

SOUTHSIDE BANCSHARES INC
Form 10-K
March 06, 2008
UNITED STATES

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

Form 10-K
(Mark One)

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

For the fiscal year ended December 31, 2007

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 of incorporation)

75-1848732
(I.R.S. Employer Identification No.)

1201 S. Beckham Avenue, Tyler, Texas
(Address of Principal Executive Offices)

75701
(Zip Code)

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

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

Title of each class	Name of each exchange on which registered
COMMON STOCK, \$1.25 PAR VALUE	NASDAQ Global Select Market

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

NONE

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

YES NO

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act.

YES NO

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was

Edgar Filing: SOUTHSIDE BANCSHARES INC - Form 10-K

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act. (Check one):
Large accelerated filer Accelerated filer
Non-accelerated filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act).

YES NO

The aggregate market value of the common stock held by non-affiliates of the registrant as of June 29, 2007 was \$240,147,310.

As of February 15, 2008, 13,142,462 shares of common stock of Southside Bancshares, Inc. were outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Certain portions of the Registrant's Proxy Statement to be filed for the Annual Meeting of Shareholders to be held April 17, 2008 are incorporated by reference into Part III of this Annual Report on Form 10-K. Other than those portions of the proxy statement specifically incorporated by reference pursuant to Items 10-14 of Part III hereof, no other portions of the proxy statement shall be deemed so incorporated.

TABLE OF CONTENTS

PART I

ITEM 1. BUSINESS

ITEM 1A. RISK FACTORS

ITEM 1B. UNRESOLVED STAFF COMMENTS

ITEM 2. PROPERTIES

ITEM 3. LEGAL PROCEEDINGS

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

PART II

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

ITEM 6. SELECTED FINANCIAL DATA

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

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

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

ITEM 9A. CONTROLS AND PROCEDURES

ITEM 9B. OTHER INFORMATION

PART III

ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE

ITEM 11. EXECUTIVE COMPENSATION

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

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

ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES

PART IV.

ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES

SIGNATURES

Report of Independent Registered Public Accounting Firm

INDEX TO EXHIBITS

Subsidiaries of the Registrant

Consent of Independent Registered Public Accounting Firm

Certification Pursuant to Section 302

Certification Pursuant to Section 302

Certification Pursuant to Section 906

IMPORTANT INFORMATION ABOUT THIS REPORT

In this report, the words “the Company,” “we,” “us,” and “our” refer to the combined entities of Southside Bancshares, Inc. and its subsidiaries. The words “Southside” and “Southside Bancshares” refer to Southside Bancshares, Inc. The words “Southside Bank” and “Fort Worth National Bank” refer to those entities, respectively, and the words “the Banks” refers to those entities collectively. The word “SFG” refers to Southside Financial Group, LLC., of which Southside owns a 50% interest.

PART I

ITEM 1. BUSINESS

FORWARD-LOOKING INFORMATION

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

GENERAL

Southside Bancshares, Inc., incorporated in Texas in 1982, is a bank holding company for Southside Bank, a Texas state bank headquartered in Tyler, Texas and Southside Bancshares, Inc. acquired Fort Worth Bancshares, Inc., the bank holding company for Fort Worth National Bank, headquartered in Fort Worth, Texas. Tyler has a metropolitan area population of approximately 195,000 and is located approximately 90 miles east of Dallas, Texas and 90 miles west of Shreveport, Louisiana. Fort Worth is the fifth largest city in Texas with a population of approximately 620,000.

At December 31, 2007, our total assets were \$2.20 billion, total loans were \$961.2 million, deposits were \$1.53 billion, and shareholders’ equity was \$132.3 million. Our net income was \$16.7 million and \$15.0 million and fully diluted earnings per common share were \$1.24 and \$1.12 for the years ended December 31, 2007 and 2006, respectively. We have paid a cash dividend every year since 1970.

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

Our consumer loan services include 1-4 family residential mortgage loans, home equity loans, home improvement loans, automobile loans and other installment loans. Commercial loan services include short-term working capital loans for inventory and accounts receivable, short and medium-term loans for equipment or other business capital expansion, commercial real estate loans and municipal loans. We also offer construction loans for 1-4 family residential and commercial real estate. During the third quarter we acquired a 50% ownership interest and 51% voting interest in SFG, a start-up company that purchases existing high yield automobile loan portfolios from lenders throughout the United States.

We offer a variety of deposit accounts with a wide range of interest rates and terms, including savings, money market, interest and noninterest bearing checking accounts and certificates of deposit (“CDs”). Our trust services include investment, management, administration and advisory services, primarily for individuals and, to a lesser extent, partnerships and corporations. At December 31, 2007, our trust department managed approximately \$718 million of trust assets.

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

Our administrative offices are located at 1201 S. Beckham Avenue, Tyler, Texas 75701, and our telephone number is 903-531-7111. Our website can be found at www.southside.com. Our public filings with the Securities and Exchange Commission (the "SEC") may be obtained free of charge at either our website or the SEC's website, www.sec.gov, as soon as reasonably practicable after filing with the SEC.

RECENT DEVELOPMENTS

On October 10, 2007, Southside completed the acquisition of Fort Worth Bancshares, Inc. and its wholly-owned subsidiaries, Fort Worth Bancorporation, Inc., Fort Worth National Bank and Magnolia Trust Company I. Southside purchased all of the outstanding capital stock of Fort Worth Bancshares, Inc. for approximately \$37 million. Fort Worth National Bank operates two banking offices in Fort Worth, one banking office in Arlington and a loan production office in Austin. At the time of purchase, Fort Worth National Bank had approximately \$124 million in total assets, \$105 million in loans and \$103 million in deposits. Southside retained many of the key employees of Fort Worth National Bank, and continues to operate Fort Worth National Bank as a separate depository institution under its existing charter.

On August 8, 2007, Southside acquired a 50% ownership interest, through a subsidiary of Southside Bank, in Southside Financial Group, LLC. SFG is engaged in the business of purchasing high-yield portfolios of automobile loans on a basis from lenders across the United States. SFG has retained a management team with extensive experience in the automobile loan industry. Southside Bank's initial capital contribution to SFG was \$500,000.

MARKET AREA

We consider our primary market area to be all of Smith, Gregg, Tarrant, Travis, Cherokee, Anderson, Kaufman, Henderson and Wood Counties in Texas, and to a lesser extent, portions of adjoining counties. During 2007, we acquired Fort Worth National Bank, which operates with two branches in Fort Worth, one branch in Arlington and a loan production office in Austin. In addition, we opened a full service grocery store branch in Hawkins in Wood County, as well as our sixth full service grocery store branch in our largest market area, the city of Tyler, in Smith County. Our expectation is that our presence in all of the market areas we serve will continue to grow in the future. In addition, we continue to explore new markets in which we believe we can expand successfully.

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

We serve our markets through 44 branch locations, 18 of which are located in grocery stores. The branches are located in and around Tyler, Longview, Lindale, Gresham, Jacksonville, Bullard, Chandler, Hawkins, Seven Points, Palestine, Forney, Gun Barrel City, Athens, Whitehouse, Fort Worth and Arlington. Our television and radio advertising has extended into most of our East Texas market areas for several years, providing us name recognition throughout Smith, Gregg and Cherokee counties along with portions of Anderson and Henderson counties. We anticipate that continued advertising combined with strategically placed branches should expand our name recognition

in this part of the state. Fort Worth National Bank is a well recognized name in the Fort Worth and Arlington markets.

We also maintain eight motor bank facilities. Our customers may also access various banking services through our 45 automatic teller machines (“ATMs”) and ATMs owned by others, through debit cards, and through our automated telephone, internet and electronic banking products. These products allow our customers to apply for loans from their computers, access account information and conduct various other transactions from their telephones and computers.

THE BANKING INDUSTRY IN TEXAS

The banking industry is affected by general economic conditions such as interest rates, inflation, recession, unemployment and other factors beyond our control. During the last ten to fifteen years the Texas economy has continued to diversify, decreasing the overall impact of fluctuations in oil and gas prices; however, the oil and gas industry is still a significant component of the Texas economy. During 2007, we believe our market areas have been relatively resilient and we have not experienced the effects of the housing led slowdown that impacted other regions of the United States. We cannot predict whether current economic conditions will improve, remain the same or decline.

COMPETITION

The activities we are engaged in are highly competitive. Financial institutions such as savings and loan associations, credit unions, consumer finance companies, insurance companies, brokerage companies and other financial institutions with varying degrees of regulatory restrictions compete vigorously for a share of the financial services market. During 2007, the number of financial institutions in our market areas increased, a trend that we expect will continue. Brokerage and insurance companies continue to become more competitive in the financial services arena and pose an ever increasing challenge to banks. Legislative changes also greatly affect the level of competition we face. Federal legislation allows credit unions to use their expanded membership capabilities, combined with tax-free status, to compete more fiercely for traditional bank business. The tax-free status granted to credit unions provides them a significant competitive advantage. Many of the largest banks operating in Texas, including some of the largest banks in the country, have offices in our market areas. Many of these institutions have capital resources, broader geographic markets, and legal lending limits substantially in excess of those available to us. We face competition from institutions that offer products and services we do not or cannot currently offer. Some institutions we compete with offer interest rate levels on loan and deposit products that we are unwilling to offer due to interest rate risk and overall profitability concerns. We expect the level of competition to increase.

EMPLOYEES

At February 15, 2008, we employed approximately 530 full time equivalent persons. None of the employees are represented by any unions or similar groups, and we have not experienced any type of strike or labor dispute. We consider the relationship with our employees to be good.

EXECUTIVE OFFICERS OF THE REGISTRANT

Our executive officers as of December 31, 2007, were as follows:

B. G. Hartley (Age 78), Chairman of the Board and Chief Executive Officer of Southside Bancshares, Inc. since 1983. He also serves as Chairman of the Board and Chief Executive Officer of Southside Bank, having served in these capacities since Southside Bank's inception in 1960.

Sam Dawson (Age 60), President, Secretary and Director of Southside Bancshares, Inc. since 1998. He also has served as President, Chief Operations Officer and Director of Southside Bank since 1996. He became an officer of Southside Bancshares, Inc. in 1982 and of Southside Bank in 1975.

Robbie N. Edmonson (Age 75), Vice Chairman of the Board of Southside Bancshares, Inc. and Southside Bank since 1998. He joined Southside Bank as a vice president in 1968.

3

Jeryl Story (Age 56), Executive Vice President of Southside Bancshares, Inc. since 2000, and Senior Executive Vice President - Loan Administration, Senior Lending Officer and Director of Southside Bank since 1996. He joined Southside Bank in 1979 as an officer in Loan Documentation.

Lee R. Gibson (Age 51), Executive Vice President and Chief Financial Officer of Southside Bancshares, Inc. and of Southside Bank since 2000. He is also a Director of Southside Bank. He became an officer of Southside Bancshares, Inc. in 1985 and of Southside Bank in 1984.

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

SUPERVISION AND REGULATION

General

Banking is a complex, highly regulated industry. Consequently, our growth and earnings performance can be affected not only by decisions of management and national and local economic conditions, but also by the statutes administered by, and the regulations and policies of, various governmental authorities. For bank holding companies, Texas state-chartered banks, and national banks, these authorities include, but are not limited to, the Federal Reserve, the Federal Deposit Insurance Corporation (“FDIC”), the Texas Department of Banking (“TDB”), the Office of the Comptroller of the Currency (“OCC”), United States Department of Treasury (the “Treasury Department”), the Internal Revenue Service and state taxing authorities.

