

SOUTHSIDE BANCSHARES INC

Form 10-Q

August 07, 2014

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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2014

OR

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

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

Commission file number: 0-12247

SOUTHSIDE BANCSHARES, INC.

(Exact name of registrant as specified in its charter)

TEXAS

(State or other jurisdiction of incorporation or  
organization)

75-1848732

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

1201 S. Beckham Avenue, Tyler, Texas

(Address of principal executive offices)

903-531-7111

(Registrant's telephone number, including area code)

75701

(Zip Code)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer

Non-accelerated filer

(Do not check if a smaller reporting company)

Accelerated filer

Smaller reporting company

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

The number of shares of the issuer's common stock, par value \$1.25, outstanding as of August 4, 2014 was 18,845,618 shares.

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PART I. FINANCIAL INFORMATION  
ITEM 1. FINANCIAL STATEMENTS  
SOUTHSIDE BANCSHARES, INC. AND SUBSIDIARIES  
CONSOLIDATED BALANCE SHEETS  
(UNAUDITED)  
(in thousands, except share amounts)

	June 30, 2014	December 31, 2013
<b>ASSETS</b>		
Cash and due from banks	\$53,880	\$45,624
Interest earning deposits	100,543	8,807
Total cash and cash equivalents	154,423	54,431
Investment securities:		
Available for sale, at estimated fair value	351,908	337,429
Held to maturity, at carrying value (estimated fair value of \$394,638 and \$377,383, respectively)	390,221	391,552
Mortgage-backed securities:		
Available for sale, at estimated fair value	751,740	840,258
Held to maturity, at carrying value (estimated fair value of \$266,185 and \$271,836, respectively)	260,659	275,569
FHLB stock, at cost	25,512	34,065
Other investments, at cost	2,064	2,065
Loans held for sale	755	151
Loans:		
Loans	1,391,285	1,351,273
Less: Allowance for loan losses	(18,408)	(18,877)
Net Loans	1,372,877	1,332,396
Premises and equipment, net	53,322	52,060
Goodwill	22,034	22,034
Other intangible assets, net	123	178
Interest receivable	20,512	21,973
Deferred tax asset	12,726	18,415
Unsettled trades to sell securities	19,183	3,933
Other assets	60,603	59,154
<b>TOTAL ASSETS</b>	<b>\$3,498,662</b>	<b>\$3,445,663</b>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Deposits:		
Noninterest bearing	\$711,391	\$529,897
Interest bearing	1,890,087	1,997,911
Total deposits	2,601,478	2,527,808
Short-term obligations:		
Federal funds purchased and repurchase agreements	2,057	859
FHLB advances	8,413	73,445
Total short-term obligations	10,470	74,304
Long-term obligations:		
FHLB advances	505,710	499,349
Long-term debt	60,311	60,311
Total long-term obligations	566,021	559,660

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Unsettled trades to purchase securities	10,269	973
Other liabilities	26,464	23,400
<b>TOTAL LIABILITIES</b>	<b>3,214,702</b>	<b>3,186,145</b>

Off-Balance-Sheet Arrangements, Commitments and Contingencies (Note 12)

Shareholders' equity:

Common stock (\$1.25 par, 40,000,000 shares authorized, 21,315,256 shares issued at June 30, 2014 and 20,386,221 shares issued at December 31, 2013)	26,644	25,483
Paid-in capital	240,305	214,091
Retained earnings	63,469	78,673
Treasury stock (2,469,638 shares at cost)	(37,692)	(37,692)
Accumulated other comprehensive loss	(8,766)	(21,037)
<b>TOTAL SHAREHOLDERS' EQUITY</b>	<b>283,960</b>	<b>259,518</b>
<b>TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY</b>	<b>\$3,498,662</b>	<b>\$3,445,663</b>

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

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SOUTHSIDE BANCSHARES, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF INCOME  
(UNAUDITED)

(in thousands, except per share data)

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2014	2013	2014	2013
Interest income				
Loans	\$ 18,305	\$ 18,390	\$ 36,668	\$ 36,055
Investment securities – taxable	143	169	266	533
Investment securities – tax-exempt	6,021	5,907	11,979	10,395
Mortgage-backed securities	7,557	4,680	15,239	8,616
FHLB stock and other investments	38	34	108	99
Other interest earning assets	22	35	65	78
Total interest income	32,086	29,215	64,325	55,776
Interest expense				
Deposits	1,984	2,001	4,100	4,071
Short-term obligations	56	389	127	1,639
Long-term obligations	2,190	1,954	4,350	3,735
Total interest expense	4,230	4,344	8,577	9,445
Net interest income	27,856	24,871	55,748	46,331
Provision for loan losses	2,650	2,021	6,783	2,513
Net interest income after provision for loan losses	25,206	22,850	48,965	43,818
Noninterest income				
Deposit services	3,794	3,904	7,432	7,657
Net gain on sale of securities available for sale	498	5,001	509	9,346
Total other-than-temporary impairment losses	—	—	—	(52 )
Portion of loss recognized in other comprehensive income (before taxes)	—	—	—	10
Net impairment losses recognized in earnings	—	—	—	(42 )
Gain on sale of loans	81	241	161	560
Trust income	762	733	1,542	1,453
Bank owned life insurance income	307	264	621	518
Other	1,073	953	2,056	1,844
Total noninterest income	6,515	11,096	12,321	21,336
Noninterest expense				
Salaries and employee benefits	13,092	13,401	26,194	26,610
Occupancy expense	1,786	1,897	3,540	3,768
Advertising, travel & entertainment	605	656	1,148	1,297
ATM and debit card expense	302	303	619	684
Professional fees	1,304	562	2,231	1,202
Software and data processing expense	486	444	987	987
Telephone and communications	320	384	598	835
FDIC insurance	434	409	882	830
FHLB prepayment fees	—	988	—	988
Other	2,097	2,122	4,409	4,284
Total noninterest expense	20,426	21,166	40,608	41,485

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Income before income tax expense	11,295	12,780	20,678	23,669
Provision for income tax expense	838	1,712	1,997	3,559
Net income	\$10,457	\$11,068	\$18,681	\$20,110
Earnings per common share – basic	\$0.55	\$0.59	\$0.99	\$1.07
Earnings per common share – diluted	\$0.55	\$0.59	\$0.99	\$1.07
Dividends paid per common share	\$0.21	\$0.20	\$0.42	\$0.40

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

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

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2014	2013	2014	2013
Net income	\$10,457	\$11,068	\$18,681	\$20,110
Other comprehensive income (loss):				
Unrealized holding gains (losses) on available for sale securities during the period	8,308	(38,536)	18,319	(44,280)
Change in net unrealized loss on securities transferred to held to maturity	278	28	554	28
Noncredit portion of other-than-temporary impairment losses on the AFS securities	—	—	—	(10)
Reclassification adjustment for net gain on sale of available for sale securities, included in net income	(498)	(5,001)	(509)	(9,346)
Reclassification of other-than-temporary impairment charges on available for sale securities, included in net income	—	—	—	42
Amortization of net actuarial loss, included in net periodic benefit cost	289	751	521	1,394
Amortization of prior service credit, included in net periodic benefit cost	(4)	(11)	(7)	(22)
Other comprehensive income (loss), before tax	8,373	(42,769)	18,878	(52,194)
Income tax (expense) benefit related to other items of comprehensive income	(2,930)	14,969	(6,607)	18,268
Other comprehensive income (loss), net of tax	5,443	(27,800)	12,271	(33,926)
Comprehensive income (loss)	\$15,900	\$(16,732)	\$30,952	\$(13,816)

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



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

(in thousands, except share and per share data)

	Common Stock	Paid In Capital	Retained Earnings	Treasury Stock	Accumulated Other Comprehensive Income (Loss)	Total Shareholders' Equity
Balance at December 31, 2012	\$24,308	\$195,602	\$70,708	\$(35,793 )	\$2,938	\$257,763
Net Income			20,110			20,110
Other comprehensive loss					(33,926 )	(33,926 )
Issuance of common stock (28,529 shares)	35	593				628
Purchase of common stock (90,300 shares)				(1,899 )		(1,899 )
Stock compensation expense		373				373
Tax benefits related to stock awards		22				22
Net issuance of common stock under employee stock plan	12	63	(62 )			13
Cash dividends paid on common stock (\$0.40 per share)			(6,964 )			(6,964 )
Stock dividend declared	1,065	15,995	(17,060 )			—
Balance at June 30, 2013	\$25,420	\$212,648	\$66,732	\$(37,692 )	\$(30,988 )	\$236,120
Balance at December 31, 2013	\$25,483	\$214,091	\$78,673	\$(37,692 )	\$(21,037 )	\$259,518
Net Income			18,681			18,681
Other comprehensive income					12,271	12,271
Issuance of common stock (18,265 shares)	23	500				523
Stock compensation expense		577				577
Tax benefits related to stock awards		38				38
Net issuance of common stock under employee stock plan	14	158	(103 )			69
Cash dividends paid on common stock (\$0.42 per share)			(7,717 )			(7,717 )
Stock dividend declared	1,124	24,941	(26,065 )			—
Balance at June 30, 2014	\$26,644	\$240,305	\$63,469	\$(37,692 )	\$(8,766 )	\$283,960

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  
(UNAUDITED)  
(in thousands)

	Six Months Ended June 30,	
	2014	2013
<b>OPERATING ACTIVITIES:</b>		
Net income	\$18,681	\$20,110
Adjustments to reconcile net income to net cash provided by operations:		
Depreciation	1,615	1,807
Amortization of premium	10,750	16,015
Accretion of discount and loan fees	(1,971)	(2,852)
Provision for loan losses	6,783	2,513
Stock compensation expense	577	373
Deferred tax (benefit) expense	(1,361)	909
Excess tax benefits from stock-based compensation	(42)	(22)
Net gain on sale of securities available for sale	(509)	(9,346)
Net other-than-temporary impairment losses	—	42
Gain on premises and equipment	(7)	—
Loss (gain) on other real estate owned	65	(72)
Net change in:		
Interest receivable	1,461	(1,947)
Other assets	(1,459)	(6,990)
Interest payable	(40)	(481)
Other liabilities	3,356	69
Loans held for sale	(604)	2,877
Net cash provided by operating activities	37,295	23,005
<b>INVESTING ACTIVITIES:</b>		
Securities held to maturity:		
Purchases	—	(115,647)
Maturities, calls and principal repayments	14,797	118,178
Securities available for sale:		
Purchases	(327,668)	(1,018,900)
Sales	252,696	612,459
Maturities, calls and principal repayments	153,637	179,203
Proceeds from redemption of FHLB stock	8,938	5,242
Purchases of FHLB stock and other investments	(384)	(4,506)
Net increase in loans	(49,047)	(35,355)
Purchases of premises and equipment	(2,878)	(1,918)
Proceeds from sales of premises and equipment	8	—
Proceeds from sales of other real estate owned	275	461
Proceeds from sales of repossessed assets	3,268	2,304
Net cash provided by (used in) investing activities	53,642	(258,479)

(continued)



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

	Six Months Ended June 30,	
	2014	2013
<b>FINANCING ACTIVITIES:</b>		
Net increase in demand and savings accounts	157,322	140,307
Net decrease in certificates of deposit	(83,711 )	(3,947 )
Net increase (decrease) in federal funds purchased and repurchase agreements	1,198	(127 )
Proceeds from FHLB advances	6,267,018	6,792,758
Repayment of FHLB advances	(6,325,689 )	(6,786,150 )
Excess tax benefits from stock-based awards	42	22
Net issuance of common stock under employee stock plan	69	13
Purchase of common stock	—	(1,899 )
Proceeds from the issuance of common stock	523	628
Cash dividends paid	(7,717 )	(6,964 )
Net cash provided by financing activities	9,055	134,641
Net increase (decrease) in cash and cash equivalents	99,992	(100,833 )
Cash and cash equivalents at beginning of period	54,431	150,630
Cash and cash equivalents at end of period	\$154,423	\$49,797
<b>SUPPLEMENTAL DISCLOSURES FOR CASH FLOW INFORMATION:</b>		
Interest paid	\$8,617	\$9,925
Income taxes paid	\$3,550	\$1,600
<b>SUPPLEMENTAL DISCLOSURES OF NONCASH INVESTING AND FINANCING ACTIVITIES:</b>		
Loans transferred to other repossessed assets and real estate through foreclosure	\$2,807	\$2,555
Transfer of available for sale securities to held to maturity securities	\$—	\$290,136
Adjustment to pension liability	\$(514 )	\$(1,372 )
5% stock dividend	\$26,065	\$17,060
Unsettled trades to purchase securities	\$(10,269 )	\$(27,814 )
Unsettled trades to sell securities	\$19,183	\$—
Unsettled issuances of brokered CDs	\$—	\$11,069

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

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SOUTHSIDE BANCSHARES, INC. AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. Basis of Presentation

In this report, the words “the Company,” “we,” “us,” and “our” refer to the combined entities of Southside Bancshares, Inc. and its subsidiaries. The words “Southside” and “Southside Bancshares” refer to Southside Bancshares, Inc. The words “Southside Bank” and “the Bank” refer to Southside Bank. “SFG” refers to SFG Finance, LLC (formerly Southside Financial Group, LLC), which is a wholly-owned subsidiary of the Bank.

In early 2013, we decided to close Southside Securities, Inc., our introducing broker-dealer. We completed the closure of Southside Securities, Inc. during the second quarter of 2013.

The consolidated balance sheet as of June 30, 2014, and the related consolidated statements of income, comprehensive income, changes in shareholders' equity and cash flows and notes to the financial statements for the three- and six-month periods ended June 30, 2014 and 2013 are unaudited; in the opinion of management, all adjustments necessary for a fair statement of such financial statements have been included. Such adjustments consisted only of normal recurring items. All significant intercompany accounts and transactions are eliminated in consolidation. The preparation of these consolidated financial statements in conformity with U.S. generally accepted accounting principles (“GAAP”) requires the use of management’s estimates. These estimates are subjective in nature and involve matters of judgment. Actual amounts could differ from these estimates.

Interim results are not necessarily indicative of results for a full year. These financial statements should be read in conjunction with the financial statements and notes thereto in our Annual Report on Form 10-K for the year ended December 31, 2013. For a description of our significant accounting and reporting policies, refer to Note 1 of the Notes to Consolidated Financial Statements in our Annual Report on Form 10-K for the year ended December 31, 2013.

On March 20, 2014, our board of directors declared a 5% stock dividend to common stock shareholders of record as of April 10, 2014, which was paid on May 1, 2014. All share data has been adjusted to give retroactive recognition to stock dividends.

Accounting Pronouncements

In January 2014, the Financial Accounting Standards Board (“FASB”) issued Accounting Standard Update (ASU) 2014-04 “Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans Upon Foreclosure” to clarify when an entity is considered to have obtained physical possession of a residential real estate property collateralizing a consumer mortgage loan. Upon physical possession (from an in-substance possession or foreclosure) of such real property, an entity is required to reclassify the nonperforming mortgage loan to other real estate owned. The ASU is effective for our interim and annual periods beginning after January 1, 2015. Early adoption is permitted. ASU 2014-04 is not expected to have a material impact on our consolidated financial statements.

