704                    | 3,291     | 13,187    |   |
| Weighted average interest rate during the period (3) | 1.4                      | % 2.7     | % 3.1     | % |
| Interest rate at end of period                       | 0.4                      | % 2.6     | % 3.3     | % |
| FHLB advances  |                          |           |           |   |
| Balance at end of period                             | \$150,985                | \$361,811 | \$189,094 |   |
| Average amount outstanding during the period (1)     | 282,741                  | 292,242   | 300,428   |   |
| Maximum amount outstanding during the period (2)     | 440,246                  | 466,316   | 401,893   |   |
| Weighted average interest rate during the period (3) | 2.2                      | % 2.2     | % 2.4     | % |
| Interest rate at end of period                       | 3.7                      | % 1.6     | % 3.6     | % |
| Other obligations                                    |                          |           |           |   |
| Balance at end of period                             | \$219                    | \$219     | \$2,651   |   |
| Average amount outstanding during the period (1)     | 219                      | 2,581     | 2,522     |   |
| Maximum amount outstanding during the period (2)     | 219                      | 2,963     | 3,135     |   |
| Weighted average interest rate during the period (3) | 8.0                      | % 0.7     | % 0.2     | % |
| Interest rate at end of period                       | 8.0                      | % 8.0     | % 0.7     | % |

(1) The average amount outstanding during the period was computed by dividing the total daily outstanding principal balances by the number of days in the period.

(2) The maximum amount outstanding at any month-end during the period.

(3) The weighted average interest rate during the period was computed by dividing the actual interest expense by the average balance outstanding during the period.



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

|  | December 31,<br>2012 | December 31,<br>2011 |
|--|----------------------|----------------------|
| FHLB Advances (1)                          |                      |                      |
| Varying maturities to 2028                 | \$369,097            | \$260,724            |
| 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                | \$429,408            | \$321,035            |

(1) At December 31, 2012, the weighted average cost of these advances was 1.6%.

(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 3.251% through March 30, 2013 and adjusts quarterly at a rate equal to three-month LIBOR plus 294 basis points.

(4) This debt carries an adjustable rate of 1.61325% through January 29, 2013 and adjusts quarterly at a rate equal to three-month LIBOR plus 130 basis points.

(5) This debt carries an adjustable rate of 2.558% through March 14, 2013 and adjusts quarterly at a rate equal to three-month LIBOR plus 225 basis points.

(6) This debt carries an adjustable rate of 2.1115% through February 24, 2013 and adjusts quarterly at a rate equal to three-month LIBOR plus 180 basis points.

Long-term FHLB advances increased \$108.4 million, or 41.6%, during 2012 to \$369.1 million when compared to \$260.7 million in 2011. The increase was the result of an increase in long-term FHLB advances purchased during 2012 which more than offset the advances classified as long-term at December 31, 2011 rolling into the short-term FHLB advance category. During 2012, we have been actively calling our brokered CDs and replacing them with long-term FHLB advances which has allowed us to extend the maturities and lower the funding costs.

In addition, as \$150 million of the \$200 million par in long-term advance commitments from the FHLB expired, long-term advances at rates below the advance commitment rates that expired were taken out. During 2011 and 2010, we entered into the option to fund between one and a half years and two years forward from the advance commitment date, \$200 million par in long-term advance commitments from the FHLB at the FHLB rates on the date the option was purchased. During the year ended December 31, 2012, \$150 million par of long-term advance commitments expired unexercised. In order to obtain these commitments from the FHLB, we paid fees of \$10.95 million. During the third quarter of 2011, the value of the FHLB advance option fees became impaired. They were further impaired during the fourth quarter of 2011 resulting in a total charge of \$8.9 million in 2011. During 2012, the FHLB advance option fees were further impaired and completely written down for a total charge of \$2.0 million for the year ended December 31, 2012. At December 31, 2012, there was no remaining carrying value recorded in our balance sheet.

Long-term debt was \$60.3 million at December 31, 2012 and 2011. Long-term debt consists of \$20.6 million of our junior subordinated debentures issued in 2003 and \$36.1 million issued in August 2007 in connection with the issuance of trust preferred securities by Southside Statutory Trusts III, IV and V and the assumption in October 2007 of \$3.6 million of junior subordinated debentures issued by FWBS to Magnolia Trust Company I.



## CAPITAL RESOURCES

Our total shareholders' equity at December 31, 2012 of \$257.8 million decreased 0.4%, or \$1.2 million, from December 31, 2011 and represented 8.0% of total assets at December 31, 2012 compared to 7.8% at December 31, 2011.

The decrease in shareholders' equity at December 31, 2012 was the result of a decrease of \$11.8 million in accumulated other comprehensive income, \$19.1 million in cash dividends paid and the repurchase of \$7.4 million of common stock which more than offset the \$34.7 million of net income for 2012 and the issuance of \$1.9 million in common stock (94,134 shares) through our employee stock and dividend reinvestment plans. The decrease in accumulated other comprehensive income is composed of a decrease of \$6.3 million, net of tax, in the unrealized gain on securities, net of reclassification adjustment (see "Note 3 – Comprehensive Income (Loss)") and a decrease of \$5.5 million, net of tax, related to the change in the unfunded status of our defined benefit plans. Our dividend policy requires that any cash dividend payments may not exceed consolidated 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.

We are subject to various regulatory capital requirements administered by the federal banking agencies. 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. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, we must meet specific capital guidelines that involve quantitative measures of our assets, liabilities, and certain off-balance-sheet items as calculated under regulatory accounting practices. Our capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.

Quantitative measures established by regulation to ensure capital adequacy require us to maintain minimum amounts and ratios (set forth in the table below) of Total and Tier 1 Capital (as defined in the regulations) to risk-weighted assets (as defined), and of Tier 1 Capital (as defined) to average assets (as defined). Tier 1 Capital is defined as the sum of shareholders' equity and qualifying subordinated debt, excluding unrealized gains or losses on debt securities available for sale, unrealized gains on equity securities available for sale and unrealized gains or losses on cash flow hedges, net of deferred income taxes; plus certain mandatorily redeemable capital securities, less nonqualifying intangible assets net of applicable deferred income taxes, and certain nonfinancial equity investments. Total capital is defined as the sum of Tier 1 Capital, a qualifying portion of the allowance for loan losses, and qualifying subordinated debt. Management believes, as of December 31, 2012, that we meet all capital adequacy requirements to which we are subject.

In addition, for a depository institution to be considered “well capitalized” under the regulatory framework for prompt corrective action, its Tier 1 and Total Capital ratios must be at least 6.0% and 10.0% on a risk-adjusted basis, respectively and its leverage ratio must be at least 5.0%.

|  | Actual                 |       | For Capital Adequacy Purposes |       | To Be Well Capitalized Under Prompt Corrective Action Provisions |       |   |
|--|------------------------|-------|-------------------------------|-------|--|-------|---|
|  | Amount                 | Ratio | Amount                        | Ratio | Amount   | Ratio |   |
| As of December 31, 2012:                 |                        |       |                               |       |  |       |   |
| Total Capital (to Risk Weighted Assets)  | (dollars in thousands) |       |                               |       |  |       |   |
| Consolidated                             | \$ 308,133             | 22.42 | % \$ 109,962                  | 8.00  | % N/A  | N/A   |   |
| Bank Only                                | \$ 300,196             | 21.86 | % \$ 109,852                  | 8.00  | % \$ 137,315   | 10.00 | % |
| Tier 1 Capital (to Risk Weighted Assets) |                        |       |                               |       |  |       |   |
| Consolidated                             | \$ 290,873             | 21.16 | % \$ 54,981                   | 4.00  | % N/A  | N/A   |   |
| Bank Only                                | \$ 282,936             | 20.60 | % \$ 54,926                   | 4.00  | % \$ 82,389  | 6.00  | % |
| Tier 1 Capital (to Average Assets) (1)   |                        |       |                               |       |  |       |   |
| Consolidated                             | \$ 290,873             | 9.11  | % \$ 127,698                  | 4.00  | % N/A  | N/A   |   |
| Bank Only                                | \$ 282,936             | 8.87  | % \$ 127,531                  | 4.00  | % \$ 159,413   | 5.00  | % |
| As of December 31, 2011:                 |                        |       |                               |       |  |       |   |
| Total Capital (to Risk Weighted Assets)  |                        |       |                               |       |  |       |   |
| Consolidated                             | \$ 296,715             | 22.36 | % \$ 106,152                  | 8.00  | % N/A  | N/A   |   |
| Bank Only                                | \$ 285,539             | 21.52 | % \$ 106,159                  | 8.00  | % \$ 132,699   | 10.00 | % |
| Tier 1 Capital (to Risk Weighted Assets) |                        |       |                               |       |  |       |   |
| Consolidated                             | \$ 280,050             | 21.11 | % \$ 53,076                   | 4.00  | % N/A  | N/A   |   |
| Bank Only                                | \$ 268,874             | 20.26 | % \$ 53,080                   | 4.00  | % \$ 79,619  | 6.00  | % |
| Tier 1 Capital (to Average Assets) (1)   |                        |       |                               |       |  |       |   |
| Consolidated                             | \$ 280,050             | 8.63  | % \$ 129,795                  | 4.00  | % N/A  | N/A   |   |
| Bank Only                                | \$ 268,874             | 8.29  | % \$ 129,698                  | 4.00  | % \$ 162,122   | 5.00  | % |

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

The capital requirements applicable to the Company and Southside Bank are subject to change because, over the coming years, the regulatory capital framework is expected to change in important respects as a result of the Dodd-Frank Act and as a result of a separate, international regulatory capital initiative known as “Basel III.” Complying with the new Basel III capital requirements will likely affect our operations, and the extent to which we will be affected will be known with more certainty once additional clarity is provided on the underlying details of these new requirements. These new requirements have been endorsed by the U.S. banking regulators, but have not yet been translated by the regulators into official, final regulations for U.S. financial institutions. It is anticipated that the regulators will adopt new regulatory capital requirements similar to those proposed by the BCBS, and, as noted above, it was anticipated that the new requirements would be phased-in for U.S. financial institutions beginning in 2013. However, on November 9, 2012, U.S. regulators announced that the implementation of rules implementing Basel III would be delayed and regulators have not provided a specific timeframe for their implementation of these requirements. Furthermore, it is widely anticipated that the capital requirements for most bank and financial holding companies, as well as for most insured depository institutions, will increase, although the nature and amounts of the

increase have not yet been specified.

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The table below summarizes our key equity ratios for the years ended December 31, 2012, 2011 and 2010:

|  | Years Ended December 31, |         |         |  |   |
|--|--------------------------|---------|---------|--|---|
|  | 2012                     | 2011    | 2010    |  |   |
| Return on Average Assets                             | 1.05                     | % 1.25  | % 1.30  |  | % |
| Return on Average Shareholders' Equity               | 12.83                    | % 16.20 | % 17.98 |  | % |
| Dividend Payout Ratio – Basic                        | 55.50                    | % 39.82 | % 37.78 |  | % |
| Dividend Payout Ratio – Diluted                      | 55.50                    | % 39.82 | % 37.78 |  | % |
| Average Shareholders' Equity to Average Total Assets | 8.17                     | % 7.69  | % 7.24  |  | % |

## ACCOUNTING PRONOUNCEMENTS

See “Note 1 – Summary of Significant Accounting and Reporting Policies” to our consolidated financial statements included in this report.

## EFFECTS OF INFLATION

Our consolidated financial statements, and their related notes, have been prepared in accordance with GAAP that require the measurement of financial position and operating results in terms of historical dollars, without considering the change in the relative purchasing power of money over time and due to inflation. The impact of inflation is reflected in the increased cost of our operations. Unlike many industrial companies, nearly all of our assets and liabilities are monetary. As a result, interest rates have a greater impact on our performance than do the effects of general levels of inflation. Interest rates do not necessarily move in the same direction or to the same extent as the price of goods and services. Inflation can affect the amount of money customers have for deposits, as well as ability to repay loans.

## MANAGEMENT OF LIQUIDITY

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 December 31, 2012, these investments were 18.6% of total assets, as compared with 19.0% for December 31, 2011, and 16.8% for December 31, 2010. The decrease to 18.6% at December 31, 2012 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 three lines of credit for the purchase of overnight federal funds at prevailing rates. One \$25.0 million and two \$15.0 million unsecured lines of credit have been established with Frost Bank, Comerica Bank and TIB -The Independent Bankers Bank, respectively. There were no federal funds purchased at December 31, 2012. Southside Bank has a \$5.0 million line of credit with Frost Bank to be used to issue letters of credit. At December 31, 2012, the amount of additional funding Southside Bank could obtain from FHLB using unpledged securities at FHLB was approximately \$221.6 million, net of FHLB stock purchases required. Southside Bank obtained no 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 new 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 of 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.

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## OFF-BALANCE-SHEET ARRANGEMENTS

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 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 \$132.8 million and \$116.0 million at December 31, 2012 and 2011, respectively. Each commitment has a maturity date or an annual cancellation 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 December 31, 2012 and 2011 were \$13.0 million and \$12.7 million, respectively, and are reflected in the due after one year category. We had outstanding standby letters of credit of \$5.6 million and \$6.5 million at December 31, 2012 and 2011, respectively.

The scheduled maturities of unused commitments as of December 31, 2012 and 2011 were as follows (in thousands):

|                         | December 31, |           |
|-------------------------|--------------|-----------|
|                         | 2012         | 2011      |
| Unused commitments:     |              |           |
| Due in one year or less | \$84,756     | \$85,737  |
| Due after one year      | 48,061       | 30,291    |
| Total                   | \$132,817    | \$116,028 |

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 creditworthiness 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.



## COMMITMENTS AND CONTRACTUAL OBLIGATIONS

The following summarizes our contractual cash obligations and commercial commitments at December 31, 2012, and the effect such obligations are expected to have on liquidity and cash flow in future periods. Payments reflected in the table below do not include interest.

|  | Payments Due By Period                |           |           |                      | Total       |
|--|---------------------------------------|-----------|-----------|----------------------|-------------|
|  | Less than 1<br>Year<br>(in thousands) | 1-3 Years | 3-5 Years | More than 5<br>Years |             |
| Contractual obligations:                         |                                       |           |           |                      |             |
| Long-term debt, including current maturities (1) | \$—                                   | \$—       | \$—       | \$60,311             | \$60,311    |
| FHLB advances (2)                                | 152,175                               | 58,594    | 268,463   | 40,850               | 520,082     |
| Operating leases (3)                             | 1,357                                 | 1,769     | 851       | 629                  | 4,606       |
| Deferred compensation agreements (4)             | 484                                   | 1,051     | 887       | 5,035                | 7,457       |
| Time deposits (5)                                | 415,980                               | 183,329   | 44,037    | 1,271                | 644,617     |
| Securities purchased not paid for                | 10,047                                | —         | —         | —                    | 10,047      |
| Capital lease obligations                        | —                                     | —         | —         | —                    | —           |
| Purchase obligations                             | —                                     | —         | —         | —                    | —           |
| Total contractual obligations                    | \$580,043                             | \$244,743 | \$314,238 | \$108,096            | \$1,247,120 |

(1) The total balance of long-term debt was \$60.3 million at December 31, 2012. The scheduled maturities and interest rates were as follows:

Floating rate debt of \$20.6 million with a scheduled maturity of 2033, was indexed to three-month LIBOR plus 294 basis points and adjusts on a quarterly basis. The rate of interest associated with this debt is 3.251% through March 30, 2013.

Floating rate debt of \$23.2 million with a scheduled maturity of 2037, was indexed to three-month LIBOR plus 130 basis points and adjusts on a quarterly basis. The rate of interest associated with this debt is 1.61325% through January 29, 2013.

Floating rate debt of \$12.9 million with a scheduled maturity of 2037, was indexed to three-month LIBOR plus 225 basis points and adjusts on a quarterly basis. The rate of interest associated with this debt is 2.558% through March 14, 2013.

Floating rate debt of \$3.6 million with a scheduled maturity of 2035, was indexed to three-month LIBOR plus 180 basis points and adjusts on a quarterly basis. The rate of interest associated with this debt is 2.1115% through February 24, 2013.

(2) We had fixed rate FHLB advances with maturity dates ranging from 2013 through 2028, with interest rates ranging from 0.9% to 7.6% with a total balance of \$520.1 million at December 31, 2012.

(3) We had various operating leases for our office machines that total \$578,000 and expire on or before the end of 2017. In addition, we have operating leases totaling \$4.0 million on our retail branch locations and loan production offices which have future commitments of up to ten years and additional options, which we control, beyond the commitment period.

(4) We have deferred compensation agreements (the "agreements") with 18 officers totaling \$7.5 million. Payments from the agreements are to commence at the time of retirement. As of December 31, 2012, \$1.0 million in payments had been made from such agreements. Of the 18 officers included in the agreements, two were eligible for retirement

at December 31, 2012 and two retired officers are currently receiving benefits. One officer becomes eligible in each of the years 2014 through 2017. The remaining 10 officers are eligible at various dates after five years. The totals reflected under five years assume the retirement of the two eligible officers at December 31, 2012 and the retirement of the eligible officers in years 2014 through 2017. Additional information regarding executive compensation is incorporated into “Item 11. Executive Compensation” of this Annual Report on Form 10-K.

(5) We had \$19.5 million of brokered CDs at December 31, 2012 with maturity dates ranging from 2015 through 2017 and coupons ranging from 0.75% to 1.5%.

During 2011 and 2010, we entered into the option to purchase between one and a half years and two years forward from the advance commitment date, \$200 million par in long-term advance commitments from the FHLB at the FHLB rates on the date the option was purchased. During the year ended December 31, 2012, \$150 million par of long-term advance commitments expired unexercised. In order to obtain these commitments from the FHLB, we paid fees, which at December 31, 2012, were completely written down.

We expect to contribute between \$2.0 million and \$3.0 million to our defined benefit plan during 2013. We also expect to contribute to our defined benefit plan in future years, however, those amounts are indeterminable at this time.

## ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

In the banking industry, a major risk exposure is changing interest rates. The primary objective of monitoring our interest rate sensitivity, or risk, is to provide management the tools necessary to manage the balance sheet to minimize adverse changes in net interest income as a result of changes in the direction and level of interest rates. Federal Reserve Board monetary control efforts, the effects of deregulation, the current economic downturn and legislative changes have been significant factors affecting the task of managing interest rate sensitivity positions in recent years.

In an attempt to manage our exposure to changes in interest rates, management closely monitors our exposure to interest rate risk through our ALCO. Our ALCO meets regularly and reviews our interest rate risk position and makes recommendations to our board for adjusting this position. In addition, our board reviews our asset/liability position on a monthly basis. We primarily use two methods for measuring and analyzing interest rate risk: net income simulation analysis and MVPE modeling. We utilize the net income simulation model as the primary quantitative tool in measuring the amount of interest rate risk associated with changing market rates. The model quantifies the effects of various interest rate scenarios on projected net interest income and net income over the next 12 months. The model was used to measure the impact on net interest income relative to a base case scenario of rates increasing 100 and 200 basis points or decreasing 100 and 200 basis points over the next 12 months. These simulations incorporate assumptions regarding balance sheet growth and mix, pricing and the repricing and maturity characteristics of the existing and projected balance sheet. The impact of interest rate-related risks such as prepayment, basis and option risk are also considered. Due to the low level of interest rates many of the current interest rates cannot decline 100 or 200 basis points. The model has floors for each of those interest rates and none are assumed to go negative. As of December 31, 2012, the model simulations projected that 100 and 200 basis point immediate increases in interest rates would result in positive variances on net interest income of 0.79% and 0.08%, respectively, relative to the base case over the next 12 months, while an immediate decrease in interest rates of 100 and 200 basis points would result in a negative variance in net interest income of 2.77% and 3.92%, respectively, relative to the base case over the next 12 months. As of December 31, 2011, the model simulations projected that 100 and 200 basis point increases in interest rates would result in negative variances on net interest income of 1.60% and 3.59%, respectively, relative to the base case over 12 months, while decreases in interest rates of 100 and 200 basis points would result in negative variances in net interest income of 2.16% and 1.95%, respectively, relative to the base case over the next 12 months. As part of the overall assumptions, certain assets and liabilities have been given reasonable floors. This type of simulation analysis requires numerous assumptions including but not limited to changes in balance sheet mix, prepayment rates on mortgage-related assets and fixed rate loans, cash flows and repricings of all financial instruments, changes in volumes and pricing, future shapes of the yield curve, relationship of market interest rates to each other (basis risk), credit spread and deposit sensitivity. Assumptions are based on management's best estimates but may not accurately reflect actual results under certain changes in interest rates.

The ALCO monitors various liquidity ratios to ensure a satisfactory liquidity position for us. Management continually evaluates the condition of the economy, the pattern of market interest rates and other economic data to determine the types of investments that should be made and at what maturities. Using this analysis, management from time to time assumes calculated interest sensitivity gap positions to maximize net interest income based upon anticipated movements in the general level of interest rates. Regulatory authorities also monitor our gap position along with other liquidity ratios. In addition, as described above, we utilize a simulation model to determine the impact of net interest income under 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 mitigate the change in net interest income under these various interest rate scenarios.



## ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

The information required by this item is set forth in Part IV.

## ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

None.

## ITEM 9A. CONTROLS AND PROCEDURES

### Evaluation of Disclosure Controls and Procedures

Management, including our Chief Executive Officer ("CEO") and our Chief Financial Officer ("CFO"), undertook an evaluation of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) of the Exchange Act of 1934, as amended) as of December 31, 2012 and, based on that evaluation, our CEO and CFO concluded that our disclosure controls and procedures were effective as of that date.

### Changes in Internal Control Over Financial Reporting

No changes were made to our internal control over financial reporting (as defined in Rule 13a - 15(f) under the Exchange Act of 1934, as amended) during the last fiscal quarter of the period covered by this report that materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

### Management's Report on Internal Control Over Financial Reporting

Management is responsible for establishing and maintaining adequate internal control over financial reporting. Internal control over financial reporting is defined in Rules 13a-15(f) and 15d-15(f) under the Securities Exchange Act of 1934, as amended, is a process designed by, or under the supervision of, our CEO and CFO and effected by our board of directors, management and other personnel to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles and includes those policies and procedures that:

pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of our assets;

provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that our receipts and expenditures are being made only in accordance with authorizations of our management and directors; and

provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of our assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risks that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate. Management assessed the effectiveness of our internal control over financial reporting as of December 31, 2012. In making this assessment, management used the criteria set forth by the Committee of

Sponsoring Organizations of the Treadway Commission (“COSO”) in Internal Control-Integrated Framework.