The primary goals of the bank regulatory system are to maintain a safe and sound banking system and to facilitate the conduct of sound monetary policy. In furtherance of these goals, Congress has created several largely autonomous regulatory agencies and enacted numerous laws that govern banks, bank holding companies and the banking industry. The system of supervision and regulation applicable to us establishes a comprehensive framework for our operations and is intended primarily for the protection of the FDIC’s Deposit Insurance Fund, our depositors and the public, rather than our shareholders and creditors. The following summarizes certain of the more important relevant laws, rules and regulations governing banks and bank holding companies, but does not purport to be a complete summary of all applicable laws, rules and regulations governing banks and bank holding companies. The descriptions are qualified in their entirety by reference to the specific statutes and regulations discussed.

Holding Company Regulation

The Bank Holding Company Act. As bank holding companies under the Bank Holding Company Act of 1956 (“BHCA”), as amended, Southside Bancshares, Inc. and its wholly-owned subsidiary, Southside Delaware Financial Corporation, Fort Worth Bancshares, Inc. and Fort Worth Bancorporation, Inc. (collectively, the “Holding Companies”) are registered with and subject to regulation by the Federal Reserve. The Holding Companies are required to file annual and other reports with, and furnish information to, the Federal Reserve, which makes periodic inspections of the Holding Companies.

The Bank Holding Company Act provides that a bank holding company must obtain the prior approval of the Federal Reserve (i) for the acquisition of more than five percent of the voting stock in any bank or bank holding company, (ii) for the acquisition of substantially all the assets of any bank or bank holding company or (iii) in order to merge or consolidate with another bank holding company. The BHCA also provides that, with certain exceptions, a bank holding company may not engage in any activities other than those of banking or managing or controlling banks and other authorized subsidiaries that are engaged in businesses that are closely related to banking or that own or control more than five percent of the voting shares of any company that is not a bank or otherwise engaged in businesses that

are closely related to banking. The Federal Reserve has deemed limited activities (such as leasing, consumer and commercial finance, certain financial consulting activities and certain securities brokerage activities) to be closely related to banking and therefore permissible for a bank holding company.

The Bank Holding Company Act restricts the extension of credit to any bank holding company or non-banking subsidiary by a subsidiary bank. A bank holding company and its subsidiaries are also prohibited from engaging in certain tying arrangements in connection with any extension of credit, lease or sale of property or furnishing of services. Bank anti-tying regulations are discussed in greater detail below.

Traditionally, the activities of bank holding companies had been limited to the business of banking and activities closely related or incidental to banking. The Gramm-Leach-Bliley Act (“GLBA”), which became effective on March 11, 2000, amended the Bank Holding Company Act and removed certain legal barriers separating the conduct of various types of financial services businesses. In addition, GLBA substantially revamped the regulatory scheme within which financial institutions operate.

Under GLBA, bank holding companies meeting certain eligibility requirements may elect to become a “financial holding company.” A financial holding company may engage in activities that are “financial in nature,” as well as additional activities that the Federal Reserve or Treasury Department determine are financial in nature or incidental or complimentary to financial activities. Under GLBA, “financial activities” specifically include insurance brokerage and underwriting, securities underwriting and dealing, merchant banking, investment advisory and lending activities.

A bank holding company may become a financial holding company under GLBA if each of its subsidiary banks is “well capitalized” under the FDIC Improvement Act prompt corrective action provisions, is “well managed” and has at least a “satisfactory” rating under the Community Reinvestment Act. In addition, the bank holding company must file a declaration with the Federal Reserve that the bank holding company elects to become a financial holding company. A bank holding company that falls out of compliance with these requirements may be required to cease engaging in certain of its activities.

Under GLBA, the Federal Reserve serves as the primary regulator of financial holding companies, with supervisory authority over the parent company and limited authority over its subsidiaries. Expanded financial activities of financial holding companies generally will be regulated according to the type of such financial activity: banking activities by banking regulators, securities activities by securities regulators and insurance activities by insurance regulators. As noted, none of the Holding Companies have elected to become a financial holding company and to conduct the broader activities permitted under GLBA. However, there can be no assurance that they will not make such an election in the future.

In addition, GLBA also imposes additional restrictions and heightened obligations, including disclosure requirements, regarding private information collected by financial institutions. The Holding Companies and their subsidiaries (including the Banks) are subject to these obligations.

Interstate Banking. Federal banking law generally provides that a bank holding company may acquire or establish banks in any state of the United States, subject to certain age and deposit concentration limits. In approving acquisitions by bank holding companies of banks and companies engaged in banking-related activities under sections 3 and 4 of the BHCA, the Federal Reserve considers a number of factors, including expected benefits to the public such as greater convenience, increased competition, or gains in efficiency, as weighed against the risks of possible adverse effects, such as undue concentration of resources, decreased or unfair competition, conflicts of interest, or unsound banking practices. The Federal Reserve is also empowered to differentiate between new activities and activities commenced through the acquisition of a going concern. In addition, Texas banking laws permit a bank holding company that owns stock of a bank located outside the State of Texas to acquire a bank or bank holding company located in Texas. This type of acquisition may occur only if the Texas bank to be directly or indirectly controlled by the out-of-state bank holding company has existed and continuously operated as a bank for a period of at least five years. In any event, a bank holding company may not own or control banks in Texas the deposits of which would exceed 20% of the total deposits of all federally-insured deposits in Texas. Texas banking laws also would not prevent us from making bank acquisitions or establishing banks outside of the state of Texas. We have no present plans to acquire or establish banks outside the State of Texas but have not eliminated the possibility of doing so.

Capital Adequacy. Each of the federal banking agencies, including the Federal Reserve, the OCC, and the FDIC, has issued substantially similar risk-based and leverage capital guidelines applicable to banking organizations they supervise, including bank holding companies and banks. Under the risk-based capital requirements, the Holding Companies and the Banks are each generally required to maintain a minimum ratio of total capital to risk-weighted assets (including certain off-balance sheet activities, such as standby letters of credit) of 8%. At least half of the total capital must be composed of common shareholders' equity excluding unrealized gains or losses on debt securities available for sale, unrealized gains on equity securities available for sale and unrealized gains or losses on cash flow hedges, net of deferred income taxes; plus certain mandatorily redeemable capital securities; less nonqualifying intangible assets net of applicable deferred income taxes and certain nonfinancial equity investments. This is called "Tier 1 capital." The remainder may consist of qualifying subordinated debt, certain hybrid capital instruments, qualifying preferred stock and a limited amount of the allowance for credit losses. This is called "Tier 2 capital." Tier 1 capital and Tier 2 capital combined are referred to as total regulatory capital. The Federal Reserve also expects bank holding companies to maintain a minimum ratio of Tier 1 capital to risk-weighted assets of 4%.

The Federal Reserve requires bank holding companies that engage in trading activities to adjust their risk-based capital ratios to take into consideration market risks that may result from movements in market prices of covered trading positions in trading accounts, or from foreign exchange or commodity positions, whether or not in trading accounts, including changes in interest rates, equity prices, foreign exchange rates or commodity prices. Any capital required to be maintained under these provisions may consist of a new "Tier 3 capital" consisting of forms of short-term subordinated debt.

Each of the federal bank regulatory agencies, including the Federal Reserve, also has established minimum leverage capital requirements for banking organizations. These requirements provide that banking organizations that meet certain criteria, including excellent asset quality, high liquidity, low interest rate exposure and good earnings, and that have received the highest regulatory rating must maintain a ratio of Tier 1 capital to total adjusted average assets of at least 3%. Institutions not meeting these criteria, as well as institutions with supervisory, financial or operational weaknesses, are expected to maintain a minimum Tier 1 capital to total adjusted average assets ratio equal to 100 to 200 basis points above that stated minimum. Holding companies experiencing internal growth or making acquisitions are expected to maintain strong capital positions substantially above the minimum supervisory levels without significant reliance on intangible assets. The Federal Reserve also continues to consider a "tangible Tier 1 capital leverage ratio" (deducting all intangibles) and other indicators of capital strength in evaluating proposals for expansion or new activity.

In addition, the Federal Reserve, the OCC and the FDIC have adopted risk-based capital standards that explicitly identify concentrations of credit risk and the risk arising from non-traditional activities, as well as an institution's ability to manage these risks, as important factors to be taken into account by each agency in assessing an institution's overall capital adequacy. The capital guidelines provide that an institution's exposure to a decline in the economic value of its capital due to changes in interest rates be considered by the agency as a factor in evaluating a banking organization's capital adequacy. The agencies also require banks and bank holding companies to adjust their regulatory capital to take into consideration the risk associated with certain recourse obligations, direct credit subsidies, residual interest and other positions in securitized transactions that expose banking organizations to credit risk.

The ratios of Tier 1 capital, total capital to risk-adjusted assets, and leverage capital of the Company and the Banks as of December 31, 2007, are shown in the following table.

	Capital Adequacy Ratios				
	Regulatory Minimums	Regulatory Minimums to be Well-Capitalized	Southside Bancshares, Inc.	Southside Bank	Fort Worth National Bank
Risk-based capital ratios:					
Tier 1 Capital (1)	4.0%	6.0%	14.92%	15.50%	14.54%
Total risk-based capital (2)	8.0	10.0	17.02	16.41	15.51
Tier 1 leverage ratio (3)	4.0	5.0	7.73	7.67	13.13

- (1) Common shareholders' equity excluding unrealized gains or losses on debt securities available for sale, unrealized gains on equity securities available for sale and unrealized gains or losses on cash flow hedges, net of deferred income taxes; plus certain mandatorily redeemable capital securities, less nonqualifying intangible assets net of applicable deferred income taxes, and certain nonfinancial equity investments; computed as a ratio of risk-weighted assets, as defined in the risk-based capital guidelines.
- (2) The sum of Tier 1 capital, a qualifying portion of the allowance for credit losses, qualifying subordinated debt and qualifying unrealized gains on available for sale equity securities; computed as a ratio of risk-weighted assets, as defined in the risk-based capital guidelines.
- (3) Tier 1 capital computed as a percentage of fourth quarter average assets less nonqualifying intangibles and certain nonfinancial equity investments.

The federal banking agencies, including the OCC and the FDIC, are required to take "prompt corrective action" in respect of depository institutions that do not meet minimum capital requirements. The law establishes five capital categories for insured depository institutions for this purpose: "well-capitalized," "adequately capitalized," "undercapitalized," "significantly undercapitalized" and "critically undercapitalized." To be considered "well-capitalized" under these standards, an institution must maintain a total risk-based capital ratio of 10% or greater; a Tier 1 risk-based capital ratio of 6% or greater; a leverage capital ratio of 5% or greater; and must not be subject to any order or written directive to meet and maintain a specific capital level for any capital measure. The Banks meet the criteria for "well-capitalized." Federal law also requires the bank regulatory agencies to implement systems for "prompt corrective action" for institutions that fail to meet minimum capital requirements within the five capital categories, with progressively more severe restrictions on operations, management and capital distributions according to the category in which an institution is placed. Failure to meet capital requirements may also cause an institution to be directed to raise additional capital. Federal law also mandates that the agencies adopt safety and soundness standards relating generally to operations and management, asset quality and executive compensation, and authorizes administrative action against an institution that fails to meet such standards.