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## 2. Pending Acquisitions

On April 28, 2014, the Company entered into an Agreement and Plan of Merger (the “Merger Agreement”) with OmniAmerican Bancorp, Inc., a Maryland corporation (“OmniAmerican”) and the holding company for OmniAmerican Bank, a federal savings association based in Fort Worth, Texas. As of June 30, 2014, OmniAmerican had \$1.4 billion in assets. The Merger Agreement provides that, subject to the terms and conditions thereof, OmniAmerican will merge with and into the Company, with the Company as the surviving corporation. The merger is expected to close during the fourth quarter of 2014, subject to receipt of regulatory approvals and approvals by both our shareholders and OmniAmerican's stockholders.

Pursuant to the Merger Agreement, each outstanding share of common stock of OmniAmerican will be converted into (a) 0.4459 of a share of common stock of the Company, subject to adjustment pursuant to the terms of the Merger Agreement and (b) \$13.125 in cash.

## 3. Earnings Per Share

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2014	2013	2014	2013
Basic and Diluted Earnings:				
Net income	\$10,457	\$11,068	\$18,681	\$20,110
Basic weighted-average shares outstanding	18,832	18,744	18,825	18,748
Add: Stock options	93	34	89	28
Diluted weighted-average shares outstanding	18,925	18,778	18,914	18,776
Basic Earnings Per Share:	\$0.55	\$0.59	\$0.99	\$1.07
Diluted Earnings Per Share:	\$0.55	\$0.59	\$0.99	\$1.07

For the three- and six-month periods ended June 30, 2014, there were approximately 18,000 and 21,000 anti-dilutive shares, respectively. For the three- and six-month periods ended June 30, 2013, there were approximately 10,000 and 18,000 anti-dilutive shares, respectively.

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## 4. Accumulated Other Comprehensive (Loss) Income

The changes in accumulated other comprehensive income by component are as follows (in thousands):

	Six Months Ended June 30, 2014				
	Unrealized Gains (Losses) on Securities		Pension Plans		Total
	Other	OTTI	Net Prior	Net Gain	
Service (Cost) Credit			(Loss)		
Beginning balance, net of tax	\$ (8,656 )	\$ —	\$ (12 )	\$ (12,369 )	\$ (21,037 )
Other comprehensive income (loss) before reclassifications	18,873	—	—	—	18,873
Reclassified to income	(509 )	—	(7 )	521	5
Income tax benefit (expense)	(6,427 )	—	2	(182 )	(6,607 )
Net current-period other comprehensive income (loss), net of tax	11,937	—	(5 )	339	12,271
Ending balance, net of tax	\$3,281	\$—	\$ (17 )	\$ (12,030 )	\$ (8,766 )

	Three Months Ended June 30, 2014				
	Unrealized Gains (Losses) on Securities		Pension Plans		Total
	Other	OTTI	Net Prior	Net Gain	
Service (Cost) Credit			(Loss)		
Beginning balance, net of tax	\$ (1,977 )	\$ —	\$ (14 )	\$ (12,218 )	\$ (14,209 )
Other comprehensive income (loss) before reclassifications	8,586	—	—	—	8,586
Reclassified to income	(498 )	—	(4 )	289	(213 )
Income tax benefit (expense)	(2,830 )	—	1	(101 )	(2,930 )
Net current-period other comprehensive income (loss), net of tax	5,258	—	(3 )	188	5,443
Ending balance, net of tax	\$3,281	\$—	\$ (17 )	\$ (12,030 )	\$ (8,766 )

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	Six Months Ended June 30, 2013				
	Unrealized Gains (Losses) on Securities		Pension Plans		
	Other	OTTI	Net Prior Service (Cost) Credit	Net Gain (Loss)	Total
Beginning balance, net of tax	\$30,500	\$(1,140)	) \$248	\$(26,670)	) \$2,938
Other comprehensive income (loss) before reclassifications	(44,416)	) 154	—	—	(44,262)
Reclassified to income	(9,346)	) 42	(22)	) 1,394	(7,932)
Income tax benefit (expense)	18,816	(68)	) 8	(488)	) 18,268
Net current-period other comprehensive (loss) income, net of tax	(34,946)	) 128	(14)	) 906	(33,926)
Ending balance, net of tax	\$(4,446)	) \$(1,012)	) \$234	\$(25,764)	) \$(30,988)
	Three Months Ended June 30, 2013				
	Unrealized Gains (Losses) on Securities		Pension Plans		
	Other	OTTI	Net Prior Service (Cost) Credit	Net Gain (Loss)	Total
Beginning balance, net of tax	\$24,194	\$(1,371)	) \$241	\$(26,252)	) \$(3,188)
Other comprehensive income (loss) before reclassifications	(39,060)	) 552	—	—	(38,508)
Reclassified to income	(5,001)	) —	(11)	) 751	(4,261)
Income tax benefit (expense)	15,421	(193)	) 4	(263)	) 14,969
Net current-period other comprehensive (loss) income, net of tax	(28,640)	) 359	(7)	) 488	(27,800)
Ending balance, net of tax	\$(4,446)	) \$(1,012)	) \$234	\$(25,764)	) \$(30,988)



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The reclassifications out of accumulated other comprehensive income into net income are presented below (in thousands):

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2014	2013	2014	2013
Unrealized gains and losses on available for sale securities:				
Realized net (loss) gain on sale of securities <sup>(1)</sup>	\$498	\$5,001	\$509	\$9,346
Impairment losses <sup>(2)</sup>	—	—	—	(42 )
Total before tax	498	5,001	509	9,304
Tax expense	(174 )	(1,750 )	(178 )	(3,256 )
Net of tax	\$324	\$3,251	\$331	\$6,048
Amortization of pension plan items:				
Net actuarial loss <sup>(3)</sup>	\$(289 )	\$(751 )	\$(521 )	\$(1,394 )
Prior service credit <sup>(3)</sup>	4	11	7	22
Total before tax	(285 )	(740 )	(514 )	(1,372 )
Tax benefit	100	259	180	480
Net of tax	\$(185 )	\$(481 )	\$(334 )	\$(892 )
Total reclassifications for the period, net of tax	\$139	\$2,770	\$(3 )	\$5,156

(1) Listed as Net gain on sale of securities available for sale on the Statements of Income.

(2) Listed as Net impairment losses recognized in earnings on the Statements of Income.

(3) These accumulated other comprehensive income components are included in the computation of net periodic benefit cost presented in "Note 8 - Employee Benefit Plans."

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## 5. Securities

The amortized cost, carrying value, and estimated fair value of investment and mortgage-backed securities as of June 30, 2014 and December 31, 2013 are reflected in the tables below (in thousands):

	June 30, 2014						
	Amortized	Recognized in OCI		Carrying	Not recognized in OCI		Estimated
	Cost	Gross Unrealized Gains	Gross Unrealized Losses	Value	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
<b>AVAILABLE FOR SALE</b>							
Investment Securities:							
U.S. Treasuries	\$29,388	\$74	\$56	\$29,406			\$29,406
State and Political Subdivisions	306,164	6,505	3,438	309,231			309,231
Other Stocks and Bonds	13,080	191	—	13,271			13,271
Mortgage-backed Securities: <sup>(1)</sup>							
Residential	639,149	14,396	1,484	652,061			652,061
Commercial	99,137	1,018	476	99,679			99,679
Total	\$1,086,918	\$22,184	\$5,454	\$1,103,648			\$1,103,648
<b>HELD TO MATURITY</b>							
Investment Securities:							
State and Political Subdivisions	\$395,077	\$5,554	\$10,410	\$390,221	\$6,895	\$2,478	\$394,638
Mortgage-backed Securities: <sup>(1)</sup>							
Residential	59,335	—	84	59,251	3,515	—	62,766
Commercial	208,149	—	6,741	201,408	3,935	1,924	203,419
Total	\$662,561	\$5,554	\$17,235	\$650,880	\$14,345	\$4,402	\$660,823

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	December 31, 2013						
	Amortized	Recognized in OCI		Carrying	Not recognized in OCI		Estimated
Cost	Gross Unrealized	Gross Unrealized	Gross Unrealized		Gross Unrealized	Gross Unrealized	
<b>AVAILABLE FOR SALE</b>							
Investment Securities:							
U.S. Government Agency Debentures	\$11,612	\$—	\$1,483	\$10,129			\$10,129
State and Political Subdivisions	322,412	4,537	12,875	314,074			314,074
Other Stocks and Bonds	13,074	159	7	13,226			13,226
Mortgage-backed Securities: <sup>(1)</sup>							
Residential	760,418	14,940	3,273	772,085			772,085
Commercial	71,262	220	3,309	68,173			68,173
<b>Total</b>	<b>\$1,178,778</b>	<b>\$19,856</b>	<b>\$20,947</b>	<b>\$1,177,687</b>			<b>\$1,177,687</b>
<b>HELD TO MATURITY</b>							
Investment Securities:							
State and Political Subdivisions	\$396,549	\$5,925	\$10,922	\$391,552	\$1,207	\$15,376	\$377,383
Mortgage-backed Securities: <sup>(1)</sup>							
Residential	74,129	—	99	74,030	3,923	—	77,953
Commercial	208,667	—	7,128	201,539	—	7,656	193,883
<b>Total</b>	<b>\$679,345</b>	<b>\$5,925</b>	<b>\$18,149</b>	<b>\$667,121</b>	<b>\$5,130</b>	<b>\$23,032</b>	<b>\$649,219</b>

(1) All mortgage-backed securities issued and/or guaranteed by U.S. government agencies or U.S. government-sponsored enterprises.

During 2013, the Company transferred certain commercial mortgage-backed securities and state and political subdivision securities from available for sale (“AFS”) to held to maturity (“HTM”). We transferred these securities due to overall balance sheet strategies, and our management has the current intent and ability to hold these securities until maturity. The net unrealized loss on the transferred securities included in accumulated other comprehensive income at the time of transfer will be amortized over the remaining life of the underlying security as an adjustment of the yield on those securities. There were no securities transferred from AFS to HTM during the six months ended June 30, 2014.

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The following table represents the unrealized loss on securities as of June 30, 2014 and December 31, 2013 (in thousands):

	As of June 30, 2014		More Than 12 Months		Total	
	Less Than 12 Months Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
<b>AVAILABLE FOR SALE</b>						
Investment Securities:						
U.S. Treasuries	\$14,622	\$56	\$—	\$—	\$14,622	\$56
State and Political Subdivisions	52,132	424	118,123	3,014	170,255	3,438
Mortgage-backed Securities:						
Residential	55,955	224	47,083	1,260	103,038	1,484
Commercial	5,442	13	26,967	463	32,409	476
Total	\$128,151	\$717	\$192,173	\$4,737	\$320,324	\$5,454
<b>HELD TO MATURITY</b>						
Investment Securities:						
State and Political Subdivisions	\$61,771	\$320	\$130,419	\$2,158	\$192,190	\$2,478
Mortgage-backed Securities:						
Commercial	—	—	100,580	1,924	100,580	1,924
Total	\$61,771	\$320	\$230,999	\$4,082	\$292,770	\$4,402
	As of December 31, 2013		More Than 12 Months		Total	
	Less Than 12 Months Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
<b>AVAILABLE FOR SALE</b>						
Investment Securities:						
U.S. Government Agency Debentures	\$—	\$—	\$10,129	\$1,483	\$10,129	\$1,483
State and Political Subdivisions	191,117	11,757	18,408	1,118	209,525	12,875
Other Stocks and Bonds	2,992	7	—	—	2,992	7
Mortgage-backed Securities:						
Residential	126,965	3,266	1,351	7	128,316	3,273
Commercial	65,406	3,309	—	—	65,406	3,309
Total	\$386,480	\$18,339	\$29,888	\$2,608	\$416,368	\$20,947
<b>HELD TO MATURITY</b>						
Investment Securities:						
State and Political Subdivisions	\$283,667	\$15,311	\$1,705	\$65	\$285,372	\$15,376
Mortgage-backed Securities:						
Commercial	193,883	7,656	—	—	193,883	7,656
Total	\$477,550	\$22,967	\$1,705	\$65	\$479,255	\$23,032

We review securities in an unrealized loss position to evaluate if a classification of other-than-temporarily impaired is warranted. 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. The Company considers an other-than-temporary impairment to have occurred when there is an adverse change in expected cash flows. 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 to other comprehensive income for the noncredit portion.

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The majority of the unrealized loss positions are comprised of highly rated municipal securities and U.S. Agency mortgage-backed securities ("MBS") where the unrealized loss is a direct result of the change in interest rates and spreads. Based upon the length of time and the extent to which fair value is less than cost, we believe the securities with an unrealized loss are not other-than-temporarily impaired at June 30, 2014.

Prior to December 31, 2013, we held pooled trust preferred securities ("TRUPs"). The turmoil in the capital markets had a significant impact on our estimate of fair value of our TRUPs. These TRUPs were structured products with cash flows dependent upon securities issued by U.S. financial institutions, including banks and insurance companies. Given the facts and circumstances associated with the TRUPs, we reviewed the financial condition of each of the underlying issuing banks within the TRUP collateral pool that had not deferred and defaulted and performed detailed cash flow modeling for each TRUP. During the first six months of 2013, the additional write-down recognized in earnings was approximately \$42,000.

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

	Three Months Ended June 30, 2013	Six Months Ended June 30, 2013
Balance, beginning of period	\$3,298	\$3,256
Additions for credit losses recognized on debt securities that had previously incurred impairment losses	—	42
Balance, end of period	\$3,298	\$3,298

On December 13, 2013, management decided to sell all TRUPs as a result of new guidance effective in 2014 as listed in Section 419 of the Dodd-Frank Act (the "Volcker Rule"). The sale of the TRUPs, with a \$2.7 million amortized-cost basis, resulted in a loss of approximately \$959,000. Until the final rules under the Volcker Rule were issued by the agencies on December 10, 2013, management did not intend to sell the securities and it was not more likely than not that we would be required to sell the security before the anticipated recovery of its amortized cost basis.

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

	Six Months Ended June 30,	
	2014	2013
U.S. Treasury	\$41	\$17
U.S. Government Agency Debentures	100	305
State and Political Subdivisions	12,001	10,507
Other Stocks and Bonds	103	99
Mortgage-backed Securities	15,239	8,616
Total interest income on securities	\$27,484	\$19,544
	Three Months Ended June 30,	
	2014	2013
U.S. Treasury	\$41	\$—
U.S. Government Agency Debentures	41	93
State and Political Subdivisions	6,031	5,929
Other Stocks and Bonds	51	54
Mortgage-backed Securities	7,557	4,680

Total interest income on securities	\$13,721	\$10,756
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Of the approximately \$509,000 in net securities gains from the AFS portfolio for the six months ended June 30, 2014, there were \$4.6 million in realized gains and \$4.1 million in realized losses. Of the \$9.3 million in net securities gains from the AFS portfolio for the six months ended June 30, 2013, there were \$10.7 million in realized gains and approximately \$1.4 million in realized losses. There were no sales from the HTM portfolio during the six months ended June 30, 2014 or 2013.

The amortized cost, carrying value and fair value of securities at June 30, 2014, are presented below by contractual maturity. Expected maturities may differ from contractual maturities because issuers may have the right to call or prepay obligations. MBS are presented in total by category due to the fact that MBS 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 security 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.