Based on this assessment, management concluded that we maintained effective internal control over financial reporting as of December 31, 2012.

The effectiveness of our internal control over financial reporting as of December 31, 2012 has been audited by Ernst & Young LLP, an independent registered public accounting firm, as stated in their report which appears in this Item under the heading “Attestation Report of Independent Registered Public Accounting Firm.”

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Attestation Report of Independent Registered Public Accounting Firm

Report of Independent Registered Public Accounting Firm

Board of Directors and Shareholders of  
Southside Bancshares, Inc.

We have audited Southside Bancshares, Inc. and subsidiaries' internal control over financial reporting as of December 31, 2012, based on criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). Southside Bancshares, Inc. and subsidiaries' management is responsible for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting included in the accompanying Management's Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on the company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

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

In our opinion, Southside Bancshares, Inc. and subsidiaries maintained, in all material respects, effective internal control over financial reporting as of December 31, 2012, based on the COSO criteria.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the 2012 consolidated financial statements of Southside Bancshares, Inc. and subsidiaries and our report dated March 6, 2013 expressed an unqualified opinion thereon.

/s/ Ernst & Young LLP

Dallas, Texas  
March 6, 2013

ITEM 9B. OTHER INFORMATION

None.

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PART III

ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE

The information required by this Item is incorporated herein by reference to our Proxy Statement (Schedule 14A) for our 2013 Annual Meeting of shareholders to be filed with the SEC within 120 days of our fiscal year-end.

ITEM 11. EXECUTIVE COMPENSATION

The information required by this Item is incorporated herein by reference to our Proxy Statement (Schedule 14A) for our 2013 Annual Meeting of shareholders to be filed with the SEC within 120 days of our fiscal year-end.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

The information required by this Item is incorporated herein by reference to our Proxy Statement (Schedule 14A) for our 2013 Annual Meeting of shareholders to be filed with the SEC within 120 days of our fiscal year-end.

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE

The information required by this Item is incorporated herein by reference to our Proxy Statement (Schedule 14A) for our 2013 Annual Meeting of shareholders to be filed with the SEC within 120 days of our fiscal year-end.

ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES

The information required by this Item is incorporated herein by reference to our Proxy Statement (Schedule 14A) for our 2013 Annual Meeting of shareholders to be filed with the SEC within 120 days of our fiscal year-end.

PART IV

ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES

1. Financial Statements

The following consolidated financial statements of Southside Bancshares, Inc. and its subsidiaries are filed as part of this report.

☉ Consolidated Balance Sheets as of December 31, 2012 and 2011.

☉ Consolidated Statements of Income for the years ended December 31, 2012, 2011 and 2010.

☉ Consolidated Statements of Comprehensive Income for the years ended December 31, 2012, 2011 and 2010.

☉ Consolidated Statements of Changes in Equity for the years ended December 31, 2012, 2011 and 2010.

☉ Consolidated Statements of Cash Flow for the years ended December 31, 2012, 2011 and 2010.

♠ Notes to Consolidated Financial Statements.

2. Financial Statement Schedules

All schedules are omitted because they are not applicable or not required, or because the required information is included in the consolidated financial statements or notes thereto.

3. Exhibits

The exhibits listed in the Exhibit Index (following the signature pages of this report) are filed with, or incorporated by reference in, this report.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

SOUTHSIDE BANCSHARES, INC.

BY: /s/ SAM DAWSON  
Sam Dawson, Chief Executive Officer  
(Principal Executive Officer)

DATE: March 6, 2013

BY: /s/ LEE R. GIBSON  
Lee R. Gibson, CPA, Senior Executive Vice President  
and Chief Financial Officer  
(Principal Financial Officer)

DATE: March 6, 2013

BY: /s/ JULIE N. SHAMBURGER  
Julie N. Shamburger, CPA, Executive Vice President  
and Chief Accounting Officer  
(Principal Accounting Officer)

DATE: March 6, 2013

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

| Signature                                      | Title                                      | Date          |
|--|--|---------------|
| /s/ B. G. HARTLEY<br>(B. G. Hartley)           | Chairman of the Board<br>and Director      | March 6, 2013 |
| /s/ SAM DAWSON<br>(Sam Dawson)                 | Chief Executive Officer<br>and Director    | March 6, 2013 |
| (Robbie N. Edmonson)                           | Vice Chairman of the Board<br>and Director | March 6, 2013 |
| /s/ LAWRENCE ANDERSON<br>(Lawrence Anderson)   | Director                                   | March 6, 2013 |
| /s/ HERBERT C. BUIE<br>(Herbert C. Buie)       | Director                                   | March 6, 2013 |
| /s/ ALTON CADE<br>(Alton Cade)                 | Director                                   | March 6, 2013 |
| /s/ PIERRE DE WET<br>(Pierre de Wet)           | Director                                   | March 6, 2013 |
| /s/ BOB GARRETT<br>(Bob Garrett)               | Director                                   | March 6, 2013 |
| /s/ MELVIN B. LOVELADY<br>(Melvin B. Lovelady) | Director                                   | March 6, 2013 |
| /s/ JOE NORTON<br>(Joe Norton)                 | Director                                   | March 6, 2013 |
| /s/ PAUL W. POWELL<br>(Paul W. Powell)         | Director                                   | March 6, 2013 |
| /s/ WILLIAM SHEEHY<br>(William Sheehy)         | Director                                   | March 6, 2013 |
| /s/ PRESTON SMITH<br>(Preston Smith)           | Director                                   | March 6, 2013 |
| /s/ DON THEDFORD<br>(Don Thedford)             | Director                                   | March 6, 2013 |



Report of Independent Registered Public Accounting Firm

Board of Directors and Shareholders of  
Southside Bancshares, Inc.

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

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

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

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), Southside Bancshares, Inc.'s internal control over financial reporting as of December 31, 2012, based on criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated March 6, 2013 expressed an unqualified opinion thereon.

/s/ Ernst & Young LLP

Dallas, Texas  
March 6, 2013

Report of Independent Registered Public Accounting Firm

To the Board of Directors and Shareholders of  
Southside Bancshares, Inc:

In our opinion, the consolidated balance sheet as of December 31, 2011 and the related consolidated statements of income, of comprehensive income, of changes in equity, and of cash flows for each of two years in the period ended December 31, 2011 present fairly, in all material respects, the financial position of Southside Bancshares, Inc. and its subsidiaries at December 31, 2011, and the results of their operations and their cash flows for each of the two years in the period ended December 31, 2011, in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

/s/ PricewaterhouseCoopers LLP

Dallas, Texas  
March 26, 2012

SOUTHSIDE BANCSHARES, INC. AND SUBSIDIARIES  
CONSOLIDATED BALANCE SHEETS  
(in thousands, except share amounts)

|   | December<br>31, 2012 | December<br>31, 2011 |
|---|----------------------|----------------------|
| <b>ASSETS</b>                                     |                      |                      |
| Cash and due from banks                           | \$47,312             | \$40,989             |
| Interest bearing deposits                         | 103,318              | 2,249                |
| Total cash and cash equivalents                   | 150,630              | 43,238               |
| Investment securities:                            |                      |                      |
| Available for sale, at estimated fair value       | 617,707              | 282,956              |
| Held to maturity, at amortized cost               | 1,009                | 1,496                |
| Mortgage-backed and related securities:           |                      |                      |
| Available for sale, at estimated fair value       | 806,360              | 716,126              |
| Securities carried at fair value through income   | —                    | 647,759              |
| Held to maturity, at amortized cost               | 245,538              | 365,631              |
| FHLB stock, at cost                               | 27,889               | 33,869               |
| Other investments, at cost                        | 2,064                | 2,064                |
| Loans held for sale                               | 3,601                | 3,552                |
| Loans:  |                      |                      |
| Loans   | 1,262,977            | 1,087,230            |
| Less: Allowance for loan losses                   | (20,585)             | (18,540)             |
| Net loans   | 1,242,392            | 1,068,690            |
| Premises and equipment, net                       | 50,075               | 50,595               |
| Goodwill  | 22,034               | 22,034               |
| Other intangible assets, net                      | 324                  | 522                  |
| Interest receivable                               | 18,936               | 19,426               |
| Deferred tax asset                                | 4,120                | —                    |
| Other assets                                      | 44,724               | 45,859               |
| <b>TOTAL ASSETS</b>                               | <b>\$3,237,403</b>   | <b>\$3,303,817</b>   |
| <b>LIABILITIES AND EQUITY</b>                     |                      |                      |
| Deposits:   |                      |                      |
| Noninterest bearing                               | \$595,093            | \$505,594            |
| Interest bearing                                  | 1,756,804            | 1,816,077            |
| Total deposits                                    | 2,351,897            | 2,321,671            |
| Short-term obligations:                           |                      |                      |
| Federal funds purchased and repurchase agreements | 984                  | 2,945                |
| FHLB advances                                     | 150,985              | 361,811              |
| Other obligations                                 | 219                  | 219                  |
| Total short-term obligations                      | 152,188              | 364,975              |
| Long-term obligations:                            |                      |                      |
| FHLB advances                                     | 369,097              | 260,724              |
| Long-term debt                                    | 60,311               | 60,311               |
| Total long-term obligations                       | 429,408              | 321,035              |
| Deferred tax liability                            | —                    | 3,458                |
| Unsettled trades to purchase securities           | 10,047               | 1,196                |



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|                          |                  |                  |
|--------------------------|------------------|------------------|
| Other liabilities        | 36,100           | 32,555           |
| <b>TOTAL LIABILITIES</b> | <b>2,979,640</b> | <b>3,044,890</b> |

Off-Balance-Sheet Arrangements, Commitments and Contingencies (Note 16)

Shareholders' equity:

|   |                    |                    |
|---|--------------------|--------------------|
| Common stock: (\$1.25 par, 40,000,000 shares authorized, 19,446,187 shares issued in 2012 and 18,517,101 shares issued in 2011) | 24,308             | 23,146             |
| Paid-in capital   | 195,602            | 176,791            |
| Retained earnings   | 70,708             | 72,646             |
| Treasury stock (2,379,338 and 2,023,838 shares at cost )  | (35,793            | ) (28,377 )        |
| Accumulated other comprehensive income  | 2,938              | 14,721             |
| <b>TOTAL SHAREHOLDERS' EQUITY</b>   | <b>257,763</b>     | <b>258,927</b>     |
| <b>TOTAL LIABILITIES AND EQUITY</b>   | <b>\$3,237,403</b> | <b>\$3,303,817</b> |

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

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

|   | Years Ended December 31, |          |          |   |
|---|--------------------------|----------|----------|---|
|   | 2012                     | 2011     | 2010     |   |
| Interest income   |                          |          |          |   |
| Loans   | \$69,462                 | \$66,736 | \$69,973 |   |
| Investment securities – taxable   | 519                      | 64       | 91       |   |
| Investment securities – tax-exempt                                      | 13,644                   | 12,520   | 10,889   |   |
| Mortgage-backed and related securities                                  | 32,118                   | 51,467   | 50,130   |   |
| FHLB stock and other investments  | 240                      | 233      | 259      |   |
| Other interest earning assets   | 37                       | 18       | 32       |   |
| Total interest income   | 116,020                  | 131,038  | 131,374  |   |
| Interest expense  |                          |          |          |   |
| Deposits  | 10,841                   | 15,647   | 18,969   |   |
| Short-term obligations  | 6,340                    | 6,577    | 7,563    |   |
| Long-term obligations   | 9,714                    | 13,407   | 18,775   |   |
| Total interest expense  | 26,895                   | 35,631   | 45,307   |   |
| Net interest income   | 89,125                   | 95,407   | 86,067   |   |
| Provision for loan losses   | 10,736                   | 7,496    | 13,737   |   |
| Net interest income after provision for loan losses                     | 78,389                   | 87,911   | 72,330   |   |
| Noninterest income  |                          |          |          |   |
| Deposit services  | 15,433                   | 15,943   | 16,819   |   |
| Gain on sale of securities available for sale                           | 17,966                   | 11,795   | 25,789   |   |
| (Loss) gain on sale of securities carried at fair value through income  | (498                     | ) 937    | —        |   |
| Total other-than-temporary impairment losses                            | (21                      | ) —      | (39      | ) |
| Portion of loss recognized in other comprehensive income (before taxes) | (160                     | ) —      | (36      | ) |
| Net impairment losses recognized in earnings                            | (181                     | ) —      | (75      | ) |
| Fair value gain (loss) – securities                                     | —                        | 6,693    | (598     | ) |
| FHLB advance option impairment charges                                  | (2,031                   | ) (8,923 | ) —      |   |
| Gain on sale of loans   | 1,119                    | 1,230    | 1,751    |   |
| Trust income  | 2,794                    | 2,610    | 2,368    |   |
| Bank owned life insurance income  | 1,110                    | 1,087    | 1,155    |   |
| Other   | 4,309                    | 3,950    | 3,589    |   |
| Total noninterest income  | 40,021                   | 35,322   | 50,798   |   |
| Noninterest expense   |                          |          |          |   |
| Salaries and employee benefits  | 48,084                   | 45,421   | 43,957   |   |
| Occupancy expense   | 7,498                    | 7,205    | 6,780    |   |
| Equipment expense   | 2,169                    | 2,055    | 1,899    |   |
| Advertising, travel & entertainment                                     | 2,463                    | 2,414    | 2,319    |   |
| ATM and debit card expense  | 1,063                    | 987      | 825      |   |
| Director fees   | 1,213                    | 914      | 950      |   |
| Supplies  | 747                      | 746      | 902      |   |
| Professional fees   | 2,034                    | 2,160    | 2,015    |   |
| Postage   | 700                      | 725      | 800      |   |

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|  |          |          |          |
|--|----------|----------|----------|
| Telephone and communications                                 | 1,665    | 1,325    | 1,443    |
| FDIC insurance   | 1,744    | 1,817    | 2,909    |
| Other  | 6,727    | 6,579    | 6,515    |
| Total noninterest expense                                    | 76,107   | 72,348   | 71,314   |
| Income before income tax expense                             | 42,303   | 50,885   | 51,814   |
| Provision (benefit) for income tax expense                   |          |          |          |
| Current  | 8,841    | 11,665   | 11,100   |
| Deferred   | (1,233)  | (1,271)  | 656      |
| Total income taxes   | 7,608    | 10,394   | 11,756   |
| Net income   | 34,695   | 40,491   | 40,058   |
| Less: Net income attributable to the noncontrolling interest | —        | (1,358)  | (955)    |
| Net income attributable to Southside Bancshares, Inc.        | \$34,695 | \$39,133 | \$39,103 |
| Earnings per common share – basic                            | \$2.00   | \$2.26   | \$2.25   |
| Earnings per common share – diluted                          | \$2.00   | \$2.26   | \$2.25   |
| Dividends paid per common share                              | \$1.11   | \$0.90   | \$0.85   |

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

SOUTHSIDE BANCSHARES, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME  
(in thousands)

|   | Years ended December 31, |           |           |   |
|---|--------------------------|-----------|-----------|---|
|   | 2012                     | 2011      | 2010      |   |
| Net income  | \$ 34,695                | \$ 40,491 | \$ 40,058 |   |
| Other comprehensive (loss) income:  |                          |           |           |   |
| Unrealized holding gains on available for sale securities during the period   | 7,880                    | 52,506    | 15,021    |   |
| Noncredit portion of other-than-temporary impairment losses on the AFS securities                                   | 160                      | —         | 36        |   |
| Reclassification adjustment for gain on sale of available for sale securities included in net income                | (17,966                  | ) (11,795 | ) (25,789 | ) |
| Reclassification of other-than-temporary impairment charges on available for sale securities included in net income | 181                      | —         | 75        |   |
| Amortization of net actuarial loss, included in net periodic benefit cost   | 2,022                    | 1,466     | 1,296     |   |
| Amortization of prior service credit included in net periodic benefit cost  | (43                      | ) (44     | ) (44     | ) |
| Change in the net actuarial gain/loss   | (10,362                  | ) (9,804  | ) (6,783  | ) |
| Other comprehensive (loss) income   | (18,128                  | ) 32,329  | (16,188   | ) |
| Income tax benefit (expense) related to other items of comprehensive income   | 6,345                    | (11,315   | ) 5,666   |   |
| Other comprehensive (loss) income, net of tax   | (11,783                  | ) 21,014  | (10,522   | ) |
| Comprehensive income  | \$ 22,912                | \$ 61,505 | \$ 29,536 |   |

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

SOUTHSIDE BANCSHARES, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF CHANGES IN EQUITY  
(in thousands, except share amounts)

|  | Common<br>Stock | Paid In<br>Capital | Retained<br>Earnings | Treasury<br>Stock | Accu-<br>mulated-<br>Other<br>Compre-<br>hensive<br>Income<br>(Loss) | Noncon-<br>trolling<br>Interest | Total<br>Equity |
|--|-----------------|--------------------|----------------------|-------------------|--|---------------------------------|-----------------|
| Balance at December 31, 2009                                       | \$20,928        | \$146,357          | \$53,812             | \$(23,545)        | \$4,229  | \$468                           | \$202,249       |
| Net Income   |                 |                    | 39,103               |                   |  | 955                             | 40,058          |
| Other comprehensive loss   |                 |                    |                      |                   | (10,522)   |                                 | (10,522)        |
| Issuance of common stock<br>(163,313 shares)                       | 204             | 1,619              |                      |                   |  |                                 | 1,823           |
| Purchase of common stock<br>(261,577 shares)                       |                 |                    |                      | (4,832)           |  |                                 | (4,832)         |
| Tax benefit of incentive stock<br>options                          |                 | 331                |                      |                   |  |                                 | 331             |
| Capital distribution to<br>noncontrolling interest<br>shareholders |                 |                    |                      |                   |  | (310)                           | (310)           |
| Cash dividends paid on common<br>stock (\$0.85 per share)          |                 |                    | (13,223)             |                   |  |                                 | (13,223)        |
| Stock dividend declared  | 943             | 14,570             | (15,513)             |                   |  |                                 | —               |
| Balance at December 31, 2010                                       | 22,075          | 162,877            | 64,179               | (28,377)          | (6,293)  | 1,113                           | 215,574         |
| Net Income   |                 |                    | 39,133               |                   |  | 1,358                           | 40,491          |
| Other comprehensive income   |                 |                    |                      |                   | 21,014   |                                 | 21,014          |
| Issuance of common stock<br>(71,925 shares)                        | 90              | 1,391              |                      |                   |  |                                 | 1,481           |
| Stock compensation expense   |                 | 261                |                      |                   |  |                                 | 261             |
| Tax benefit of incentive stock<br>options                          |                 | 2                  |                      |                   |  |                                 | 2               |
| Capital distribution to<br>noncontrolling interest<br>shareholders |                 |                    |                      |                   |  | (475)                           | (475)           |
| Purchase of noncontrolling<br>interest                             |                 | (2,754)            |                      |                   |  | (1,996)                         | (4,750)         |
| Cash dividends paid on common<br>stock (\$0.90 per share)          |                 |                    | (14,671)             |                   |  |                                 | (14,671)        |
| Stock dividend declared  | 981             | 15,014             | (15,995)             |                   |  |                                 | —               |
| Balance at December 31, 2011                                       | 23,146          | 176,791            | 72,646               | (28,377)          | 14,721   | —                               | 258,927         |
| Net Income   |                 |                    | 34,695               |                   |  |                                 | 34,695          |
| Other comprehensive loss   |                 |                    |                      |                   | (11,783)   |                                 | (11,783)        |
| Issuance of common stock<br>(94,134 shares)                        | 118             | 1,756              |                      |                   |  |                                 | 1,874           |
| Purchase of common stock<br>(355,500 shares)                       |                 |                    |                      | (7,416)           |  |                                 | (7,416)         |

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|  |          |           |           |             |         |     |           |
|--|----------|-----------|-----------|-------------|---------|-----|-----------|
| Stock compensation expense                             |          | 511       |           |             |         |     | 511       |
| Tax benefits related to stock awards                   |          | 44        |           |             |         |     | 44        |
| Net issuance of common stock under employee stock plan | 10       | 75        | (90 )     |             |         |     | (5 )      |
| Cash dividends paid on common stock (\$1.11 per share) |          |           | (19,084 ) |             |         |     | (19,084 ) |
| Stock dividend declared                                | 1,034    | 16,425    | (17,459 ) |             |         |     | —         |
| Balance at December 31, 2012                           | \$24,308 | \$195,602 | \$70,708  | \$(35,793 ) | \$2,938 | \$— | \$257,763 |