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

The regulations also establish procedures for “downgrading” an institution to a lower capital category based on supervisory factors other than capital. Specifically, a federal banking agency may, after notice and an opportunity for a hearing, reclassify a well-capitalized institution as adequately capitalized and may require an adequately capitalized institution or an undercapitalized institution to comply with supervisory actions as if it were in the next lower category if the institution is operating in an unsafe or unsound condition or engaging in an unsafe or unsound practice. The FDIC may not, however, reclassify a significantly undercapitalized institution as critically undercapitalized.

Federal Reserve policy requires a bank holding company to act as a source of financial strength and to take measures to preserve and protect bank subsidiaries in situations where additional investments in a troubled bank may not otherwise be warranted. In addition, where a bank holding company has more than one bank or thrift subsidiary, each of the bank holding company’s subsidiary depository institutions are responsible for any losses to the FDIC as a result of an affiliated depository institution’s failure or anticipated failure. As a result, a bank holding company may be required to contribute additional capital to its subsidiaries in the form of capital notes or other instruments which qualify as capital under regulatory rules. Any such loans from the holding company to its subsidiary banks likely will be unsecured and subordinated to the bank’s depositors and perhaps to other creditors of the bank.

Dividends. As a bank holding company that does not, as an entity, currently engage in separate business activities of a material nature, the Holding Companies’ ability to pay cash dividends depends upon the cash dividends received from the Banks. We must pay essentially all of our operating expenses from funds we receive from the Banks. Therefore, shareholders may receive dividends from us only to the extent that funds are available after payment of our operating expenses. In general, the Federal Reserve discourages bank holding companies from paying dividends except out of operating earnings, and the prospective rate of earnings retention appears consistent with the bank holding company’s capital needs, asset quality and overall financial condition. We are also subject to certain restrictions on the payment of dividends as a result of the requirement that we maintain an adequate level of capital as described above and serve as a source of strength for our subsidiaries.

Change in Bank Control Act. Under the Change in Bank Control Act (“CBCA”), persons who intend to acquire control of a bank holding company, either directly or indirectly, must give 60 days prior notice to the Federal Reserve. “Control” would exist when an acquiring party directly or indirectly has control of at least 25% of our voting securities or the power to direct management or policies. Under Federal Reserve regulations, a rebuttable presumption of control would arise with respect to an acquisition where, after the transaction, the acquiring party has ownership control or the power to vote at least 10% (but less than 25%) of our voting securities.

The Attorney General of the United States may, within 15 days after approval by the Federal Reserve Board of an acquisition under section 3 of the BHCA, bring an action challenging such acquisition under the federal antitrust laws, in which case the effectiveness of such approval is stayed pending a final ruling by the courts. Failure of the Attorney General to challenge a section 3 acquisition and the absence of a specific right of action to challenge section 4 or CBCA acquisitions do not, however, exempt the holding company from complying with both state and federal antitrust laws after the acquisition is consummated.

The Federal Reserve has broad authority to prohibit activities of bank holding companies and their non-bank subsidiaries which represent unsafe and unsound banking practices or which constitute knowing or reckless violations of laws or regulations, if those activities caused a substantial loss to a depository institution. These penalties can be as high as one million dollars for each day the activity continues.

Bank Regulation

Southside Bank is chartered under the laws of the State of Texas, is an “insured institution” and is a member of the FDIC’s Deposit Insurance Fund. It is not a member of the Federal Reserve System. As such, it is subject to various requirements and restrictions under the laws of the United States and the State of Texas, and to regulation, supervision and regular examination by the TDB and the FDIC. The TDB and the FDIC have the power to enforce compliance with applicable banking statutes and regulations. These requirements and restrictions include requirements to maintain reserves against deposits, restrictions on the nature and amount of loans that may be made and the interest that may be charged thereon and restrictions relating to investments and other activities of Southside Bank. Fort Worth National Bank is a national bank, and as such is subject to supervision, regulation and examination by the OCC. The FDIC also has back-up enforcement authority over Fort Worth National Bank. Ongoing supervision is provided through regular examinations and other means that allow the regulators to gauge management’s ability to identify, assess and control risk in all areas of operations in a safe and sound manner and to ensure compliance with laws and regulations. As a result, the scope of routine examinations of the Banks is rather extensive. To facilitate supervision, the Banks are required to file periodic reports with the regulatory agencies, and much of this information is made available to the public by the agencies.

Deposit Insurance. The Banks’ deposits are generally insured up to \$100,000 per depositor and up to \$250,000 for certain retirement accounts by the FDIC’s Deposit Insurance Fund. As insurer, the FDIC imposes deposit premiums and is authorized to conduct examinations and to require reporting. The FDIC assesses insurance premiums on a bank’s deposits at a variable rate depending on the probability that the deposit insurance fund will incur a loss with respect to the bank. The FDIC determines the deposit insurance assessment rates on the basis of the bank’s capital classification and supervisory evaluations. For 2007, the minimum assessment rate is 5 basis points for the institutions the FDIC perceives to pose the least threat to the Deposit Insurance Fund, and 47 basis points for the highest risk institutions. Our deposits insurance assessments may increase or decrease depending upon the risk assessment classification to which we are assigned by the FDIC. Any increase in insurance assessments could have an adverse effect on our earnings.

In addition to its role as insurer, the FDIC is the primary federal regulator of state-chartered banks, including Southside Bank, that are not members of a Federal Reserve Bank. The FDIC issues regulations, conducts examinations, requires the filing of reports and generally supervises and regulates the operations of state-chartered nonmember banks. FDIC approval is required prior to any merger or consolidation involving state, nonmember banks, or the establishment or relocation of an office facility thereof. FDIC supervision and regulation of Southside Bank is intended primarily for the protection of depositors and the FDIC insurance funds. With respect to Fort Worth National Bank, OCC approval is required prior to any merger or consolidation involving national banks, or the establishment or relocation of an office facility thereof. OCC and FDIC supervision and regulation of Fort Worth National Bank is intended primarily for the protection of depositors and the FDIC insurance funds.

Under the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (“FIRREA”), a depository institution insured by the FDIC can be held liable for any loss incurred by, or reasonably expected to be incurred by, the FDIC after August 9, 1989 in connection with (i) the default of a commonly controlled FDIC insured depository institution or (ii) any assistance provided by the FDIC to a commonly controlled FDIC insured depository institution in danger of default. FIRREA provides that certain types of persons affiliated with financial institutions can be fined by the federal regulatory agency having jurisdiction over a depository institution with federal deposit insurance (such as the Banks) up to \$1 million per day for each violation of certain regulations related (primarily) to lending to and transactions with executive officers, directors, and principal shareholders, including the interests of these individuals. Other violations may result in civil money penalties of \$5,000 to \$25,000 per day or in criminal fines and penalties. In addition, the FDIC has been granted enhanced authority to withdraw or to suspend deposit insurance in certain cases.

Activities and Investments of Insured State-Chartered and National Banks. The activities and investments of national banks are limited to those set forth in the National Bank Act and in statutory interpretations of the OCC. The FDIC generally limits the activities and equity investments of state nonmember banks to those that are permissible for national banks. Under regulations dealing with equity investments, an insured state bank generally may not directly or indirectly acquire or retain any equity investment of a type, or in an amount, that is not permissible for a national bank. However, a state nonmember bank may seek FDIC approval to engage in activities that are not permissible for a national bank.

An insured state bank or a national bank is not prohibited from, among other things, (i) acquiring or retaining a majority interest in a subsidiary that engages in activities permissible for the parent bank, (ii) investing as a limited partner in a partnership the sole purpose of which is direct or indirect investment in the acquisition, rehabilitation or new construction of a qualified housing project, provided that such limited partnership investment may not exceed 2% of the bank's total assets, (iii) acquiring up to 10% of the voting stock of a company that solely provides or reinsures directors', trustees' and officers' liability insurance coverage or bankers' blanket bond group insurance coverage for insured depository institutions, and (iv) acquiring or retaining the voting shares of a depository institution if certain requirements are met.

FDIC regulations implementing the Federal Deposit Insurance Act ("FDIA") provide that an insured state-chartered bank may not, directly, or indirectly through a subsidiary, engage as "principal" in any activity that is not permissible for a national bank unless the FDIC has determined that such activities would pose no risk to the insurance fund of which it is a member and the bank is in compliance with applicable regulatory capital requirements. Any insured state-chartered bank or savings bank directly or indirectly engaged in any activity that is not permitted for a national bank must cease the impermissible activity.

Loans-to-One-Borrower. The maximum aggregate amount of loans that Southside Bank will be permitted to make under Texas law to any one borrower, including related entities, is 25% of Tier 1 capital. The limit for Fort Worth National Bank under the National Bank Act is 15% of Total capital, plus an additional 10% for loans secured by readily marketable securities.

Regulation of Lending Activities. Our loans are subject to numerous federal and state laws and regulations, including the Truth in Lending Act, the Federal Consumer Credit Protection Act, the Texas Finance Code, the Texas Deceptive Trade Practices Act, the Equal Credit Opportunity Act, the Real Estate Settlement Procedures Act, the Home Mortgage Disclosure Act, the Fair Credit Reporting Act, and the Flood Disaster Protection Act. Remedies to the borrower or consumer and penalties to us are provided if we fail to comply with these laws and regulations. The scope and requirements of these laws and regulations have expanded significantly in recent years. The Fair and Accurate Credit Transactions Act of 2003 ("FACTA") substantially amended the Fair Credit Reporting Act to impose new duties on institutions such as the Banks that furnish or receive information from credit reporting agencies. The new duties relate primarily to situations in which a consumer could become the victim of an identity theft. The FDIC and other federal agencies are still in the process of developing regulations implementing the FACTA provisions.

Brokered Deposits. The Banks also may be restricted in their ability to accept brokered deposits, depending on their capital classification. "Well capitalized" banks are permitted to accept brokered deposits, but all banks that are not well capitalized are not permitted to accept such deposits. The FDIC may, on a case-by-case basis, permit banks that are adequately capitalized to accept brokered deposits if the FDIC determines that acceptance of such deposits would not constitute an unsafe or unsound banking practice with respect to the bank.

Anti-Tying Regulations. Under the Bank Holding Company Act and Federal Reserve regulations, a bank is prohibited from engaging in certain tying or reciprocity arrangements with its customers. In general, a bank may not extend credit, lease, sell property, or furnish any services or fix or vary the consideration for these products or services on the

condition that either: the customer obtain or provide some additional credit, property, or services from or to the bank, the bank holding company or subsidiaries thereof, or that the customer may not obtain some other credit, property, or services from a competitor, except to the extent reasonable conditions are imposed to assure the soundness of the credit extended. Certain arrangements

10

are permissible: a bank may offer combined-balance products and may otherwise offer more favorable terms if a customer obtains two or more traditional bank products; and certain foreign transactions are exempt from the general rule. A bank holding company or any bank affiliate also is subject to anti-tying requirements in connection with electronic benefit transfer services.