	June 30, 2014	
	Amortized Cost	Fair Value
	(in thousands)	
<b>AVAILABLE FOR SALE</b>		
Investment Securities:		
Due in one year or less	\$3,410	\$3,456
Due after one year through five years	18,990	19,509
Due after five years through ten years	63,009	63,789
Due after ten years	263,223	265,154
	348,632	351,908
Mortgage-backed Securities:	738,286	751,740
Total	\$1,086,918	\$1,103,648
	June 30, 2014	
	Carrying Value	Fair Value
	(in thousands)	
<b>HELD TO MATURITY</b>		
Investment Securities:		
Due in one year or less	\$—	\$—
Due after one year through five years	329	331
Due after five years through ten years	18,741	18,739
Due after ten years	371,151	375,568
	390,221	394,638
Mortgage-backed Securities:	260,659	266,185
Total	\$650,880	\$660,823

Investment and MBS with carrying values of \$976.6 million and \$1.14 billion were pledged as of June 30, 2014 and December 31, 2013, respectively, to collateralize Federal Home Loan Bank (“FHLB”) advances, repurchase agreements, and public funds 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 their fair value and are assessed for other-than-temporary impairment. These securities have no maturity date.



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## 6. Loans and Allowance for Probable Loan Losses

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

	June 30, 2014	December 31, 2013
Real Estate Loans:		
Construction	\$ 164,668	\$ 125,219
1-4 Family Residential	391,675	390,499
Other	271,858	262,536
Commercial Loans	156,893	157,655
Municipal Loans	239,883	245,550
Loans to Individuals	166,308	169,814
Total Loans	1,391,285	1,351,273
Less: Allowance for Loan Losses	18,408	18,877
Net Loans	\$ 1,372,877	\$ 1,332,396

## Real Estate Construction Loans

Our construction loans are collateralized by property located primarily in the market areas we serve. A majority of our construction loans will be owner-occupied. Construction loans for speculative projects 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. Speculative and commercial construction loans are subject to underwriting standards similar to that of the commercial portfolio. Owner occupied 1-4 family residential construction loans are subject to the underwriting standards of the permanent loan.

## Real Estate 1-4 Family Residential 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 loan originations are secured by properties located in or near our market areas.

Our 1-4 family residential 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. Our 1-4 family residential loans are made at both fixed and adjustable interest rates.

Underwriting for 1-4 family residential loans includes debt-to-income analysis, credit history analysis, appraised value and down payment considerations. Changes in the market value of real estate can affect the potential losses in the portfolio.

## Other Real Estate

Other Real Estate loans primarily include loans collateralized by 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. Other real estate loans are made at both fixed and adjustable interest rates for terms generally up to 20 years.

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### Commercial Loans

Our commercial loans are diversified loan types including 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.

### Loans to Individuals

Substantially all originations of our loans to individuals are made to consumers in our market areas. The majority of loans to individuals are collateralized by titled equipment, which are primarily automobiles. Loan pools purchased through SFG are subjected to a modeling system that takes into consideration credit scores and estimated collateral values to determine expected defaults in each pool. SFG purchased loan pools of approximately \$30.4 million and \$45.3 million, net of discount, during the six months ended June 30, 2014 and June 30, 2013, respectively. For the three months ended June 30, 2014 and June 30, 2013, SFG purchased loan pools of approximately \$9.6 million and \$23.5 million, net of discount.

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.

### Allowance for Loan Losses

The allowance for loan losses is based on the most current review of the loan portfolio and is a result of multiple processes. First, the bank utilizes historical data to establish general reserve amounts for each class of loans. The historical charge off figure is further adjusted through qualitative factors that include general trends in past dues, nonaccruals and classified loans to more effectively and promptly react to both positive and negative movements. 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 senior loan administration, the Special Assets department, and the Loan Review department. Third, the Loan Review department independently reviews 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 considerations including the size of the loan, the type of credit extended, the seasoning of the loan and the performance of the loan. The Loan Review scope, as it relates to size, focuses more on larger dollar loan relationships, typically, for example, aggregate debt of \$500,000 or greater. The Loan Review officer also reviews specific reserves 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.



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At each review, a subjective analysis methodology is used to grade the respective loan. Categories of grading vary in severity from loans that do not appear to have a significant probability of loss at the time of review to loans that indicate a probability that the entire balance of the loan will be uncollectible. If full collection of the loan balance appears unlikely at the time of review, estimates of future expected cash flows or appraisals of the collateral securing the debt are used to 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.

SFG loans, included in loans to individuals, experiencing past due status or extension of maturity characteristics are reserved for at 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 repay 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.

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, and geographic and industry loan concentration.

### 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:

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

Pass Watch (Rating 5) – Special Treatment Required – 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 Loan Review; 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.

Loans that are accruing and not considered troubled debt restructurings ("TDR") are reserved for as a group of similar type 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 charge-off trends;
- 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.

The following tables detail activity in the allowance for loan losses by portfolio segment for the periods presented (in thousands):

	Six Months Ended June 30, 2014							Unallocated	Total
	Real Estate			Commercial Loans	Municipal Loans	Loans to Individuals			
	Construction	1-4 Family Residential	Other						
Balance at beginning of period	\$2,142	\$3,277	\$2,572	\$ 1,970	\$ 668	\$ 8,248	\$—	\$ 18,877	
Provision (reversal) for loan losses	309	628	(140 )	(319 )	(5 )	6,310	—	6,783	
Loans charged off	(14 )	(22 )	—	(5 )	—	(8,273 )	—	(8,314 )	
Recoveries of loans charged off	59	32	4	111	—	856	—	1,062	
Balance at end of period	\$2,496	\$3,915	\$2,436	\$ 1,757	\$ 663	\$ 7,141	\$—	\$ 18,408	

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Three Months Ended June 30, 2014								
Real Estate								
	Construction	1-4 Family Residential	Other	Commercial Loans	Municipal Loans	Loans to Individuals	Unallocated	Total
Balance at beginning of period	\$2,130	\$3,797	\$2,411	\$2,031	\$777	\$7,641	\$—	\$18,787
Provision (reversal) for loan losses	319	92	24	(322 )	(114 )	2,651	—	2,650
Loans charged off	—	—	—	(5 )	—	(3,541 )	—	(3,546 )
Recoveries of loans charged off	47	26	1	53	—	390	—	517
Balance at end of period	\$2,496	\$3,915	\$2,436	\$1,757	\$663	\$7,141	\$—	\$18,408

Six Months Ended June 30, 2013								
Real Estate								
	Construction	1-4 Family Residential	Other	Commercial Loans	Municipal Loans	Loans to Individuals	Unallocated	Total
Balance at beginning of period	\$2,355	\$3,545	\$2,290	\$3,158	\$633	\$7,373	\$1,231	\$20,585
Provision (reversal) for loan losses	(277 )	281	(129 )	(620 )	—	3,916	(658 )	2,513
Loans charged off	—	(228 )	(67 )	(198 )	—	(5,364 )	—	(5,857 )
Recoveries of loans charged off	22	11	10	110	—	976	—	1,129
Balance at end of period	\$2,100	\$3,609	\$2,104	\$2,450	\$633	\$6,901	\$573	\$18,370

Three Months Ended June 30, 2013								
Real Estate								
	Construction	1-4 Family Residential	Other	Commercial Loans	Municipal Loans	Loans to Individuals	Unallocated	Total
Balance at beginning of period	\$2,247	\$3,488	\$2,002	\$2,847	\$621	\$6,451	\$886	\$18,542
Provision (reversal) for loan losses	(152 )	114	118	(330 )	12	2,572	(313 )	2,021
Loans charged off	—	—	(21 )	(127 )	—	(2,557 )	—	(2,705 )
Recoveries of loans charged off	5	7	5	60	—	435	—	512
Balance at end of period	\$2,100	\$3,609	\$2,104	\$2,450	\$633	\$6,901	\$573	\$18,370

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The following tables present the balance in the allowance for loan losses by portfolio segment based on impairment method (in thousands):

	As of June 30, 2014						
	Real Estate						
	Construction	1-4 Family Residential	Other	Commercial Loans	Municipal Loans	Loans to Individuals	Total
Ending balance – individually evaluated for impairment	\$ 113	\$ 226	\$ 160	\$ 372	\$ 15	\$ 72	\$ 958
Ending balance – collectively evaluated for impairment	2,383	3,689	2,276	1,385	648	7,069	17,450
Balance at end of period	\$ 2,496	\$ 3,915	\$ 2,436	\$ 1,757	\$ 663	\$ 7,141	\$ 18,408

	As of December 31, 2013						
	Real Estate						
	Construction	1-4 Family Residential	Other	Commercial Loans	Municipal Loans	Loans to Individuals	Total
Ending balance – individually evaluated for impairment	\$ 103	\$ 161	\$ 73	\$ 240	\$ 15	\$ 173	\$ 765
Ending balance – collectively evaluated for impairment	2,039	3,116	2,499	1,730	653	8,075	18,112
Balance at end of period	\$ 2,142	\$ 3,277	\$ 2,572	\$ 1,970	\$ 668	\$ 8,248	\$ 18,877

The following tables present the recorded investment in loans by portfolio segment based on impairment method (in thousands):

	June 30, 2014						
	Real Estate						
	Construction	1-4 Family Residential	Other	Commercial Loans	Municipal Loans	Loans to Individuals	Total
Loans individually evaluated for impairment	\$ 2,067	\$ 3,991	\$ 3,567	\$ 1,087	\$ 759	\$ 347	\$ 11,818
Loans collectively evaluated for impairment	162,601	387,684	268,291	155,806	239,124	165,961	1,379,467
Total ending loan balance	\$ 164,668	\$ 391,675	\$ 271,858	\$ 156,893	\$ 239,883	\$ 166,308	\$ 1,391,285

	December 31, 2013						
	Real Estate						
	Construction	1-4 Family Residential	Other	Commercial Loans	Municipal Loans	Loans to Individuals	Total



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		Residential		Loans	Loans	Individuals	
Loans individually evaluated for impairment	\$1,472	\$2,624	\$1,778	\$1,369	\$759	\$559	\$8,561
Loans collectively evaluated for impairment	123,747	387,875	260,758	156,286	244,791	169,255	1,342,712
Total ending loan balance	\$125,219	\$390,499	\$262,536	\$157,655	\$245,550	\$169,814	\$1,351,273

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

	June 30, 2014					
	Pass	Pass Watch	Special Mention	Substandard	Doubtful	Total
Real Estate Loans:						
Construction	\$ 158,774	\$ 1,746	\$ 1,401	\$ 2,694	\$ 53	\$ 164,668
1-4 Family Residential	381,530	1,476	1,733	6,231	705	391,675
Other	259,575	3,873	2,617	5,783	10	271,858
Commercial Loans	135,174	14,534	—	6,889	296	156,893
Municipal Loans	238,874	—	—	1,009	—	239,883
Loans to Individuals	165,609	28	—	493	178	166,308
Total	\$ 1,339,536	\$ 21,657	\$ 5,751	\$ 23,099	\$ 1,242	\$ 1,391,285

	December 31, 2013					
	Pass	Pass Watch	Special Mention	Substandard	Doubtful	Total
Real Estate Loans:						
Construction	\$ 121,280	\$ —	\$ 1,419	\$ 2,454	\$ 66	\$ 125,219
1-4 Family Residential	380,741	1,626	3,025	4,901	206	390,499
Other	249,381	2,553	4,698	5,887	17	262,536
Commercial Loans	150,683	836	9	5,826	301	157,655
Municipal Loans	244,505	—	—	1,045	—	245,550
Loans to Individuals	168,764	27	2	719	302	169,814
Total	\$ 1,315,354	\$ 5,042	\$ 9,153	\$ 20,832	\$ 892	\$ 1,351,273

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

	At June 30, 2014	At December 31, 2013
Nonaccrual loans	\$ 9,620	\$ 8,088
Accruing loans past due more than 90 days	4	3
Restructured loans	4,036	3,888
Other real estate owned	383	726
Reposessed assets	492	901
Total Nonperforming Assets	\$ 14,535	\$ 13,606

## Nonaccrual and Past Due Loans

Nonaccrual loans are loans 90 days or more delinquent and collection in full of both the principal and interest is not expected. 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



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payments are reasonably assured. Other factors, such as the value of collateral securing the loan and the financial condition of the borrower, are considered in judgments as to potential loan loss.

Loans are considered impaired if, based on current information and events, it is probable that we will be unable to collect the scheduled payments of principal and interest when due according to the contractual terms of the loan agreement. The measurement of loss on 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):

	June 30, 2014		December 31, 2013	
	Nonaccrual	Accruing Loans Past Due More Than 90 Days	Nonaccrual	Accruing Loans Past Due More Than 90 Days
Real Estate Loans:				
Construction	\$2,067	\$—	\$1,472	\$—
1-4 Family Residential	2,566	—	1,435	—
Other	2,431	—	599	—
Commercial Loans	513	—	1,062	—
Loans to Individuals	2,043	4	3,520	3
Total	\$9,620	\$4	\$8,088	\$3

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

	June 30, 2014			Total Past Due	Current	Total
	30-59 Days Past Due	60-89 Days Past Due	Greater than 90 Days Past Due			
Real Estate Loans:						
Construction	\$—	\$—	\$2,067	\$2,067	\$162,601	\$164,668
1-4 Family Residential	40	559	2,566	3,165	388,510	391,675
Other	990	197	2,431	3,618	268,240	271,858
Commercial Loans	16	36	513	565	156,328	156,893
Municipal Loans	—	—	—	—	239,883	239,883
Loans to Individuals	6,705	2,440	2,047	11,192	155,116	166,308
Total	\$7,751	\$3,232	\$9,624	\$20,607	\$1,370,678	\$1,391,285



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	December 31, 2013			Total Past Due	Current	Total
	30-59 Days Past Due	60-89 Days Past Due	Greater than 90 Days Past Due			
Real Estate Loans:						
Construction	\$311	\$—	\$1,472	\$1,783	\$123,436	\$125,219
1-4 Family Residential	4,340	781	1,435	6,556	383,943	390,499
Other	2,652	—	599	3,251	259,285	262,536
Commercial Loans	411	22	1,062	1,495	156,160	157,655
Municipal Loans	—	—	—	—	245,550	245,550
Loans to Individuals	7,241	2,590	3,523	13,354	156,460	169,814
Total	\$14,955	\$3,393	\$8,091	\$26,439	\$1,324,834	\$1,351,273

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):

	Six Months Ended June 30, 2014			June 30, 2013		
	Average Recorded Investment	Interest Income Recognized	Accruing Interest at Original Contracted Rate	Average Recorded Investment	Interest Income Recognized	Accruing Interest at Original Contracted Rate
Real Estate Loans:						
Construction	\$1,578	\$11	\$69	\$1,919	\$3	\$82
1-4 Family Residential	2,982	65	110	3,121	20	82
Other	2,362	75	81	2,159	28	78
Commercial Loans	1,446	19	37	1,979	6	57
Municipal Loans	759	21	21	—	—	—
Loans to Individuals	2,679	103	235	3,030	150	300
Total	\$11,806	\$294	\$553	\$12,208	\$207	\$599

	Three Months Ended June 30, 2014			June 30, 2013		
	Average Recorded Investment	Interest Income Recognized	Accruing Interest at Original Contracted Rate	Average Recorded Investment	Interest Income Recognized	Accruing Interest at Original Contracted Rate
Real Estate Loans:						
Construction	\$1,643	\$9	\$35	\$1,551	\$2	\$41
1-4 Family residential	3,418	21	55	3,238	5	42
Other	2,838	22	40	1,900	10	39
Commercial loans	1,444	12	18	1,914	1	28
Municipal loans	759	21	21	—	—	—
Loans to individuals	2,144	23	146	2,689	54	162
Total	\$12,246	\$108	\$315	\$11,292	\$72	\$312



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

	June 30, 2014				
	Unpaid Contractual Principal Balance	Recorded Investment With No Allowance	Recorded Investment With Allowance	Total Recorded Investment	Related Allowance for Loan Losses
Real Estate Loans:					
Construction	\$2,743	\$—	\$2,067	\$2,067	\$113
1-4 Family Residential	4,106	—	3,991	3,991	226
Other	3,577	—	3,567	3,567	160
Commercial Loans	1,236	—	1,087	1,087	372
Municipal Loans	759	—	759	759	15
Loans to Individuals	2,368	—	2,155	2,155	1,048
Total	\$14,789	\$—	\$13,626	\$13,626	\$1,934
	December 31, 2013				
	Unpaid Contractual Principal Balance	Recorded Investment With No Allowance	Recorded Investment With Allowance	Total Recorded Investment	Related Allowance for Loan Losses
Real Estate Loans:					
Construction	\$2,629	\$—	\$1,472	\$1,472	\$103
1-4 Family Residential	2,748	—	2,624	2,624	161
Other	1,800	—	1,778	1,778	73
Commercial Loans	1,606	—	1,369	1,369	240
Municipal Loans	759	—	759	759	15
Loans to Individuals	4,280	—	3,943	3,943	1,950
Total	\$13,822	\$—	\$11,945	\$11,945	\$2,542

At the time a loss is probable in the collection of contractual amounts, specific reserves are allocated. Loans are charged off when deemed uncollectible or 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.