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 FLOW  
(in thousands)

|   | Years Ended December 31, |           |             |
|---|--------------------------|-----------|-------------|
|   | 2012                     | 2011      | 2010        |
| <b>OPERATING ACTIVITIES:</b>  |                          |           |             |
| Net income  | \$34,695                 | \$40,491  | \$40,058    |
| Adjustments to reconcile net income to net cash provided by operations: |                          |           |             |
| Depreciation  | 3,606                    | 3,365     | 3,204       |
| Amortization of premium   | 45,926                   | 37,117    | 35,245      |
| Accretion of discount and loan fees                                     | (4,746)                  | (4,336)   | (4,502)     |
| Provision for loan losses   | 10,736                   | 7,496     | 13,737      |
| Stock compensation expense  | 511                      | 261       | —           |
| Deferred tax (benefit) expense  | (1,233)                  | (1,254)   | 673         |
| Excess tax benefits from stock-based awards                             | (11)                     | —         | —           |
| Loss (gain) on sale of securities carried at fair value through income  | 498                      | (937)     | —           |
| Gain on sale of securities available for sale                           | (17,966)                 | (11,795)  | (25,789)    |
| Net other-than-temporary impairment losses                              | 181                      | —         | 75          |
| Fair value (gain) loss – securities                                     | —                        | (6,693)   | 598         |
| FHLB advance option impairment charges                                  | 2,031                    | 8,923     | —           |
| Gain on sale of assets  | (1)                      | (4)       | (7)         |
| Loss on retirement of assets  | —                        | 90        | —           |
| Impairment on other real estate owned                                   | 28                       | 264       | 20          |
| (Gain) loss on sale of other real estate owned                          | (19)                     | (298)     | 153         |
| Net change in:  |                          |           |             |
| Interest receivable   | 490                      | (1,393)   | 449         |
| Other assets  | (271)                    | (2,254)   | (8,289)     |
| Interest payable  | (886)                    | (888)     | (879)       |
| Other liabilities   | (3,952)                  | 2,396     | 1,566       |
| Loans held for sale   | (49)                     | 3,031     | (3,726)     |
| Net cash provided by operating activities                               | 69,568                   | 73,582    | 52,586      |
| <b>INVESTING ACTIVITIES:</b>  |                          |           |             |
| Securities held to maturity:  |                          |           |             |
| Purchases   | —                        | (11,875)  | (258,935)   |
| Maturities, calls and principal repayments                              | 113,086                  | 46,396    | 74,915      |
| Securities available for sale:  |                          |           |             |
| Purchases   | (1,807,157)              | (629,911) | (1,399,085) |
| Sales   | 1,004,315                | 582,362   | 1,325,221   |
| Maturities, calls and principal repayments                              | 362,887                  | 268,514   | 357,164     |
| Securities carried at fair value through income:                        |                          |           |             |
| Purchases   | (57,606)                 | (868,937) | (32,689)    |
| Sales   | 675,255                  | 234,403   | —           |
| Maturities, calls and principal repayments                              | 25,279                   | 56,406    | 3,462       |
| Proceeds from redemption of FHLB stock                                  | 18,572                   | 18,236    | 6,818       |
| Purchases of FHLB stock and other investments                           | (12,592)                 | (17,393)  | (2,900)     |
| Net increase in loans   | (186,814)                | (21,898)  | (58,985)    |
| Purchases of premises and equipment                                     | (3,109)                  | (3,915)   | (6,902)     |
| Proceeds from sales of premises and equipment                           | 24                       | 13        | 38          |

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|   |         |            |        |
|---|---------|------------|--------|
| Proceeds from sales of other real estate owned      | 567     | 1,431      | 1,648  |
| Proceeds from sales of repossessed assets           | 4,453   | 4,820      | 4,949  |
| Net cash provided by (used in) investing activities | 137,160 | (341,348 ) | 14,719 |

(continued)

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

|   | Years Ended December 31, |              |              |
|---|--------------------------|--------------|--------------|
|   | 2012                     | 2011         | 2010         |
| <b>FINANCING ACTIVITIES:</b>  |                          |              |              |
| Net increase in demand and savings accounts                                   | 267,513                  | 150,439      | 190,323      |
| Net (decrease) increase in certificates of deposit                            | (237,848 )               | 40,842       | 87,268       |
| Net decrease in federal funds purchased and repurchase agreements             | (1,961 )                 | (899 )       | (9,481 )     |
| Proceeds from FHLB advances   | 16,010,884               | 13,270,293   | 8,949,688    |
| Repayment of FHLB advances  | (16,113,337)             | (13,210,331) | (9,241,985 ) |
| Net capital distributions to noncontrolling interest in consolidated entities | —                        | (475 )       | (310 )       |
| Purchase of noncontrolling interest   | —                        | (4,750 )     | —            |
| Excess tax benefits from stock-based awards                                   | 11                       | —            | —            |
| Tax benefit of incentive stock options  | 33                       | 2            | 331          |
| Net issuance of common stock under employee stock plan                        | (5 )                     | —            | —            |
| Purchase of common stock  | (7,416 )                 | —            | (4,832 )     |
| Proceeds from the issuance of common stock                                    | 1,874                    | 1,481        | 1,823        |
| Cash dividends paid   | (19,084 )                | (14,671 )    | (13,223 )    |
| Net cash (used in) provided by financing activities                           | (99,336 )                | 231,931      | (40,398 )    |
| Net increase (decrease) in cash and cash equivalents                          | 107,392                  | (35,835 )    | 26,907       |
| Cash and cash equivalents at beginning of year                                | 43,238                   | 79,073       | 52,166       |
| Cash and cash equivalents at end of year                                      | \$ 150,630               | \$ 43,238    | \$ 79,073    |

**SUPPLEMENTAL DISCLOSURES FOR CASH FLOW  
INFORMATION:**

|                   |          |          |          |
|-------------------|----------|----------|----------|
| Interest paid     | \$27,781 | \$36,519 | \$46,186 |
| Income taxes paid | \$11,200 | \$9,000  | \$10,650 |

**SUPPLEMENTAL DISCLOSURES OF NONCASH INVESTING AND  
FINANCING ACTIVITIES:**

|   |             |            |          |
|---|-------------|------------|----------|
| Loans transferred to other repossessed assets and real estate through foreclosure | \$5,659     | \$6,232    | \$6,990  |
| Adjustment to pension liability   | \$8,383     | \$8,382    | \$5,531  |
| 5% stock dividend   | \$17,459    | \$15,995   | \$15,513 |
| Unsettled trades to purchase securities   | \$(10,047 ) | \$(1,196 ) | \$(145 ) |
| Unsettled issuances of brokered CDs   | \$—         | \$—        | \$4,960  |

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



NOTES TO CONSOLIDATED FINANCIAL  
STATEMENTS

Southside Bancshares, Inc. and Subsidiaries

## 1. SUMMARY OF SIGNIFICANT ACCOUNTING AND REPORTING POLICIES

The significant accounting and reporting policies of Southside Bancshares, Inc. (the "Company"), and its wholly-owned subsidiaries, Southside Delaware Financial Corporation, Southside Bank ("Southside Bank"), and our nonbank subsidiaries, are summarized below.

**Organization and Basis of Presentation.** The consolidated financial statements include the accounts of Southside Bancshares, Inc., Southside Bank, SFG Finance, LLC (formerly Southside Financial Group) and the nonbank subsidiaries. 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. In addition, during the second quarter of 2011 Southside Securities, Inc., which is a wholly-owned subsidiary of Southside Bancshares, Inc., began doing business as a broker-dealer. Effective February 14, 2012, Southside Bank became a direct wholly-owned subsidiary of Southside Bancshares, Inc. as a result of the merger of Southside Delaware Financial Corporation with and into Southside Bancshares, Inc.

Subsequent to December 31, 2012, we made a decision to close Southside Securities, Inc. It is our expectation that we will complete the closing in the first half of 2013.

We offer a full range of financial services to commercial, industrial, financial and individual customers. 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.

We determine if we have a controlling financial interest in an entity by first evaluating whether the entity is a voting interest entity or a variable interest entity ("VIE") under accounting principles generally accepted in the United States. Voting interest entities are entities in which the total equity investment at risk is sufficient to enable the entity to finance itself independently and provides the equity holders with the obligation to absorb losses, the right to receive residual returns and the right to make decisions about the entity's activities. We consolidate voting interest entities in which we have all, or at least a majority of, the voting interest. As defined in applicable accounting standards, VIEs are entities that lack one or more of the characteristics of a voting interest entity. A controlling financial interest in a VIE is present when an enterprise has both the power to direct the activities of the VIE that most significantly impact the VIEs economic performance and an obligation to absorb losses or the right to receive benefits that could potentially be significant to the VIE. The enterprise with a controlling financial interest, known as the primary beneficiary, consolidates the VIE.

**Cash Equivalents.** Cash equivalents, for purposes of reporting cash flow, include cash, amounts due from banks and federal funds sold that have an initial maturity of less than 90 days. We maintain deposits with other institutions in amounts that exceed federal deposit insurance coverage. Management regularly evaluates the credit risk associated with the counterparties to these transactions and believes that we are not exposed to any significant credit risks on cash and cash equivalents.

We are no longer required to maintain cash reserve balances with the Federal Reserve Bank. The required reserve balance with the Federal Reserve Bank was \$250,000 as of December 31, 2011.

**Basic and Diluted Earnings per Common Share.** Basic earnings per common share is based on net income divided by the weighted-average number of common shares outstanding during the period. Diluted earnings per common share include the dilutive effect of stock options granted using the treasury stock method. A reconciliation of the weighted-average shares used in calculating basic earnings per common share and the weighted average common shares used in calculating diluted earnings per common share for the reported periods is provided in “Note 2 – Earnings Per Share.”

**Comprehensive Income.** Comprehensive income includes all changes in shareholders’ equity during a period, except those resulting from transactions with shareholders. Besides net income, other components of comprehensive income include the after tax effect of changes in the fair value of securities available for sale, changes in the funded status of defined benefit retirement plans and the noncredit portion of other-than-temporary impairment. Comprehensive income is reported in the accompanying consolidated statements of changes in shareholders’ equity and in “Note 3 – Comprehensive Income (Loss).”

**Loans.** All loans are stated at principal outstanding net of unearned discount and other deferred expenses or fees. Interest income on loans is recognized using the level yield method. Loans receivable that management has the intent and ability to hold for the foreseeable future or until maturity or pay-off are reported at their outstanding principal adjusted for any charge-offs, the allowance for loan losses, and any unamortized deferred fees or costs on originated loans and unamortized premiums or discounts on purchased loans. A loan is considered impaired, based on current information and events, if 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. Substantially all of our impaired loans are collateral-dependent, and as such, are measured for impairment based on the fair value of the collateral.

**Loans Held For Sale.** Loans originated and intended for sale in the secondary market are carried at the lower of aggregate cost or fair value, as determined by aggregate outstanding commitments from investors or current investor yield requirements. Net unrealized losses are recognized through a valuation allowance by charges to income. Gains or losses on sales of mortgage loans are recognized based on the difference between the selling price and the carrying value of the related mortgage loans sold.

**Loan Fees.** We treat loan fees, net of direct costs, as an adjustment to the yield of the related loan over its term.

**Allowance for Loan Losses.** An allowance for loan losses is provided through charges to income in the form of a provision for loan losses. Loans which management believes are uncollectible are charged against this account with subsequent recoveries, if any, credited to the account. The amount of the allowance for loan losses is determined by management's evaluation of the quality and inherent risks in the loan portfolio, economic conditions and other factors which warrant current recognition.

**Nonaccrual Loans.** A loan is placed on nonaccrual when principal or interest is contractually past due 90 days or more unless, in the determination of management, the principal and interest on the loan are well collateralized and in the process of collection. In addition, a loan is placed on nonaccrual when, in the opinion of management, the future collectability of interest and principal is in serious doubt. When classified as nonaccrual, accrued interest receivable on the loan is reversed and the future accrual of interest is suspended. 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.

**Other Real Estate Owned.** Other Real Estate Owned ("OREO") includes real estate acquired in full or partial settlement of loan obligations. OREO is initially carried at the fair value of the collateral net of estimated selling costs. Prior to foreclosure, the recorded amount of the loan is written down, if necessary, to the appraised fair value of the real estate to be acquired, less selling costs, by charging the allowance for loan losses. Any subsequent reduction in fair value net of estimated selling costs is charged to noninterest expense. Costs of maintaining and operating foreclosed properties are expensed as incurred and included in other expense in our income statement. Expenditures to complete or improve foreclosed properties are capitalized only if expected to be recovered; otherwise, they are expensed.

**Securities.** We use the specific identification method to determine the basis for computing realized gain or loss. We account for debt and equity securities as follows:

**Held to Maturity ("HTM").** Debt securities that management has the positive intent and ability to hold until maturity are classified as HTM and are carried at their remaining unpaid principal balance, net of unamortized premiums or unaccreted discounts. Premiums are amortized and discounts are accreted using the level interest yield method over the estimated remaining term of the underlying security.

**Available for Sale ("AFS").** Debt and equity securities that will be held for indefinite periods of time, including securities that may be sold in response to changes in market interest or prepayment rates, needs for liquidity and changes in the availability of and the yield of alternative investments are classified as AFS. These assets are carried at

fair value. Fair value is determined using published quotes as of the close of business. If quoted market prices are not available, fair values are based on quoted market prices for similar securities or estimates from independent pricing services.

Securities Carried at Fair Value through Income. Debt securities purchased at significant premiums that contain an embedded derivative where the embedded derivative is not readily identifiable and measurable and as such cannot be bifurcated, are classified as securities carried at fair value through income. Fair value is determined using quoted market prices. If quoted market prices are not available, fair values are based on quoted market prices for similar securities or estimates from independent pricing services. Changes in fair value are reported through the income statement as fair value gain (loss) – securities.

Unrealized gains and losses on AFS securities are excluded from earnings and reported net of tax in Accumulated Other Comprehensive Income until realized. Declines in the fair value of securities below their cost are reflected in earnings as realized losses to the extent the impairment is deemed to be other-than-temporary credit losses. The amount of the impairment related to other factors is recognized in other comprehensive income unless there is no ability or intent to hold to recovery.

Purchase premiums and discounts are recognized in interest income using the effective interest rate method over the terms of the securities. Declines in the fair value of HTM and AFS securities below their cost that are deemed to be other-than-temporary are reflected in earnings as realized losses. In estimating other-than-temporary impairment losses, management considers (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, and (3) our intent and ability to retain our investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value. Gains and losses on the sale of securities are recorded on the trade date and are determined using the specific identification method.

Securities with limited marketability, such as stock in the Federal Home Loan Bank (“FHLB”), are carried at cost and assessed for other-than-temporary impairment.

**Premises and Equipment.** Bank premises and equipment are stated at cost, net of accumulated depreciation. Depreciation is computed on a straight line basis over the estimated useful lives of the related assets. Useful lives are estimated to be 15 to 40 years for premises and 3 to 10 years for equipment. Leasehold improvements are generally depreciated over the lesser of the term of the respective leases or the estimated useful lives of the improvements. Maintenance and repairs are charged to income as incurred while major improvements and replacements are capitalized.

**Goodwill and Other Intangibles.** Intangible assets consist primarily of core deposits and customer relationships. Intangible assets with definite useful lives are amortized on an accelerated basis over their estimated life. Goodwill and intangible assets that have indefinite useful lives are subject to at least an annual impairment test and more frequently if a triggering event occurs. If any such impairment is determined, a write-down is recorded.

We measured our goodwill for impairment at December 31, 2012. At December 31, 2012, the fair value of the reporting unit was greater than the carrying value of the reporting unit. As a result, we did not record any goodwill impairment for the year ended December 31, 2012 and we had no cumulative goodwill impairment.

For the years ended December 31, 2012, 2011 and 2010, amortization expense related to our core deposit intangible was \$198,000, \$255,000 and \$319,000, respectively.

**Repurchase Agreements.** We sell certain securities under agreements to repurchase. The agreements are treated as collateralized financing transactions and the obligations to repurchase securities sold are reflected as a liability in the accompanying consolidated balance sheets. The dollar amount of the securities underlying the agreements remains in the asset account. We determine the type of securities to pledge. Generally we pledge U.S. agency mortgage-backed securities.

**Advertising Costs.** Advertising costs are expensed as incurred.

**Income Taxes.** We file a consolidated federal income tax return. Income tax expense represents the taxes expected to be paid or returned for current year taxes adjusted for the change in deferred tax assets and liabilities. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of changes in tax rates is recognized in income in the period the change occurs.

**Use of Estimates.** In preparing consolidated financial statements in conformity with GAAP, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities as of the date of the

balance sheet and reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change in the near term relate to the determination of the allowance for loan losses, assumptions used in the defined benefit plan and the fair values of financial instruments. The status of contingencies are particularly subject to change and significant assumptions used in periodic evaluation of securities for other-than-temporary impairment.

**FHLB Advance Option Fees.** Option fees paid to the FHLB giving us the option to enter into long-term advance commitments at specified interest rates in the future are capitalized and reviewed for impairment. Once the option is exercised, the FHLB advance option fee is amortized over the term of the advance as interest expense.

**Fair Value of Financial Instruments.** Fair values of financial instruments are estimated using relevant market information and other assumptions. Fair value estimates involve uncertainties and matters of significant judgment. 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.



**Fair Value Option.** We elect the fair value option for mortgage-backed securities purchased at a significant premium.

**Share Based Awards.** Share-based compensation transactions are recognized as compensation cost in the income statement based on their fair values on the date of the grant.

**Loss Contingencies.** Loss contingencies, including claims and legal actions arising in the ordinary course of business are recorded as liabilities when the likelihood of loss is probable and an amount or range of loss can be reasonably estimated.

**Trust Assets.** Assets of our trust department, other than cash on deposit at Southside Bank, are not included in the accompanying financial statements because they are not our assets.

**Segment Information.** We have determined that our business is conducted in one reportable segment.

**Accounting Pronouncements:**

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. We adopted ASU 2011-03 on January 1, 2012 and it did not 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. We adopted ASU 2011-04 on January 1, 2012 and it did not have a significant impact on our consolidated financial statements. See "Note 12 - Fair Value Measurement."

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. Certain provisions related to the presentation of reclassification adjustments have been deferred by ASU 2011-12 "Comprehensive Income (Topic 220) – Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in Accounting Standards Update No. 2011-05." We adopted ASU 2011-05 on January 1, 2012 and it did not have a significant impact on our consolidated financial statements. See "Consolidated Statements of Comprehensive Income" directly following our Consolidated Statements of Income in our consolidated financial statements.

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. We adopted ASU 2011-08 on January 1, 2012, and it did not have a significant impact on our consolidated financial statements.

ASU 2011-11, "Balance Sheet (Topic 210) – Disclosures about Offsetting Assets and Liabilities." ASU 2011-11 amends Topic 210, "Balance Sheet," to require an entity to disclose both gross and net information about financial instruments, such as sales and repurchase agreements and reverse sale and repurchase agreements and securities borrowing/lending arrangements, and derivative instruments that are eligible for offset in the statement of financial position and/or subject to a master netting arrangement or similar agreement. We adopted ASU 2011-11 on January 1, 2013, and it is

not expected to have a significant impact on our consolidated financial statements.

ASU 2012-02, "Intangibles-Goodwill and Other (Topic 320) – Testing Indefinite-Lived Intangible Assets for Impairment No. 2012-02." ASU 2012-02 allows an entity to first assess qualitative factors to determine whether it is necessary to perform a quantitative impairment test. Under these amendments, an entity would not be required to calculate the fair value of an indefinite-lived intangible asset unless the entity determines, based on qualitative assessment, that it is not more likely than not, the indefinite-lived intangible asset is impaired. We adopted ASU 2012-02 September 15, 2012 and it did not have a significant impact on our consolidated financial statements.

ASU 2013-02, "Comprehensive Income (Topic 220) – Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income." ASU 2013-02 requires entities to provide information about the amounts reclassified out of accumulated other comprehensive income by component. We adopted ASU 2013-02 on January 1, 2013, and it 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 has been adjusted to give retroactive recognition to stock dividends and is calculated as follows (in thousands, except per share amounts):

|   | Years Ended December 31, |          |          |
|---|--------------------------|----------|----------|
|   | 2012                     | 2011     | 2010     |
| Basic and Diluted Earnings:                 |                          |          |          |
| Net Income – Southside Bancshares, Inc.     | \$34,695                 | \$39,133 | \$39,103 |
| Basic weighted-average shares outstanding:  | 17,325                   | 17,272   | 17,350   |
| Add: Stock options                          | 12                       | 8        | 29       |
| Diluted weighted-average shares outstanding | 17,337                   | 17,280   | 17,379   |
| Basic Earnings Per Share:                   |                          |          |          |
| Net Income – Southside Bancshares, Inc.     | \$2.00                   | \$2.26   | \$2.25   |
| Diluted Earnings Per Share:                 |                          |          |          |
| Net Income – Southside Bancshares, Inc.     | \$2.00                   | \$2.26   | \$2.25   |

During the third quarter of 2012, 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 both the years ended December 31, 2012 and 2011, there were approximately 12,000 anti-dilutive options. For the year ended December 31, 2010 there were no antidilutive options.