Dividends. All dividends paid by Southside Bank are paid to the Company, as sole indirect shareholder of Southside Bank, through Southside Delaware. All dividends paid by Fort Worth National Bank are paid to the Company, as sole indirect shareholder of Fort Worth National Bank, through Fort Worth Bancorporation, Inc. and Fort Worth Bancshares, Inc. Our general dividend policy is to pay dividends at levels consistent with maintaining liquidity and preserving applicable capital ratios and servicing obligations. The dividend policies of the Banks are subject to the discretion of their respective boards of directors and will depend upon such factors as future earnings, financial conditions, cash needs, capital adequacy, compliance with applicable statutory and regulatory requirements and general business conditions.

The ability of Southside Bank, as a Texas banking association, to pay dividends is restricted under applicable law and regulations. We generally may not pay a dividend reducing our capital and surplus without the prior approval of the Texas Banking Commissioner. All dividends must be paid out of net profits then on hand, after deducting expenses, including losses and provisions for loan losses. The FDIC has the right to prohibit the payment of dividends by us where the payment is deemed to be an unsafe and unsound banking practice. We are also prohibited from paying dividends that will reduce our capital below the “well-capitalized” level as defined by the FDIC, and as a general matter, prefer to maintain a strong capital position which necessarily limits the amount of dividends we are prepared to declare and pay.

The ability of Fort Worth National Bank to pay dividends is subject to similar restrictions. Fort Worth National Bank may not, without prior OCC approval, pay a dividend that would exceed the sum of net income in calendar year to date plus retained net earnings of the immediately previous two years. As a policy matter, the OCC prefers that national banks pay dividends solely out of net profits then on hand.

The exact amount of future dividends on the Banks will be a function of the profitability of the Banks in general (which cannot be accurately estimated or assured), applicable tax rates in effect from year to year and the discretion of their respective boards of directors.

In addition, FDIC regulations generally prohibits FDIC-insured depository institutions, such the Banks, from making any capital distribution (including payment of dividends) or paying any management fee to its holding company if the depository institution would thereafter be undercapitalized. Undercapitalized depository institutions are subject to restrictions on borrowing from the Federal Reserve. In addition, undercapitalized depository institutions are subject to growth limitations and are required to submit capital restoration plans. A depository institution’s holding company must guarantee the capital plan, up to an amount equal to the lesser of 5% of the depository institution’s assets at the time it becomes undercapitalized or the amount of the capital deficiency when the institution fails to comply with the plan. The federal banking agencies may not accept a capital plan without determining, among other things, that the plan is based on realistic assumptions and is likely to succeed in restoring the depository institution’s capital. If a depository institution fails to submit an acceptable plan, it is treated as if it is significantly undercapitalized.

Significantly undercapitalized depository institutions may be subject to a number of requirements and restrictions, including orders to sell sufficient voting stock to become adequately capitalized, requirements to reduce total assets and cessation of receipt of deposits from correspondent banks. Critically undercapitalized depository institutions are subject to appointment of a receiver or conservator.

Various other legislation, including proposals to revise the bank regulatory system and to limit or expand the investments that a depository institution may make with insured funds, is from time to time introduced in Congress.

The TDB, the OCC, and the FDIC will examine the Banks periodically for compliance with various regulatory requirements. Such examinations, however, are for the protection of the DIF and for depositors and not for the protection of investors and shareholders.

Transactions with Affiliates. The Holding Companies are legal entities separate and distinct from the Banks and their other subsidiaries. Various legal limitations restrict the Banks from lending or otherwise advancing funds to the Holding Companies or their non-bank subsidiaries. The Holding Companies and the Banks are subject to Sections 23A and 23B of the Federal Reserve Act and Federal Reserve Regulation W. Generally, Sections 23A and 23B (i) limit the extent to which a bank or its subsidiaries may engage in "covered transactions" with any one affiliate to an amount equal to 10% of such institution's capital stock and surplus; (ii) limit such transactions with all affiliates to an amount equal to 20% of such capital stock and surplus; and (iii) require that all such transactions be on terms that are consistent with safe and sound banking practices. The term "covered transaction" includes the making of loans to an affiliate, the purchase of or investment in securities issued by an affiliate, the purchase of assets from an affiliate, the issuance of a guarantee for the benefit of an affiliate, and similar transactions. Most loans by a bank to any of its affiliates must be secured by collateral in amounts ranging from 100 to 130 percent of the loan amount, depending on the nature of the collateral. In addition, any covered transaction by a bank with an affiliate and any sale of assets or provision of services to an affiliate must be on terms that are substantially the same, or at least as favorable, to the bank as those prevailing at the time for comparable transactions with nonaffiliated companies. The Banks are also restricted in the loans that it may make to its executive officers and directors, the executive officers and directors of the Company, any owner of 10% or more of its stock or the stock of the Company, and certain entities affiliated with any such person. Section 23B also prohibits a bank from purchasing low-quality assets from the bank's affiliates, and requires that all of a bank's extensions of credit to an affiliate be appropriately secured by acceptable collateral, generally United States government or agency securities.

Under Sections 23A and 23B of the Federal Reserve Act, an affiliate of a bank is any company or entity that controls, is controlled by or is under common control with the bank. A subsidiary of a bank that is not also a depository institution is not treated as an affiliate of a bank for purposes of Sections 23A and 23B unless it engages in activities not permissible for a national bank to engage in directly.

Insider Loans. Under Regulation O of the Federal Reserve, the Bank's are restricted in the loans that they may make to their executive officers and directors, the executive officers and directors of Southside Bancshares, Inc., any owner of 10% or more of its stock or the stock of Southside Bancshares, Inc., and certain entities affiliated with any such person.

Standards for Safety and Soundness. The FDIA requires the federal banking regulatory agencies to prescribe, by regulation or guideline, operational and managerial standards for all insured depository institutions relating to: (i) internal controls, information systems and internal audit systems; (ii) loan documentation; (iii) credit underwriting; (iv) interest rate risk exposure; and (v) asset growth. The agencies also must prescribe standards for asset quality, earnings, and stock valuation, as well as standards for compensation, fees and benefits. The federal banking agencies have adopted regulations and Interagency Guidelines Prescribing Standards for Safety and Soundness ("Guidelines") to implement these required standards. The Guidelines set forth the safety and soundness standards that the federal banking agencies use to identify and address problems at insured depository institutions before capital becomes impaired. Under the regulations, if the FDIC or the OCC, as applicable, determines that the Banks fail to meet any standards prescribed by the Guidelines, the agency may require the Bank in question to submit to the agency an acceptable plan to achieve compliance with the standard, as required by the FDIC or the OCC. The final regulations establish deadlines for the submission and review of such safety and soundness compliance plans.

Community Reinvestment Act. Under the Community Reinvestment Act, we have a continuing and affirmative obligation consistent with safe and sound banking practices to help meet the needs of our entire community, including low- and moderate-income neighborhoods. The Community Reinvestment Act does not establish specific lending requirements or programs for financial institutions nor does it limit our discretion to develop the types of products and services that we believe are best suited to our particular community. Current CRA regulations rate institutions based on their actual performance in meeting community credit needs. CRA performance is evaluated by the FDIC and the OCC, the Banks' primary federal regulators, using a lending test, an investment test, and a service test. The regulators also will consider: (i) demographic data about the community; (ii) the institution's capacity and constraints; (iii) the

institution's product offerings and business strategy; and (iv) data on the prior performance of the institution and similarly-situated lenders. On a periodic basis, the FDIC or the OCC, as applicable, is charged with preparing a written evaluation of our record of meeting the credit needs of the entire community and assigning a rating. Our regulatory agencies will take that record into account in their evaluation of any application made by us for, among other things, approval of the acquisition or establishment of a branch or other deposit facility, an office relocation, a merger or the acquisition of shares of capital stock of another financial institution. An "unsatisfactory" Community Reinvestment Act rating may be used as the basis to deny an application. In addition, as discussed above, a bank holding company may not become a financial holding company unless each of its subsidiary banks has a Community Reinvestment Act rating of at least satisfactory. We were last examined for compliance with the Community Reinvestment Act on March 12, 2007 and received a rating of "outstanding."

Consumer Regulation. Activities of the Banks are subject to a variety of statutes and regulations designed to protect consumers, including the Fair Credit Reporting Act (FCRA), Equal Credit Opportunity Act (ECOA), and Truth-in-Lending Act (TILA). These laws and regulations include provisions that:

- limit the interest and other charges collected or contracted for by the Banks;
- govern the Banks' disclosures of credit terms to consumer borrowers;
- require the Banks to provide information to enable the public and public officials to determine whether they are fulfilling its obligation to help meet the housing needs of the community it serves;
- prohibit the Banks from discriminating on the basis of race, creed or other prohibited factors when they make decisions to extend credit;
- require that the Banks safeguard the personal nonpublic information of their customers, provide annual notices to consumers regarding the usage and sharing of such information, and limit disclosure of such information to third parties except under specific circumstances; and
- govern the manner in which the Banks may collect consumer debts.

The deposit operations of the Banks are also subject to laws and regulations that:

- require the Banks to adequately disclose the interest rates and other terms of consumer deposit accounts;
- impose a duty on the Banks to maintain the confidentiality of consumer financial records and prescribe procedures for complying with administrative subpoenas of financial records; and
- govern automatic deposits to and withdrawals from deposit accounts with the Banks and the rights and liabilities of customers who use automated teller machines and other electronic banking services.

USA PATRIOT Act/Anti-Money Laundering. Following the events of September 11, 2001, President Bush, on October 26, 2001, signed into law the United and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001. Also known as the “USA PATRIOT Act,” the law enhances the powers of the federal government and law enforcement organizations to combat terrorism, organized crime and money laundering. The USA PATRIOT Act significantly amends and expands the application of the Bank Secrecy Act, including enhanced measures regarding customer identity, new suspicious activity reporting rules and enhanced anti-money laundering programs. Under the Act, each financial institution is required to establish and maintain anti-money laundering compliance and due diligence programs, which include, at a minimum, the development of internal policies, procedures, and controls; the designation of a compliance officer; an ongoing employee training program; and an independent audit function to test programs. In addition, the Act requires the bank regulatory agencies to

13

consider the record of a bank or bank holding company in combating money laundering activities in their evaluation of bank and bank holding company merger or acquisition transactions.

Furthermore, financial institutions must maintain anti-money laundering programs that include established internal policies, procedures, and controls; a designated compliance officer; an ongoing employee training program; and testing of the program by an independent audit function. The Company and the Banks are also prohibited from entering into specified financial transactions and account relationships and must meet enhanced standards for due diligence and “knowing your customer” in their dealings with foreign financial institutions and foreign customers. Financial institutions must take reasonable steps to conduct enhanced scrutiny of account relationships to guard against money laundering and to report any suspicious transactions, and recent laws provide law enforcement authorities with increased access to financial information maintained by banks. Anti-money laundering obligations have been substantially strengthened as a result of the USA Patriot Act, which was renewed in 2006. Bank regulators routinely examine institutions for compliance with these obligations and are required to consider compliance in connection with the regulatory review of applications. The regulatory authorities have been active in imposing “cease and desist” orders and money penalty sanctions against institutions found to be violating these obligations.