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## Troubled Debt Restructurings

The restructuring of a loan is considered a 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.

The following tables set forth the recorded investment in TDRs for the periods presented (dollars in thousands):

	Six Months Ended June 30, 2014				
	Extend Amortization Period	Interest Rate Reductions	Combination <sup>(1)</sup>	Total Modifications	Number of Loans
Real Estate Loans:					
1-4 Family Residential	\$—	\$284	\$—	\$284	1
Other	—	—	413	413	2
Commercial Loans	313	—	56	369	5
Loans to Individuals	—	15	45	60	4
Total	\$313	\$299	\$514	\$1,126	12
	Three Months Ended June 30, 2014				
	Extend Amortization Period	Interest Rate Reductions	Combination <sup>(1)</sup>	Total Modifications	Number of Loans
Real Estate Loans:					
1-4 Family Residential	\$—	\$—	\$—	\$—	—
Other	—	—	388	388	1
Commercial Loans	60	—	—	60	2
Loans to Individuals	—	—	—	—	—
Total	\$60	\$—	\$388	\$448	3
	Six Months Ended June 30, 2013				
	Extend Amortization Period	Interest Rate Reductions	Combination <sup>(1)</sup>	Total Modifications	Number of Loans
Real Estate Loans:					
Construction	\$40	\$—	\$—	\$40	1
1-4 Family Residential	285	—	468	753	6
Other	—	—	16	16	1
Commercial Loans	307	—	19	326	5
Loans to Individuals	14	185	35	234	32
Total	\$646	\$185	\$538	\$1,369	45

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	Three Months Ended June 30, 2013			Total Modifications	Number of Loans
	Extend Amortization Period	Interest Rate Reductions	Combination <sup>(1)</sup>		
Real Estate Loans:					
1-4 Family Residential	\$—	\$—	\$391	\$391	2
Other	—	—	16	16	1
Commercial Loans	22	—	—	22	1
Loans to Individuals	14	185	28	227	30
Total	\$36	\$185	\$435	\$656	34

(1) These modifications include an extension of the amortization period and interest rate reduction.

The majority of loans restructured as TDRs during the three and six months ended June 30, 2014 were modified with a combination of interest rate reductions and maturity extensions. 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 three and six months ended June 30, 2014 and June 30, 2013 were insignificant. Generally, 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 three and six months ended June 30, 2014 and 2013, there were no material defaults. Payment defaults for TDRs did not significantly impact the determination of the allowance for loan loss.

At June 30, 2014 and December 31, 2013, there were no commitments to lend additional funds to borrowers whose terms had been modified in TDRs.

## 7. Long-term Obligations

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

	June 30, 2014	December 31, 2013
FHLB Advances <sup>(1)</sup>	\$505,710	\$499,349
Long-term Debt <sup>(2)</sup>		
Southside Statutory Trust III Due 2033 <sup>(3)</sup>	20,619	20,619
Southside Statutory Trust IV Due 2037 <sup>(4)</sup>	23,196	23,196
Southside Statutory Trust V Due 2037 <sup>(5)</sup>	12,887	12,887
Magnolia Trust Company I Due 2035 <sup>(6)</sup>	3,609	3,609
Total Long-term Debt	60,311	60,311
Total Long-term Obligations	\$566,021	\$559,660

(1) At June 30, 2014, the weighted average cost of these advances was 1.44%. Long-term FHLB Advances have maturities ranging from July 2015 through July 2028.

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

(3)

This debt carries an adjustable rate of 3.1741% through September 29, 2014 and adjusts quarterly at a rate equal to three-month LIBOR plus 294 basis points.

- (4) This debt carries an adjustable rate of 1.52485% through July 29, 2014 and adjusts quarterly at a rate equal to three-month LIBOR plus 130 basis points.

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(5) This debt carries an adjustable rate of 2.4806% through September 14, 2014 and adjusts quarterly at a rate equal to three-month LIBOR plus 225 basis points.

(6) This debt carries an adjustable rate of 2.02735% through August 22, 2014 and adjusts quarterly at a rate equal to three-month LIBOR plus 180 basis points.

## 8. Employee Benefit Plans

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

	Six Months Ended June 30,			
	Defined Benefit Pension Plan		Restoration Plan	
	2014	2013	2014	2013
Service cost	\$849	\$1,059	\$137	\$149
Interest cost	1,748	1,577	281	234
Expected return on assets	(2,824 )	(2,397 )	—	—
Net actuarial loss recognition	272	1,099	249	295
Prior service (credit) cost amortization	(10 )	(21 )	3	(1 )
Net periodic benefit cost	\$35	\$1,317	\$670	\$677
	Three Months Ended June 30,			
	Defined Benefit Pension Plan		Restoration Plan	
	2014	2013	2014	2013
Service cost	\$401	\$503	\$68	\$98
Interest cost	876	792	145	135
Expected return on assets	(1,412 )	(1,199 )	—	—
Net loss recognition	141	554	148	197
Prior service credit amortization	(6 )	(10 )	2	(1 )
Net periodic benefit cost	\$—	\$640	\$363	\$429

Employer Contributions. As of June 30, 2014, contributions of \$120,000 have been made to our Restoration Plan. We do not anticipate contributing to our Defined Benefit Pension Plan in 2014.

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## 9. 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 1,340,098 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 first six months of 2014 and 2013, there were no grants of RSUs or NQSOs pursuant to the 2009 Incentive Plan.

As of June 30, 2014, there were 356,407 unvested awards outstanding. For the three and six months ended June 30, 2014, there was share-based compensation expense of \$291,000 and \$577,000, respectively, with an associated income tax benefit for the three and six months of \$102,000 and \$202,000, respectively. As of June 30, 2013, there were 305,403 unvested awards outstanding. Share-based compensation expense for the three and six months ended June 30, 2013 was \$166,000 and \$373,000, respectively, with an associated income tax benefit for the three and six months of \$58,000 and \$131,000, respectively.

As of June 30, 2014 and 2013, there was \$2.5 million and \$1.7 million of unrecognized compensation cost, respectively, related to the unvested awards outstanding. The remaining cost at June 30, 2014 is expected to be recognized over a weighted-average period of 2.74 years.

The NQSOs have contractual terms of 10 years and vest in equal annual installments over three- and four-year periods.

The fair value of each RSU is the closing stock price on the date of grant. The RSUs vest in equal annual installments over three- and four-year periods.

Each award is evidenced by an award agreement that specifies the exercise 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 the six months ended June 30, 2014 and 2013, there were 11,812 and 9,994 shares, respectively, issued in connection with stock compensation awards from available authorized shares.

The following table presents activity related to our RSUs and NQSOs as of June 30, 2014.

	Shares Available for Grant	Restricted Stock Units Outstanding	Weighted-Average Grant-Date Fair Value	Stock Options Outstanding	Weighted-Average Exercise Price	Weighted-Average Grant-Date Fair Value
Balance, January 1, 2014	738,764	56,823	\$22.00	501,846	\$20.56	\$6.18
Granted	—	—	—	—	—	—
Stock options exercised	—	—	—	(4,949 )	17.29	5.13

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Stock awards vested	—	(6,525	) 16.58	—	—	—
Forfeited	16,988	(2,901	) 22.11	(14,087	) 22.30	6.69
Canceled/expired	1,898	—	—	(1,898	) 18.99	5.27
Balance, June 30, 2014	757,650	47,397	\$22.73	480,912	\$20.55	\$6.18

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Other information regarding options outstanding and exercisable as of June 30, 2014 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
\$16.58 - \$25.85	480,912	\$20.55	8.20	171,902	\$17.37
Total	480,912	\$20.55	8.20	171,902	\$17.37

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) of outstanding stock options and exercisable stock options was \$4.0 million and \$2.0 million at June 30, 2014, respectively.

Cash received from stock options exercises for the six months ended June 30, 2014 and 2013 was \$86,000 and \$38,000, respectively. The total intrinsic value related to stock options exercised during the six months ended June 30, 2014 and 2013, was approximately \$50,000 and \$14,000, respectively.

#### 10. 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.



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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.

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 six months ended June 30, 2014.

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 June 30, 2014 and December 31, 2013, based on our estimates of fair value, no valuation allowance was recognized.

Foreclosed Assets – Foreclosed assets are initially recorded at fair value less costs to sell. The fair value 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 initial recognition of foreclosed assets, we recognize charge-offs through the allowance for loan losses to the extent the fair value of the foreclosed asset, less costs to sell, is less than the loan amount.

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 June 30, 2014 and December 31, 2013, 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 and tested for goodwill impairment.

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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 Six Months Ended June 30, 2014				
	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. Treasuries	\$29,406	\$29,406	\$—	\$—	\$—
State and Political Subdivisions	309,231	—	309,231	—	—
Other Stocks and Bonds	13,271	—	13,271	—	—
Mortgage-backed Securities: <sup>(1)</sup>					
Residential	652,061	—	652,061	—	—
Commercial	99,679	—	99,679	—	—
Total recurring fair value measurements	\$1,103,648	\$29,406	\$1,074,242	\$—	\$—
Nonrecurring fair value measurements					
Foreclosed assets <sup>(2)</sup>	\$875	\$—	\$—	\$875	\$—
Impaired loans <sup>(3)</sup>	11,692	—	—	11,692	(22 )
Total nonrecurring fair value measurements	\$12,567	\$—	\$—	\$12,567	\$(22 )

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	At or For the Year Ended December 31, 2013				
	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	\$ 10,129	\$—	\$ 10,129	\$—	\$—
State and Political Subdivisions	314,074	—	314,074	—	—
Other Stocks and Bonds	13,226	—	13,226	—	—
Mortgage-backed Securities: <sup>(1)</sup>					
Residential	772,085	—	772,085	—	—
Commercial	68,173	—	68,173	—	—
Total recurring fair value measurements	\$ 1,177,687	\$—	\$ 1,177,687	\$—	\$—
Nonrecurring fair value measurements					
Foreclosed assets <sup>(2)</sup>	\$ 1,627	\$—	\$—	\$ 1,627	\$(485 )
Impaired loans <sup>(3)</sup>	9,403	—	—	9,403	(64 )
Total nonrecurring fair value measurements	\$ 11,030	\$—	\$—	\$ 11,030	\$(549 )

(1) All mortgage-backed securities issued and/or guaranteed by U.S. government agencies or U.S. government-sponsored enterprises.

(2) Losses represent related losses on foreclosed properties that were written down subsequent to their initial classification as foreclosed properties.

(3) 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.

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For the periods prior to the TRUPs sale in December 2013, the following table presents additional information about the TRUPs measured at fair value on a recurring basis and for which we utilized Level 3 inputs to determine fair value (in thousands):

	Three Months Ended June 30, 2013	Six Months Ended June 30, 2013
TRUPs		
Balance at Beginning of Period	\$592	\$990
Total gains or losses (realized/unrealized):		
Included in earnings	—	(42 )
Included in other comprehensive income (loss)	552	196
Purchases	—	—
Issuances	—	—
Settlements	—	—
Transfers in and/or out of Level 3	—	—
Balance at End of Period	\$1,144	\$1,144

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	\$—	\$(42 )
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The significant unobservable inputs used in the fair value measurement of our 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.

Level 3 assets recorded at fair value on a nonrecurring basis at June 30, 2014, 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.

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 amount for cash and cash equivalents is a reasonable estimate of those assets' fair value.

Investment and mortgage-backed 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.

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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 generally have original terms to maturity of one day and repurchase agreements, generally less than one year, and therefore both 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 measured on a nonrecurring basis at both their respective carrying amounts and fair value (in thousands):

June 30, 2014	Carrying Amount	Estimated Fair Value			
		Total	Level 1	Level 2	Level 3
Financial Assets:					
Cash and cash equivalents	\$ 154,423	\$ 154,423	\$ 154,423	\$—	\$—
Investment securities:					
Held to maturity, at carrying value	390,221	394,638	—	394,638	—
Mortgage-backed securities:					
Held to maturity, at carrying value	260,659	266,185	—	266,185	—
FHLB stock and other investments, at cost	27,576	27,576	—	27,576	—
Loans, net of allowance for loan losses	1,372,877	1,349,385	—	—	1,349,385
Loans held for sale	755	755	—	755	—
Financial Liabilities:					
Retail deposits	\$2,601,478	\$2,600,319	\$—	\$2,600,319	\$—
Federal funds purchased and repurchase agreements	2,057	2,057	—	2,057	—
FHLB advances	514,123	503,535	—	503,535	—
Long-term debt	60,311	43,742	—	43,742	—

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December 31, 2013	Carrying Amount	Estimated Fair Value			
		Total	Level 1	Level 2	Level 3
Financial Assets:					
Cash and cash equivalents	\$54,431	\$54,431	\$54,431	\$—	\$—
Investment securities:					
Held to maturity, at carrying value	391,552	377,383	—	377,383	—
Mortgage-backed securities:					
Held to maturity, at carrying value	275,569	271,836	—	271,836	—
FHLB stock and other investments, at cost	36,130	36,130	—	36,130	—
Loans, net of allowance for loan losses	1,332,396	1,306,524	—	—	1,306,524
Loans held for sale	151	151	—	151	—
Financial Liabilities:					
Retail deposits	\$2,527,808	\$2,526,143	\$—	\$2,526,143	\$—
Federal funds purchased and repurchase agreements	859	859	—	859	—
FHLB advances	572,794	559,648	—	559,648	—
Long-term debt	60,311	43,476	—	43,476	—

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.