## 3. COMPREHENSIVE INCOME (LOSS)

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

|  | Year Ended December 31, 2012 |                             |                      |
|--|------------------------------|-----------------------------|----------------------|
|  | Before-Tax<br>Amount         | Tax<br>(Expense)<br>Benefit | Net-of-Tax<br>Amount |
| Unrealized losses on securities:   |                              |                             |                      |
| Unrealized holding gains arising during period   | \$7,880                      | \$(2,758 )                  | \$5,122              |
| Noncredit portion of other-than-temporary impairment losses on the AFS securities                          | 160                          | (56 )                       | 104                  |
| Less: reclassification adjustment for gain on sale of AFS securities included in net income                | 17,966                       | (6,288 )                    | 11,678               |
| Less: reclassification of other-than-temporary impairment charges of AFS securities included in net income | (181 )                       | 63                          | (118 )               |
| Net unrealized losses on securities  | (9,745 )                     | 3,411                       | (6,334 )             |
| Change in pension plans  | (8,383 )                     | 2,934                       | (5,449 )             |
| Other comprehensive loss   | \$(18,128 )                  | \$6,345                     | \$(11,783 )          |
|  |                              |                             |                      |
|  | Year ended December 31, 2011 |                             |                      |
|  | Before-Tax<br>Amount         | Tax<br>(Expense)<br>Benefit | Net-of-Tax<br>Amount |
| Unrealized gains on securities:  |                              |                             |                      |
| Unrealized holding gains arising during period   | \$52,506                     | \$(18,377 )                 | \$34,129             |
| Less: reclassification adjustment for gain on sale of AFS securities included in net income                | 11,795                       | (4,128 )                    | 7,667                |
| Net unrealized gains on securities   | 40,711                       | (14,249 )                   | 26,462               |
| Change in pension plans  | (8,382 )                     | 2,934                       | (5,448 )             |
| Other comprehensive income   | \$32,329                     | \$(11,315 )                 | \$21,014             |
|  |                              |                             |                      |
|  | Year ended December 31, 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   | \$15,021                     | \$(5,257 )                  | \$9,764              |
| Noncredit portion of other-than-temporary impairment losses on the AFS securities                          | 36                           | (13 )                       | 23                   |
| Less: reclassification adjustment for gain on sale of AFS securities included in net income                | 25,789                       | (9,026 )                    | 16,763               |
| Less: reclassification of other-than-temporary impairment charges on AFS securities included in net income | (75 )                        | 26                          | (49 )                |
| Net unrealized losses on securities  | (10,657 )                    | 3,730                       | (6,927 )             |
| Change in pension plans  | (5,531 )                     | 1,936                       | (3,595 )             |
| Other comprehensive loss   | \$(16,188 )                  | \$5,666                     | \$(10,522 )          |



The components of accumulated other comprehensive income, net of tax, as of December 31, 2012 and 2011, are reflected in the table below (in thousands):

|  | Years Ended December 31, |           |
|--|--------------------------|-----------|
|  | 2012                     | 2011      |
| Unrealized gains on AFS securities               | \$29,360                 | \$35,694  |
| Net unfunded liability for defined benefit plans | (26,422 )                | (20,973 ) |
| Total  | \$2,938                  | \$14,721  |

#### 4. SECURITIES

The amortized cost and estimated fair value of investment and mortgage-backed securities as of December 31, 2012 and 2011, are reflected in the tables below (in thousands):

|                                   | December 31, 2012 |            |                   |            |             |
|-----------------------------------|-------------------|------------|-------------------|------------|-------------|
|                                   | Amortized         | Gross      | Gross             | Estimated  |             |
|                                   | Cost              | Unrealized | Unrealized Losses | Fair Value |             |
| AVAILABLE FOR SALE:               |                   | Gains      | OTTI              | Other      |             |
| Investment Securities:            |                   |            |                   |            |             |
| U.S. Government Agency Debentures | \$61,461          | \$—        | \$—               | \$598      | \$60,863    |
| State and Political Subdivisions  | 515,116           | 30,888     | —                 | 316        | 545,688     |
| Other Stocks and Bonds            | 12,807            | 104        | 1,754             | 1          | 11,156      |
| Mortgage-backed Securities:       |                   |            |                   |            |             |
| U.S. Government Agencies          | 86,182            | 3,636      | —                 | 15         | 89,803      |
| Government-Sponsored Enterprises  | 703,174           | 14,367     | —                 | 984        | 716,557     |
| Total                             | \$1,378,740       | \$48,995   | \$1,754           | \$1,914    | \$1,424,067 |

|                                  | December 31, 2012 |            |                   |            |           |
|----------------------------------|-------------------|------------|-------------------|------------|-----------|
|                                  | Amortized         | Gross      | Gross             | Estimated  |           |
|                                  | Cost              | Unrealized | Unrealized Losses | Fair Value |           |
| HELD TO MATURITY:                |                   | Gains      | OTTI              | Other      |           |
| Investment Securities:           |                   |            |                   |            |           |
| State and Political Subdivisions | \$1,009           | \$128      | \$—               | \$—        | \$1,137   |
| Mortgage-backed Securities:      |                   |            |                   |            |           |
| U.S. Government Agencies         | 20,135            | 1,191      | —                 | 47         | 21,279    |
| Government-Sponsored Enterprises | 225,403           | 7,579      | —                 | —          | 232,982   |
| Total                            | \$246,547         | \$8,898    | \$—               | \$47       | \$255,398 |

|                                  | December 31, 2011 |            |                   |            |           |
|----------------------------------|-------------------|------------|-------------------|------------|-----------|
|                                  | Amortized         | Gross      | Gross             | Estimated  |           |
|                                  | Cost              | Unrealized | Unrealized Losses | Fair Value |           |
| AVAILABLE FOR SALE:              |                   | Gains      | OTTI              | Other      |           |
| Investment Securities:           |                   |            |                   |            |           |
| State and Political Subdivisions | \$251,281         | \$31,221   | \$—               | \$45       | \$282,457 |
| Other Stocks and Bonds           | 2,925             | —          | 2,426             | —          | 499       |
| Mortgage-backed Securities:      |                   |            |                   |            |           |
| U.S. Government Agencies         | 99,974            | 7,158      | —                 | 80         | 107,052   |
| Government-Sponsored Enterprises | 589,687           | 20,127     | —                 | 740        | 609,074   |

|       |           |          |         |       |           |
|-------|-----------|----------|---------|-------|-----------|
| Total | \$943,867 | \$58,506 | \$2,426 | \$865 | \$999,082 |
|-------|-----------|----------|---------|-------|-----------|

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|                                  | December 31, 2011 |                              |                             |                 | Estimated<br>Fair Value |
|----------------------------------|-------------------|------------------------------|-----------------------------|-----------------|-------------------------|
|                                  | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>OTTI | Losses<br>Other |                         |
| <b>HELD TO MATURITY:</b>         |                   |                              |                             |                 |                         |
| Investment Securities:           |                   |                              |                             |                 |                         |
| State and Political Subdivisions | \$ 1,010          | \$ 196                       | \$—                         | \$—             | \$ 1,206                |
| Other Stocks and Bonds           | 486               | 15                           | —                           | —               | 501                     |
| Mortgage-backed Securities:      |                   |                              |                             |                 |                         |
| U.S. Government Agencies         | 22,999            | 1,159                        | —                           | 43              | 24,115                  |
| Government-Sponsored Enterprises | 342,632           | 14,848                       | —                           | 11              | 357,469                 |
| Total                            | \$367,127         | \$ 16,218                    | \$—                         | \$ 54           | \$383,291               |

Year-end securities carried at fair value through income were as follows (in thousands):

|                                  | At December 31, |           |           |
|----------------------------------|-----------------|-----------|-----------|
|                                  | 2012            | 2011      | 2010      |
| Mortgage-backed Securities:      |                 |           |           |
| U.S. Government Agencies         | \$—             | \$ 30,413 | \$ 5,392  |
| Government-Sponsored Enterprises | —               | 617,346   | 66,784    |
| Total                            | \$—             | \$647,759 | \$ 72,176 |

Net gains and losses on securities carried at fair value through income were as follows (in thousands):

|   | Year Ended December 31, |          |           |
|---|-------------------------|----------|-----------|
|   | 2012                    | 2011     | 2010      |
| Net gain on sales transactions                              | \$ (498 )               | \$ 937   | \$—       |
| Net mark-to-market gains (losses)                           | —                       | 6,693    | (598 )    |
| Net gain on securities carried at fair value through income | \$ (498 )               | \$ 7,630 | \$ (598 ) |



The following table represents the unrealized loss on securities for the years ended December 31, 2012 and 2011 (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 December 31, 2012:          |                     |                 |                     |                 |            |                 |
| Available for Sale                |                     |                 |                     |                 |            |                 |
| U.S. Government Agency Debentures | \$60,863            | \$598           | \$—                 | \$—             | \$60,863   | \$598           |
| State and Political Subdivisions  | 49,548              | 316             | —                   | —               | 49,548     | 316             |
| Other Stocks and Bonds            | 4,856               | 1               | 990                 | 1,754           | 5,846      | 1,755           |
| Mortgage-backed Securities        | 260,909             | 967             | 3,122               | 32              | 264,031    | 999             |
| Total                             | \$376,176           | \$1,882         | \$4,112             | \$1,786         | \$380,288  | \$3,668         |
| Held to Maturity                  |                     |                 |                     |                 |            |                 |
| Mortgage-backed Securities        | \$3,251             | \$47            | \$—                 | \$—             | \$3,251    | \$47            |
| Total                             | \$3,251             | \$47            | \$—                 | \$—             | \$3,251    | \$47            |
| As of December 31, 2011:          |                     |                 |                     |                 |            |                 |
| Available for Sale                |                     |                 |                     |                 |            |                 |
| State and Political Subdivisions  | \$1,668             | \$42            | \$307               | \$3             | \$1,975    | \$45            |
| Other Stocks and Bonds            | —                   | —               | 499                 | 2,426           | 499        | 2,426           |
| Mortgage-backed Securities        | 148,171             | 754             | 5,322               | 66              | 153,493    | 820             |
| Total                             | \$149,839           | \$796           | \$6,128             | \$2,495         | \$155,967  | \$3,291         |
| Held to Maturity                  |                     |                 |                     |                 |            |                 |
| Mortgage-backed Securities        | \$8,918             | \$54            | \$—                 | \$—             | \$8,918    | \$54            |
| Total                             | \$8,918             | \$54            | \$—                 | \$—             | \$8,918    | \$54            |

When it is determined that a decline in fair value of HTM and 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 fair values are reflective of illiquidity and credit impairment. At December 31, 2012, we have in AFS Other Stocks and Bonds, \$2.7 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 December 31, 2012 for the TRUPs is approximately \$990,000 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 December 31, 2012 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 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 December 31, 2012. 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, was estimated at \$3.3 million and \$3.1 million at December 31, 2012 and 2011, respectively. The noncredit charge to other comprehensive income was estimated at \$1.8 million at December 31, 2012 and \$2.4 million at December 31, 2011. The carrying amount of the TRUPs was written down with \$181,000 recognized in earnings for the year ended December 31, 2012. There was no write-down recognized in earnings during 2011 and \$75,000 of write-down was recognized in earnings during 2010. 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 December 31, 2012. 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 December 31, 2012 (in thousands):

| TRUP | Par     | Credit Loss | Amortized Cost | Fair Value | Tranche | Credit Rating |
|------|---------|-------------|----------------|------------|---------|---------------|
| 1    | \$2,000 | \$1,256     | \$744          | \$134      | C1      | Ca            |
| 2    | 2,000   | 550         | 1,450          | 474        | B1      | C             |
| 3    | 2,000   | 1,450       | 550            | 382        | B2      | C             |
|      | \$6,000 | \$3,256     | \$2,744        | \$990      |         |               |



The following table presents a roll forward of the credit losses recognized in earnings on AFS debt securities (in thousands):

|  | Years Ended December 31, |         |         |
|--|--------------------------|---------|---------|
|  | 2012                     | 2011    | 2010    |
| Balance, beginning of period   | \$3,075                  | \$3,075 | \$3,000 |
| Additions for credit losses recognized on debt securities that had no previous impairment losses         | —                        | —       | —       |
| Additions for credit losses recognized on debt securities that had previously incurred impairment losses | 181                      | —       | 75      |
| Balance, end of period   | \$3,256                  | \$3,075 | \$3,075 |

Interest income recognized on securities for the years presented (in thousands):

|                                     | Years Ended December 31, |          |          |
|-------------------------------------|--------------------------|----------|----------|
|                                     | 2012                     | 2011     | 2010     |
| U.S. Treasury                       | \$—                      | \$2      | \$8      |
| U.S. Government Agency Debentures   | 372                      | —        | —        |
| State and Political Subdivisions    | 13,697                   | 12,548   | 10,926   |
| Other Stocks and Bonds              | 94                       | 34       | 46       |
| Mortgage-backed Securities          | 32,118                   | 51,467   | 50,130   |
| Total interest income on securities | \$46,281                 | \$64,051 | \$61,110 |

There were no securities transferred from AFS to HTM during 2012 and 2011. There were no sales from the HTM portfolio during the years ended December 31, 2012, 2011 or 2010. There were \$246.5 million and \$367.1 million of securities classified as HTM at December 31, 2012 and 2011, respectively.

Of the \$18.0 million in net securities gains from the AFS portfolio for the year ended December 31, 2012, there were \$18.5 million in realized gains and approximately \$572,000 in realized losses. Of the \$11.8 million in net securities gains from the AFS portfolio for the year ended December 31, 2011, there were \$11.9 million in realized gains and \$121,000 in realized losses. Of the \$25.8 million in net securities gains from the AFS portfolio for the year ended December 31, 2010, there were \$28.3 million in realized gains and \$2.5 million in realized losses.

The amortized cost and fair value of securities at December 31, 2012, 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.

|  | December 31, 2012 |             |
|--|-------------------|-------------|
|  | Amortized<br>Cost | Fair Value  |
|  | (in thousands)    |             |
| Available for sale securities:         |                   |             |
| Investment Securities                  |                   |             |
| Due in one year or less                | \$4,459           | \$4,473     |
| Due after one year through five years  | 21,780            | 22,128      |
| Due after five years through ten years | 148,750           | 152,422     |
| Due after ten years                    | 414,395           | 438,684     |
|  | 589,384           | 617,707     |
| Mortgage-backed securities             | 789,356           | 806,360     |
| Total                                  | \$1,378,740       | \$1,424,067 |

|  | December 31, 2012 |            |
|--|-------------------|------------|
|  | Amortized<br>Cost | Fair Value |
|  | (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 | —                 | —          |
| Due after ten years                    | 1,009             | 1,137      |
|  | 1,009             | 1,137      |
| Mortgage-backed securities             | 245,538           | 254,261    |
| Total                                  | \$246,547         | \$255,398  |

Investment and mortgage-backed securities with book values of \$945.7 million and \$1.04 billion were pledged as of December 31, 2012 and 2011, respectively, to collateralize 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 fair value and are assessed for other-than-temporary impairment. These securities have no maturity date.

## 5. LOANS AND ALLOWANCE FOR PROBABLE LOAN LOSSES

Loans in the accompanying consolidated balance sheets are classified as follows:

|                                 | December 31,<br>2012 | December 31,<br>2011 |
|---------------------------------|----------------------|----------------------|
|                                 | (in thousands)       |                      |
| Real Estate Loans:              |                      |                      |
| Construction                    | \$113,744            | \$111,361            |
| 1-4 Family residential          | 368,845              | 247,479              |
| Other                           | 236,760              | 206,519              |
| Commercial loans                | 160,058              | 143,552              |
| Municipal loans                 | 220,947              | 207,261              |
| Loans to individuals            | 162,623              | 171,058              |
| Total loans                     | 1,262,977            | 1,087,230            |
| Less: Allowance for loan losses | 20,585               | 18,540               |
| Net loans                       | \$1,242,392          | \$1,068,690          |

## Loans to Affiliated Parties

In the normal course of business, we make loans to certain of our own executive officers and directors and their related interests. As of December 31, 2012 and 2011, these loans totaled \$4.3 million and \$4.1 million, respectively. These loans represented 1.7% and 1.6% of shareholders' equity as of December 31, 2012 and 2011, respectively. Such loans are made in the normal course of business at normal credit terms, including interest rate and collateral requirements and do not represent more than normal credit risks contained in the rest of the loan portfolio for loans of similar types.

## 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. Previously, a review of data for one year was used to establish a general reserve. Beginning in the fourth quarter of 2012, an average three year history of annualized net charge-offs against the average portfolio balance for that time period is utilized. The historical charge off figure is further adjusted through qualitative factors that include six month general trends in past dues, nonaccruals and classified loans to more effectively and promptly react to both positive and negative movements. Management feels this change in methodology is appropriate to accurately estimate the bank's inherent losses in the current fragile economic climate. 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. 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 along with 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 effectiveness 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 determine 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 determine 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.

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Industry and our own experience indicates that a portion of our loans will become delinquent and a portion of the loans will require partial or full 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 appropriateness of the 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 in accordance with GAAP), 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 and evaluated for troubled debt classification. The remaining term extensions increase the risk of collateral deterioration and, accordingly, reserves are increased to recognize this risk.

New pools purchased are reserved at their estimated annual loss. Thereafter, the reserve is adjusted based on the actual performance versus projected performance. Additionally, we use data mining measures to track migration within risk tranches. Reserves are adjusted quarterly to match the migration metrics.

#### Credit Quality Indicators

We categorize loans into risk categories on an ongoing basis, 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.

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; and
- A dependence on a single, or few customers, or sources of supply and materials without suitable substitutes or alternatives.

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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 as 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.

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Loss (Rating 9) – Loans classified as Loss are currently in the process of being charged off and are fully reserved. They are considered uncollectible and 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 five 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;
  - Changes in the level of concentrations of credit; and
- Changes in external factors, such as competition and legal and regulatory requirements.

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

|                                      | Year Ended December 31, 2012 |                        |         |                  |                 |                      |             |           |
|--------------------------------------|------------------------------|------------------------|---------|------------------|-----------------|----------------------|-------------|-----------|
|                                      | Real Estate                  |                        |         |                  |                 |                      |             |           |
|                                      | Construction                 | 1-4 Family Residential | Other   | Commercial Loans | Municipal Loans | Loans to Individuals | Unallocated | Total     |
| Balance at beginning of period       | \$2,620                      | \$1,957                | \$3,051 | \$2,877          | \$619           | \$6,244              | \$1,172     | \$18,540  |
| Provision (reversal) for loan losses | (345 )                       | 1,655                  | (608 )  | 371              | 14              | 9,590                | 59          | 10,736    |
| Loans charged off                    | (41 )                        | (239 )                 | (159 )  | (402 )           | —               | (10,188 )            | —           | (11,029 ) |
| Recoveries of loans charged off      | 121                          | 172                    | 6       | 312              | —               | 1,727                | —           | 2,338     |
| Balance at end of period             | \$2,355                      | \$3,545                | \$2,290 | \$3,158          | \$633           | \$7,373              | \$1,231     | \$20,585  |
|                                      | Year ended December 31, 2011 |                        |         |                  |                 |                      |             |           |
|                                      | Real Estate                  |                        |         |                  |                 |                      |             |           |
|                                      | Construction                 | 1-4 Family Residential | Other   | Commercial Loans | Municipal Loans | Loans to Individuals | Unallocated | Total     |
| Balance at beginning of period       | \$2,585                      | \$1,988                | \$3,354 | \$3,746          | \$607           | \$7,978              | \$453       | \$20,711  |
| Provision (reversal) for loan losses | 20                           | 546                    | (307 )  | (64 )            | 12              | 6,570                | 719         | 7,496     |
| Loans charged off                    | (46 )                        | (675 )                 | (271 )  | (1,254 )         | —               | (10,231 )            | —           | (12,477 ) |
| Recoveries of loans charged off      | 61                           | 98                     | 275     | 449              | —               | 1,927                | —           | 2,810     |
| Balance at end of period             | \$2,620                      | \$1,957                | \$3,051 | \$2,877          | \$619           | \$6,244              | \$1,172     | \$18,540  |
|                                      | Year ended December 31, 2010 |                        |         |                  |                 |                      |             |           |
|                                      | Real Estate                  |                        |         |                  |                 |                      |             |           |
|                                      | Construction                 | 1-4 Family Residential | Other   | Commercial Loans | Municipal Loans | Loans to Individuals | Unallocated | Total     |
| 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 | 213                          | 803                    | 756     | 2,311            | 207             | 10,270               | (823 )      | 13,737    |

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|                                 |         |   |         |   |         |   |         |   |       |         |   |       |          |   |
|---------------------------------|---------|---|---------|---|---------|---|---------|---|-------|---------|---|-------|----------|---|
| Loans charged off               | (873    | ) | (288    | ) | (577    | ) | (2,603  | ) | —     | (12,072 | ) | —     | (16,413  | ) |
| Recoveries of loans charged off | 165     |   | 13      |   | —       |   | 854     |   | —     | 2,459   |   | —     | 3,491    |   |
| Balance at end of period        | \$2,585 |   | \$1,988 |   | \$3,354 |   | \$3,746 |   | \$607 | \$7,978 |   | \$453 | \$20,711 |   |

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The following tables present the balance in the allowance for loan losses and the recorded investment in loans by portfolio segment based on impairment method as described in the allowance for loan losses methodology discussion (in thousands):

|  | As of December 31, 2012 |                        |         |                  |                 |                      |             | Total    |
|--|-------------------------|------------------------|---------|------------------|-----------------|----------------------|-------------|----------|
|  | Real Estate             |                        |         |                  |                 |                      |             |          |
|  | Construction            | 1-4 Family Residential | Other   | Commercial Loans | Municipal Loans | Loans to Individuals | Unallocated |          |
| Ending balance – individually evaluated for impairment | \$592                   | \$500                  | \$387   | \$1,015          | \$89            | \$308                | \$—         | \$2,891  |
| Ending balance – collectively evaluated for impairment | 1,763                   | 3,045                  | 1,903   | 2,143            | 544             | 7,065                | 1,231       | 17,694   |
| Balance at end of period                               | \$2,355                 | \$3,545                | \$2,290 | \$3,158          | \$633           | \$7,373              | \$1,231     | \$20,585 |

|  | As of December 31, 2011 |                        |         |                  |                 |                      |             | Total    |
|--|-------------------------|------------------------|---------|------------------|-----------------|----------------------|-------------|----------|
|  | Real Estate             |                        |         |                  |                 |                      |             |          |
|  | Construction            | 1-4 Family Residential | Other   | Commercial Loans | Municipal Loans | Loans to Individuals | Unallocated |          |
| Ending balance – individually evaluated for impairment | \$888                   | \$788                  | \$511   | \$1,108          | \$110           | \$347                | \$—         | \$3,752  |
| Ending balance – collectively evaluated for impairment | 1,732                   | 1,169                  | 2,540   | 1,769            | 509             | 5,897                | 1,172       | 14,788   |
| Balance at end of period                               | \$2,620                 | \$1,957                | \$3,051 | \$2,877          | \$619           | \$6,244              | \$1,172     | \$18,540 |

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

|  | Years Ended December 31, |      |      |
|--|--------------------------|------|------|
|  | 2012                     | 2011 | 2010 |
| Reserve For Unfunded Loan Commitments:                       |                          |      |      |
| Balance at beginning of period                               | \$26                     | \$30 | \$5  |
| Provision (reversal) for losses on unfunded loan commitments | (21                      | ) (4 | ) 25 |
| Balance at end of period                                     | \$5                      | \$26 | \$30 |



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):

| December 31,<br>2012                        | Real Estate  |                           |           | Commercial<br>Loans | Municipal<br>Loans | Individuals | Total       |
|---|--------------|---------------------------|-----------|---------------------|--------------------|-------------|-------------|
|   | Construction | 1-4 Family<br>Residential | Other     |                     |                    |             |             |
| Loans individually evaluated for impairment | \$7,653      | \$8,563                   | \$10,366  | \$6,284             | \$559              | \$1,165     | \$34,590    |
| Loans collectively evaluated for impairment | 106,091      | 360,282                   | 226,394   | 153,774             | 220,388            | 161,458     | 1,228,387   |
| Total ending loans balance                  | \$113,744    | \$368,845                 | \$236,760 | \$160,058           | \$220,947          | \$162,623   | \$1,262,977 |

| December 31,<br>2011                        | Real Estate  |                           |           | Commercial<br>Loans | Municipal<br>Loans | Loans to<br>Individuals | Total       |
|---|--------------|---------------------------|-----------|---------------------|--------------------|-------------------------|-------------|
|   | Construction | 1-4 Family<br>Residential | Other     |                     |                    |                         |             |
| Loans individually evaluated for impairment | \$6,274      | \$12,453                  | \$9,394   | \$5,986             | \$651              | \$1,320                 | \$36,078    |
| Loans collectively evaluated for impairment | 105,087      | 235,026                   | 197,125   | 137,566             | 206,610            | 169,738                 | 1,051,152   |
| Total ending loans balance                  | \$111,361    | \$247,479                 | \$206,519 | \$143,552           | \$207,261          | \$171,058               | \$1,087,230 |