Privacy and Data Security. The GLB Act imposed new requirements on financial institutions with respect to consumer privacy. The GLB Act generally prohibits disclosure of consumer information to non-affiliated third parties unless the consumer has been given the opportunity to object and has not objected to such disclosure. Financial institutions are further required to disclose their privacy policies to consumers annually. Financial institutions, however, will be required to comply with state law if it is more protective of consumer privacy than the GLB Act. The GLB Act also directed federal regulators, including the FDIC, to prescribe standards for the security of consumer information. The Banks are subject to such standards, as well as standards for notifying consumers in the event of a security breach. Under federal law, the Company must disclose its privacy policy to consumers, permit consumers to “opt out” of having non-public customer information disclosed to third parties, and allow customers to opt out of receiving marketing solicitations based on information about the customer received from another subsidiary. States may adopt more extensive privacy protections. The Banks and the Company are similarly required to have an information security program to safeguard the confidentiality and security of customer information and to ensure proper disposal. Customers must be notified when unauthorized disclosure involves sensitive customer information that may be misused.

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

In 1994, Congress adopted the Reigle-Neal Interstate Banking and Branching Efficiency Act of 1994. That statute provides for nationwide interstate banking and branching, subject to certain aging and deposit concentration limits that may be imposed under applicable state laws. Texas law permits interstate branching in two manners, with certain exceptions. First, a financial institution with its main office outside of Texas may establish a branch in the State of Texas by acquiring a financial institution located in Texas that is at least five years old, so long as the resulting institution and its affiliates would not hold more than 20% of the total deposits in the state after the acquisition. In addition, a financial institution with its main office outside of Texas generally may establish a branch in the State of Texas on a de novo basis if the financial institution’s main office is located in a state that would permit Texas institutions to establish a branch on a de novo basis in that state. These limitations apply to both of the Banks.

The FDIC has adopted regulations under the Reigle-Neal Act to prohibit an out-of-state bank from using the interstate branching authority primarily for the purpose of deposit production. These regulations include guidelines to insure that interstate branches operated by an out-of-state bank in a host state are reasonably helping to meet the credit needs of the communities served by the out-of-state bank.

Enforcement Authority. The federal banking laws also contain civil and criminal penalties available for use by the appropriate regulatory agency against certain “institution-affiliated parties” primarily including management, employees and agents of a financial institution, as well as independent contractors such as attorneys and accountants and others who participate in the conduct of the financial institution’s affairs and who caused or are likely to cause more than minimum financial loss to or a significant adverse affect on the institution, who knowingly or recklessly violate a law or regulation, breach a fiduciary duty or engage in unsafe or unsound practices. These practices can include the failure of an institution to timely file required reports or the submission of inaccurate reports. These laws authorize the appropriate banking agency to issue cease and desist orders that may, among other things, require affirmative action to correct any harm resulting from a violation or practice, including restitution, reimbursement, indemnification or guarantees against loss. A financial institution may also be ordered to restrict its growth, dispose of certain assets or take other action as determined by the ordering agency to be appropriate. The FDIC and the OCC, respectively, are the appropriate regulatory agencies for Southside Bank and Fort Worth National Bank; the Federal Reserve is the appropriate regulatory agency for the Holding Companies.

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

Annual Audits. Every bank with total assets in excess of \$500 million, such as us, must have an annual independent audit made of the bank’s financial statements by a certified public accountant to verify that the financial statements of the bank are presented in accordance with United States generally accepted accounting principles (“GAAP”) and comply with such other disclosure requirements as prescribed by the FDIC.

All of the above laws and regulations add to the cost of our operations and thus have a negative impact on profitability. It should be noted that there has been a tremendous expansion experienced in recent years by financial service providers that are not subject to the same rules and regulations as are applicable to the Holding Companies. Management cannot predict what other legislation might be enacted or what other regulations might be adopted and the effects thereof on us.

Usury Laws. Texas usury laws limit the rate of interest that may be charged by state banks. Certain federal laws provide a limited preemption of Texas usury laws. The maximum rate of interest that we may charge on direct business loans under Texas law varies between 18% per annum and (i) 28% per annum for business and agricultural loans above \$250,000 or (ii) 24% per annum for other direct loans. Texas floating usury ceilings are tied to the 26-week United States Treasury Bill Auction rate. Other ceilings apply to open-end credit card loans and dealer paper we purchase. A federal statute removes interest ceilings under usury laws for our loans that are secured by first liens on residential real property. These restrictions generally apply to both of the Banks.

Economic Environment. The monetary policies of regulatory authorities, including the Federal Reserve, have a significant effect on the operating results of bank holding companies and their subsidiaries. The Federal Reserve regulates the national supply of bank credit. Among the means available to the Federal Reserve are open market operations in United States Government Securities, changes in the discount rate on member bank borrowings, changes in reserve requirements against member and nonmember bank deposits, and loans and limitations on interest rates which member banks may pay on time or demand deposits. These methods are used in varying combinations to influence overall growth and distribution of bank loans, investments and deposits. Their use may affect interest rates

charged on loans or paid for deposits.

Also see discussion of "Banking Industry in Texas" above.

ITEM 1A. RISK FACTORS

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

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

RISKS RELATED TO OUR BUSINESS

We are subject to interest rate risk.

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

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

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

Although management believes we have implemented effective asset and liability management strategies to reduce the potential effects of changes in interest rates on our results of operations, any substantial, unexpected, prolonged change in market interest rates could have a material adverse effect on our financial condition and results of operations. See the section captioned “Net Interest Income” in “Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations” for further discussion related to our management of interest rate risk.

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

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

Our interest rate risk, liquidity, market value of securities and profitability are subject to risks associated with the successful implementation of our leverage strategy.

We implemented a leverage strategy in 1998 for the purpose of enhancing overall profitability by maximizing the use of our capital. The effectiveness of our leverage strategy, and therefore our profitability, may be adversely affected by a number of factors, including reduced net interest margin and spread, adverse market value changes to the investment and mortgage-backed and related securities, incorrect modeling results due to the unpredictable nature of mortgage-backed securities prepayments, the length of interest rate cycles, and the slope of the interest rate yield curve. In addition, we may not be able to obtain wholesale funding to profitably and properly fund the leverage program. If our leverage strategy is flawed or poorly implemented, we may incur significant losses. See the section captioned "Leverage Strategy" in "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations."

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

A significant portion of our loan portfolio is dependent on real estate. In addition to the financial strength and cash flow characteristics of the borrower in each case, often loans are secured with real estate collateral. At December 31, 2007, approximately 56.8% of our loans have real estate as a primary or secondary component of collateral. The real estate in each case provides an alternate source of repayment in the event of default by the borrower and may deteriorate in value during the time the credit is extended. Beginning in the third quarter of 2007, there were well-publicized developments in the credit markets, beginning with a decline in the sub-prime mortgage lending market, which later extended to the markets for collateralized mortgage obligations, mortgage-backed securities and the lending markets generally. This decline has resulted in restrictions in the resale markets for non-conforming loans and has had an adverse effect on retail mortgage lending operations in many markets. We believe our markets have been relatively resilient and we have not experienced effects associated with these market trends; however, a continued decline in the credit markets generally could adversely effect our financial condition and results of operations if we are unable to extend credit or sell loans in the secondary market. An adverse change in the economy affecting values of real estate generally or in our primary markets specifically could significantly impair the value of collateral and our ability to sell the collateral upon foreclosure. Furthermore, it is likely that, in a declining real estate market, we would be required to further increase our allowance for loan losses. If we are required to liquidate the collateral securing a loan to satisfy the debt during a period of reduced real estate values or to increase our allowance for loan losses, our profitability and financial condition could be adversely impacted.

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

A significant portion of our loan portfolio is dependent on the medical community. The primary source of repayment for loans in the medical community is cash flow from continuing operations. However, changes in the amount the government pays the medical community through the various government health insurance programs could adversely impact the medical community, which in turn could result in higher default rates by borrowers in the medical industry. Increased regulation of the medical community

could also negatively impact profitability and cash flow in the medical community. It is likely that, should there be any significant adverse impact to the medical community, our profitability and financial condition would also be adversely impacted.

Our allowance for probable loan losses may be insufficient.

We maintain an allowance for probable loan losses, which is a reserve established through a provision for probable loan losses charged to expense. This allowance represents management's best estimate of probable losses that have been incurred within the existing portfolio of loans. The allowance, in the judgment of management, is necessary to reserve for estimated loan losses and risks inherent in the loan portfolio. The level of the allowance reflects management's continuing evaluation of industry concentrations; specific credit risks; loan loss experience; current loan portfolio quality; present economic, political and regulatory conditions; and unidentified losses inherent in the current loan portfolio. The determination of the appropriate level of the allowance for probable loan losses inherently involves a high degree of subjectivity and requires us to make significant estimates and assumptions regarding current credit risks and future trends, all of which may undergo material changes. Changes in economic conditions affecting borrowers, new information regarding existing loans, identification of additional problem loans and other factors, both within and outside our control, may require an increase in the allowance for probable loan losses. In addition, bank regulatory agencies periodically review our allowance for loan losses and may require an increase in the provision for probable loan losses or the recognition of further loan charge-offs, based on judgments different than those of management. In addition, if charge-offs in future periods exceed the allowance for probable loan losses, we will need additional provisions to increase the allowance for probable loan losses. Any increases in the allowance for probable loan losses will result in a decrease in net income and, possibly, capital, and may have a material adverse effect on our financial condition and results of operations. See the section captioned "Loan Loss Experience and Allowance for Loan Losses" in "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations" for further discussion related to our process for determining the appropriate level of the allowance for probable loan losses.

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

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

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

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

We operate in a highly competitive industry and market area.

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

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

- The ability to develop, maintain and build upon long-term customer relationships based on top quality service, high ethical standards and safe, sound assets.
 - The ability to expand our market position.
- The scope, relevance and pricing of products and services offered to meet customer needs and demands.
 - The rate at which we introduce new products and services relative to our competitors.
 - Customer satisfaction with our level of service.
 - Industry and general economic trends.

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

We are subject to extensive government regulation and supervision.

Southside Bancshares, Inc., primarily through Southside Bank, Fort Worth National Bank and certain non-bank subsidiaries, is subject to extensive federal and state regulation and supervision. Banking regulations are primarily intended to protect depositors' funds, federal deposit insurance funds and the banking system as a whole, not shareholders. These regulations affect our lending practices, capital structure, investment practices and dividend policy and growth, among other things. Congress and federal and state regulatory agencies continually review banking laws, regulations and policies for possible changes. Changes to statutes, regulations or regulatory policies, including changes in interpretation or implementation of statutes, regulations or policies, could affect us in substantial and unpredictable ways. Such changes could subject us to additional costs, limit the types of financial services and products we may offer and/or increase the ability of non-banks to offer competing financial services and products,

among other things. Failure to comply with laws, regulations or policies could result in sanctions by regulatory agencies, civil money penalties and/or reputation damage, which could have a material adverse effect on our business, financial condition and results of operations. While our

policies and procedures are designed to prevent any such violations, there can be no assurance that such violations will not occur. See the section captioned “Supervision and Regulation” in “Item 1. Business” and “Note 15 – Shareholders’ Equity” in the notes to consolidated financial statements included in “Item 8. Financial Statements and Supplementary Data,” which are located elsewhere in this report.

Our controls and procedures may fail or be circumvented.