## 11. Income Taxes

The provision for income taxes included in the accompanying statements of income consist of the following (in thousands):

	Three Months Ended		Six Months Ended	
	June 30, 2014	2013	June 30, 2014	2013
Current tax provision	\$1,342	\$1,895	\$3,358	\$2,711
Deferred tax (benefit) provision	(504)	(183)	(1,361)	848
Provision for tax expense charged to operations	\$838	\$1,712	\$1,997	\$3,559

Net deferred tax assets totaled \$12.7 million at June 30, 2014 and \$18.4 million at December 31, 2013. The decrease in net deferred tax assets resulted primarily from a decrease in unrealized losses on securities available for sale, partially offset by an increase in the alternative minimum tax. No valuation allowance for deferred tax assets was recorded at June 30, 2014 or December 31, 2013, as management believes it is more likely than not that all of the deferred tax assets will be realized because they are supported by recoverable taxes paid in prior years. There was approximately \$50,000 in unrecognized tax benefits at June 30, 2014.

We recognized income tax expense of \$838,000 and \$2.0 million, for an effective tax rate of 7.4% and 9.7% for the three and six months ended June 30, 2014, respectively, compared to \$1.7 million and \$3.6 million, for an effective tax rate of 13.4% and 15.0% for the three and six months ended June 30, 2013, respectively. The effective tax rate

differed from the U.S. statutory rate of 35% during the comparable periods primarily due to the effect of tax-exempt interest from loans,

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securities and bank owned life insurance. The lower effective tax rate for the three and six months ended June 30, 2014 was due to an increase in tax-exempt income as a percentage of taxable income as compared to the same periods in 2013.

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 2010.

## 12. 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 \$192.4 million and \$156.2 million at June 30, 2014 and December 31, 2013, 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 June 30, 2014 and December 31, 2013 were \$14.0 million and \$13.8 million, respectively, and are reflected in the due after one year category. We had outstanding standby letters of credit of \$6.1 million and \$5.9 million at June 30, 2014 and December 31, 2013, respectively.

The scheduled maturities of unused commitments were as follows (in thousands):

	At June 30, 2014	At December 31, 2013
Unused commitments:		
Due in one year or less	\$133,385	\$110,210
Due after one year	59,031	46,032
Total	\$192,416	\$156,242

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. It is expected that certain leases will be renewed, or equipment replaced with new leased equipment, as these leases expire.

**Securities.** In the normal course of business we buy and sell securities. There were \$10.3 million and \$973,000 of unsettled trades to purchase securities at June 30, 2014 and December 31, 2013, respectively. There were \$19.2

million and \$3.9 million unsettled trades to sell securities as of June 30, 2014 and December 31, 2013, respectively.

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Deposits. There were no unsettled issuances of brokered CDs at June 30, 2014 or December 31, 2013.

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.

Litigation Relating to the Merger. On June 25, 2014, a purported stockholder of OmniAmerican filed a lawsuit in the Circuit Court for Baltimore City, Maryland captioned McDougal v. OmniAmerican Bancorp, Inc., et al., Case No. 24-C-14-003920, naming OmniAmerican, members of OmniAmerican's board of directors, Southside and Omega Merger Sub, Inc., a wholly owned subsidiary of Southside ("Merger Sub"), as defendants. The lawsuit is purportedly brought on behalf of a putative class of OmniAmerican's public stockholders and seeks a declaration that it is properly maintainable as a class action and a certification of the plaintiff and her counsel as class representative and class counsel. The lawsuit asserts direct and derivative claims against OmniAmerican's directors and alleges that they breached their fiduciary duties and that OmniAmerican, Southside and Merger Sub aided and abetted those alleged breaches by, among other things, (a) failing to take steps to maximize shareholder value for OmniAmerican public stockholders; (b) failing to properly value OmniAmerican; (c) failing to protect against conflicts of interest; (d) failing to disclose material information necessary for OmniAmerican stockholders to make an informed vote on the merger; and (e) agreeing to deal protection devices that preclude a fair sales process. Among other relief, the plaintiff seeks to enjoin the merger. On July 9, 2014, the plaintiff filed a motion to transfer the case to Maryland's Business and Technology Case Management Program.

OmniAmerican and Southside believe the claims asserted are without merit and intend to vigorously defend against this lawsuit.

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

The following is a discussion of the consolidated financial condition, changes in financial condition, and results of our operations, and should be read and reviewed in conjunction with the financial statements, and the notes thereto, in this Quarterly Report on Form 10-Q and in our Annual Report on Form 10-K for the year ended December 31, 2013. We reported a decrease in net income for the three and six months ended June 30, 2014 compared to the same period in 2013. Net income for the three and six months ended June 30, 2014 was \$10.5 million and \$18.7 million, respectively, compared to \$11.1 million and \$20.1 million, respectively, for the same period in 2013.

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," "would," "seek," "intend," "probability," "risk," "goal," "objective," "plans," "potential," and similar expressions. Forward-looking statements are statements with respect to our beliefs, plans, expectations, objectives, goals, anticipations, assumptions, estimates, intentions and future performance, and are subject to significant known and unknown risks and uncertainties, which could cause our actual results to differ materially from the results discussed in the forward-looking statements. For example, discussions of the effect of our expansion, trends in asset quality and earnings from growth, and certain market risk disclosures are based upon information presently available to management and are dependent on choices about key model characteristics and assumptions and are subject to various limitations. By their nature, certain of the market risk disclosures are only estimates and could be materially different from what actually occurs in the future. As a result, actual income gains and losses could materially differ from those that have been estimated. Other factors that could cause actual results to differ materially from forward-looking statements include, but are not limited to, the following:

- general economic conditions, either globally, nationally, in the State of Texas, or in the specific markets in which we operate, including, without limitation, the deterioration of the commercial real estate, residential real estate, construction and development, credit and liquidity markets, which could cause an adverse change in our net interest margin, or a decline in the value of our assets, which could result in realized losses;
- legislation, regulatory changes or changes in monetary or fiscal policy that adversely affect the businesses in which we are engaged, including the impact of the Dodd-Frank Act, the Federal Reserve's actions with respect to interest rates and other regulatory responses to current economic conditions;
- adverse changes in the status or financial 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 ("MBS") 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;

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risks related to actual U.S. Agency MBS prepayments exceeding projected prepayment levels;

risks related to U.S. Agency MBS 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 potential occurrence of an event, change or other circumstance that could give rise to the termination of a transaction, the outcome of legal proceedings relating to a transaction, the inability to complete transactions due to the failure to satisfy the conditions to closing, including the receipt of regulatory and shareholder approvals, the 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;

risks related to loans secured by real estate, including the risk that the value and marketability of collateral could decline; and

other risks and uncertainties discussed in Part I - "Item 1A. Risk Factors" in our Annual Report on Form 10-K for the year ended December 31, 2013.

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, unless otherwise required by law.

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 many of its provisions. Regulatory agencies are still in the process of issuing regulations, rules and reporting requirements as mandated by the Dodd-Frank Act. The effect of the Dodd-Frank Act on us and the financial services industry as a whole will continue to be clarified as further regulations are issued. Major elements of the Dodd-Frank Act include:

A permanent increase in deposit insurance coverage to \$250,000 per account, 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 elimination of newly issued trust preferred securities as a permitted element of Tier 1 capital;



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- 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.

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 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 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 loss on impaired loans is generally based on the present value of expected future cash flows discounted at the historical effective interest rate stipulated in the loan agreement, except that all collateral-dependent loans are measured for impairment based on the fair value of the collateral. In measuring the fair



value of the collateral, in addition to relying on third party appraisals, we use assumptions such as discount rates, and

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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 June 30, 2014, our review of the loan portfolio indicated that a loan loss allowance of \$18.4 million was appropriate to cover probable losses in the portfolio.

Refer to "Part II - Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations - Loan Loss Experience and Allowance for Loan Losses" and "Note 5- Loans and Allowance for Probable Loan Losses" of the Notes to Consolidated Financial Statements in our Annual Report on Form 10-K for the year ended December 31, 2013 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 MBS 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.

**Impairment of Investment Securities and Mortgage-backed Securities.** Investment and MBS classified as available for sale ("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 (loss) income," 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. 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. Factors considered in determining whether a decline in value is other-than-temporary include: (1) whether the decline is substantial; the duration of the decline; and the reasons for the decline in value; (2) whether the decline is related to a credit event, a change in interest rate or a change in the market discount rate; (3) the financial condition and near-term prospects of the issuer; and (4) whether we have a current intent to sell the security and whether 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. For certain assets we consider expected cash flows of the investment in determining if impairment exists.

**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" of the Notes to Consolidated Financial Statements in our Annual Report on Form 10-K for the year ended December 31, 2013. 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, 2013. 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 June 30, 2014, the weighted-average actuarial assumptions of the Plan were: a discount rate of 5.06%; a long-term rate of return on Plan assets of 7.25%; and assumed salary increases of

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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.

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

Details of our off-balance-sheet arrangements, commitments and contingencies as of June 30, 2014 and December 31, 2013 are included in “Note 12 – Off-Balance-Sheet Arrangements, Commitments and Contingencies” in the accompanying Notes to Consolidated Financial Statements included in this report.

### Balance Sheet Strategy

We utilize wholesale funding and securities to enhance our profitability and balance sheet composition by determining acceptable levels of credit, interest rate and liquidity risk consistent with prudent capital management. This balance sheet strategy consists of borrowing a combination of long and short-term funds from the FHLB, and when determined appropriate, issuing brokered CDs. These funds are invested primarily in U.S. Agency MBS, and to a lesser extent, long-term municipal securities. Although U.S. Agency MBS 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 MBS 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 MBS and municipal securities, the unpredictable nature of MBS prepayments and credit risks associated with the municipal securities. See “Part I - Item 1A. Risk Factors – Risks Related to Our Business” in our Annual Report on Form 10-K for the year ended December 31, 2013, 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 MBS 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 3. Quantitative and Qualitative Disclosures about Market Risk” in this report.

Determining the appropriate size of the balance sheet is one of the critical decisions any bank makes. Our balance sheet is not merely the result of a series of micro-decisions, but rather the size is controlled based on the economics of assets compared to the economics of funding. 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 the current economics associated with increasing the securities portfolio, changes in our overall loan and deposit levels, and 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 MBS or sales. Our

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balance sheet strategy is designed such that our securities portfolio should help mitigate financial performance associated with slower loan growth and higher credit costs.

During the quarter ended June 30, 2014, we sold shorter duration U.S. Agency Collateralized Mortgage Obligation (“CMOs”) and long duration U.S. Agency debentures and commercial MBS that resulted in a slight overall gain on the sale of AFS securities of \$498,000. The purpose of these security sales was two fold. As long-term interest rates decreased, we sold shorter duration CMOs where the structure and collateral presented prepayment concerns should prepayments increase. The longer duration securities were sold due to the yield on those securities and the increased anticipation that the Federal Reserve will begin raising short-term interest rates during 2015. During the quarter we purchased U.S. Agency CMOs at prices that create a favorable risk reward scenario with limited extension. In addition, we purchased tax free municipal bonds in anticipation of the additional taxable income that the OmniAmerican merger will generate once it is completed and fully integrated. Our total investment securities and U.S. Agency MBS decreased from \$1.84 billion at December 31, 2013 to \$1.75 billion at June 30, 2014. At June 30, 2014, total unamortized premium for our MBS decreased to \$23.5 million from \$26.8 million at December 31, 2013, primarily as a result of a net decrease in the MBS portfolio of approximately \$103 million during the six months ended June 30, 2014. Total unamortized premium for our MBS was approximately \$33.0 million at June 30, 2013. The average coupon of the MBS portfolio decreased to 4.13% at June 30, 2014 from 4.31% at December 31, 2013. The average coupon of the municipal securities portfolio decreased to 4.88% at June 30, 2014 when compared to 4.91% at December 31, 2013. At June 30, 2014, securities as a percentage of assets decreased to 50.1% as compared to 53.5% at December 31, 2013. Our balance sheet management strategy is dynamic and will be continually reevaluated as market conditions warrant. As interest rates, yield curves, MBS 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 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 decreased 10.2%, or \$58.7 million, to \$514.1 million at June 30, 2014 from \$572.8 million at December 31, 2013, due to the increase in deposits and the decrease in the securities portfolio. During the six months ended June 30, 2014, our long-term FHLB advances increased \$6.4 million, to \$505.7 million, from \$499.3 million at December 31, 2013. We will continue to purchase long-term FHLB advances as a hedge against future potential high interest rates. Our long-term brokered CDs decreased from \$54.4 million at December 31, 2013 to \$19.4 million at June 30, 2014. 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 at the time of issuance better matched overall ALCO objectives 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. When looking at deposits without brokered CDs, the overall growth in deposits resulted in a decrease in our total wholesale funding as a percentage of deposits, to 20.7% at June 30, 2014 from 22.8% at June 30, 2013 and 25.4% at December 31, 2013.

### 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.

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Net interest income for the six months ended June 30, 2014 was \$55.7 million, an increase of \$9.4 million, or 20.3%, compared to the same period in 2013 as a result of an increase in interest income, along with a decrease in interest expense.

During the six months ended June 30, 2014, total interest income increased \$8.5 million, or 15.3%, to \$64.3 million compared to \$55.8 million for the same period in 2013. The increase in total interest income was the result of an increase in the average yield on earning assets from 4.12% for the six months ended June 30, 2013 to 4.46% for the six months ended June 30, 2014, and the increase in average interest earning assets of \$194.9 million, or 6.3%, from \$3.07 billion for the six months ended June 30, 2013 to \$3.27 billion for the same period in 2014. Total interest expense decreased \$868,000, or 9.2%, to \$8.6 million, during the six months ended June 30, 2014, as compared to \$9.4 million during the same period in 2013. The decrease was attributable to a decrease in the average yield on interest bearing liabilities for the six months ended June 30, 2014, to 0.67% from 0.79% for the same period in 2013, which more than offset the increase in average interest bearing liabilities of \$193.7 million, or 8.0%, from \$2.41 billion for the six months ended June 30, 2013, to \$2.60 billion for the same period in 2014.

Net interest income increased during the three months ended June 30, 2014, when compared to the same period in 2013 primarily as a result of an increase in mortgage-backed securities income. Our average interest earning assets during this period increased \$112.9 million, or 3.6%.

Our average yield on interest bearing liabilities decreased for the three months ended June 30, 2014, as a result of a continued low interest rate environment, the repricing of deposits into this low interest rate environment and the repricing of higher priced FHLB advances that matured or were prepaid. For the three months ended June 30, 2014, our net interest spread and net interest margin increased to 3.79% and 3.94%, respectively, from 3.51% and 3.66%, respectively, for the same period in 2013.

During the six months ended June 30, 2014, average loans increased \$90.1 million, or 7.1%, to \$1.37 billion, when compared to \$1.28 billion for the same period in 2013. Construction real estate loans represent a large part of this increase. The average yield on loans decreased from 5.99% for the six months ended June 30, 2013, to 5.70% for the six months ended June 30, 2014, due to overall lower interest rates. Interest income on loans increased \$613,000, or 1.7%, to \$36.7 million for the six months ended June 30, 2014, when compared to \$36.1 million for the same period in 2013 as a result of an increase in the average balance which more than offset the decrease in the average yield. For the three months ended June 30, 2014, average loans increased \$83.1 million, or 6.5%, to \$1.37 billion, when compared to \$1.29 billion for the same period in 2013. The average yield on loans decreased from 6.01% for the three months ended June 30, 2013 to 5.64% for the three months ended June 30, 2014. Due to the competitive loan pricing environment, we anticipate that we may be required to continue to offer lower interest rate loans that compete with those offered by other financial institutions in order to retain quality loan relationships. Offering lower interest rate loans could impact the overall yield on loans and, therefore, profitability.