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

| December 31,<br>2012   | Pass        | Pass Watch | Special<br>Mention | Substandard | Doubtful | Loss | Total       |
|------------------------|-------------|------------|--------------------|-------------|----------|------|-------------|
| Real Estate Loans:     |             |            |                    |             |          |      |             |
| Construction           | \$106,091   | \$—        | \$3,637            | \$3,941     | \$75     | \$—  | \$113,744   |
| 1-4 Family residential | 360,282     | 1,805      | 170                | 5,711       | 877      | —    | 368,845     |
| Other                  | 226,394     | 2,721      | 4,073              | 3,319       | 253      | —    | 236,760     |
| Commercial loans       | 153,774     | 731        | —                  | 4,690       | 863      | —    | 160,058     |
| Municipal loans        | 220,388     | 204        | —                  | 355         | —        | —    | 220,947     |
| Loans to individuals   | 161,458     | 27         | 4                  | 723         | 393      | 18   | 162,623     |
| Total                  | \$1,228,387 | \$5,488    | \$7,884            | \$18,739    | \$2,461  | \$18 | \$1,262,977 |

| December 31,<br>2011 | Pass | Pass Watch | Special<br>Mention | Substandard | Doubtful | Loss | Total |
|----------------------|------|------------|--------------------|-------------|----------|------|-------|
| Real Estate Loans:   |      |            |                    |             |          |      |       |

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|                        |             |         |         |          |         |      |             |
|------------------------|-------------|---------|---------|----------|---------|------|-------------|
| Construction           | \$105,087   | \$785   | \$20    | \$5,285  | \$184   | \$—  | \$111,361   |
| 1-4 Family residential | 235,026     | 1,763   | 5,299   | 4,345    | 1,046   | —    | 247,479     |
| Other                  | 197,126     | 2,911   | 2,877   | 3,475    | 130     | —    | 206,519     |
| Commercial loans       | 137,565     | 908     | 242     | 4,772    | 55      | 10   | 143,552     |
| Municipal loans        | 206,610     | 231     | —       | 420      | —       | —    | 207,261     |
| Loans to individuals   | 169,738     | 81      | —       | 976      | 236     | 27   | 171,058     |
| Total                  | \$1,051,152 | \$6,679 | \$8,438 | \$19,273 | \$1,651 | \$37 | \$1,087,230 |

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The following table sets forth nonperforming assets for the periods presented (in thousands):

|   | At<br>December 31,<br>2012 | At<br>December 31,<br>2011 |
|---|----------------------------|----------------------------|
| Nonaccrual loans                          | \$10,314                   | \$10,299                   |
| Accruing loans past due more than 90 days | 15                         | 5                          |
| Restructured loans                        | 2,998                      | 2,109                      |
| Other real estate owned                   | 686                        | 453                        |
| Reposessed assets                         | 704                        | 322                        |
| Total Nonperforming Assets                | \$14,717                   | \$13,188                   |

#### 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 any 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.

All loans not classified as pass loans are individually evaluated for impairment. 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. Loans that are evaluated and determined not to meet the definition of an impaired loan are reserved for at the general reserve rate for its appropriate class.

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):

|                    | December 31, 2012                   | December 31, 2011                   |
|--------------------|-------------------------------------|-------------------------------------|
|                    | Accruing<br>Loans                   | Accruing<br>Loans                   |
|                    | Past Due<br>More<br>Than 90<br>Days | Past Due<br>More<br>Than 90<br>Days |
| Real Estate Loans: | Nonaccrual                          | Nonaccrual                          |

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|                        |          |      |          |     |
|------------------------|----------|------|----------|-----|
| Construction           | \$2,416  | \$—  | \$3,894  | \$— |
| 1-4 Family residential | 2,001    | —    | 2,362    | —   |
| Other                  | 1,357    | —    | 781      | —   |
| Commercial loans       | 1,812    | —    | 1,353    | —   |
| Loans to individuals   | 2,728    | 15   | 1,909    | 5   |
| Total                  | \$10,314 | \$15 | \$10,299 | \$5 |

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The following tables present the aging of the recorded investment in past due loans by class of loans (in thousands):

|                        | December 31, 2012   |                     |                               | Total Past Due | Current Loans | Total       |
|------------------------|---------------------|---------------------|-------------------------------|----------------|---------------|-------------|
|                        | 30-59 Days Past Due | 60-89 Days Past Due | Greater than 90 Days Past Due |                |               |             |
| Real Estate Loans:     |                     |                     |                               |                |               |             |
| Construction           | \$1,589             | \$—                 | \$2,416                       | \$4,005        | \$109,739     | \$113,744   |
| 1-4 Family residential | 4,450               | 977                 | 2,001                         | 7,428          | 361,417       | 368,845     |
| Other                  | 1,639               | 273                 | 1,357                         | 3,269          | 233,491       | 236,760     |
| Commercial loans       | 769                 | 175                 | 1,812                         | 2,756          | 157,302       | 160,058     |
| Municipal loans        | 709                 | —                   | —                             | 709            | 220,238       | 220,947     |
| Loans to individuals   | 5,908               | 1,191               | 2,743                         | 9,842          | 152,781       | 162,623     |
| Total                  | \$15,064            | \$2,616             | \$10,329                      | \$28,009       | \$1,234,968   | \$1,262,977 |
|                        |                     |                     |                               |                |               |             |
|                        | December 31, 2011   |                     |                               | Total Past Due | Current Loans | Total       |
|                        | 30-59 Days Past Due | 60-89 Days Past Due | Greater than 90 Days Past Due |                |               |             |
| Real Estate Loans:     |                     |                     |                               |                |               |             |
| Construction           | \$185               | \$146               | \$3,894                       | \$4,225        | \$107,136     | \$111,361   |
| 1-4 Family residential | 4,289               | 1,051               | 2,362                         | 7,702          | 239,777       | 247,479     |
| Other                  | 1,129               | 296                 | 781                           | 2,206          | 204,313       | 206,519     |
| Commercial loans       | 1,353               | 129                 | 1,353                         | 2,835          | 140,717       | 143,552     |
| Municipal loans        | —                   | —                   | —                             | —              | 207,261       | 207,261     |
| Loans to individuals   | 4,614               | 960                 | 1,914                         | 7,488          | 163,570       | 171,058     |
| Total                  | \$11,570            | \$2,582             | \$10,304                      | \$24,456       | \$1,062,774   | \$1,087,230 |

The following table sets forth interest income recognized on nonaccrual and restructured loans by class of loans for the periods presented. Average recorded investment is reported on a year-to-date basis (in thousands):

|                        | December 31, 2012                 |                               |   |
|------------------------|-----------------------------------|-------------------------------|---|
|                        | Average<br>Recorded Investment    | Interest Income<br>Recognized | Accruing Interest at<br>Original Contracted<br>Rate |
| Real Estate Loans:     |                                   |                               |   |
| Construction           | \$3,222                           | \$2                           | \$241   |
| 1-4 Family residential | 2,873                             | 38                            | 128   |
| Other                  | 1,734                             | 69                            | 178   |
| Commercial loans       | 2,234                             | 32                            | 128   |
| Loans to individuals   | 3,170                             | 431                           | 673   |
| Total                  | \$13,233                          | \$572                         | \$1,348   |
|                        | December 31, 2011                 |                               |   |
|                        | Average<br>Recorded<br>Investment | Interest Income<br>Recognized | Accruing Interest at<br>Original Contracted<br>Rate |
| Real Estate Loans:     |                                   |                               |   |
| Construction           | \$4,054                           | \$18                          | \$292   |
| 1-4 Family residential | 2,362                             | 112                           | 153   |
| Other                  | 1,744                             | 50                            | 130   |
| Commercial loans       | 1,748                             | 2                             | 65  |
| Loans to individuals   | 4,508                             | 761                           | 1,191   |
| Total                  | \$14,416                          | \$943                         | \$1,831   |
|                        | December 31, 2010                 |                               |   |
|                        | Average<br>Recorded<br>Investment | Interest Income<br>Recognized | Accruing Interest at<br>Original Contracted<br>Rate |
| Real Estate Loans:     |                                   |                               |   |
| Construction           | \$6,013                           | \$4                           | \$356   |
| 1-4 Family residential | 1,250                             | 49                            | 139   |
| Other                  | 1,445                             | 16                            | 117   |
| Commercial loans       | 1,950                             | 8                             | 48  |
| Loans to individuals   | 7,904                             | 980                           | 1,547   |
| Total                  | \$18,562                          | \$1,057                       | \$2,207   |



The following table sets forth impaired loans by class of loans for the periods presented (in thousands):

| December 31, 2012      | 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 Losses<br>Allocated |
|------------------------|---|--|---|---------------------------------|--------------------------|
| Real Estate Loans:     |   |  |   |                                 |                          |
| Construction           | \$3,716                                       | \$—  | \$2,465                                     | \$2,465                         | \$200                    |
| 1-4 Family residential | 2,907   | —  | 2,799                                       | 2,799                           | 222                      |
| Other                  | 3,133   | —  | 2,613                                       | 2,613                           | 243                      |
| Commercial loans       | 2,215   | —  | 2,043                                       | 2,043                           | 630                      |
| Loans to individuals   | 3,626   | 1  | 3,359                                       | 3,360                           | 1,428                    |
| Total                  | \$15,597                                      | \$1  | \$13,279                                    | \$13,280                        | \$2,723                  |
|                        |   |  |   |                                 |                          |
| December 31, 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 Losses<br>Allocated |
| Real Estate Loans:     |   |  |   |                                 |                          |
| Construction           | \$4,909                                       | \$—  | \$3,895                                     | \$3,895                         | \$597                    |
| 1-4 Family residential | 2,449   | —  | 2,362                                       | 2,362                           | 320                      |
| Other                  | 1,930   | —  | 1,508                                       | 1,508                           | 380                      |
| Commercial loans       | 1,570   | —  | 1,493                                       | 1,493                           | 485                      |
| Loans to individuals   | 3,389   | 4  | 3,108                                       | 3,112                           | 857                      |
| Total                  | \$14,247                                      | \$4  | \$12,366                                    | \$12,370                        | \$2,639                  |

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.

### Troubled Debt Restructurings

The restructuring of a loan is considered a troubled debt restructuring ("TDR") 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. We reassessed all loan modifications occurring since January 1, 2011 for identification as TDRs.

The following tables set forth the Recorded Investment in Loans Modified for the period presented (dollars in thousands):

|                        | Year Ended December 31, 2012     |                             |                          |                    |                        |                        |
|------------------------|----------------------------------|-----------------------------|--------------------------|--------------------|------------------------|------------------------|
|                        | Extend<br>Amortization<br>Period | Interest Rate<br>Reductions | Principal<br>Forgiveness | Combination<br>(1) | Total<br>Modifications | Number of<br>Contracts |
| Real Estate Loans:     |                                  |                             |                          |                    |                        |                        |
| Construction           | \$—                              | \$—                         | \$—                      | \$—                | \$—                    | —                      |
| 1-4 Family residential | 644                              | 32                          | —                        | 428                | 1,104                  | 13                     |
| Other                  | 510                              | 204                         | —                        | 349                | 1,063                  | 9                      |
| Commercial loans       | 372                              | —                           | —                        | 516                | 888                    | 12                     |
| Loans to individuals   | 27                               | 7                           | —                        | 98                 | 132                    | 26                     |
| Total                  | \$1,553                          | \$243                       | \$—                      | \$1,391            | \$3,187                | 60                     |

|                        | Year ended December 31, 2011     |                             |                          |                    |                        |                        |
|------------------------|----------------------------------|-----------------------------|--------------------------|--------------------|------------------------|------------------------|
|                        | Extend<br>Amortization<br>Period | Interest Rate<br>Reductions | Principal<br>Forgiveness | Combination<br>(1) | Total<br>Modifications | Number of<br>Contracts |
| Real Estate Loans:     |                                  |                             |                          |                    |                        |                        |
| Construction           | \$—                              | \$54                        | \$33                     | \$—                | \$87                   | 2                      |
| 1-4 Family residential | 107                              | 213                         | —                        | —                  | 320                    | 4                      |
| Other                  | 728                              | —                           | —                        | —                  | 728                    | 1                      |
| Commercial loans       | 89                               | 52                          | —                        | —                  | 141                    | 2                      |
| Loans to individuals   | 39                               | 39                          | 4                        | 7                  | 89                     | 12                     |
| Total                  | \$963                            | \$358                       | \$37                     | \$7                | \$1,365                | 21                     |

(1) These modifications include more than one of the following—extension of the amortization period, lowering interest rate and principal forgiveness.

The majority of loans restructured as TDRs during the year ended December 31, 2012 were modified to extend the maturity. Interest continues to be charged on principal balances outstanding during the term extended. Therefore, the financial effects of the recorded investment of loans restructured as TDRs during the years ended December 31, 2012 and December 31, 2011 were insignificant. The loans identified as TDRs were previously reported as impaired loans prior to restructuring and therefore the modification did not impact our determination of the allowance for loan losses. On an ongoing basis, the performance of the restructured loans is monitored for subsequent payment default. Payment default for TDRs is recognized when the borrower is 90 days or more past due. For the year ended December 31, 2012, one loan classified as "Real Estate - Other" modified as an extension of terms totaling \$85,000 was in payment default. This default did not significantly impact the determination of the allowance for loan loss. For the year ended December 31, 2011, there were no defaults on any loans that were modified as TDRs.

At December 31, 2012 and December 31, 2011, there were no commitments to lend additional funds to borrowers whose terms have been modified in TDRs.

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## 6. PREMISES AND EQUIPMENT

|                                | December 31,<br>2012 | December 31,<br>2011 |
|--------------------------------|----------------------|----------------------|
|                                | (in thousands)       |                      |
| Premises                       | \$63,011             | \$61,221             |
| Furniture and equipment        | 25,710               | 24,874               |
|                                | 88,721               | 86,095               |
| Less: accumulated depreciation | 38,646               | 35,500               |
| Total                          | \$50,075             | \$50,595             |

During the years ended December 31, 2012 and 2011, assets with accumulated depreciation of \$460,000 and \$239,000, respectively, were written off.

Depreciation expense was \$3.6 million, \$3.4 million and \$3.2 million for the years ended December 31, 2012, 2011 and 2010, respectively.

## 7. OTHER REAL ESTATE OWNED

For the years ended December 31, 2012 and 2011, the total of OREO was \$686,000 and \$453,000, respectively. OREO is reflected in other assets in our consolidated balance sheet.

For the year ended December 31, 2012 there were losses on impairment or sale of OREO of \$9,000 compared to a gain on the sale of OREO of \$34,000 for the year ended December 31, 2011. For the year ended December 31, 2010, losses on impairment or sale of OREO were \$173,000.

For the years ended December 31, 2012, 2011 and 2010, OREO operating expense exceeded income by \$126,000, \$29,000 and \$157,000, respectively.

## 8. DEPOSITS

Year-end deposits were as follows (in thousands):

|   | December 31,<br>2012 | December 31,<br>2011 |
|---|----------------------|----------------------|
| Noninterest bearing demand deposits:                      |                      |                      |
| Commercial and individual                                 | \$559,121            | \$493,744            |
| Public funds  | 35,972               | 11,850               |
| Total noninterest bearing demand deposits                 | 595,093              | 505,594              |
| Interest bearing deposits:                                |                      |                      |
| Private accounts:   |                      |                      |
| Savings deposits  | 103,834              | 91,196               |
| Money market demand deposits                              | 141,038              | 129,709              |
| Platinum money market deposits                            | 268,995              | 270,635              |
| Premier business checking                                 | 6,874                | 4,425                |
| NOW demand deposits                                       | 189,837              | 174,487              |
| Certificates and other time deposits of \$100,000 or more | 206,469              | 228,117              |
| Certificates and other time deposits under \$100,000      | 162,372              | 328,250              |
| Total private accounts                                    | 1,079,419            | 1,226,819            |
| Public accounts:  |                      |                      |
| Savings deposits  | 5                    | 7                    |
| Money market demand deposits                              | 662                  | 381                  |
| Platinum money market deposits                            | 335,059              | 180,475              |
| Premier business checking                                 | 37                   | 47                   |
| NOW demand deposits                                       | 65,846               | 82,811               |
| Certificates and other time deposits of \$100,000 or more | 275,241              | 324,802              |
| Certificates and other time deposits under \$100,000      | 535                  | 735                  |
| Total public accounts                                     | 677,385              | 589,258              |
| Total interest bearing deposits                           | 1,756,804            | 1,816,077            |
| Total deposits  | \$2,351,897          | \$2,321,671          |

For the years ended December 31, 2012, 2011 and 2010, interest expense on time deposits of \$100,000 or more was \$4.3 million, \$5.5 million and \$5.4 million, respectively.

At December 31, 2012, the scheduled maturities of certificates and other time deposits, including public funds, are as follows (in thousands):

|                     |           |
|---------------------|-----------|
| 2013                | \$415,980 |
| 2014                | 133,438   |
| 2015                | 49,891    |
| 2016                | 25,994    |
| 2017                | 18,043    |
| 2018 and thereafter | 1,271     |
|                     | \$644,617 |

At December 31, 2012, we had \$19.5 million in long-term brokered certificates of deposit ("CDs") that represented 0.8% of our deposits. These brokered CDs mature within five years and are reflected in the CDs under \$100,000 category. At December 31, 2011, we had \$163.8 million in brokered CDs. We utilized long-term 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 current policy allows for a maximum of \$180 million in brokered CDs.

The aggregate amount of demand deposit overdrafts that have been reclassified as loans were \$1.0 million and \$1.1 million at December 31, 2012 and 2011, respectively.

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## 9. SHORT-TERM BORROWINGS

Information related to short-term borrowings is provided in the table below:

|  | Years Ended December 31, |           |   |   |
|--|--------------------------|-----------|---|---|
|  | 2012                     | 2011      |   |   |
|  | (dollars in thousands)   |           |   |   |
| Federal funds purchased and repurchase agreements    |                          |           |   |   |
| Balance at end of period                             | \$984                    | \$2,945   |   |   |
| Average amount outstanding during the period (1)     | 1,770                    | 3,137     |   |   |
| Maximum amount outstanding during the period (2)     | 2,704                    | 3,291     |   |   |
| Weighted average interest rate during the period (3) | 1.4                      | % 2.7     | % | % |
| Interest rate at end of period                       | 0.4                      | % 2.6     | % | % |
| FHLB advances  |                          |           |   |   |
| Balance at end of period                             | \$150,985                | \$361,811 |   |   |
| Average amount outstanding during the period (1)     | 282,741                  | 292,242   |   |   |
| Maximum amount outstanding during the period (2)     | 440,246                  | 466,316   |   |   |
| Weighted average interest rate during the period (3) | 2.2                      | % 2.2     | % | % |
| Interest rate at end of period                       | 3.7                      | % 1.6     | % | % |
| Other obligations                                    |                          |           |   |   |
| Balance at end of period                             | \$219                    | \$219     |   |   |
| Average amount outstanding during the period (1)     | 219                      | 2,581     |   |   |
| Maximum amount outstanding during the period (2)     | 219                      | 2,963     |   |   |
| Weighted average interest rate during the period (3) | 8.0                      | % 0.7     | % | % |
| Interest rate at end of period                       | 8.0                      | % 8.0     | % | % |

- (1) The average amount outstanding during the period was computed by dividing the total daily outstanding principal balances by the number of days in the period.
- (2) The maximum amount outstanding at any month-end during the period.
- (3) The weighted average interest rate during the period was computed by dividing the actual interest expense by the average balance outstanding during the period.

Southside Bank has three lines of credit for the purchase of overnight federal funds at prevailing rates. One \$25.0 million and two \$15.0 million unsecured lines of credit have been established with Frost Bank, Comerica Bank and TIB – The Independent Bankers Bank, respectively. Southside Bank has a \$5.0 million line of credit with Frost Bank to be used to issue letters of credit. At December 31, 2012, the amount of additional funding Southside Bank could obtain from FHLB using unpledged securities at FHLB was approximately \$221.6 million, net of FHLB stock purchases required. There were no federal funds purchased at December 31, 2012 or 2011. Southside Bank obtained no letters of credit from FHLB as collateral for a portion of its public fund deposits.

Securities sold under agreements to repurchase are secured by borrowings and are stated at the amount of cash received in connection with the transaction. Securities sold under agreements to repurchase totaled \$984,000 in demand deposits at December 31, 2012. These agreements have maturities of less than one year. There were \$1.7 million in demand deposits and \$1.2 million in CDs sold under agreements to repurchase at December 31, 2011.



## 10. LONG-TERM OBLIGATIONS

|  | Years Ended December 31, |           |                        |  |
|--|--------------------------|-----------|------------------------|--|
|  | 2012                     | 2011      | (dollars in thousands) |  |
| FHLB advances  |                          |           |                        |  |
| Balance at end of period                             | \$369,097                | \$260,724 |                        |  |
| Weighted average interest rate during the period (1) | 2.0                      | % 3.5     | %                      |  |
| Interest rate at end of period                       | 1.6                      | % 3.3     | %                      |  |
| Long-term debt (2)                                   |                          |           |                        |  |
| Balance at end of period                             | \$60,311                 | \$60,311  |                        |  |
| Weighted average interest rate during the period (1) | 5.1                      | % 5.4     | %                      |  |
| Interest rate at end of period                       | 2.4                      | % 5.4     | %                      |  |

Maturities of fixed rate long-term obligations based on scheduled repayments at December 31, 2012 are as follows (in thousands):

|                             | Years Ended December 31, |          |          |          |           |            | Total     |
|-----------------------------|--------------------------|----------|----------|----------|-----------|------------|-----------|
|                             | 2013                     | 2014     | 2015     | 2016     | 2017      | Thereafter |           |
| FHLB advances               | \$1,190                  | \$20,086 | \$38,508 | \$38,029 | \$230,434 | \$40,850   | \$369,097 |
| Long-term debt              | —                        | —        | —        | —        | —         | 60,311     | 60,311    |
| Total long-term obligations | \$1,190                  | \$20,086 | \$38,508 | \$38,029 | \$230,434 | \$101,161  | \$429,408 |

FHLB advances represent borrowings with fixed interest rates ranging from 0.9% to 7.6% and with maturities of one to sixteen years. FHLB advances are collateralized by FHLB stock, nonspecified real estate loans and mortgage-backed securities.

|  | Years Ended December 31, |          |
|--|--------------------------|----------|
|  | 2012                     | 2011     |
| (in thousands)                             |                          |          |
| Long-term Debt                             |                          |          |
| 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 |

(1) The weighted average interest rate during the period was computed by dividing the actual interest expense by the average balance outstanding during the period.