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

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

From time to time, we may implement new delivery systems, such as internet banking, or offer new products and services within existing lines of business. In August, 2007, through a subsidiary of Southside Bank, we entered into a joint venture engaged in the purchase and sale of portfolios of automobile loans nationwide. Although we have retained a management team with expertise in this industry, we cannot provide any assurance as to our ability to profitably operate this line of business. There are substantial risks and uncertainties associated with these efforts, particularly in instances where the markets are not fully developed. In developing and marketing new delivery systems and/or new products and services, we may invest significant time and resources. Initial timetables for the introduction and development of new lines of business and/or new products or services may not be achieved and price and profitability targets may not prove feasible. External factors, such as compliance with regulations, competitive alternatives, and shifting market preferences, may also impact the successful implementation of a new line of business or a new product or service. Furthermore, any new line of business and/or new product or service could have a significant impact on the effectiveness of our system of internal controls. Failure to successfully manage these risks in the development and implementation of new lines of business or new products or services could have a material adverse effect on our business, results of operations and financial condition.

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

Southside Bancshares, Inc. is a separate and distinct legal entity from our subsidiaries. We receive substantially all of our revenue from dividends from our subsidiaries. These dividends are the principal source of funds to pay dividends on our common stock and interest and principal on our debt. Various federal and/or state laws and regulations limit the amount of dividends that Southside Bank, Fort Worth National Bank, and certain non-bank subsidiaries may pay to Southside Bancshares, Inc. Also, Southside Bancshares, Inc.’s right to participate in a distribution of assets upon a subsidiary’s liquidation or reorganization is subject to the prior claims of the subsidiary’s creditors. In the event Southside Bank or Fort Worth National Bank is unable to pay dividends to Southside Bancshares, Inc., Southside Bancshares, Inc. may not be able to service debt, pay obligations or pay dividends on common stock. The inability to receive dividends from Southside Bank or Fort Worth National Bank could have a material adverse effect on Southside Bancshares, Inc.’s business, financial condition and results of operations. See the section captioned “Supervision and Regulation” in “Item 1. Business” and “Note 15 – Shareholders’ Equity” in the notes to consolidated financial statements included in “Item 8. Financial Statements and Supplementary Data,” which are located elsewhere in this report.

We may not be able to access capital on favorable terms, including cost of funds.

The availability and cost of funds may increase as a result of general economic condition, increased interest rates and competitive pressures. If we are unable to obtain funds on terms that are favorable to us, we could be restricted in our ability to extend credit, and may not be able to obtain sufficient funds to support growth through branching or acquisition initiatives.

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

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

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

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

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

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

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

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

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

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

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

We rely heavily on communications and information systems to conduct our business. Any failure, interruption or breach in security of these systems could result in failures or disruptions in our customer relationship management, general ledger, deposit, loan and other systems. While we have policies and procedures designed to prevent or limit the effect of the failure, interruption or security breach of our information systems, there can be no assurance that we can prevent any such failures, interruptions or security breaches or, if they do occur, that they will be adequately addressed. The occurrence of any failures, interruptions or security breaches of our information systems could damage our reputation, result in a loss of customer business, subject us to additional regulatory scrutiny, or expose us to civil litigation and possible financial liability, any of which could have a material adverse effect on our financial condition and results of operations.

We continually encounter technological change.

The financial services industry is continually undergoing rapid technological change with frequent introductions of new technology-driven products and services. The effective use of technology increases efficiency and enables financial institutions to better serve customers and to reduce costs. Our future success depends, in part, upon our ability to address the needs of our customers by using technology to provide products and services that will satisfy customer demands, as well as to create additional efficiencies in our operations. Many of our competitors have substantially greater resources to invest in technological improvements. We may not be able to effectively implement new technology-driven products and services or be successful in marketing these products and services to our customers and even if we implement such products and services, we may incur substantial costs in doing so. Failure to successfully keep pace with technological change affecting the financial services industry could have a material adverse impact on our business, financial condition and results of operations.

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

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

are founded or unfounded, defending claims is costly and diverts management's attention, and if such claims and legal actions are not resolved in a manner favorable to us, they may result in significant financial liability and/or adversely affect our market perception and products and

services as well as impact customer demand for those products and services. Any financial liability or reputation damage could have a material adverse effect on our business, financial condition and results of operations.

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

Severe weather, natural disasters, acts of war or terrorism and other adverse external events could have a significant impact on our ability to conduct business. Such events could affect the stability of our deposit base, impair the ability of borrowers to repay outstanding loans, impair the value of collateral securing loans, cause significant property damage, result in loss of revenue and/or cause us to incur additional expenses. For example, during 2005, hurricanes Katrina and Rita caused extensive flooding and destruction along the coastal areas of the Gulf of Mexico. While the impact of these hurricanes did not significantly affect us, other severe weather or natural disasters, acts of war or terrorism or other adverse external events may occur in the future. Although management has established disaster recovery policies and procedures, there can be no assurance of the effectiveness of such policies and procedures, and the occurrence of any such event could have a material adverse effect on our business, financial condition and results of operations.

RISKS ASSOCIATED WITH OUR COMMON STOCK

Our stock price can be volatile.

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

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

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

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

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

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

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

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

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

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

RISKS ASSOCIATED WITH THE BANKING INDUSTRY

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

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

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

In deciding whether to extend credit or enter into other transactions, we may rely on information furnished by or on behalf of customers and counterparties, including financial statements, credit reports and other financial information. We may also rely on representations of those customers, counterparties or other third parties, such as independent auditors, as to the accuracy and completeness of that

information. Reliance on inaccurate or misleading financial statements, credit reports or other financial information could have a material adverse impact on our business, financial condition and results of operations.

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

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

ITEM 1B. UNRESOLVED STAFF COMMENTS

None

ITEM 2. PROPERTIES

Southside Bank owns and operates the following properties:

- Southside Bank main branch at 1201 South Beckham Avenue, Tyler, Texas. The executive offices of Southside Bancshares, Inc. are located at this location;
- Southside Bank Annex at 1211 South Beckham Avenue, Tyler, Texas. The Southside Bank Annex is directly adjacent to the main bank building. Human Resources, the Trust Department and other support areas are located in this building;
- Operations Annex at 1221 South Beckham Avenue, Tyler, Texas. Various back office, lending and training facilities and other support areas are located in this building;
 - Southside main branch motor bank facility at 1010 East First Street, Tyler, Texas;
 - South Broadway branch at 6201 South Broadway, Tyler, Texas;
 - South Broadway branch motor bank facility at 6019 South Broadway, Tyler, Texas;
 - Downtown branch at 113 West Ferguson Street, Tyler, Texas;
- Gentry Parkway branch and motor bank facility at 2121 West Gentry Parkway, Tyler, Texas;
- Longview main branch and motor bank facility at 2001 Judson Road, Longview, Texas;
- Lindale main branch and motor bank facility at 2510 South Main Street, Lindale, Texas;
- Whitehouse main branch and motor bank facility at 901 Highway 110 North, Whitehouse, Texas;
- Jacksonville main branch and motor bank facility at 1015 South Jackson Street, Jacksonville, Texas;
 - Gun Barrel City main branch at 901 West Main, Gun Barrel City, Texas; and

- 42 ATM's located throughout Smith, Gregg, Cherokee, Anderson and Henderson Counties.

Edgar Filing: SOUTHSIDE BANCSHARES INC - Form 10-K

Southside Bank currently operates full service banks in leased space in 18 grocery stores and two lending centers in leased office space in the following locations:

- one in Bullard, Texas;
- one in Lindale, Texas;
- one in Flint, Texas;
- one in Whitehouse, Texas;
- one in Chandler, Texas;
- one in Seven Points, Texas;
- one in Palestine, Texas;
- one in Athens, Texas;
- one in Hawkins, Texas;
- three in Longview, Texas;
- six in Tyler, Texas;
- Gresham loan production office at 16637 FM 2493, Tyler, Texas; and
- Forney loan production office at 413 North McGraw, Forney, Texas.

Fort Worth National Bank owns and operates the following properties:

- Arlington branch at 2831 W. Park Row, Arlington, Texas;
- Fort Worth branch at 9516 Clifford Street, Fort Worth, Texas; and
- 3 ATM's located in Fort Worth and Arlington, Texas.

Fort Worth National Bank currently operates its main branch and one lending center in leased office space in the following locations:

- Main branch at 701 W. Magnolia, Fort Worth, Texas; and
- Austin loan production office at 8200 N. Mopac, Ste. 130, Austin, Texas.

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

- 1600 E. Pioneer Parkway, Ste. 300, Arlington, Texas.

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

ITEM 3. LEGAL PROCEEDINGS

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

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

During the three months ended December 31, 2007, there were no meetings, annual or special, of our shareholders. No matters were submitted to a vote of the shareholders, nor were proxies solicited by management or any other person.

PART II

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

MARKET INFORMATION

Our common stock trades on the NASDAQ Global Select Market (formerly the NASDAQ National Market) under the symbol "SBSI." The high/low prices shown below represent the daily weighted average prices on the NASDAQ Global Select Market for the period from January 1, 2006 to December 31, 2007. During the second quarter of 2007 and the first quarter of 2006, we declared and paid a 5% stock dividend. Stock prices listed below have been adjusted to give retroactive recognition to stock splits and stock dividends.

Year Ended	1st Quarter	2nd Quarter	3rd Quarter	4th Quarter
December 31, 2007	\$ 24.64-21.04	\$ 22.51-21.11	\$ 23.93-19.24	\$ 23.74-18.72
December 31, 2006	\$ 19.77-18.22	\$ 21.49-18.12	\$ 25.55-21.59	\$ 26.18-23.44

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

SHAREHOLDERS

There were approximately 1,100 holders of record of our common stock, the only class of equity securities currently issued and outstanding, as of February 15, 2008.

DIVIDENDS

Cash dividends declared and paid were \$0.50 and \$0.47 per share for the years ended December 31, 2007 and 2006, respectively. Stock dividends of 5% were also declared and paid during each of the years ended December 31, 2007, 2006 and 2005. We have paid a cash dividend at least once every year since 1970. Future dividends will depend on our earnings, financial condition and other factors that our board of directors considers to be relevant. In addition, we must make payments on our junior subordinated debentures before any dividends can be paid on the common stock. For additional discussion relating to restrictions that limit our ability to pay dividends refer to "Supervision and Regulation" in "Item 1. Business" and in "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations -Capital Resources." The cash dividends were paid quarterly each year as listed below.

Quarterly Cash Dividends Paid

Edgar Filing: SOUTHSIDE BANCSHARES INC - Form 10-K

Year Ended	1st Quarter	2nd Quarter	3rd Quarter	4th Quarter
December 31, 2007	\$ 0.11	\$ 0.12	\$ 0.12	\$ 0.15
December 31, 2006	\$ 0.11	\$ 0.11	\$ 0.11	\$ 0.14

27

STOCK-BASED COMPENSATION PLANS

Information regarding stock-based compensation awards outstanding and available for future grants as of December 31, 2007, is presented in “Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters” of this Annual Report on Form 10-K. Additional information regarding stock-based compensation plans is presented in “Note 14 — Employee Benefit Plans” in the notes to consolidated financial statements located elsewhere in this report.

UNREGISTERED SALES OF EQUITY SECURITIES, USE OF PROCEEDS AND ISSUER SECURITY REPURCHASES

During 2007, we did not approve any additional funding for our stock repurchase plan. No common stock was purchased during the fourth quarter ended December 31, 2007.