Average investment and mortgage-backed securities increased \$108.7 million, or 6.4%, from \$1.71 billion to \$1.82 billion, for the six months ended June 30, 2014 when compared to the same period in 2013. At June 30, 2014, substantially all of our mortgage-backed securities were fixed rate securities. The overall yield on average investment and mortgage-backed securities increased to 3.71% during the six months ended June 30, 2014, from 2.90% during the same period in 2013. Interest income on investment and mortgage-backed securities increased \$7.9 million during the six months ended June 30, 2014, or 40.6%, compared to the same period in 2013 due to an increase in the average yield and average balance. For the three months ended June 30, 2014, average investment and mortgage-backed securities increased \$43.4 million, or 2.5%, to \$1.81 billion, when compared to \$1.77 billion for the same period in 2013. The overall yield on average investment and mortgage-backed securities increased to 3.70% during the three months ended June 30, 2014, from 3.08% during the same period in 2013. Interest income from investment and mortgage-backed securities increased \$3.0 million, or 27.6%, to \$13.7 million for the three months ended June 30, 2014, compared to \$10.8 million for the same period in 2013. The increase in the average yield for the three and six months ended June 30, 2014 primarily reflects an overall higher interest rate environment during 2014, a decrease in prepayments on the mortgage-backed securities and the purchase of higher yielding securities when compared to those securities paying off, maturing or sold. The increase in interest income for the three and six months ended June 30,



2014 was due to an increase in the average yield and average balance, compared to the comparable periods in 2013.

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Average interest earning deposits decreased \$4.4 million, or 7.8%, to \$51.9 million for the six months ended June 30, 2014, when compared to \$56.4 million for the same period in 2013. Interest income from interest earning deposits was \$65,000 and \$78,000 for the six months ended June 30, 2014 and 2013, respectively. The decrease in interest income from interest-earning deposits was the result of a decrease in the average balance along with a decrease in the average yield from 0.28% for the six months ended June 30, 2013 to 0.25% for the same period in 2014. Average interest earning deposits decreased \$11.7 million, or 25.2%, to \$34.7 million for the three months ended June 30, 2014, when compared to \$46.4 million for the same period in 2013. Interest income from interest earning deposits decreased \$13,000, or 37.1%, for the three months ended June 30, 2014, when compared to the same period in 2013, as a result of a decrease in the average balance and average yield from 0.30% in 2013 to 0.25% in 2014.

During the six months ended June 30, 2014, our average securities increased more than our average loans increased compared to the same period in 2013. However, the mix of our average interest earning assets remained consistent as average total securities as a percentage of total average interest earning assets was 56.5% during both the six months ended June 30, 2014, and 2013. Average loans increased to 41.9% of average total interest earning assets and other interest earning asset categories averaged 1.6% for the six months ended June 30, 2014. During the same period in 2013, the comparable mix was 41.7% in loans and 1.8% in the other interest earning asset categories.

Total interest expense decreased \$868,000, or 9.2%, to \$8.6 million during the six months ended June 30, 2014, as compared to \$9.4 million during the same period in 2013. The decrease was primarily attributable to decreased funding costs as the average yield on interest bearing liabilities decreased from 0.79% for the six months ended June 30, 2013, to 0.67% for the six months ended June 30, 2014, which more than offset the increase in average interest bearing liabilities of \$193.7 million, or 8.0%, for the six months ended June 30, 2014 compared to the same period in 2013. This increase in average interest bearing liabilities included an increase in interest bearing deposits of \$178.8 million, or 10.0%, and an increase in long-term FHLB advances of \$106.0 million, or 26.6%, which was partially offset by a decrease in short-term interest bearing liabilities of \$91.1 million, or 59.9%. For the three months ended June 30, 2014, total interest expense decreased \$114,000, or 2.6%, to \$4.2 million, compared to \$4.3 million for the same period in 2013, as a result of a decrease in the average yield while partially offset by an increase in the average balance on interest bearing liabilities. Average interest bearing liabilities increased \$103.1 million, or 4.2%, while the average yield decreased from 0.71% for the three months ended June 30, 2013 to 0.67% for the three months ended June 30, 2014.

Our average total deposits increased \$185.8 million, or 7.9%, from \$2.36 billion for the six months ended June 30, 2013 to \$2.54 billion for the six months ended June 30, 2014. The increase in our average total deposits was primarily the result of an increase in public fund deposits and deposit growth due to market penetration. Average interest bearing deposits increased \$178.8 million, or 10.0%, from \$1.80 billion for the six months ended June 30, 2013 to \$1.97 billion for the same period in 2014, while the average rate paid decreased from 0.46% for the six months ended June 30, 2013, to 0.42% for the six months ended June 30, 2014. Average time deposits increased \$2.5 million, or 0.4%, from \$618.2 million for the six months ended June 30, 2013 to \$620.6 million for the same period in 2014, while the average rate paid decreased slightly to 0.73% for the six months ended June 30, 2014, as compared to 0.74% for the same period in 2013. Average interest bearing demand deposits increased \$168.7 million, or 15.8%, while the average rate paid decreased to 0.29% for the six months ended June 30, 2014, as compared to 0.32% for the same period in 2013. Average savings deposits increased \$7.6 million, or 7.1%, while the average rate paid decreased slightly to 0.12% for the six months ended June 30, 2014, as compared to 0.13% for the same period in 2013. Interest expense for interest bearing deposits for the six months ended June 30, 2014, increased \$78,000, or 4.5%, when compared to the same period in 2013, due to the increase in the average balance which was slightly offset by a decrease in the average yield. Average noninterest bearing demand deposits increased \$7.0 million, or 1.3%, during the six months ended June 30, 2014 compared to the same period in 2013. The latter three categories, interest bearing demand deposits, savings deposits and noninterest bearing demand deposits, are considered the lowest cost deposits and comprised 75.6% of total average deposits during the six months ended June 30, 2014 compared to 73.8% during the same period in 2013.

At June 30, 2014, we had \$19.4 million in brokered CDs which represented 0.8% of deposits, all with maturities of less than seven years. At December 31, 2013, we had \$54.4 million in brokered CDs which represented 2.2% of deposits, all with maturities of less than seven years.

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For the three and six months ended June 30, 2014, average short-term interest bearing liabilities, consisting primarily of FHLB advances, federal funds purchased and repurchase agreements, were \$32.8 million and \$61.0 million, respectively, and reflected decreases of \$117.1 million, or 78.1%, and \$91.1 million, or 59.9%, respectively, when compared to the same periods in 2013. Average short-term interest bearing liabilities decreased due to the increase in average deposits and the increase in the use of long-term funding. Interest expense associated with short-term interest bearing liabilities decreased \$1.5 million, or 92.3%, for the six months ended June 30, 2014 compared to the same period in 2013 and the average rate paid decreased to 0.42% for the six months ended June 30, 2014, compared to 2.17% for the same period in 2013. Interest expense associated with short-term interest bearing liabilities decreased \$333,000, or 85.6%, while the average rate paid decreased to 0.69% for the three months ended June 30, 2014, when compared to 1.04% for the same period in 2013.

Average long-term interest bearing liabilities consisting of FHLB advances increased \$106.0 million, or 26.6%, during the six months ended June 30, 2014 to \$504.6 million, as compared to \$398.6 million for the six months ended June 30, 2013. Interest expense associated with long-term FHLB advances increased \$633,000, or 21.0%, while the average rate paid decreased six basis points for the six months ended June 30, 2014, when compared to the same period in 2013. For the three months ended June 30, 2014, average long-term interest bearing liabilities increased \$79.3 million, or 18.5%, when compared to the same period in 2013. Interest expense associated with long-term FHLB advances increased \$244,000, or 15.3%, while the average rate paid decreased to 1.45% for the three months ended June 30, 2014, when compared to 1.49% for the same period in 2013. The increase in the average long-term FHLB advances during the three and six months ended June 30, 2014, when compared to the same period in 2013 was due to the continued use of long-term advances as a hedge against future potential high interest rates.

Average long-term debt, consisting of our junior subordinated debentures, was \$60.3 million for the three and six months ended June 30, 2014 and 2013, respectively. Interest expense associated with long-term debt decreased slightly for the three and six months ended June 30, 2014 compared to the same periods in 2013, respectively, as a result of a slight decrease in the average yield during the three and six months ended June 30, 2014. 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, adjusts quarterly at a rate equal to three-month LIBOR plus 180 basis points.

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## RESULTS OF OPERATIONS

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

## AVERAGE BALANCES AND YIELDS

	(dollars in thousands)					
	(unaudited)					
	Six Months Ended					
	June 30, 2014		June 30, 2013			
	AVG	INTEREST	AVG	AVG	INTEREST	YIELD
	BALANCE	YIELD	BALANCE	BALANCE	YIELD	YIELD
<b>ASSETS</b>						
<b>INTEREST EARNING ASSETS:</b>						
Loans <sup>(1) (2)</sup>	\$1,368,110	\$38,677	5.70 %	\$1,277,991	\$ 37,950	5.99 %
Loans Held For Sale	379	8	4.26 %	1,786	28	3.16 %
Securities:						
Investment Securities (Taxable) <sup>(4)</sup>	28,856	266	1.86 %	64,835	533	1.66 %
Investment Securities (Tax-Exempt) <sup>(3)(4)</sup>	649,639	17,874	5.55 %	603,286	15,392	5.15 %
Mortgage-backed Securities <sup>(4)</sup>	1,136,608	15,239	2.70 %	1,038,261	8,616	1.67 %
Total Securities	1,815,103	33,379	3.71 %	1,706,382	24,541	2.90 %
FHLB stock and other investments, at cost	29,855	108	0.73 %	27,999	99	0.71 %
Interest Earning Deposits	51,947	65	0.25 %	56,369	78	0.28 %
Total Interest Earning Assets	3,265,394	72,237	4.46 %	3,070,527	62,696	4.12 %
<b>NONINTEREST EARNING ASSETS:</b>						
Cash and Due From Banks	44,430			46,485		
Bank Premises and Equipment	52,699			50,171		
Other Assets	123,572			127,715		
Less: Allowance for Loan Loss	(18,641 )			(19,044 )		
Total Assets	\$3,467,454			\$3,275,854		
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>						
<b>INTEREST BEARING LIABILITIES:</b>						
Savings Deposits	\$114,052	69	0.12 %	\$106,444	71	0.13 %
Time Deposits	620,631	2,233	0.73 %	618,157	2,280	0.74 %
Interest Bearing Demand Deposits	1,239,645	1,798	0.29 %	1,070,951	1,720	0.32 %
Total Interest Bearing Deposits	1,974,328	4,100	0.42 %	1,795,552	4,071	0.46 %
Short-term Interest Bearing Liabilities	60,952	127	0.42 %	152,090	1,639	2.17 %
Long-term Interest Bearing Liabilities – FHLB Dallas	504,617	3,644	1.46 %	398,570	3,011	1.52 %
Long-term Debt <sup>(5)</sup>	60,311	706	2.36 %	60,311	724	2.42 %
Total Interest Bearing Liabilities	2,600,208	8,577	0.67 %	2,406,523	9,445	0.79 %
<b>NONINTEREST BEARING LIABILITIES:</b>						
Demand Deposits	566,782			559,762		
Other Liabilities	27,392			51,087		
Total Liabilities	3,194,382			3,017,372		
<b>SHAREHOLDERS' EQUITY</b>						
Total Liabilities and Shareholders' Equity	\$3,467,454			\$3,275,854		
NET INTEREST INCOME		\$63,660			\$ 53,251	

NET INTEREST MARGIN ON AVERAGE EARNING ASSETS	3.93 %	3.50 %
NET INTEREST SPREAD	3.79 %	3.33 %

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

(2) Interest income includes taxable-equivalent adjustments of \$2,017 and \$1,923 for the six months ended June 30, 2014 and 2013, respectively.

(3) Interest income includes taxable-equivalent adjustments of \$5,895 and \$4,997 for the six months ended June 30, 2014 and 2013, respectively.

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

(5) Represents issuance of junior subordinated debentures.

Note: As of June 30, 2014 and 2013, loans totaling \$9,620 and \$8,179, respectively, were on nonaccrual status. Our policy is to reverse previously accrued but unpaid interest on nonaccrual loans; thereafter, interest income is recorded to the extent received when appropriate.

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## AVERAGE BALANCES AND YIELDS

(dollars in thousands)

(unaudited)

Three Months Ended

	June 30, 2014				June 30, 2013		
	AVG		AVG	AVG		AVG	
	BALANCE	INTEREST	YIELD	BALANCE	INTEREST	YIELD	

## ASSETS

## INTEREST EARNING ASSETS:

Loans <sup>(1) (2)</sup>	\$ 1,371,609	\$ 19,302	5.64 %	\$ 1,288,494	\$ 19,322	6.01 %
Loans Held For Sale	335	3	3.59 %	1,311	12	3.67 %
Securities:						
Investment Securities (Taxable) <sup>(4)</sup>	31,250	143	1.84 %	39,719	169	1.71 %
Investment Securities (Tax-Exempt) <sup>(3)(4)</sup>	655,865	9,032	5.52 %	692,237	8,720	5.05 %
Mortgage-backed Securities <sup>(4)</sup>	1,125,085	7,557	2.69 %	1,036,866	4,680	1.81 %
Total Securities	1,812,200	16,732	3.70 %	1,768,822	13,569	3.08 %
FHLB stock and other investments, at cost	28,109	38	0.54 %	29,074	34	0.47 %
Interest Earning Deposits	34,693	22	0.25 %	46,362	35	0.30 %
Total Interest Earning Assets	3,246,946	36,097	4.46 %	3,134,063	32,972	4.22 %

## NONINTEREST EARNING ASSETS:

Cash and Due From Banks	42,887			44,334		
Bank Premises and Equipment	53,108			50,214		
Other Assets	126,015			125,881		
Less: Allowance for Loan Loss	(18,635 )			(18,095 )		
Total Assets	\$ 3,450,321			\$ 3,336,397		

## LIABILITIES AND SHAREHOLDERS'

## EQUITY

## INTEREST BEARING LIABILITIES:

Savings Deposits	\$ 116,390	34	0.12 %	\$ 108,446	35	0.13 %
Time Deposits	603,903	1,070	0.71 %	614,115	1,118	0.73 %
Interest Bearing Demand Deposits	1,223,788	880	0.29 %	1,080,605	848	0.31 %
Total Interest Bearing Deposits	1,944,081	1,984	0.41 %	1,803,166	2,001	0.45 %
Short-term Interest Bearing Liabilities	32,777	56	0.69 %	149,913	389	1.04 %
Long-term Interest Bearing Liabilities – FHLB Dallas	508,128	1,836	1.45 %	428,800	1,592	1.49 %
Long-term Debt <sup>(5)</sup>	60,311	354	2.35 %	60,311	362	2.41 %
Total Interest Bearing Liabilities	2,545,297	4,230	0.67 %	2,442,190	4,344	0.71 %

## NONINTEREST BEARING LIABILITIES:

Demand Deposits	597,852			580,572		
Other Liabilities	29,241			55,120		
Total Liabilities	3,172,390			3,077,882		

## SHAREHOLDERS' EQUITY

Total Liabilities and Shareholders' Equity	\$ 3,450,321			\$ 3,336,397		
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NET INTEREST INCOME \$ 31,867 \$ 28,628

NET INTEREST MARGIN ON AVERAGE EARNING ASSETS 3.94 % 3.66 %

NET INTEREST SPREAD 3.79 % 3.51 %

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

- (2) Interest income includes taxable-equivalent adjustments of \$1,000 and \$944 for the three months ended June 30, 2014 and 2013, respectively.
- (3) Interest income includes taxable-equivalent adjustments of \$3,011 and \$2,813 for the three months ended June 30, 2014 and 2013, respectively.
- (4) For the purpose of calculating the average yield, the average balance of securities is presented at historical cost.
- (5) Represents issuance of junior subordinated debentures.