(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 3.251% through March 30, 2013 and adjusts quarterly at a rate equal to three-month LIBOR plus 294 basis points.

(4) This debt carries an adjustable rate of 1.61325% through January 29, 2013 and adjusts quarterly at a rate equal to three-month LIBOR plus 130 basis points.

(5)

This debt carries an adjustable rate of 2.558% through March 14, 2013 and adjusts quarterly at a rate equal to three-month LIBOR plus 225 basis points.

- (6) This debt carries an adjustable rate of 2.1115% through February 24, 2013 and adjusts quarterly at a rate equal to three-month LIBOR plus 180 basis points.

During 2010 and 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. During the year ended December 31, 2012, \$150 million par of long-term advance commitments expired unexercised. During the years ended December 31, 2012 and 2011, we recorded impairment charges of \$2.0 million and \$8.9 million, respectively, in our income statement. At December 31, 2012, the remaining FHLB advance option fees recorded on our balance sheet were fully impaired.

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 Rate | Option Fee Paid | Impairment | Fair Value Option Fee |
|--------------------|------------------------|--|-------------------------|-----------------|------------|-----------------------|
| \$20,000           | 03/18/13               | 60 months                                | 2.510%                  | \$1,528         | \$1,528    | \$—                   |
| 15,000             | 03/18/13               | 36 months                                | 1.622%                  | 828             | 828        | —                     |
| 15,000             | 03/18/13               | 48 months                                | 2.086%                  | 1,017           | 1,017      | —                     |
| \$50,000           |                        |  |                         | \$3,373         | \$3,373    | \$—                   |

## 11. EMPLOYEE BENEFITS

Southside Bank has deferred compensation agreements with 18 of its executive officers, which generally provides for payment of an aggregate amount of \$7.5 million over a maximum period of 15 years after retirement or death. Of the 18 executives included in the agreements, two were eligible for retirement at December 31, 2012 and two retired executives are currently receiving benefits. Deferred compensation expense was \$481,000, \$361,000 and \$256,000 for the years ended December 31, 2012, 2011 and 2010, respectively. For the years ended December 31, 2012 and 2011, the deferred compensation plan liability totaled \$3.9 million and \$4.3 million, respectively.

We provide accident and health insurance for substantially all employees through a self-funded insurance program. The cost of health care benefits was \$4.1 million, \$3.5 million and \$3.7 million for the years ended December 31, 2012, 2011 and 2010, respectively. Our healthcare plan was amended to provide health insurance coverage for any retiree having 50 years of service with the Company. In addition, the eligible retiree must have Medicare coverage, including part A, part B and part D. Premiums paid will be billed at the Consolidated Omnibus Budget Reconciliation Act (“COBRA”) rates. There were no retirees participating in the health insurance plan as of December 31, 2012 and 2011.

We have an Employee Stock Ownership Plan (the “ESOP”) which covers substantially all employees. Contributions to the ESOP are at the sole discretion of the board of directors. There was \$250,000 contributed to the ESOP for each of the years ended December 31, 2012, 2011 and 2010. At December 31, 2012 and 2011, 385,492 and 345,054 shares of common stock were owned by the ESOP, respectively. The number of shares has been adjusted as a result of stock dividends. These shares are treated as externally held shares for dividend and earnings per share calculations.

We have an officer’s long-term disability income policy which provides coverage in the event they become disabled as defined under its terms. Individuals are automatically covered under the policy if they (a) have been elected as an officer, (b) have been an employee of Southside Bank for three years and (c) receive earnings of \$50,000 or more on an annual basis. The policy provides, among other things, that should a covered individual become totally disabled he would receive two-thirds of his current salary, not to exceed \$15,000 per month. The benefits paid out of the policy are limited by the benefits paid to the individual under the terms of our other Company-sponsored benefit plans.



We entered into split dollar agreements with eight of our executive officers. The agreements provide we will be the beneficiary of bank owned life insurance (“BOLI”) insuring the executives’ lives. The agreements provide the executives the right to designate the beneficiaries of the death benefits guaranteed in each agreement. The agreements originally provided for death benefits of an initial aggregate amount of \$4.5 million. The individual amounts are increased annually on the anniversary date of the agreement by inflation adjustment factors ranging from 3% to 5%. As of December 31, 2012, the expected death benefits total \$5.7 million. The agreements also state that after the executive’s retirement, we shall also pay an annual gross-up bonus to the executive in an amount sufficient to enable the executive to pay federal income tax on both the economic benefit and on the gross-up bonus. The expense required to record the post retirement liability associated with the split dollar post retirement bonuses was

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\$17,000, \$10,000 and \$41,000 for the years ended December 31, 2012, 2011 and 2010, respectively. For the years ended December 31, 2012 and 2011, the split dollar liability totaled \$1.6 million and \$1.4 million, respectively.

We have a defined benefit pension plan (“the Plan”) pursuant to which participants are entitled to benefits based on final average monthly compensation and years of credited service determined in accordance with plan provisions.

Entrance into the Plan by new employees was frozen effective December 31, 2005. Employees hired after December 31, 2005 are not eligible to participate in the plan. All participants in the Plan are fully vested. Benefits are payable monthly commencing on the later of age 65 or the participant’s date of retirement. Eligible participants may retire at reduced benefit levels after reaching age 55. We contribute amounts to the pension fund sufficient to satisfy funding requirements of the Employee Retirement Income Security Act.

Plan assets, which consist primarily of marketable equity and debt instruments, are valued using market quotations. Plan obligations and the annual pension expense are determined by independent actuaries and through the use of a number of assumptions. 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 the defined benefit pension plan and restoration plans. In developing the cash flow matching analysis, we had our actuaries construct a portfolio of high quality noncallable bonds to match as closely as possible the timing of future benefit payments of the plans at December 31, 2012. We utilized a bond selection-settlement approach that selects a portfolio of bonds from a universe of high quality corporate bonds rated Aa by at least half of the rating agencies available. Based on the results of this cash flow matching analysis, we were able to determine an appropriate discount rate.

Salary increase assumptions are based upon historical experience and anticipated future management actions. The expected long-term rate of return assumption reflects the average return expected based on the investment strategies and asset allocation of 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 December 31, 2012, the weighted-average actuarial assumptions used to determine the benefit obligation of the Plan were: a discount rate of 4.08%; 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.

Plan assets included 193,165 shares of our stock at December 31, 2012 and 2011. Our stock included in Plan assets was purchased at fair value. The number of shares has been adjusted as a result of stock dividends. During 2012, our underfunded status increased to \$14.8 million at December 31, 2012 from an underfunded status of \$7.8 million at December 31, 2011, primarily as a result of the decrease in the discount rate to 4.08% at December 31, 2012 from 4.84% at December 31, 2011.

We have a nonfunded supplemental retirement plan (the “Restoration Plan”) for our employees whose benefits under the principal retirement plan are reduced because of compensation deferral elections or limitations under federal tax laws.

We use a measurement date of December 31 for our plans.

|  | 2012           |             | 2011        |             | 2010      |             |
|--|----------------|-------------|-------------|-------------|-----------|-------------|
|  | Defined        | Restoration | Defined     | Restoration | Defined   | Restoration |
|  | Benefit        | Plan        | Benefit     | Plan        | Benefit   | Plan        |
|  | Pension        | Plan        | Pension     | Plan        | Pension   | Plan        |
|  | Plan           |             | Plan        |             | Plan      |             |
|  | (in thousands) |             |             |             |           |             |
| Change in Projected Benefit Obligation:        |                |             |             |             |           |             |
| Benefit obligation at end of prior year        | \$64,062       | \$8,309     | \$53,471    | \$7,174     | \$45,290  | \$4,789     |
| Service cost                                   | 1,736          | 160         | 1,536       | 174         | 1,363     | 154         |
| Interest cost                                  | 3,068          | 390         | 2,980       | 395         | 2,832     | 384         |
| Actuarial loss                                 | 10,866         | 1,022       | 7,741       | 646         | 5,538     | 1,927       |
| Benefits paid                                  | (1,617)        | ) (80       | ) (1,554)   | ) (80       | ) (1,469) | ) (80       |
| Expenses paid                                  | (113)          | ) —         | (112)       | ) —         | (83)      | ) —         |
| Benefit obligation at end of year              | 78,002         | 9,801       | 64,062      | 8,309       | 53,471    | 7,174       |
| Change in Plan Assets:                         |                |             |             |             |           |             |
| Fair value of plan assets at end of prior year | 56,252         | —           | 53,452      | —           | 47,669    | —           |
| Actual return                                  | 5,643          | —           | 2,466       | —           | 4,335     | —           |
| Employer contributions                         | 3,000          | 80          | 2,000       | 80          | 3,000     | 80          |
| Benefits paid                                  | (1,617)        | ) (80       | ) (1,554)   | ) (80       | ) (1,469) | ) (80       |
| Expenses paid                                  | (113)          | ) —         | (112)       | ) —         | (83)      | ) —         |
| Fair value of plan assets at end of year       | 63,165         | —           | 56,252      | —           | 53,452    | —           |
| Funded status at end of year                   | (14,837)       | ) (9,801)   | ) (7,810)   | ) (8,309)   | ) (19)    | ) (7,174)   |
| Accrued liability recognized                   | \$(14,837)     | ) \$(9,801) | ) \$(7,810) | ) \$(8,309) | ) \$(19)  | ) \$(7,174) |
| Accumulated benefit obligation at end of year  | \$62,117       | \$7,540     | \$51,071    | \$6,088     | \$42,043  | \$4,586     |

Amounts related to our defined benefit pension and restoration plans recognized as a component of other comprehensive income (loss) were as follows (in thousands):

|   | 2012      |             | 2011        |             | 2010        |             |
|---|-----------|-------------|-------------|-------------|-------------|-------------|
|   | Defined   | Restoration | Defined     | Restoration | Defined     | Restoration |
|   | Benefit   | Plan        | Benefit     | Plan        | Benefit     | Plan        |
|   | Pension   | Plan        | Pension     | Plan        | Pension     | Plan        |
|   | Plan      |             | Plan        |             | Plan        |             |
| Recognition of net loss                       | \$1,704   | \$318       | \$1,163     | \$303       | \$1,006     | \$290       |
| Recognition of prior service credit           | (42)      | ) (1        | ) (42)      | ) (2        | ) (42)      | ) (2        |
| Net gain (loss) occurring during the year     | (9,340)   | ) (1,022)   | ) (9,158)   | ) (646)     | ) (4,856)   | ) (1,927)   |
|   | (7,678)   | ) (705)     | ) (8,037)   | ) (345)     | ) (3,892)   | ) (1,639)   |
| Deferred tax benefit                          | 2,687     | 247         | 2,813       | 121         | 1,362       | 574         |
| Other comprehensive income (loss), net of tax | \$(4,991) | ) \$(458)   | ) \$(5,224) | ) \$(224)   | ) \$(2,530) | ) \$(1,065) |



Net amounts recognized in net periodic benefit cost and other comprehensive loss as of December 31, 2012 and 2011 were as follows (in thousands):

|  | 2012    |             | 2011    |             |
|--|---------|-------------|---------|-------------|
|  | Defined | Restoration | Defined | Restoration |
|  | Benefit | Plan        | Benefit | Plan        |
|  | Pension |             | Pension |             |
|  | Plan    |             | Plan    |             |
| Net loss   | \$1,704 | \$318       | \$1,163 | \$303       |
| Prior service credit                             | (42     | ) (1        | ) (42   | ) (2        |
|  | 1,662   | 317         | 1,121   | 301         |
| Deferred tax benefit                             | (582    | ) (111      | ) (392  | ) (105      |
| Accumulated other comprehensive loss, net of tax | \$1,080 | \$206       | \$729   | \$196       |

Amounts recognized as a component of accumulated other comprehensive loss as of December 31, 2012 and 2011 were as follows (in thousands):

|  | 2012      |             | 2011        |             |
|--|-----------|-------------|-------------|-------------|
|  | Defined   | Restoration | Defined     | Restoration |
|  | Benefit   | Plan        | Benefit     | Plan        |
|  | Pension   |             | Pension     |             |
|  | Plan      |             | Plan        |             |
| Net loss   | \$(36,374 | ) \$(4,658  | ) \$(28,738 | ) \$(3,954  |
| Prior service credit                             | 380       | 2           | 422         | 3           |
|  | (35,994   | ) (4,656    | ) (28,316   | ) (3,951    |
| Deferred tax benefit                             | 12,598    | 1,630       | 9,911       | 1,383       |
| Accumulated other comprehensive loss, net of tax | \$(23,396 | ) \$(3,026  | ) \$(18,405 | ) \$(2,568  |

At December 31, 2012 and 2011, the assumptions used to determine the benefit obligation were as follows:

|                            | 2012    |             | 2011    |             |   |
|----------------------------|---------|-------------|---------|-------------|---|
|                            | Defined | Restoration | Defined | Restoration |   |
|                            | Benefit | Plan        | Benefit | Plan        |   |
|                            | Pension |             | Pension |             |   |
|                            | Plan    |             | Plan    |             |   |
| Discount rate              | 4.08    | % 4.08      | % 4.84  | % 4.84      | % |
| Compensation increase rate | 4.50    | % 4.50      | % 4.50  | % 4.50      | % |

Net periodic pension cost and postretirement benefit cost for the years ended December 31, 2012, 2011 and 2010 included the following components (in thousands):

|                                   | 2012     | 2011     | 2010     |
|-----------------------------------|----------|----------|----------|
| Defined Benefit Pension Plan      |          |          |          |
| Service cost                      | \$ 1,736 | \$ 1,536 | \$ 1,363 |
| Interest cost                     | 3,068    | 2,980    | 2,832    |
| Expected return on assets         | (4,117 ) | (3,883 ) | (3,652 ) |
| Net loss amortization             | 1,704    | 1,163    | 1,006    |
| Prior service credit amortization | (42 )    | (42 )    | (42 )    |
| Net periodic benefit cost         | \$ 2,349 | \$ 1,754 | \$ 1,507 |
| Restoration Plan                  |          |          |          |
| Service cost                      | \$ 160   | \$ 174   | \$ 154   |
| Interest cost                     | 390      | 395      | 384      |
| Net loss amortization             | 318      | 303      | 290      |
| Prior service credit amortization | (1 )     | (2 )     | (2 )     |
| Net periodic benefit cost         | \$ 867   | \$ 870   | \$ 826   |

For the years ended December 31, 2012, 2011, and 2010, the assumptions used to determine net periodic pension cost and postretirement benefit cost were as follows:

|  | 2012 | 2011   | 2010   |
|--|------|--------|--------|
| Defined Benefit Pension Plan                     |      |        |        |
| Discount rate                                    | 4.84 | % 5.63 | % 6.10 |
| Expected long-term rate of return on plan assets | 7.25 | % 7.25 | % 7.50 |
| Compensation increase rate                       | 4.50 | % 4.50 | % 4.50 |
| Restoration Plan                                 |      |        |        |
| Discount rate                                    | 4.84 | % 5.63 | % 6.10 |
| Compensation increase rate                       | 4.50 | % 4.50 | % 4.50 |

The amounts in accumulated other comprehensive income (loss) that are expected to be recognized as components of net periodic benefit cost during 2013 are as follows (in thousands):

|  | Defined Benefit Pension Plan | Restoration Plan |
|--|------------------------------|------------------|
| Net loss   | \$ 2,137                     | \$ 393           |
| Prior service credit                             | (42 )                        | (1 )             |
| Deferred tax benefit                             | 2,095                        | 392              |
| Accumulated other comprehensive loss, net of tax | (733 )                       | (137 )           |
|  | \$ 1,362                     | \$ 255           |

The major categories of assets in our Plan as of year-end are presented in the following table. Assets are segregated by the level of the valuation inputs within the fair value hierarchy established by ASC Topic 820 “Fair Value Measurements and Disclosures,” utilized to measure fair value (see “Note 12 – Fair Value Measurement”). Our Restoration Plan is unfunded.

|  | 2012           | 2011     |
|--|----------------|----------|
|  | (in thousands) |          |
| Level 1:                                   |                |          |
| Cash                                       | \$2,251        | \$2,149  |
| Equity Securities:                         |                |          |
| U.S. large cap (1)                         | 34,573         | 30,093   |
| U.S. mid cap (1)                           | 756            | 1,914    |
| U.S. small cap (2)                         | 4,158          | 3,985    |
| International developed (3)                | 460            | 387      |
| International emerging (4)                 | 396            | 329      |
| Level 2:                                   |                |          |
| Cash equivalents                           | 10,813         | 6,474    |
| Fixed Income Securities:                   |                |          |
| Corporate bonds (5)                        | 934            | 943      |
| U.S. government agencies (5)               | 4,561          | 6,252    |
| Municipal bonds (5)                        | 3,076          | 2,189    |
| U.S. agency mortgage-backed securities (6) | 1,187          | 1,537    |
| Total fair value of plan assets            | \$63,165       | \$56,252 |

(1) This category is comprised of individual securities that are actively managed.

(2) This category is comprised primarily of Southside Bancshares stock that is owned in the Plan.

(3) This category is comprised of a broadly ‘passive’ mutual fund.

(4) This category is comprised of a broadly diversified ‘passive’ mutual fund.

(5) This category is comprised of individual investment grade securities that are generally held to maturity.

(6) This category is comprised of individual securities that are generally not held to maturity.

We did not have any plan assets with Level 3 input fair value measurements at December 31, 2012 or 2011. There were no transfers between Level 1 and Level 2 during the year ended December 31, 2012.

Our overall investment strategy is to realize long-term growth of the plan within acceptable risk parameters, while funding benefit payments from dividend and interest income, to the extent possible. The target allocations for plan assets are 65% equities, 33% fixed income and 2% cash equivalents. Equity securities are diversified among U.S. and international (both developed and emerging), large, mid and small caps, and value and growth securities. The investment objective of equity funds is long-term capital appreciation with current income. Fixed income securities include U.S. Treasuries, agencies, CDs, corporate bonds, and mortgage-backed securities. The investment objective of fixed income funds is to maximize investment return while preserving investment principal. Mutual funds, primarily because of the superior diversification they provide, are used to provide specific international developed and emerging market exposure.

As of December 31, 2012, expected future benefit payments related to our defined benefit pension plan and restoration plan were as follows (in thousands):

|      | Defined Benefit<br>Pension Plan | Restoration<br>Plan |
|------|---------------------------------|---------------------|
| 2013 | \$2,112                         | \$250               |

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|                   |          |         |
|-------------------|----------|---------|
| 2014              | 2,308    | 294     |
| 2015              | 2,600    | 323     |
| 2016              | 2,801    | 367     |
| 2017              | 3,075    | 539     |
| 2018 through 2022 | 19,502   | 3,446   |
|                   | \$32,398 | \$5,219 |

We expect to contribute between \$2.0 million and \$3.0 million to our defined benefit pension plan and \$80,000 to our postretirement benefit plan in 2013.

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#### 401(k) Plan

We have a 401(k) defined contribution plan (the “401(k) Plan”) covering substantially all employees, who have completed one year of service and are age 21 or older. A participant may elect to defer a percentage of their compensation subject to certain limits based on federal tax laws. For the years ended December 31, 2012, 2011 and 2010, expense attributable to the 401(k) Plan amounted to \$247,000, \$194,000 and \$119,000, respectively.

#### Share-based Incentive Plans

##### 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 1,215,507 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 years ended December 31, 2012 and 2011, we granted RSUs and NQSOs pursuant to the 2009 Incentive Plan but none were granted during 2010.

As of December 31, 2012, there were 340,391 unvested awards outstanding. For the year ended December 31, 2012, there was \$511,000 of share-based compensation expense related to the 2009 Incentive Plan. For the year ended December 31, 2012, there was \$179,000 of income tax benefit related to the stock compensation expense. As of December 31, 2011, there were 214,438 unvested awards outstanding. As of December 31, 2010, there were no unvested awards outstanding. There was share-based compensation expense and income tax benefit for the year ended December 31, 2011 of \$261,000 and \$91,000, respectively. There was no share-based compensation expense or income tax benefit for the year ended December 31, 2010.

As of December 31, 2012 and December 31, 2011, there was \$2.2 million and \$1.4 million of unrecognized compensation cost related to the 2009 Incentive Plan, respectively. The remaining cost at December 31, 2012 is expected to be recognized over a weighted-average period of 2.90 years. There was no unrecognized compensation expense related to the 2009 Incentive Plan as of December 31, 2010.

The NQSOs 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.

Shares issued in connection with stock compensation awards are issued from authorized shares and not from treasury shares. During 2012, 19,572 shares issued in connection with stock compensation awards were issued from available authorized shares. During 2011 and 2010, 880 and 107,846 shares, respectively, issued in connection with stock compensation awards were issued from available authorized shares.