FINANCIAL PERFORMANCE

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

Southside Bancshares, Inc.

Index	Period Ending					
	12/31/02	12/31/03	12/31/04	12/31/05	12/31/06	12/31/07
Southside Bancshares, Inc.	100.00	133.89	177.37	168.33	229.87	196.58
Russell 2000	100.00	147.25	174.24	182.18	215.64	212.26
Southside Bancshares Peer Group*	100.00	137.24	160.09	168.91	187.11	156.29

*Southside Bancshares' Peer Group includes the following Texas banks: Cullen/Frost Bankers, Inc., First Financial Bankshares, Inc., International Bancshares Corporation, MetroCorp Bancshares, Inc., Prosperity Bancshares, Inc., Sterling Bancshares, Inc., Texas Capital Bancshares, Inc. and Franklin Bank Corp.

Source : SNL Financial LC, Charlottesville, VA

ITEM 6. SELECTED FINANCIAL DATA

The following table sets forth selected financial data regarding our results of operations and financial position for, and as of the end of, each of the fiscal years in the five-year period ended December 31, 2007. This information should be read in conjunction with "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations" and "Item 8. Financial Statements and Supplementary Data," as set forth in this report.

As of and For the Years Ended December 31,
2007 2006 2005 2004 2003
(in thousands, except per share data)

Balance Sheet Data:

Investment Securities	\$ 110,403	\$ 100,303	\$ 121,240	\$ 133,535	\$ 144,876
Mortgage-backed and Related Securities	\$ 917,518	\$ 869,326	\$ 821,756	\$ 720,533	\$ 590,963
Loans, Net of Allowance for Loan Losses	\$ 951,477	\$ 751,954	\$ 673,274	\$ 617,077	\$ 582,721
Total Assets	\$ 2,196,322	\$ 1,890,976	\$ 1,783,462	\$ 1,619,643	\$ 1,454,952
Deposits	\$ 1,530,491	\$ 1,282,475	\$ 1,110,813	\$ 940,986	\$ 872,529
Long-term Obligations	\$ 146,558	\$ 149,998	\$ 229,032	\$ 351,287	\$ 272,694

Income Statement Data:

Interest & Deposit Service Income	\$ 123,021	\$ 112,434	\$ 94,275	\$ 80,793	\$ 73,958
Net Income	\$ 16,684	\$ 15,002	\$ 14,592	\$ 16,099	\$ 13,564

Per Share Data:

Net Income Per Common Share:

Basic	\$	1.28	\$	1.16	\$	1.15	\$	1.27	\$	1.24
Diluted	\$	1.24	\$	1.12	\$	1.10	\$	1.20	\$	1.05
Cash Dividends Paid Per Common Share	\$	0.50	\$	0.47	\$	0.46	\$	0.42	\$	0.36

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

The following discussion and analysis provides a comparison of our results of operations for the years ended December 31, 2007, 2006, and 2005 and financial condition as of December 31, 2007 and 2006. This discussion should be read in conjunction with the financial statements and related notes included elsewhere in this report. All share data has been adjusted to give retroactive recognition to stock splits and stock dividends.

CAUTIONARY NOTICE REGARDING FORWARD-LOOKING STATEMENTS

Certain statements of other than historical fact that are contained in this document and in written material, press releases and oral statements issued by or on behalf of Southside Bancshares, Inc., a bank holding company, may be considered to be "forward-looking statements" within the meaning of and subject to the protections of the Private Securities Litigation Reform Act of 1995. These forward-looking statements are not guarantees of future performance, nor should they be relied upon as representing management's views as of any subsequent date. These statements may include words such as "expect," "estimate," "project," "anticipate," "appear," "believe," "could," "should," "may," "intend," "probability," "risk," "target," "objective," "plans," "potential," and similar expressions. Forward-looking statements are statements with respect to our beliefs, plans, expectations, objectives, goals, anticipations, assumptions, estimates, intentions and future performance, and are subject to significant known and unknown risks and uncertainties, which could cause our actual results to differ materially from the results discussed in the forward-looking statements. For example, discussions of the effect of our expansion, trends in asset quality and earnings from growth, and certain market risk disclosures are based upon information presently available to management and are dependent on choices about key model characteristics and assumptions and are subject to various limitations. See "Item 1. Business" and "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations." By their nature, certain of the market risk disclosures are only estimates and could be materially different from what actually occurs in the future. As a result, actual income gains and losses could materially differ from those that have been estimated. Other factors that could cause actual results to differ materially from forward-looking statements include, but are not limited to, the following:

- general economic conditions, either globally, nationally, in the State of Texas, or in the specific markets in which we operate;
- legislation, regulatory changes or changes in monetary or fiscal policy that adversely affect the businesses in which we are engaged;
- 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;
 - economic or other disruptions caused by acts of terrorism in the United States, Europe or other areas;
- changes in the interest rate yield curve such as flat, inverted or steep yield curves, or changes in the interest rate environment that impact interest margins and may impact prepayments on the mortgage-backed securities portfolio;
 - unexpected outcomes of existing or new litigation involving us;
 - changes impacting the leverage strategy;
 - 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;
 - the costs and effects of unanticipated litigation;
- risks of mergers and acquisitions including the related time and cost of implementing transactions and the potential failure to achieve expected gains, revenue growth or expense savings; and
 - failure of assumptions underlying allowance for loan losses and other estimates.

Additional information concerning us and our business, including additional factors that could materially affect our financial results, is included in our filings with the SEC. 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.

CRITICAL ACCOUNTING ESTIMATES

Our accounting and reporting estimates conform with accounting principles generally accepted in the United States 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, and 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. 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 or appraisals of the collateral securing the debt are used to allocate the necessary allowances. The internal loan review department maintains a list of all loans or loan relationships that are graded as having more than the normal degree of risk associated with them. In addition, a list of loans or loan relationships of \$50,000 or more is updated on a periodic basis in order to properly allocate necessary allowance and

keep management informed on the status of attempts to correct the deficiencies noted with respect to the loan.

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

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

As of December 31, 2007, our review of the loan portfolio indicated that a loan loss allowance of \$9.8 million was adequate to cover probable losses in the portfolio.

Refer to “Loan Loss Experience and Allowance for Loan Losses” and “Note 1 – Summary of Significant Accounting and Reporting Policies” to our consolidated financial statements for a detailed description of our estimation process and methodology related to the allowance for loan losses.

Estimation of Fair Value. The estimation of fair value is significant to a number of our assets and liabilities. GAAP requires disclosure of the fair value of financial instruments as a part of the notes to the consolidated financial statements. Fair values are volatile and may be influenced by a number of factors, including market interest rates, prepayment speeds, discount rates and the shape of yield curves.

Fair values for most investment and mortgage-backed securities are based on quoted market prices, where available. If quoted market prices are not available, fair values are based on the quoted prices of similar instruments. 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 underlying value of the collateral where applicable. 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. The fair value of Federal Home Loan Bank (“FHLB”) 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. The fair values of other real estate owned (“OREO”) are typically determined based on appraisals by third parties, less estimated costs to sell and recorded at the lower of cost or fair value. The fair value of the fixed rate long-term debt is estimated by discounting future cash flows using rates at which fixed rate long-term debt would be made to borrowers with similar credit ratings and for remaining maturities.

Impairment of Investment Securities and Mortgage-backed Securities. Investment and mortgage-backed securities 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 income (loss),” a separate component of shareholders’ equity. Securities classified as AFS or held to maturity (“HTM”) are subject to our review to identify when a decline in value is other-than-temporary. Factors considered in determining whether a decline in value is other-than-temporary include: whether the decline is substantial; the duration of the decline; the reasons for the decline in value; whether the decline is related to a credit event or to a change in interest rate; our ability and intent to hold the investment for a period of time that will allow for a recovery of value; and the financial condition and near-term prospects of the issuer. 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.

Defined Benefit Pension Plan. The plan obligations and related assets of the defined benefit pension plan (the "Plan") are presented in "Note 14 – Employee Benefits" to our consolidated financial statements. Plan assets, which consist primarily of marketable equity and debt instruments, are valued using market quotations. Plan obligations and the annual pension expense are determined by independent actuaries and through the use of a number of assumptions. Key assumptions in measuring the plan obligations include the discount rate, the rate of salary increases and the estimated future return on plan assets. In determining the discount rate, we utilized a cash flow matching analysis to determine a range of appropriate discount rates for our defined benefit pension and restoration plans. In developing the cash flow matching analysis, we constructed a portfolio of high quality non-callable bonds (rated AA- or better) to match as close as possible the timing of future benefit payments of the plans at December 31, 2007. Based on this cash flow matching analysis, we were able to determine an appropriate discount rate.

Salary increase assumptions are based upon historical experience and our anticipated future actions. The expected long-term rate of return assumption reflects the average return expected based on the investment strategies and asset allocation on the assets invested to provide for the Plan's liabilities. We considered broad equity and bond indices, long-term return projections, and actual long-term historical Plan performance when evaluating the expected long-term rate of return assumption. At December 31, 2007, the weighted-average actuarial assumptions of the Plan were: a discount rate of 6.25%; a long-term rate of return on plan assets of 7.50%; and assumed salary increases of 4.50%. Material changes in pension benefit costs may occur in the future due to changes in these assumptions. Future annual amounts could be impacted by changes in the number of plan participants, changes in the level of benefits provided, changes in the discount rates, changes in the expected long-term rate of return, changes in the level of contributions to the Plan and other factors.

OVERVIEW

OPERATING RESULTS

During the year ended December 31, 2007, our net income increased \$1.7 million, or 11.2%, to \$16.7 million, from \$15.0 million for the same period in 2006. The increase in net income was primarily attributable to the increase in net interest income and noninterest income partially offset by an increase in the provision for loan losses and noninterest expense. This increase in noninterest income was offset by noninterest expense due primarily to increases in salaries and employee benefits due to the acquisition of Fort Worth National Bank during the fourth quarter of 2007 and an interest in SFG in the third quarter of 2007. Earnings per fully diluted share increased \$0.12, or 10.7% to \$1.24, for the year ended December 31, 2007, from \$1.12 for the same period in 2006.

During the year ended December 31, 2006, our net income increased \$410,000, or 2.8%, to \$15.0 million, from \$14.6 million for the same period in 2005. The increase in net income was primarily attributable to the increase in noninterest income and decrease in the provision for loan losses. This increase in noninterest income was offset by noninterest expense due primarily to increases in salaries and employee benefits due to normal payroll increases and staff increases due to branch expansion and the new regional lending initiative. Earnings per fully diluted share were \$1.12 and \$1.10, respectively, for the years ended December 31, 2006 and 2005.

FINANCIAL CONDITION

Our total assets increased \$305.3 million, or 16.1%, to \$2.20 billion at December 31, 2007 from \$1.89 billion at December 31, 2006. The increase was partially attributable to our acquisition of Fort Worth Bancshares, Inc. during October 2007. Fort Worth Bancshares, Inc.'s total consolidated assets as of December 31, 2007 were \$158.8 million. The acquisition of Fort Worth Bancshares, Inc. and our interest in SFG contributed to our increase in loans of \$202.1 million, or 26.6%, as compared to December 31, 2006. Fort Worth National Bank loans acquired represented

\$105.6 million of the increase in loans. SFG loans represented approximately \$56 million of the increase in loans. At December 31, 2007, loans were \$961.2

million compared to \$759.1 million at December 31, 2006. Our securities portfolio also contributed to the increase by \$53.7 million, or 5.4%, to \$1.0 billion as compared to \$996.1 million at December 31, 2006. Our organic increase in loans and securities was funded by increases in deposits.