Note: As of June 30, 2014 and 2013, loans totaling \$9,620 and \$8,179, respectively, were on nonaccrual status. Our policy is to reverse previously accrued but unpaid interest on nonaccrual loans; thereafter, interest income is recorded to the extent received when appropriate.



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## Liquidity and Interest Rate Sensitivity

Liquidity management involves our ability to convert assets to cash with a minimum of loss to enable us to meet our obligations to our customers at any time. This means addressing (1) the immediate cash withdrawal requirements of depositors and other funds providers; (2) the funding requirements of all lines and letters of credit; and (3) the short-term credit needs of customers. Liquidity is provided by short-term investments that can be readily liquidated with a minimum risk of loss. Cash, interest earning deposits, federal funds sold and short-term investments with maturities or repricing characteristics of one year or less continue to be a substantial percentage of total assets. At June 30, 2014, these investments were 15.7% of total assets as compared with 14.1% for December 31, 2013 and 11.3% for June 30, 2013. The increase to 15.7% at June 30, 2014 is primarily reflective of the increase in cash and interest earning deposits. 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 \$30.0 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 June 30, 2014. Southside Bank has a \$5.0 million line of credit with Frost Bank to be used to issue letters of credit. At June 30, 2014, the amount of additional funding Southside Bank could obtain from FHLB using unpledged securities at FHLB was approximately \$503.1 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 on net interest income of several different interest rate scenarios. By utilizing this technology, we can determine changes that need to be made to the asset and liability mixes to minimize the change in net interest income under these various interest rate scenarios. See Part I - "Item 3. Quantitative and Qualitative Disclosures about Market Risk" in this Quarterly Report on Form 10-Q.

## Noninterest Income

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

Noninterest income was \$6.5 million and \$12.3 million for the three and six months ended June 30, 2014, respectively, compared to \$11.1 million and \$21.3 million for the same period in 2013, a decrease of \$4.6 million, or 41.3%, and \$9.0 million, or 42.3%, respectively. The primary reason for the decrease in noninterest income was the decrease in the net gain on sale of AFS securities during the three and six months ended June 30, 2014 when compared to the same period in 2013.

During the six months ended June 30, 2014, we had a net gain on sale of AFS securities of \$509,000 compared to \$9.3 million for the same period in 2013. Net gain on sale of AFS securities for the three months ended June 30, 2014 was \$498,000 compared to \$5.0 million for the same period in 2013. The fair value of the AFS securities portfolio at June 30, 2014 was \$1.10 billion with a net unrealized gain on that date of \$16.7 million. The net unrealized gain was

comprised of \$22.2 million in unrealized gains and \$5.5 million in unrealized losses. The fair value of the HTM securities portfolio at June 30, 2014 was \$660.8 million with a net unrealized loss on that date of \$1.7 million. The net unrealized loss was comprised of \$19.9 million in unrealized gains and approximately \$21.6 million in unrealized losses. During the six months ended June 30, 2014, we pro-actively managed the investment portfolio which included recalibrating the blend of our investment portfolio.

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Gain on sale of loans decreased \$160,000, or 66.4%, and \$399,000, or 71.3%, for the three and six months ended June 30, 2014, respectively, when compared to the same periods in 2013. The decrease for the three and six months ended June 30, 2014 was due primarily to a decrease in the dollar amount of loans sold and the related servicing release and secondary market fees.

Bank owned life insurance increased \$43,000, or 16.3%, and \$103,000, or 19.9%, for the three and six months ended June 30, 2014, respectively, due to an increase in average BOLI assets when compared to the same periods in 2013.

Other income increased \$120,000, or 12.6%, and \$212,000, or 11.5%, for the three and six months ended June 30, 2014, respectively, when compared to the same periods in 2013, primarily due to increases in brokerage service fees, merchant services income, and credit card fees which were slightly offset by a decrease in the Southside Select fee income.

Noninterest Expense

We incur numerous types of noninterest expenses associated with the operation of our various business activities, the largest of which are salaries and employee benefits.

Noninterest expense was \$20.4 million and \$40.6 million for the three and six months ended June 30, 2014, respectively, compared to \$21.2 million and \$41.5 million for the same periods in 2013, respectively, representing a decrease of \$740,000, or 3.5%, and \$877,000, or 2.1%, for the three and six months ended June 30, 2014, respectively.

Salaries and employee benefits expense decreased \$309,000, or 2.3%, and \$416,000, or 1.6%, during the three and six months ended June 30, 2014, respectively, when compared to the same periods in 2013. The decrease for the three and six months ended June 30, 2014, was primarily the result of the decrease in retirement expense which was partially offset by an increase in direct salary expense.

Direct salary expense and payroll taxes increased \$360,000, or 3.3%, and \$935,000, or 4.2%, during the three and six months ended June 30, 2014, respectively, when compared to the same periods in 2013. This increase was due to increases in personnel and normal salary increases effective in the first quarter of 2014.

Retirement expense, included in salary and benefits, decreased \$822,000, or 59.4%, and \$1.5 million, or 58.2%, for the three and six months ended June 30, 2014, respectively, when compared to the same periods in 2013. The decrease was primarily related to the decrease in the defined benefit plan expense due to the funded status of the plan and the increase in the discount rate to 5.06% from 4.08% for the same period in 2013.

Health and life insurance expense, included in salary and benefits, increased \$153,000, or 14.8%, and \$162,000, or 8.3%, for the three and six months ended June 30, 2014, respectively, when compared to the same periods in 2013. The increase for the three and six months ended June 30, 2014 was due to increased health claims expense and plan administrative cost for the comparable period of time. We have a self-insured health plan which is supplemented with stop loss insurance policies. Health insurance costs are rising nationwide and these costs may increase during the remainder of 2014.

Professional fees increased \$742,000, or 132.0%, and \$1.0 million, or 85.61%, for the three and six months ended June 30, 2014, respectively, when compared to the same periods in 2013, due to approximately \$680,000 of legal and accounting fees associated with the pending OmniAmerican merger.

Telephone and communications decreased \$64,000, or 16.7%, and \$237,000, or 28.4%, for the three and six months ended June 30, 2014, respectively, as compared to the same periods in 2013 due primarily to contract negotiations with our service providers.

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FHLB prepayment fees decreased \$1.0 million, or 100.0%, during the three and six months ended June 30, 2014 as a result of the prepayment of \$90.2 million of FHLB advances during the second quarter of 2013.

### Income Taxes

Pre-tax income for the three and six months ended June 30, 2014 was \$11.3 million and \$20.7 million, respectively, compared to \$12.8 million and \$23.7 million for the same periods in 2013, respectively. Income tax expense was \$838,000 and \$2.0 million for the three and six months ended June 30, 2014, respectively, compared to \$1.7 million and \$3.6 million, for the three and six months ended June 30, 2013, respectively. The effective tax rate as a percentage of pre-tax income was 7.4% and 9.7% for the three and six months ended June 30, 2014, respectively, compared to 13.4%, and 15.0%, respectively, for the same periods in 2013. The decrease in the effective tax rate for the three and six months ended June 30, 2014 was due to an increase in tax-exempt income as a percentage of taxable income, as compared to the same periods in 2013. The increase in tax-exempt income as a percentage of taxable income was primarily due to the significant increase in our average tax-exempt securities portfolio for the six months ended June 30, 2014 compared to the same period in 2013. Net deferred tax assets totaled \$12.7 million at June 30, 2014, as compared to \$18.4 million at December 31, 2013. The decrease in net deferred tax assets resulted primarily from a decrease in unrealized losses on securities available for sale, offset by an increase in the alternative minimum tax.

### Capital Resources

Our total shareholders' equity at June 30, 2014, was \$284.0 million, representing an increase of 9.4%, or \$24.4 million, from December 31, 2013, and represented 8.1% of total assets at June 30, 2014, compared to 7.5% of total assets at December 31, 2013.

Increases to our shareholders' equity consisted primarily of net income of \$18.7 million, a decrease in accumulated other comprehensive loss of \$12.3 million, stock compensation expense of \$577,000, and the issuance of \$523,000 in common stock (18,265 shares) through our dividend reinvestment plan. These increases were slightly offset by \$7.7 million in cash dividends paid.

On March 20, 2014, our board of directors declared a 5% stock dividend to common stock shareholders of record as of April 10, 2014, which was paid on May 1, 2014.

Under the Federal Reserve Board's risk-based capital guidelines for bank holding companies, the minimum ratio of total capital to risk-adjusted assets (including certain off-balance sheet items, such as standby letters of credit) is currently 8%. The minimum Tier 1 capital to risk-adjusted assets is 4%. Our trust preferred securities issued by our subsidiaries, Southside Statutory Trust III, IV, V and Magnolia Trust Company I, respectively, are considered Tier 1 capital by the Federal Reserve Board. The Federal Reserve Board also requires bank holding companies to comply with the minimum leverage ratio guidelines. The leverage ratio is the ratio of bank holding company's Tier 1 capital to its total consolidated quarterly average assets, less goodwill and certain other intangible assets. The guidelines require a minimum leverage ratio of 4% for bank holding companies that meet certain specified criteria. Failure to meet minimum capital requirements could result in certain mandatory and possibly additional discretionary actions by our regulators that, if undertaken, could have a direct material effect on our financial statements. Management believes that, as of June 30, 2014, we met all capital adequacy requirements to which we were subject.

The Federal Deposit Insurance Act requires bank regulatory agencies to take "prompt corrective action" with respect to FDIC-insured depository institutions that do not meet minimum capital requirements. A depository institution's treatment for purposes of the prompt corrective action provisions will depend on how its capital levels compare to

various capital measures and certain other factors, as established by regulation. Prompt corrective action and other discretionary actions could have a direct material effect on our financial statements.

It is management's intention to maintain our capital at a level acceptable to all regulatory authorities and future dividend payments will be determined accordingly. Regulatory authorities require that any dividend payments made by either us or the Bank, not exceed earnings for that year. Shareholders should not anticipate a continuation of the cash dividend

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simply because of the existence of a dividend reinvestment program. The payment of dividends will depend upon future earnings, our financial condition, and other related factors including the discretion of the board of directors.

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

	Actual		For Capital Adequacy Purposes		To Be Well Capitalized Under Prompt Corrective Actions Provisions		
	Amount	Ratio	Amount	Ratio	Amount	Ratio	
As of June 30, 2014:							
Total Capital (to Risk Weighted Assets)							
Consolidated	\$347,686	22.04	% \$126,183	8.00	% N/A	N/A	
Bank Only	\$344,709	21.87	% \$126,099	8.00	% \$157,624	10.00	%
Tier 1 Capital (to Risk Weighted Assets)							
Consolidated	\$328,982	20.86	% \$63,092	4.00	% N/A	N/A	
Bank Only	\$326,005	20.68	% \$63,049	4.00	% \$94,574	6.00	%
Tier 1 Capital (to Average Assets) (1)							
Consolidated	\$328,982	9.65	% \$136,348	4.00	% N/A	N/A	
Bank Only	\$326,005	9.57	% \$136,274	4.00	% \$170,343	5.00	%
As of December 31, 2013:							
Total Capital (to Risk Weighted Assets)							
Consolidated	\$335,944	21.71	% \$123,776	8.00	% N/A	N/A	
Bank Only	\$332,069	21.46	% \$123,775	8.00	% \$154,719	10.00	%
Tier 1 Capital (to Risk Weighted Assets)							
Consolidated	\$316,754	20.47	% \$61,888	4.00	% N/A	N/A	
Bank Only	\$312,879	20.22	% \$61,888	4.00	% \$92,831	6.00	%
Tier 1 Capital (to Average Assets) (1)							
Consolidated	\$316,754	9.07	% \$139,665	4.00	% N/A	N/A	
Bank Only	\$312,879	8.97	% \$139,559	4.00	% \$174,449	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 will change as a result of the Dodd-Frank Act and as a result of a separate international regulatory capital initiative known as "Basel III." See the section captioned "Supervision and Regulation" in Part I - Item 1. Business of our 2013 Annual Report on Form 10-K for more information on these topics. Management believes that, as of June 30, 2014, Southside Bancshares and Southside Bank would meet all capital adequacy requirements under the Basel III Capital Rules on a fully phased-in basis as if such requirements were currently in effect.

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The table below summarizes our key equity ratios for the three and six months ended June 30, 2014 and 2013:

	Six Months Ended		
	June 30,		
	2014	2013	
Return on Average Assets	1.09	% 1.24	%
Return on Average Shareholders' Equity	13.80	15.69	
Dividend Payout Ratio – Basic	42.42	37.38	
Dividend Payout Ratio – Diluted	42.42	37.38	
Average Shareholders' Equity to Average Total Assets	7.88	7.89	
	Three Months Ended		
	June 30,		
	2014	2013	
Return on Average Assets	1.22	% 1.33	%
Return on Average Shareholders' Equity	15.09	17.17	
Dividend Payout Ratio – Basic	38.18	33.90	
Dividend Payout Ratio – Diluted	38.18	33.90	
Average Shareholders' Equity to Average Total Assets	8.06	7.75	

## Composition of Loans

One of our main objectives is to seek attractive lending opportunities in Texas, primarily in the counties in which we operate. Refer to “Part I - Item 1. Business - Market Area” in our Annual Report on Form 10-K for the year ended December 31, 2013 for a discussion of our primary market area and the geographic concentration of our loan portfolio as of December 31, 2013. There were no substantial changes in these concentrations during the six months ended June 30, 2014. Substantially all of our loan originations are made to borrowers who live in and conduct business in our primary market area, 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 June 30, 2014, the SFG loans totaled approximately \$89.2 million. Our loan growth may accelerate in the future when the economy in the markets we serve improves and as we work to identify and develop additional markets and strategies that will allow us to expand our lending territory. Total loans increased \$40.0 million, or 3.0%, to \$1.39 billion for the six months ended June 30, 2014 from \$1.35 billion at December 31, 2013, and increased \$97.9 million, or 7.6%, from \$1.29 billion at June 30, 2013. Average loans increased \$90.1 million, or 7.1%, during the six months ended June 30, 2014 when compared to the same period in 2013.

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 a slight slowdown as a result of the real estate led downturn across the country during 2008 and continuing into 2011. During 2012 and 2013, our markets 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 real estate loan portfolio does not have Alt-A or subprime mortgage exposure.



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

	At June 30, 2014 (in thousands)	At December 31, 2013	At June 30, 2013
Real Estate Loans:			
Construction	\$164,668	\$125,219	\$123,493
1-4 Family Residential	391,675	390,499	385,241
Other	271,858	262,536	232,632
Commercial Loans	156,893	157,655	153,985
Municipal Loans	239,883	245,550	224,134
Loans to Individuals	166,308	169,814	173,944
Total Loans	\$1,391,285	\$1,351,273	\$1,293,429

Construction loans increased \$39.4 million, or 31.5%, to \$164.7 million at June 30, 2014, from \$125.2 million at December 31, 2013, and \$41.2 million, or 33.3%, from \$123.5 million at June 30, 2013, due to increased activity in the Austin and Dallas-Fort Worth markets.