The estimated weighted-average grant-date fair value per option and the underlying Black-Scholes option-pricing model assumptions are summarized in the following table:

Years Ended December 31,

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|  | 2012   | 2011   |
|--|--------|--------|
| Weighted-average grant date fair value per option                                    | \$5.83 | \$5.59 |
| Weighted-average assumptions:  |        |        |
| Risk-free interest rates   | 1.03%  | 2.30%  |
| Expected dividend yield  | 3.82%  | 3.54%  |
| Expected volatility factors of the market price of Southside Bancshares common stock | 41.96% | 41.71% |
| Expected option life (in years)  | 6.9    | 6.8    |

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A combined summary of activity in our share-based plans as of December 31, 2012 is presented below:

|                            | Restricted Stock Units Outstanding |                  |  | Stock Options Outstanding |                                 |  |
|----------------------------|------------------------------------|------------------|--|---------------------------|---------------------------------|--|
|                            | Shares Available for Grant         | Number of Shares | Weighted-Average Grant-Date Fair Value | Number of Shares          | Weighted-Average Exercise Price | Weighted-Average Grant-Date Fair Value |
| Balance, January 1, 2012   | 1,001,069                          | 35,070           | \$18.28                                | 189,857                   | \$17.82                         | \$5.45                                 |
| Granted                    | (213,793 )                         | 28,667           | 20.94                                  | 185,126                   | 20.94                           | 5.83                                   |
| Stock options exercised    | —                                  | —                | —                                      | (11,657 )                 | 10.73                           | 3.28                                   |
| Stock awards vested        | —                                  | (7,759 )         | 18.28                                  | —                         | —                               | —                                      |
| Forfeited                  | 38,582                             | (8,218 )         | 18.28                                  | (30,364 )                 | 18.28                           | 5.59                                   |
| Canceled/expired           | —                                  | —                | —                                      | —                         | —                               | —                                      |
| Balance, December 31, 2012 | 825,858                            | 47,760           | \$19.88                                | 332,962                   | \$19.76                         | \$5.73                                 |

Other information regarding options outstanding and exercisable as of December 31, 2012 is as follows:

| Range of Exercise Prices | Options Outstanding |                                 |  | Options Exercisable |                                 |
|--------------------------|---------------------|---------------------------------|--|---------------------|---------------------------------|
|                          | Number of Shares    | Weighted-Average Exercise Price | Weighted-Average Remaining Contractual Life in Years | Number of Shares    | Weighted-Average Exercise Price |
| \$18.28 - 20.94          | 332,962             | \$19.76                         | 9.08   | 40,331              | \$18.28                         |
| Total                    | 332,962             | \$19.76                         | 9.08   | 40,331              | \$18.28                         |

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 \$433,000 and \$112,000 at December 31, 2012, respectively.

The total intrinsic value of stock options exercised during the years ended December 31, 2012, 2011 and 2010 was \$115,000, \$7,000 and \$1.5 million, respectively.

Cash received from stock option exercises for the years ended December 31, 2012, 2011 and 2010 was \$125,000, \$9,000 and \$419,000, respectively. The tax benefit realized for the deductions related to stock awards was \$44,000, \$2,000 and \$331,000 for the years ended December 31, 2012, 2011 and 2010, respectively.

## 12. 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. Valuation policies and procedures are determined by our investment department and reported to our Asset/Liability Committee ("ALCO") for review. 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:

**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 – U.S. Treasury securities are reported at fair value utilizing Level 1 inputs. Other securities classified as available for sale are reported at fair value utilizing Level 2 inputs. For these securities, we obtain fair value measurements from an independent pricing service. The fair value measurements consider observable data that may include dealer quotes, market spreads, cash flows, the U.S. Treasury yield curve, live trading levels, trade execution data, market consensus prepayment speeds, credit information and the bond's terms and conditions, among other things.**

**Securities Carried at Fair Value through Income – U.S. Treasury securities are reported at fair value utilizing Level 1 inputs. Other securities classified as available for sale are reported at fair value utilizing Level 2 inputs. For these**

securities, we obtain fair value measurements from an independent pricing service. The fair value measurements consider observable data that may include dealer quotes, market spreads, cash flows, the U.S. Treasury yield curve, live trading levels, trade execution data, market consensus prepayment speeds, credit information and the bond's terms and conditions, among other things.

We review the prices quarterly supplied by the independent pricing service for reasonableness and to ensure such prices are aligned with traditional pricing matrices. In addition, we obtain an understanding of their underlying pricing methodologies and their Statement on Standards for Attestation Engagements-Reporting on Controls of a Service Organization ("SSAE 16"). We validate prices supplied by the independent pricing service by comparison to prices obtained from, in most cases, three additional third party sources. For securities where prices are outside a reasonable range, we further review those securities to determine what a reasonable price estimate is for that security, given available data.

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 year ended December 31, 2012.

**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 December 31, 2012 and 2011, based on our estimates of fair value, no valuation allowance was recognized.

**Foreclosed Assets** – Foreclosed assets are initially carried at fair value less costs to sell. The fair value measurements of foreclosed assets can include Level 2 measurement inputs such as real estate appraisals and comparable real estate sales information, in conjunction with Level 3 measurement inputs such as cash flow projections, qualitative adjustments, sales cost estimates, etc. As a result, the categorization of foreclosed assets is Level 3 of the fair value hierarchy. In connection with the measurement and initial recognition of certain foreclosed assets, we may recognize charge-offs through the allowance for loan losses.

**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 December 31, 2012 and 2011, the impact of loans with specific reserves based on the fair value of the collateral was reflected in our allowance for loan losses.

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 assets measured at fair value on a recurring and nonrecurring basis segregated by the level of the valuation inputs within the fair value hierarchy utilized to measure fair value (in thousands):

|  | At or For the Year Ended December 31, 2012 |  |   |       |                      |
|--|--|--|---|-------|----------------------|
|  | Carrying Amount                            | Fair Value Measurements at the End of the Reporting Period Using |   |       | Total Gains (Losses) |
| Quoted Prices in Active Markets for Identical Assets (Level 1) |  | Significant Other Observable Inputs (Level 2)                    | Significant Unobservable Inputs (Level 3) |       |                      |
| Recurring fair value measurements                              |  |  |   |       |                      |
| Investment Securities:   |  |  |   |       |                      |
| U.S. Government Agency Debentures                              | \$60,863                                   | \$—  | \$60,863                                  | \$—   | \$—                  |
| State and Political Subdivisions                               | 545,688                                    | —  | 545,688                                   | —     | —                    |
| Other Stocks and Bonds   | 11,156                                     | —  | 10,166                                    | 990   | (181 )               |
| Mortgage-backed Securities:                                    |  |  |   |       |                      |
| U.S. Government Agencies                                       | 89,803                                     | —  | 89,803                                    | —     | —                    |
| Government-Sponsored Enterprises                               | 716,557                                    | —  | 716,557                                   | —     | —                    |
| Total recurring fair value measurements                        | \$1,424,067                                | \$—  | \$1,423,077                               | \$990 | \$(181 )             |

Nonrecurring fair value  
measurements

|   |          |     |     |          |         |   |
|---|----------|-----|-----|----------|---------|---|
| Foreclosed assets (1)                         | \$1,390  | \$— | \$— | \$1,390  | \$(752) | ) |
| Impaired loans (2)                            | 10,557   | —   | —   | 10,557   | (81)    | ) |
| Total nonrecurring fair value<br>measurements | \$11,947 | \$— | \$— | \$11,947 | \$(833) | ) |

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|   | At or For the Year Ended December 31, 2011 |  |   |   |
|---|--|--|---|---|
|   | Carrying Amount                            | Fair Value Measurements at the End of the Reporting Period Using |   |   |
|   |  | Quoted Prices in Active Markets for Identical Assets (Level 1)   | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| Recurring fair value measurements                     |  |  |   |   |
| Securities Available for Sale                         |  |  |   |   |
| Investment Securities:                                |  |  |   |   |
| State and Political Subdivisions                      | \$282,457                                  | \$—  | \$282,457                                     | \$—                                       |
| Other Stocks and Bonds                                | 499  | —  | —   | 499                                       |
| Mortgage-backed Securities:                           |  |  |   |   |
| U.S. Government Agencies                              | 107,052                                    | —  | 107,052                                       | —   |
| Government-Sponsored Enterprises                      | 609,074                                    | —  | 609,074                                       | —   |
| Total available for sale securities                   | \$999,082                                  | \$—  | \$998,583                                     | \$499                                     |
| Securities carried at fair value through income       |  |  |   |   |
| Mortgage-backed Securities:                           |  |  |   |   |
| U.S. Government Agencies                              | \$30,413                                   | \$—  | \$30,413                                      | \$—                                       |
| Government-Sponsored Enterprises                      | 617,346                                    | —  | 617,346                                       | —   |
| Total securities carried at fair value through income | \$647,759                                  | \$—  | \$647,759                                     | \$—                                       |
| Total recurring fair value measurements               | \$1,646,841                                | \$—  | \$1,646,342                                   | \$499                                     |
| Nonrecurring fair value measurements                  |  |  |   |   |
| Foreclosed assets (1)                                 | \$775                                      | \$—  | \$—   | \$775                                     |
| Impaired loans (2)                                    | 9,731                                      | —  | —   | 9,731                                     |
| Total nonrecurring fair value measurements            | \$10,506                                   | \$—  | \$—   | \$10,506                                  |

(1) Losses represent related losses on foreclosed properties that were written down subsequent to their initial classification as foreclosed properties.

(2) Loans represent collateral dependent impaired loans with a specific valuation allowance. Losses on these loans represent charge-offs which are netted against the allowance for loan losses.



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):

|  | Year Ended December 31, |       |
|--|-------------------------|-------|
|  | 2012                    | 2011  |
| Other Stocks and Bonds                       |                         |       |
| Balance at Beginning of Period               | \$499                   | \$189 |
| Total gains or losses (realized/unrealized): |                         |       |
| Included in earnings                         | (181                    | ) —   |
| Included in other comprehensive income       | 672                     | 310   |
| Purchases                                    | —                       | —     |
| Issuances                                    | —                       | —     |
| Settlements                                  | —                       | —     |
| Transfers in and/or out of Level 3           | —                       | —     |
| Balance at End of Period                     | \$990                   | \$499 |

The amount of total gains or losses for the periods included in earnings attributable to the change in unrealized gains or losses relating to assets still held at reporting date \$ (181 ) \$—

The following tables present income statement classification of realized and unrealized gains and losses due to changes in fair value recorded in earnings for the periods presented for recurring Level 3 assets, as shown in the previous tables (in thousands):

| Securities Available for Sale | Year Ended December 31, 2012  |            |                                 |            |          |            |
|-------------------------------|-------------------------------|------------|---------------------------------|------------|----------|------------|
|                               | Net Securities Gains (Losses) |            | Other Noninterest Income (Loss) |            | Total    |            |
|                               | Realized                      | Unrealized | Realized                        | Unrealized | Realized | Unrealized |
| Investment securities:        |                               |            |                                 |            |          |            |
| Other stocks and bonds        | \$—                           | \$—        | \$(181                          | ) \$—      | \$(181   | ) \$—      |

The following table presents quantitative information related to the significant unobservable inputs utilized in our Level 3 recurring fair value measurements as of December 31, 2012. No liabilities were recorded as Level 3 at December 31, 2012 (in thousands):

| Securities Available for Sale | As of December 31, 2012 |                       |                          |                   |
|-------------------------------|-------------------------|-----------------------|--------------------------|-------------------|
|                               | Fair Value              | Valuation Techniques  | Unobservable Input       | Range of Inputs   |
| Investment securities:        |                         |                       |                          |                   |
| Other stocks and bonds        | \$990                   | Discounted Cash Flows | Constant prepayment rate | 1% - 2%           |
|                               |                         |                       | Discount Rate            | Libor + 14% - 15% |
|                               |                         |                       | Loss Severity            | 25% - 100%        |

The significant unobservable inputs used in the fair value measurement of our trust preferred securities (“TRUPS”) included the credit rating downgrades, the severity and duration of the mark-to-market loss, and the structural nuances of each TRUP. Our analysis of the underlying cash flows contemplated various default, deferral and recovery scenarios to arrive at our best estimate of cash flows. Significant increases (decreases) in any of those inputs would result in a significant lower (higher) fair value.

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Level 3 assets recorded at fair value on a nonrecurring basis at December 31, 2012 included loans for which a specific allowance was established based on the fair value of collateral and other real estate for which fair value of the properties was less than the cost basis. For both asset classes, the unobservable inputs were the additional adjustments applied by management to the appraised values to reflect such factors as non-current appraisals and revisions to estimated time to sell. These adjustments are determined based on qualitative judgments made by management on a case-by-case basis and are not quantifiable inputs, although they are used in the determination of fair value.

We reported at fair value through income certain of our mortgage-backed securities with embedded derivatives and purchased at a significant premium, which we defined as greater than 111.111% as opposed to bifurcating the embedded derivative and valuing it on a stand-alone basis, as these embedded derivatives are not readily identifiable and measurable and as such cannot be bifurcated. At December 31, 2012, we had no securities carried at fair value through income. During the first quarter of 2012, we sold all of our securities carried at fair value through income. The sale of these securities resulted in a loss on sale of securities carried at fair value through income of \$498,000. At December 31, 2011, we had \$647.8 million classified as securities carried at fair value through income. The change in fair value recorded in income was an increase of \$6.7 million for the year ended December 31, 2011.

Assets and liabilities accounted for under the fair value election are initially measured at fair value with subsequent changes in fair value recognized in earnings. Such changes in the fair value of assets for which we elected the fair value option are included in current period earnings with classification in the income statement line item reflected in the following table (in thousands):

|   | Year Ended December 31, |         |          |
|---|-------------------------|---------|----------|
|   | 2012                    | 2011    | 2010     |
| Changes in fair value included in net income: |                         |         |          |
| Mortgage-backed Securities:                   |                         |         |          |
| U.S. Government Agencies                      | \$—                     | \$629   | \$60     |
| Government-Sponsored Enterprises              | —                       | 6,064   | (658 )   |
| Total   | \$—                     | \$6,693 | \$(598 ) |

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 CDs 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.

The following tables present our financial assets, financial liabilities, and unrecognized financial instruments at both their respective carrying amounts and fair value (in thousands):

| December 31, 2012                                 | Carrying Amount | Estimated Fair Value |            |             |           |
|---|-----------------|----------------------|------------|-------------|-----------|
|   |                 | Total                | Level 1    | Level 2     | Level 3   |
| Financial assets:                                 |                 |                      |            |             |           |
| Cash and cash equivalents                         | \$ 150,630      | \$ 150,630           | \$ 150,630 | \$—         | \$—       |
| Investment securities:                            |                 |                      |            |             |           |
| Held to maturity, at amortized cost               | 1,009           | 1,137                | —          | 1,137       | —         |
| Mortgage-backed and related securities:           |                 |                      |            |             |           |
| Held to maturity, at amortized cost               | 245,538         | 254,261              | —          | 254,261     | —         |
| FHLB stock and other investments, at cost         | 29,953          | 29,953               | —          | 29,953      | —         |
| Loans, net of allowance for loan losses           | 1,242,392       | 1,235,511            | —          | —           | 1,235,511 |
| Loans held for sale                               | 3,601           | 3,601                | —          | 3,601       | —         |
| Financial liabilities:                            |                 |                      |            |             |           |
| Retail deposits                                   | \$2,351,897     | \$2,353,613          | \$—        | \$2,353,613 | \$—       |
| Federal funds purchased and repurchase agreements | 984             | 984                  | —          | 984         | —         |
| FHLB advances                                     | 520,082         | 520,488              | —          | 520,488     | —         |
| Long-term debt                                    | 60,311          | 49,507               | —          | 49,507      | —         |

| December 31, 2011                                 | Carrying Amount | Estimated Fair Value |          |             |           |
|---|-----------------|----------------------|----------|-------------|-----------|
|   |                 | Total                | Level 1  | Level 2     | Level 3   |
| Financial assets:                                 |                 |                      |          |             |           |
| Cash and cash equivalents                         | \$43,238        | \$43,238             | \$43,238 | \$—         | \$—       |
| Investment securities:                            |                 |                      |          |             |           |
| Held to maturity, at amortized cost               | 1,496           | 1,707                | —        | 1,707       | —         |
| Mortgage-backed and related securities:           |                 |                      |          |             |           |
| Held to maturity, at amortized cost               | 365,631         | 381,584              | —        | 381,584     | —         |
| FHLB stock and other investments, at cost         | 35,933          | 35,933               | —        | 35,933      | —         |
| Loans, net of allowance for loan losses           | 1,068,690       | 1,073,298            | —        | —           | 1,073,298 |
| Loans held for sale                               | 3,552           | 3,552                | —        | 3,552       | —         |
| Financial liabilities:                            |                 |                      |          |             |           |
| Retail deposits                                   | \$2,321,671     | \$2,329,243          | \$—      | \$2,329,243 | \$—       |
| Federal funds purchased and repurchase agreements | 2,945           | 2,945                | —        | 2,945       | —         |
| FHLB advances                                     | 622,535         | 636,129              | —        | 636,129     | —         |
| Long-term debt                                    | 60,311          | 45,132               | —        | 45,132      | —         |

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, estimated using Level 3 inputs, was not material at December 31, 2012 or 2011.



### 13. SHAREHOLDERS' EQUITY

Cash dividends declared and paid were \$1.11, \$0.90 and \$0.85 per share for the years ended December 31, 2012, 2011 and 2010, respectively. Future dividends will depend on our earnings, financial condition and other factors which the board of directors considers to be relevant. Our dividend policy requires that any cash dividend payments made may not exceed consolidated earnings for that year.

We are subject to various regulatory capital requirements administered by the federal banking agencies. 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. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, we must meet specific capital guidelines that involve quantitative measures of our assets, liabilities, and certain off-balance-sheet items as calculated under regulatory accounting practices. Our capital amounts and classification are also subject to qualitative judgments by the regulators regarding components, risk weightings, and other factors.

Quantitative measures established by regulation to ensure capital adequacy require us to maintain minimum amounts and ratios (set forth in the table below) of Total and Tier 1 Capital (as defined in the regulations) to risk-weighted assets (as defined), and of Tier 1 Capital (as defined) to average assets (as defined). At December 31, 2012, we exceeded all regulatory minimum capital requirements.

In addition, for a depository institution to be considered “well capitalized” under the regulatory framework for prompt corrective action, its Tier 1 and Total Capital ratios must be at least 6.0% and 10.0% on a risk-adjusted basis, respectively and its leverage ratio must be at least 5.0%.

As of December 31, 2012, the most recent notification from the FDIC categorized us as well capitalized under the regulatory framework for prompt corrective action. 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 table. There are no conditions or events since that notification that management believes have changed our category.

|  | Actual    |       | For Capital Adequacy Purposes |       | To Be Well Capitalized Under Prompt Corrective Actions Provisions |       |   |
|--|-----------|-------|-------------------------------|-------|---|-------|---|
|  | Amount    | Ratio | Amount                        | Ratio | Amount  | Ratio |   |
| As of December 31, 2012:                 |           |       |                               |       |   |       |   |
| Total Capital (to Risk Weighted Assets)  |           |       |                               |       |   |       |   |
| Consolidated                             | \$308,133 | 22.42 | % \$109,962                   | 8.00  | % N/A   | N/A   |   |
| Bank Only                                | \$300,196 | 21.86 | % \$109,852                   | 8.00  | % \$137,315   | 10.00 | % |
| Tier 1 Capital (to Risk Weighted Assets) |           |       |                               |       |   |       |   |
| Consolidated                             | \$290,873 | 21.16 | % \$54,981                    | 4.00  | % N/A   | N/A   |   |
| Bank Only                                | \$282,936 | 20.60 | % \$54,926                    | 4.00  | % \$82,389  | 6.00  | % |
| Tier 1 Capital (to Average Assets) (1)   |           |       |                               |       |   |       |   |
| Consolidated                             | \$290,873 | 9.11  | % \$127,698                   | 4.00  | % N/A   | N/A   |   |
| Bank Only                                | \$282,936 | 8.87  | % \$127,531                   | 4.00  | % \$159,413   | 5.00  | % |
| As of December 31, 2011:                 |           |       |                               |       |   |       |   |
| Total Capital (to Risk Weighted Assets)  |           |       |                               |       |   |       |   |
| Consolidated                             | \$296,715 | 22.36 | % \$106,152                   | 8.00  | % N/A   | N/A   |   |
| Bank Only                                | \$285,539 | 21.52 | % \$106,159                   | 8.00  | % \$132,699   | 10.00 | % |
| Tier 1 Capital (to Risk Weighted Assets) |           |       |                               |       |   |       |   |
| Consolidated                             | \$280,050 | 21.11 | % \$53,076                    | 4.00  | % N/A   | N/A   |   |
| Bank Only                                | \$268,874 | 20.26 | % \$53,080                    | 4.00  | % \$79,619  | 6.00  | % |
| Tier 1 Capital (to Average Assets) (1)   |           |       |                               |       |   |       |   |
| Consolidated                             | \$280,050 | 8.63  | % \$129,795                   | 4.00  | % N/A   | N/A   |   |
| Bank Only                                | \$268,874 | 8.29  | % \$129,698                   | 4.00  | % \$162,122   | 5.00  | % |

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

Our payment of dividends is limited under regulation. The amount that can be paid in any calendar year without prior approval of our regulatory agencies cannot exceed the lesser of net profits (as defined) for that year plus the net profits for the preceding two calendar years, or retained earnings.



#### 14. DIVIDEND REINVESTMENT AND COMMON STOCK REPURCHASE PLAN

We have a Dividend Reinvestment Plan funded by stock authorized but not yet issued. Proceeds from the sale of the common stock will be used for general corporate purposes and could be directed to our subsidiaries. For the year ended December 31, 2012, 82,555 shares were sold under this plan at an average price of \$21.17 per share, reflective of other trades at the time of each sale. For the year ended December 31, 2011, 71,127 shares were sold under this plan at an average price of \$20.69 per share, reflective of other trades at the time of each sale.

We have a Common Stock Repurchase Plan. Under the repurchase plan, our board of directors establishes, on a quarterly basis, total dollar limitations and price per share for stock to be repurchased. Our board reviews this plan in conjunction with our capital needs and those of Southside Bank and may, at their discretion, modify or discontinue the plan. During 2012, the board-approved additional funding to repurchase stock in the amount of \$10.0 million from which 355,500 shares of common stock were purchased at a cost of \$7.4 million. During 2011, there were no shares of common stock purchased under this plan.

Subsequent to December 31, 2012 through February 15, 2013, we purchased 90,300 shares of common stock at an average price of \$21.03.