Our 1-4 family residential mortgage loans increased \$1.2 million, or 0.3%, to \$391.7 million at June 30, 2014, from \$390.5 million at December 31, 2013, and \$6.4 million, or 1.7%, from \$385.2 million at June 30, 2013, due primarily to the low interest rate environment and increased activity in the Dallas-Fort Worth market.

Other real estate loans, which are comprised primarily of commercial real estate loans, increased \$9.3 million, or 3.6%, to \$271.9 million at June 30, 2014, from \$262.5 million at December 31, 2013, and increased \$39.2 million, or 16.9%, from \$232.6 million at June 30, 2013.

Commercial loans decreased \$762,000, or 0.5%, to \$156.9 million at June 30, 2014, from \$157.7 million at December 31, 2013, and increased \$2.9 million, or 1.9%, from \$154.0 million at June 30, 2013.

Municipal loans decreased \$5.7 million, or 2.3%, to \$239.9 million at June 30, 2014, from \$245.6 million at December 31, 2013, and increased \$15.7 million, or 7.0%, from \$224.1 million at June 30, 2013.

Loans to individuals, which includes SFG loans, decreased \$3.5 million, or 2.1%, to \$166.3 million at June 30, 2014, from \$169.8 million at December 31, 2013, and decreased \$7.6 million, or 4.4%, from \$173.9 million at June 30, 2013. The decrease for the six months ended June 30, 2014 was due to a decrease in SFG loans purchased.

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

The allowance for loan losses is based on the most current review of the loan portfolio and is a result of multiple processes. First, the bank utilizes historical data to establish general reserve amounts for each class of loans. The historical charge-off figure is further adjusted through qualitative factors that include general trends in past dues, nonaccruals and classified loans to more effectively and promptly react to both positive and negative movements. 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 senior loan administration, the Special Assets department, and the Loan Review department. Third, the Loan Review department independently reviews 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 considerations including the size of the

loan, the type of credit extended, the seasoning of the loan and the performance of the loan. The Loan Review scope, as it relates to size, focuses more on larger dollar loan relationships, typically, for example, aggregate debt of \$500,000 or

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greater. The Loan Review officer also reviews specific reserves 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, and geographic and industry loan concentration.

SFG loans, included in loans to individuals, experiencing past due status or extension of maturity characteristics are reserved for at 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 repay 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.

After all of the data in the loan portfolio is accumulated the reserve allocations are separated into various loan classes.

As of June 30, 2014, our review of the loan portfolio indicated that a loan loss allowance of \$18.4 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.

For the three and six months ended June 30, 2014, loan charge-offs were \$3.5 million and \$8.3 million, and recoveries were \$517,000 and \$1.1 million, resulting in net charge-offs of \$3.0 million and \$7.3 million, respectively. For the three and six months ended June 30, 2013, loan charge-offs were \$2.7 million and \$5.9 million, and recoveries were \$512,000 and \$1.1 million, resulting in net charge-offs of \$2.2 million and \$4.7 million. The increase in net charge-offs for the three and six months ended June 30, 2014, was primarily related to an increase in the level of charge-offs in the consumer portfolio. The necessary provision expense was estimated at \$2.7 million and \$6.8

million for the three and six months ended June 30, 2014, respectively, compared to \$2.0 million and \$2.5 million for the comparable periods in 2013, respectively. The increase in provision expense for the three and six months ended June 30, 2014, compared to the same periods in 2013 was due in part to low provision expense during the first half of 2013, an increase in the level of charge-offs in the consumer portfolio and an increase in nonperforming assets.

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## Nonperforming Assets

Nonperforming assets consist of delinquent loans 90 days or more past due, nonaccrual loans, other real estate owned ("OREO"), repossessed assets and restructured loans. Nonaccrual loans are loans 90 days or more delinquent and collection in full of both the principal and interest is not expected. 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.

The following tables set forth nonperforming assets for the periods presented (in thousands):

	At June 30, 2014	At December 31, 2013	At June 30, 2013	
Nonaccrual loans	\$9,620	\$8,088	\$8,179	
Accruing loans past due more than 90 days	4	3	—	
Restructured loans	4,036	3,888	3,053	
Other real estate owned	383	726	772	
Repossessed assets	492	901	266	
Total Nonperforming Assets	\$14,535	\$13,606	\$12,270	
	At June 30, 2014	At December 31, 2013	At June 30, 2013	
Asset Quality Ratios:				
Nonaccruing loans to total loans	0.69	% 0.60	% 0.63	%
Allowance for loan losses to nonaccruing loans	191.35	233.40	224.60	
Allowance for loan losses to nonperforming assets	126.65	138.74	149.71	
Allowance for loan losses to total loans	1.32	1.40	1.42	
Nonperforming assets to total assets	0.42	0.39	0.36	
Net charge-offs to average loans	1.07	0.82	0.75	

Total nonperforming assets at June 30, 2014 were \$14.5 million, an increase of \$929,000, or 6.8%, from \$13.6 million at December 31, 2013 and an increase of \$2.3 million, or 18.5%, from \$12.3 million at June 30, 2013. The increase in nonperforming assets for the six months ended June 30, 2014 as compared to the same period in 2013 was primarily a result of an increase in nonaccrual loans.



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From December 31, 2013 to June 30, 2014, nonaccrual loans increased \$1.5 million, or 18.9%, to \$9.6 million, and from June 30, 2013, increased \$1.4 million, or 17.6%. Of the total nonaccrual loans at June 30, 2014, 26.7% are residential real estate loans, 25.3% are commercial real estate loans, 5.3% are commercial loans, 21.2% are loans to individuals, primarily SFG automobile loans, and 21.5% are construction loans. Restructured loans increased \$148,000, or 3.8%, to \$4.0 million at June 30, 2014, from \$3.9 million at December 31, 2013 and \$983,000, or 32.2%, from \$3.1 million at June 30, 2013. OREO decreased \$343,000, or 47.2%, to \$383,000 at June 30, 2014 from \$726,000 at December 31, 2013 and \$389,000, or 50.4%, from \$772,000 at June 30, 2013. The OREO at June 30, 2014, consisted primarily of commercial real estate property. We are actively marketing all properties and none are being held for investment purposes. Repossessed assets decreased \$409,000, or 45.4%, to \$492,000 at June 30, 2014, from \$901,000 at December 31, 2013 and increased \$226,000, or 85.0%, from \$266,000 at June 30, 2013.

Pending Acquisition

On April 28, 2014, the Company entered into an Agreement and Plan of Merger (the “Merger Agreement”) with OmniAmerican Bancorp, Inc., a Maryland corporation (“OmniAmerican”) and the holding company for OmniAmerican Bank, a federal savings association based in Fort Worth, Texas. As of June 30, 2014, OmniAmerican had \$1.4 billion in assets. The Merger Agreement provides that, subject to the terms and conditions thereof, OmniAmerican will merge with and into the Company, with the Company as the surviving corporation. The merger is expected to close during the fourth quarter of 2014, subject to receipt of regulatory approvals and approvals by both our shareholders and OmniAmerican's stockholders.

Pursuant to the Merger Agreement, each outstanding share of common stock of OmniAmerican will be converted into (a) 0.4459 of a share of common stock of the Company, subject to adjustment pursuant to the terms of the Merger Agreement and (b) \$13.125 in cash.

Recent Accounting Pronouncements

See “Note 1 – Basis of Presentation” in our consolidated financial statements included in this report.

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ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The disclosures set forth in this item are qualified by the section captioned “Forward-Looking Statements” included in “Item 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations” of this report and other cautionary statements set forth elsewhere in this report.

Refer to the discussion of market risks included in “Item 7A. Quantitative and Qualitative Disclosures About Market Risks” in our Annual Report on Form 10-K for the year ended December 31, 2013. There have been no significant changes in the types of market risks we face since December 31, 2013.

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. This 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 immediately 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. As of June 30, 2014, the model simulations projected that 100 and 200 basis point immediate increases in interest rates would result in negative variances on net interest income of 3.51% and 6.15%, 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 negative variances in net interest income of 2.33% and 2.29%, respectively, relative to the base case over the next 12 months. As of December 31, 2013, the model simulations projected that 100 and 200 basis point immediate increases in interest rates would result in negative variances on net interest income of 5.86% and 8.42%, 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 negative variances in net interest income of 2.69% and 4.15%, respectively, relative to the base case over the next 12 months. As of June 30, 2013, the model simulations projected that 100 and 200 basis point immediate increases in interest rates would result in negative variances on net interest income of 5.90% and 7.52%, 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 negative variances in net interest income of 1.93% and 1.31%, 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 repricing 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

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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 4. 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 Securities Exchange Act of 1934, as amended (the “Exchange Act”)) as of the end of the period covered by this report, and, based on that evaluation, our CEO and CFO concluded that our disclosure controls and procedures were effective as of the end of the period covered by this report in recording, processing, summarizing and reporting in a timely manner the information that the Company is required to disclose in its reports under the Exchange Act and in accumulating and communicating to the Company's management, including the Company's CEO and CFO, such information as appropriate to allow timely decisions regarding required disclosure.

As disclosed in Part II, Item 9A of our Annual Report on Form 10-K for the year ended December 31, 2013, management identified a control deficiency that was determined to be a material weakness related to our interest income recognition on callable municipal securities purchased at a premium. As a result of the control deficiency, we did not properly amortize the premium to the maturity of the security, but instead we amortized the premium to the earliest call date. The control deficiency resulted in an interest income recognition error for individual callable municipal securities purchased at a premium that required specific accounting in accordance with generally accepted accounting principles.

Subsequent to December 31, 2013, we enhanced our interest income recognition controls for callable municipal securities purchased at a premium. As a result, we are amortizing all municipal securities purchased at a premium to the maturity date of the security.

As of June 30, 2014, management believes it has placed in operation controls to address the material weakness mentioned above and believes that the material weakness identified has been remediated.

Our Audit Committee has directed management to monitor and test the controls implemented and develop additional controls should any of the new controls require additional enhancement. In addition, under the direction of our Audit Committee, management will continue to review and make necessary changes to the overall design of our internal control environment, as well as policies and procedures to improve the overall effectiveness of internal control over financial reporting.

Changes in Internal Control Over Financial Reporting

Except as described above, there have been no changes in our internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) that occurred during the quarter ended June 30, 2014 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

We are party to legal proceedings arising in the normal conduct of business. Management believes that at June 30, 2014 such litigation is not material to our financial position, results of operations or cash flows.

Litigation Relating to the Merger

On June 25, 2014, a purported stockholder of OmniAmerican filed a lawsuit in the Circuit Court for Baltimore City, Maryland captioned McDougal v. OmniAmerican Bancorp, Inc., et al., Case No. 24-C-14-003920, naming OmniAmerican, members of OmniAmerican's board of directors, Southside and Merger Sub as defendants. The lawsuit is purportedly brought on behalf of a putative class of OmniAmerican's public stockholders and seeks a declaration that it is properly maintainable as a class action and a certification of the plaintiff and her counsel as class representative and class counsel. The lawsuit asserts direct and derivative claims against OmniAmerican's directors and alleges that they breached their fiduciary duties and that OmniAmerican, Southside and Merger Sub aided and abetted those alleged breaches by, among other things, (a) failing to take steps to maximize shareholder value for OmniAmerican public stockholders; (b) failing to properly value OmniAmerican; (c) failing to protect against conflicts of interest; (d) failing to disclose material information necessary for OmniAmerican stockholders to make an informed vote on the merger; and (e) agreeing to deal protection devices that preclude a fair sales process. Among other relief, the plaintiff seeks to enjoin the merger. On July 9, 2014, the plaintiff filed a motion to transfer the case to Maryland's Business and Technology Case Management Program.

OmniAmerican and Southside believe the claims asserted are without merit and intend to vigorously defend against this lawsuit.

ITEM 1A. RISK FACTORS

Additional information regarding risk factors appears in “Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations - Forward Looking Statements” of this Form 10-Q and in Part I - “Item 1A. Risk Factors” in our Annual Report on Form 10-K for the year ended December 31, 2013. There have been no material changes from the risk factors previously disclosed in our Annual Report on Form 10-K for the year ended December 31, 2013. The risks and uncertainties described in our Annual Report on Form 10-K for the year ended December 31, 2013 are not the only ones we face. 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.

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

Not Applicable.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

Not Applicable.

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ITEM 4. MINE SAFETY DISCLOSURES

Not Applicable.

ITEM 5. OTHER INFORMATION

Not Applicable.

ITEM 6. EXHIBITS

A list of exhibits to this Form 10-Q is set forth on the Exhibit Index and is incorporated herein by reference.

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SIGNATURES

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

SOUTHSIDE BANCSHARES, INC.

DATE: August 7, 2014

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

DATE: August 7, 2014

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

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Exhibit Index

Exhibit Number	Description
2	Agreement and Plan of Merger, dated April 28, 2014, by and among Southside Bancshares, Inc., Omega Merger Sub, Inc. and OmniAmerican Bancorp, Inc. (filed as Exhibit 2 to the Registrant's Form 10-Q, filed May 9, 2014, and incorporated herein by reference).
3 (a)	Restated Certificate of Formation of Southside Bancshares, Inc. effective May 2, 2014 (filed as Exhibit 3 (a) to the Registrant's Form 10-Q, filed May 9, 2014, and incorporated herein by reference).
3 (b)	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).
10.1	Form of Stockholder Voting and Support Agreement, dated April 28, 2014, by and between Southside Bancshares, Inc. and each of the non-employee directors of OmniAmerican Bancorp, Inc. (filed as Annex D to the joint proxy statement/ prospectus contained in the Registrant's Registration Statement on Form S-4, Commission File No. 333-196817, filed June 16, 2014 (the "Registration Statement"), and incorporated herein by reference).
10.2	Employment Agreement, dated April 28, 2014, by and between Southside Bank, Southside Bancshares, Inc. and Tim Carter, effective upon the closing of the OmniAmerican merger (filed as Exhibit 10.2 to Amendment No. 1 to the Registration Statement, filed July 18, 2014 ("Amendment No. 1"), and incorporated herein by reference).
10.3	Employment Agreement, dated April 28, 2014, by and between Southside Bank, Southside Bancshares, Inc. and Deborah B. Wilkinson, effective upon the closing of the OmniAmerican merger (filed as Exhibit 10.3 to Amendment No. 1 and incorporated herein by reference).
10.4	Employment Agreement, dated April 28, 2014, by and between Southside Bank, Southside Bancshares, Inc. and Anne Holland, effective upon the closing of the OmniAmerican merger (filed as Exhibit 10.4 to Amendment No. 1 and incorporated herein by reference).
10.5	Employment Agreement, dated April 28, 2014, by and between Southside Bank, Southside Bancshares, Inc. and T.L. Arnold, Jr., effective upon the closing of the OmniAmerican merger (filed as Exhibit 10.5 to Amendment No. 1 and incorporated herein by reference).
*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.

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\*101.DEF XBRL Taxonomy Extension Definition Linkbase Document.

\*Filed herewith.

† The certification attached as Exhibit 32 accompanies this Quarterly Report on Form 10-Q and is “furnished” to the Commission pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 and shall not be deemed “filed” by us for purposes of Section 18 of the Securities Exchange Act of 1934, as amended.