## 15. INCOME TAXES

The provision for income taxes included in the accompanying statements of income consist of the following (in thousands):

|   | Years Ended December 31, |          |          |
|---|--------------------------|----------|----------|
|   | 2012                     | 2011     | 2010     |
| Current tax provision                           | \$8,841                  | \$11,665 | \$11,100 |
| Deferred tax provision (benefit)                | (1,233)                  | (1,271)  | 656      |
| Provision for tax expense charged to operations | \$7,608                  | \$10,394 | \$11,756 |

The components of the net deferred tax asset (liability) as of December 31, 2012 and 2011 are summarized below (in thousands):

|   | Assets    | Liabilities |
|---|-----------|-------------|
| Write-downs on OREO                               | \$61      | \$          |
| Allowance for loan losses                         | 7,206     |             |
| Retirement and other benefit plans                |           | (3,936)     |
| Unrealized gains on securities available for sale |           | (15,810)    |
| Premises and equipment                            |           | (994)       |
| FHLB stock dividends                              |           | (11)        |
| Other-than-temporary impairment losses            | 2,320     |             |
| Unfunded status of defined benefit plan           | 14,228    |             |
| State business tax credit                         | 674       |             |
| Stock-based compensation                          | 219       |             |
| Other   | 163       |             |
| Gross deferred tax assets (liabilities)           | 24,871    | (20,751)    |
| Net deferred tax asset at December 31, 2012       | \$4,120   |             |
| Write-downs on OREO                               | \$57      | \$          |
| Allowance for loan losses                         | 6,490     |             |
| Retirement and other benefit plans                |           | (3,910)     |
| Unrealized gains on securities available for sale |           | (19,221)    |
| Premises and equipment                            |           | (1,170)     |
| FHLB stock dividends                              |           | (9)         |
| Fair value gain (loss) – securities               |           | (2,133)     |
| Other-than-temporary impairment losses            | 4,199     |             |
| Unfunded status of defined benefit plan           | 11,294    |             |
| State business tax credit                         | 692       |             |
| Stock-based compensation                          | 91        |             |
| Other   | 162       |             |
| Gross deferred tax assets (liabilities)           | 22,985    | (26,443)    |
| Net deferred tax liability at December 31, 2011   | \$(3,458) |             |

A reconciliation of tax at statutory rates and total tax expense is as follows (dollars in thousands):

|  | Years Ended December 31, |        |        |            |        |            |
|--|--------------------------|--------|--------|------------|--------|------------|
|  | 2012                     | 2011   | 2010   | Percent of | 2010   | Percent of |
|  | Amount                   | Amount | Amount | Pre-Tax    | Amount | Pre-Tax    |
|  |                          |        |        | Income     |        | Income     |
|  |                          |        |        |            |        |            |

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|  |           |      |       |           |           |   |           |      |           |   |       |    |
|--|-----------|------|-------|-----------|-----------|---|-----------|------|-----------|---|-------|----|
| Statutory Tax Expense                              | \$ 14,806 | 35.0 | %     | \$ 17,810 | 35.0      | % | \$ 18,134 | 35.0 | %         |   |       |    |
| Increase (Decrease) in Taxes<br>from:              |           |      |       |           |           |   |           |      |           |   |       |    |
| Tax Exempt Interest                                | (7,601    | )    | (17.9 | )%        | (7,182    | ) | (14.1     | )%   | (6,323    | ) | (12.2 | )% |
| State Business Tax                                 | 140       |      | 0.3   | %         | 82        |   | 0.1       | %    | 91        |   | 0.2   | %  |
| Other Net  | 263       |      | 0.6   | %         | (316      | ) | (0.6      | )%   | (146      | ) | (0.3  | )% |
| Provision for Tax Expense<br>Charged to Operations | \$ 7,608  |      | 18.0  | %         | \$ 10,394 |   | 20.4      | %    | \$ 11,756 |   | 22.7  | %  |

We file income tax returns in the U.S. federal jurisdiction and in certain states. We are no longer subject to U.S. federal income tax examinations by tax authorities for years before 2009.

## 16. 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 \$132.8 million and \$116.0 million at December 31, 2012 and 2011, 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 December 31, 2012 and 2011 were \$13.0 million and \$12.7 million, respectively, and are reflected in the due after one year category. We had outstanding standby letters of credit of \$5.6 million and \$6.5 million at December 31, 2012 and 2011, respectively.

The scheduled maturities of unused commitments as of December 31, 2012 and 2011 were as follows (in thousands):

|                         | December 31, |           |
|-------------------------|--------------|-----------|
|                         | 2012         | 2011      |
| Unused commitments:     |              |           |
| Due in one year or less | \$84,756     | \$85,737  |
| Due after one year      | 48,061       | 30,291    |
| Total                   | \$132,817    | \$116,028 |

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 creditworthiness 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. Rent expense for branch facilities was \$1.2 million for the year ended December 31, 2012, and \$1.1 million for both of the years ended December 31, 2011 and 2010, respectively. Rent expense for leased equipment was \$267,000, \$259,000, and \$228,000 for the years ended December 31, 2012, 2011, and 2010, respectively.

Future minimum rental commitments due under non-cancelable operating leases at December 31, 2012 were as follows (in thousands):

|      |         |
|------|---------|
| 2013 | \$1,357 |
| 2014 | 983     |

|            |         |
|------------|---------|
| 2015       | 786     |
| 2016       | 576     |
| 2017       | 275     |
| Thereafter | 629     |
|            | \$4,606 |

It is expected that certain leases will be renewed, or equipment replaced with new leased equipment, as these leases expire.

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Securities. In the normal course of business we buy and sell securities. There were \$10.0 million and \$1.2 million of unsettled trades to purchase securities at December 31, 2012 and December 31, 2011, respectively. There were no unsettled trades to sell securities as of December 31, 2012 and December 31, 2011.

Deposits. There were no unsettled issuances of brokered CDs at December 31, 2012 or December 31, 2011.

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 our financial position, results of operations or liquidity.

#### 17. SIGNIFICANT GROUP CONCENTRATIONS OF CREDIT RISK

Although we have a diversified loan portfolio, a significant portion of our loans are collateralized by real estate. Repayment of these loans is in part dependent upon the economic conditions in the market area. Part of the risk associated with real estate loans has been mitigated since 51.3% of this group represents loans collateralized by residential dwellings that are primarily owner-occupied. Losses on this type of loan have historically been less than those on speculative properties. Many of the remaining real estate loans are collateralized primarily with owner-occupied commercial real estate. The oil and gas industry remains a significant component of the East Texas economy and as such the health of the oil and gas industry has an effect on our business.

At December 31, 2012, approximately 38% of our total loans were to customers in Tyler, Texas. We did not have a concentration in any other city that exceeded 10% of our total loans at December 31, 2012.

A significant portion of our loan portfolio is dependent on the medical community. Medical loan types include commercial loans and commercial real estate loans. Collateral for these loans varies depending on the type of loan and financial strength of the borrower. The primary source of repayment for loans in the medical community is cash flow from continuing operations. The medical community represents a concentration of risk in our Commercial loan and Commercial Real Estate loan portfolio. See "Item 1. Business – Market Area." We believe that risk in the medical community is mitigated because it is spread among multiple practice types and multiple specialties. Should the government change the amount it pays the medical community through the various government health insurance programs or if new government regulation impacts the profitability of the medical community, the medical community could be adversely impacted which in turn could result in higher default rates by borrowers in the medical industry.

The mortgage-backed securities we hold consist exclusively of U.S. agency pass-through securities which are either directly or indirectly backed by the full faith and credit of the United States Government or guaranteed by GSEs. The GNMA mortgage-backed securities are backed by the full faith and credit of the United States Government and the Fannie Mae and Freddie Mac U.S. agency GSE guaranteed mortgage-backed securities are not backed by the full faith and credit of the United States government.

## 18. PARENT COMPANY FINANCIAL INFORMATION

Condensed financial information for Southside Bancshares, Inc. (parent company only) was as follows (in thousands, except share amounts):

| CONDENSED BALANCE SHEETS   | December 31,<br>2012 | December 31,<br>2011 |
|--|----------------------|----------------------|
| <b>ASSETS</b>  |                      |                      |
| Cash and due from banks  | \$4,534              | \$9,348              |
| Investment in bank subsidiaries at equity in underlying net assets   | 306,054              | 304,025              |
| Investment in nonbank subsidiaries at equity in underlying net assets  | 3,050                | 2,649                |
| Other assets   | 4,553                | 3,564                |
| <b>TOTAL ASSETS</b>  | <b>\$318,191</b>     | <b>\$319,586</b>     |
| <b>LIABILITIES</b>   |                      |                      |
| Long-term debt   | \$60,311             | \$60,311             |
| Other liabilities  | 117                  | 348                  |
| <b>TOTAL LIABILITIES</b>   | <b>60,428</b>        | <b>60,659</b>        |
| <b>SHAREHOLDERS' EQUITY</b>  |                      |                      |
| Common stock (\$1.25 par, 40,000,000 shares authorized, 19,446,187 shares issued in 2012 and 18,517,101 shares issued in 2011) | 24,308               | 23,146               |
| Paid-in capital  | 195,602              | 176,791              |
| Retained earnings  | 70,708               | 72,646               |
| Treasury stock (2,379,338 and 2,023,838 shares at cost)  | (35,793)             | (28,377)             |
| Accumulated other comprehensive income   | 2,938                | 14,721               |
| <b>TOTAL SHAREHOLDERS' EQUITY</b>  | <b>257,763</b>       | <b>258,927</b>       |
| <b>TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY</b>  | <b>\$318,191</b>     | <b>\$319,586</b>     |

## CONDENSED STATEMENTS OF INCOME

|  | Years Ended December 31, |                 |                 |
|--|--------------------------|-----------------|-----------------|
|  | 2012                     | 2011            | 2010            |
| <b>INCOME</b>  |                          |                 |                 |
| Dividends from subsidiary                                      | \$25,000                 | \$17,000        | \$28,000        |
| Interest income  | 93                       | 98              | 98              |
| <b>TOTAL INCOME</b>  | <b>25,093</b>            | <b>17,098</b>   | <b>28,098</b>   |
| <b>EXPENSE</b>   |                          |                 |                 |
| Interest expense   | 3,085                    | 3,266           | 3,275           |
| Other  | 2,429                    | 2,164           | 1,775           |
| <b>TOTAL EXPENSE</b>   | <b>5,514</b>             | <b>5,430</b>    | <b>5,050</b>    |
| Income before income tax expense                               | 19,579                   | 11,668          | 23,048          |
| Income tax benefit   | 1,897                    | 1,866           | 1,733           |
| Income before equity in undistributed earnings of subsidiaries | 21,476                   | 13,534          | 24,781          |
| Equity in undistributed earnings of subsidiaries               | 13,219                   | 25,599          | 14,322          |
| <b>NET INCOME</b>  | <b>\$34,695</b>          | <b>\$39,133</b> | <b>\$39,103</b> |

## CONDENSED STATEMENTS OF CASH FLOW

|   | Years Ended December 31, |          |          |
|---|--------------------------|----------|----------|
|   | 2012                     | 2011     | 2010     |
|   | (in thousands)           |          |          |
| <b>OPERATING ACTIVITIES:</b>  |                          |          |          |
| Net Income  | \$34,695                 | \$39,133 | \$39,103 |
| Adjustments to reconcile net income to net cash provided by operations: |                          |          |          |
| Equity in undistributed earnings of subsidiaries                        | (13,219)                 | (25,599) | (14,322) |
| (Increase) decrease in other assets                                     | (989)                    | (187)    | 1,022    |
| Decrease in other liabilities   | (231)                    | (22)     | (243)    |
| Net cash provided by operating activities                               | 20,256                   | 13,325   | 25,560   |
| <b>INVESTING ACTIVITIES:</b>  |                          |          |          |
| Investment in subsidiaries  | (441)                    | 713      | (1,701)  |
| Net cash (used in) provided by investing activities                     | (441)                    | 713      | (1,701)  |
| <b>FINANCING ACTIVITIES:</b>  |                          |          |          |
| Purchase of common stock  | (7,416)                  | —        | (4,832)  |
| Proceeds from issuance of common stock                                  | 1,874                    | 1,481    | 1,823    |
| Dividends paid  | (19,084)                 | (14,671) | (13,223) |
| Payments for other financing activities                                 | (3)                      | —        | —        |
| Net cash used in financing activities                                   | (24,629)                 | (13,190) | (16,232) |
| Net (decrease) increase in cash and cash equivalents                    | (4,814)                  | 848      | 7,627    |
| Cash and cash equivalents at beginning of year                          | 9,348                    | 8,500    | 873      |
| Cash and cash equivalents at end of year                                | \$4,534                  | \$9,348  | \$8,500  |



19. QUARTERLY FINANCIAL INFORMATION OF REGISTRANT  
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
 (UNAUDITED)

(in thousands, except share amounts)

|   | 2012     |          |          |          |
|---|----------|----------|----------|----------|
|   | Fourth   | Third    | Second   | First    |
|   | Quarter  | Quarter  | Quarter  | Quarter  |
| Interest income   | \$26,398 | \$28,464 | \$29,442 | \$31,716 |
| Interest expense  | 5,822    | 6,456    | 6,897    | 7,720    |
| Net interest income   | 20,576   | 22,008   | 22,545   | 23,996   |
| Provision for loan losses   | 2,245    | 3,265    | 2,174    | 3,052    |
| Gain on sale of securities available for sale   | 4,395    | 4,302    | 3,297    | 5,972    |
| Gain on sale of securities carried at fair value through income                               | —        | —        | (13      | ) (485   |
| FHLB advance option impairment charges  | —        | (195     | ) (1,364 | ) (472   |
| Noninterest income excluding net securities gains (losses) and FHLB advance option impairment | 6,259    | 6,391    | 6,142    | 5,792    |
| Noninterest expense   | 19,413   | 19,076   | 19,096   | 18,522   |
| Income before income tax expense  | 9,572    | 10,165   | 9,337    | 13,229   |
| Provision for income tax expense  | 1,352    | 1,558    | 1,608    | 3,090    |
| Net income attributable to Southside Bancshares, Inc.   | 8,220    | 8,607    | 7,729    | 10,139   |
| Earnings per common share   |          |          |          |          |
| Basic   | \$0.47   | \$0.50   | \$0.45   | \$0.58   |
| Diluted   | \$0.47   | \$0.50   | \$0.45   | \$0.58   |
|   | 2011     |          |          |          |
|   | Fourth   | Third    | Second   | First    |
|   | Quarter  | Quarter  | Quarter  | Quarter  |
| Interest income   | \$32,756 | \$32,653 | \$33,724 | \$31,905 |
| Interest expense  | 8,191    | 8,637    | 9,157    | 9,646    |
| Net interest income   | 24,565   | 24,016   | 24,567   | 22,259   |
| Provision for loan losses   | 2,044    | 1,454    | 1,860    | 2,138    |
| Gain on sale of securities available for sale   | 2,715    | 3,609    | 3,920    | 1,551    |
| Gain on sale of securities carried at fair value through income                               | 345      | 254      | 84       | 254      |
| Fair value gain (loss)-securities   | (664     | ) 3,274  | 2,456    | 1,627    |
| FHLB advance option impairment charges  | (1,104   | ) (7,819 | ) —      | —        |
| Noninterest income excluding net securities gains (losses) and FHLB advance option impairment | 6,024    | 6,417    | 6,175    | 6,204    |
| Noninterest expense   | 17,804   | 17,696   | 18,116   | 18,732   |
| Income before income tax expense  | 12,033   | 10,601   | 17,226   | 11,025   |
| Provision for income tax expense  | 2,470    | 2,038    | 4,100    | 1,786    |
| Net income  | 9,563    | 8,563    | 13,126   | 9,239    |
| Less: Net income attributable to the noncontrolling interest                                  | —        | —        | (493     | ) (865   |
| Net income attributable to Southside Bancshares, Inc.   | 9,563    | 8,563    | 12,633   | 8,374    |

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Earnings per common share

|         |        |        |        |        |
|---------|--------|--------|--------|--------|
| Basic   | \$0.55 | \$0.50 | \$0.73 | \$0.49 |
| Diluted | \$0.55 | \$0.50 | \$0.73 | \$0.49 |

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INDEX TO EXHIBITS

Exhibit No.

- 3 (a) – Amended and Restated Articles of Incorporation of Southside Bancshares, Inc. effective April 17, 2009 (filed as Exhibit 3(a) to the Registrant's Form 8-K, filed April 20, 2009, and incorporated herein by reference).
- 3 (b)(i) – Amended and Restated Bylaws of Southside Bancshares, Inc. effective August 9, 2012 (filed as Exhibit 3(b) to the Registrant's Form 8-K, filed August 10, 2012, and incorporated herein by reference).
- 4 – Management agrees to furnish to the Securities and Exchange Commission, upon request, a copy of any other agreements or instruments of Southside Bancshares, Inc. and its subsidiaries defining the rights of holders of any long-term debt whose authorization does not exceed 10% of total assets.
- \*\* 10 (a)(i) – Deferred Compensation Plan for B. G. Hartley effective February 13, 1984, as amended June 28, 1990, December 15, 1994, November 20, 1995, December 21, 1999 and June 29, 2001 (filed as Exhibit 10(a)(i) to the Registrant's Form 10-Q for the quarter ended June 30, 2001, and incorporated herein by reference).
- \*\* 10 (a)(ii) – Deferred Compensation Plan for Robbie N. Edmonson effective February 13, 1984, as amended June 28, 1990 and March 16, 1995 (filed as Exhibit 10(a)(ii) to the Registrant's Form 10-K for the year ended December 31, 1995, and incorporated herein by reference).
- \*\* 10 (b) – Officers Long-term Disability Income Plan effective June 25, 1990 (filed as Exhibit 10(b) to the Registrant's Form 10-K for the year ended June 30, 1990, and incorporated herein by reference).
- \*\* 10 (c) – Retirement Plan Restoration Plan for the subsidiaries of SoBank, Inc. (now named Southside Bancshares, Inc.) (filed as Exhibit 10(c) to the Registrant's Form 10-K for the year ended December 31, 1992, and incorporated herein by reference).
- \*\* 10 (d) – Form of Deferred Compensation Agreements dated June 30, 1994 with each of Sam Dawson, Lee Gibson and Jeryl Story, as amended October 15, 1997 (filed as Exhibit 10(f) to the Registrant's Form 10-K for the year ended December 31, 1997, and incorporated herein by reference).
- \*\* 10 (e) – Split dollar compensation plan dated October 13, 2004 with Jeryl Wayne Story (filed as exhibit 10(h) to the Registrant's Form 8-K, filed October 19, 2004, and incorporated herein by reference).
- \*\* 10 (f) – Split dollar compensation plan dated September 7, 2004 with Lee R. Gibson, III (filed as exhibit 10(i) to the Registrant's Form 8-K, filed October 19, 2004, and incorporated herein by reference).

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- \*\* 10 (g) – Split dollar compensation plan dated August 27, 2004 with B. G. Hartley (filed as exhibit 10 (j) to the Registrant’s Form 8-K, filed October 19, 2004, and incorporated herein by reference).
- \*\* 10 (h) – Split dollar compensation plan dated August 31, 2004 with Charles E. Dawson (filed as exhibit 10(k) to the Registrant’s Form 8-K, filed October 19, 2004, and incorporated herein by reference).
- \*\* 10 (i) – Employment Agreement dated October 22, 2007, by and between Southside Bank and Lee R. Gibson (filed as exhibit 10 (l) to the Registrant’s Form 8-K, filed October 26, 2007, and incorporated herein by reference).
- \*\* 10 (j) – Employment Agreement dated October 22, 2007, by and between Southside Bank and Sam Dawson (filed as exhibit 10 (m) to the Registrant’s Form 8-K, filed October 26, 2007, and incorporated herein by reference).
- 10 (k) – Master Software License Maintenance and Services Agreement dated February 4, 2008, by and between Southside Bank and Jack Henry & Associates, Inc. (filed as Item 1.01 to the Registrant’s Form 8-K, filed February 8, 2008, and incorporated herein by reference).
- \*\* 10 (l) – Retirement Agreement dated November 7, 2008, by and between Southside Bank, Southside Bancshares, Inc. and B. G. Hartley (filed as exhibit 10 (o) to the Registrant’s Form 10-Q, filed November 7, 2008, and incorporated herein by reference).

- \*\* 10 (m) – Southside Bancshares, Inc. 2009 Incentive Plan (filed as Exhibit 99.1 to the Registrant’s Form 8-K, filed April 20, 2009, and incorporated herein by reference).
- \*\* 10 (n) – Form of Southside Bancshares, Inc. Nonstatutory Stock Option Award Certificate for purchase of Options pursuant to the Southside Bancshares, Inc. 2009 Incentive Plan (filed as Exhibit 10.1 to the Registrant’s Form 10-Q filed August 8, 2011, and incorporated herein by reference).
- \*\* 10 (o) – Form of Southside Bancshares, Inc. Restricted Stock Unit Award Certificate for grant of Units pursuant to the Southside Bancshares, Inc. 2009 Incentive Plan (filed as Exhibit 10.2 to the Registrant’s Form 10-Q filed August 8, 2011, and incorporated herein by reference).
- 10 (p) – Agreement and Plan of Merger dated May 17, 2007, as amended, by and among Southside Bancshares, Inc., Southside Merger Sub, Inc. and Fort Worth Bancshares, Inc. (filed as Exhibit 10(a) to the Registrant’s Form 10-Q for the quarter ended September 30, 2007, and incorporated herein by reference).
- \* 21 – Subsidiaries of the Registrant.
- \* 23.1 – Consent of Independent Registered Public Accounting Firm
- \* 23.2 – Consent of Independent Registered Public Accounting Firm
- \* 31.1 – Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- \* 31.2 – Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- \* 32 – Certification Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- \*\*\* 101.INS – XBRL Instance Document.
- \*\*\* 101.SCH – XBRL Taxonomy Extension Schema Document.
- \*\*\* 101.CAL – XBRL Taxonomy Extension Calculation Linkbase Document.
- \*\*\* 101.LAB – XBRL Taxonomy Extension Label Linkbase Document.
- \*\*\* 101.PRE – XBRL Taxonomy Extension Presentation Linkbase Document.
- \*\*\* 101.DEF – XBRL Taxonomy Extension Definition Linkbase Document.

\*Filed herewith.

\*\*Compensation plan, benefit plan or employment contract or arrangement.

\*\*\*Pursuant to Rule 406T of Regulation S-T, the Interactive Data Files on Exhibit 101 hereto are deemed not filed or part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933, as amended, are deemed not filed for purposes of Section 18 of the Securities and Exchange Act of 1934, as amended, and otherwise are not subject to liability under those sections.