Our nonperforming assets at December 31, 2007 increased to \$3.9 million, and represented 0.18% of total assets, compared to \$2.1 million, or 0.11%, of total assets at December 31, 2006. Nonaccruing loans increased to \$2.9 million and the ratio of nonaccruing loans to total loans increased to 0.30% at December 31, 2007 as compared to \$1.3 million and 0.18% at December 31, 2006. Not including the \$2.0 million increase in nonperforming assets attributable to the SFG automobile loans, nonperforming assets for Southside would have decreased by \$148,000. Approximately \$265,000 of the nonaccrual loans at December 31, 2007, is one loan that has an average SBA guarantee of 75%. OREO decreased to \$153,000 at December 31, 2007 from \$351,000 at December 31, 2006. Loans 90 days past due at December 31, 2007 increased to \$400,000 compared to \$128,000 at December 31, 2006. Repossessed assets increased to \$255,000 at December 31, 2007 from \$78,000 at December 31, 2006. Restructured loans at December 31, 2007 increased slightly to \$225,000 compared to \$220,000 at December 31, 2006.

Our deposits increased \$248.0 million to \$1.53 billion at December 31, 2007 from \$1.28 billion at December 31, 2006. Fort Worth National Bank deposits acquired in the fourth quarter of 2007 represent \$109.1 million of the increase. The remaining \$138.9 million increase was primarily due to branch expansion and increased market penetration. Due to the increase in deposits during 2007, FHLB advances decreased \$11.6 million to \$440.0 million at December 31, 2007, from \$451.6 million at December 31, 2006. Short-term FHLB advances increased \$31.6 million to \$353.8 million at December 31, 2007 from \$322.2 million at December 31, 2006. Long-term FHLB advances decreased \$43.1 million to \$86.2 million at December 31, 2007 from \$129.4 million at December 31, 2006. Other borrowings at December 31, 2007 and 2006 totaled \$69.8 million and \$27.9 million, respectively, and at December 31, 2007 consisted of \$9.5 million of short-term borrowings and \$60.3 million of long-term debt.

The increase in long-term debt resulted from approximately \$36.1 million of subordinated debentures issued to finance the acquisition of Fort Worth Bancshares, Inc. and approximately \$3.6 million in subordinated debentures previously issued by Fort Worth Bancshares, Inc. and assumed in connection with the acquisition.

Assets under management in our trust department exceeded \$700 million for the first time during 2007 and were approximately \$718 million at December 31, 2007.

Shareholders' equity at December 31, 2007 totaled \$132.3 million compared to \$110.6 million at December 31, 2006. The increase primarily reflects the net income of \$16.7 million recorded for the year ended December 31, 2007, and the common stock issued of \$1.6 million as a result of our incentive stock option and dividend reinvestment plans, a decrease in the accumulated other comprehensive loss of \$9.8 million, all of which were partially offset by the payment of cash dividends to our shareholders of \$6.5 million. The decrease in accumulated other comprehensive loss is composed of an increase of \$1.1 million, net of tax, related to the change in the unfunded status of our defined benefit plan and an \$8.7 million, net of tax, unrealized gain on securities, net of reclassification adjustment. See "Note 4 – Comprehensive Income (Loss)" to our consolidated financial statements.

During 2007 the economy in our market area appeared to reflect only slight effects of the housing led economic slowdown impacting other regions of the United States. We cannot predict whether current economic conditions will improve, remain the same or decline.

Key financial indicators management follows include, but are not limited to, numerous interest rate sensitivity and interest rate risk indicators, credit risk, operations risk, liquidity risk, capital risk, regulatory risk, competition risk, yield curve risk, and economic risk.

LEVERAGE 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. The leverage strategy consists of borrowing a combination of long and short-term funds from the FHLB and issuing brokered CDs. These funds are invested primarily in agency mortgage-backed securities, and to a lesser extent, long-term municipal securities. Although agency mortgage-backed securities often carry lower yields than traditional mortgage loans and other types of loans we make, these securities generally increase the overall quality of our assets because of underlying insurance or guarantees, are more liquid than individual loans and may be used to collateralize our borrowings or other obligations. While the strategy of investing a substantial portion of our assets in agency mortgage-backed and municipal securities has 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 the leverage 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, and the unpredictable nature of mortgage-backed securities prepayments. See “Item 1A. Risk Factors – Risks Related to Our Business.” During the first half of 2007, the interest rate yield curve was relatively flat to only slightly positively sloped. During the second half of 2007, the Federal Reserve decreased the overnight fed funds rate by 100 basis points while at the same time short-term U. S. Treasury interest rates decreased more than long-term U. S. Treasury interest rates. These changes during 2007 resulted in a positively sloped U. S. Treasury yield curve at December 31, 2007. Our asset structure, net interest spread and net interest margin require an increase in the need to monitor our interest rate risk. An additional risk is the change in market value of the AFS securities portfolio as a result of changes in interest rates. Significant increases in interest rates, especially long-term interest rates, could adversely impact the market value of the AFS securities portfolio, which could also significantly impact our equity capital. Due to the unpredictable nature of mortgage-backed securities prepayments, the length of interest rate cycles, and the slope of the interest rate yield curve, net interest income could fluctuate more than simulated under the scenarios modeled by our Asset/Liability Committee (“ALCO”) and described under “Item 7A. Quantitative and Qualitative Disclosures about Market Risk” in this report.

The management of the securities portfolio as a percentage of earning assets is guided by changes in our overall loan and deposit levels combined with changes in our wholesale funding levels. If adequate quality loan growth is not available to achieve our goal of enhancing profitability by maximizing the use of capital, as described above, then we could purchase additional securities, if appropriate, which could cause securities as a percentage of earning assets to increase. Should we determine that increasing the securities portfolio or replacing the current securities maturities and principal payments is not an efficient use of capital, we could decrease the level of securities through proceeds from maturities, principal payments on mortgage-backed securities or sales. During the year ended December 31, 2007, credit and volatility spreads increased which, combined with the steeper yield curve, led to buying opportunities in agency mortgage-backed securities and to a lesser extent municipal securities. While loan growth during the year was adequate, a majority of this growth did not occur until the last half of the year. At December 31, 2007, the securities portfolio as a percentage of total assets decreased to 47.8% from 52.7% at December 31, 2006 primarily as a result of the Fort Worth National Bank acquisition. The current interest rate yield curve and spreads remain investment friendly and changes to the securities portfolio as a percentage of earning assets will be guided by changes in our loan and deposit levels during the first quarter of 2008 as well as the availability of attractive investment opportunities. During the year ended December 31, 2007, we increased our investment and mortgage-backed securities approximately \$45.7 million as investment and mortgage-backed securities excluding the net unrealized gain on AFS securities increased from \$976.3 million at December 31, 2006 to \$1.0 billion at December 31,

2007. Our leverage strategy is dynamic and requires ongoing management and will be reevaluated as market conditions warrant. As interest rates, yield curves, mortgage-backed securities prepayments, funding costs, security spreads and loan and deposit portfolios change, our determination of the proper

35

types and maturities of securities to own, proper amount of securities to own and funding needs and funding sources will continue to be reevaluated.

With respect to liabilities, we will continue to utilize a combination of FHLB advances and deposits to achieve our strategy of minimizing cost while achieving overall interest rate risk objectives as well as the liability management objectives of the ALCO. The FHLB funding and the brokered CDs represent wholesale funding sources we currently utilize. Our FHLB borrowings at December 31, 2007 decreased 2.6%, or \$11.6 million, to \$440.0 million from \$451.6 million at December 31, 2006 primarily as a result of an increase in deposits. At December 31, 2007, our callable brokered CDs totaled \$123.4 million. During the year ended December 31, 2007, we did not issue any brokered CDs; however, our brokered CDs increased \$9.5 million through the acquisition of Fort Worth National Bank. The callable brokered CDs have maturities from approximately one to four years and have calls that we control, all of which are currently six months or less. The \$9.5 million of brokered CDs related to Fort Worth National Bank are not callable and have maturities of approximately one year. As we integrate our funds management processes the banks will likely issue similar structures of brokered CDs when needed. We utilized long-term brokered CDs because the brokered CDs better matched overall ALCO objectives by protecting Southside Bank with fixed rates should interest rates increase, while providing Southside Bank options to call the funding should interest rates decrease. Our wholesale funding policy currently allows maximum brokered CDs of \$150 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. Due to the significant decrease in interest rates, including brokered CD rates during the first quarter of 2008, we called approximately \$91.3 million of our brokered CDs. Based on current pricing, we anticipate replacing this long-term funding with long-term FHLB borrowings. For the year ended December 31, 2007, the large increase in non-brokered deposits, partially associated with the Fort Worth National Bank acquisition, and the decrease in FHLB borrowings resulted in a decrease in our total wholesale funding as a percentage of deposits, not including brokered CDs, from 49.6% at December 31, 2006, to 41.0% at December 31, 2007.

RESULTS OF OPERATIONS

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

COMPARISON OF OPERATING RESULTS FOR THE YEARS ENDED DECEMBER 31, 2007 COMPARED TO DECEMBER 31, 2006

NET INTEREST INCOME

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

Net interest income for the year ended December 31, 2007 was \$43.9 million, an increase of \$2.2 million, or 5.3%, compared to the same period in 2006. The overall increase in net interest income was primarily the result of increases in interest income from loans and a decrease in interest expense on short-term and long-term obligations that was

partially offset by an increase in interest expense on deposits and a decrease in interest income from mortgage-backed and related securities and FHLB stock and other investments. During the year ended December 31, 2007, total interest income increased \$8.8

million, or 9.1%, from \$97.0 million to \$105.7 million. The increase in total interest income was the result of an increase in average interest earning assets of \$40.2 million, or 2.3%, from \$1.75 billion to \$1.79 billion, and the increase in average yield on average interest earning assets from 5.74% for the year ended December 31, 2006 to 6.10% for the year ended December 31, 2007. Total interest expense increased \$6.6 million, or 11.9%, to \$61.9 million during the year ended December 31, 2007 as compared to \$55.3 million during the same period in 2006. The increase was attributable to an increase in the average yield on interest bearing liabilities for the year ended December 31, 2007, to 4.30% from 3.89% for the same period in 2006 and an increase in average interest bearing liabilities of \$20.5 million, or 1.4%, from \$1.42 billion to \$1.44 billion.

Net interest income increased during 2007 as a result of increases in our average interest earning assets during 2007 when compared to 2006, and the increase in our net interest margin during the year ended December 31, 2007 to 2.64%, when compared to 2.57% for the same period in 2006. The net interest spread decreased to 1.80% as compared to 1.85% for the same period in 2006. The increase in our net interest margin reflects the volume changes combined with the rate changes. The decrease in our net interest spread reflects an increase in the average short-term borrowing and long-term FHLB advances rates that exceeded the increase in the yields on the average earning assets. Future changes in the interest rates or yield curve could influence our net interest margin and net interest spread during future quarters. Future changes in interest rates could also impact prepayment speeds on our mortgage-backed securities, which could influence our net interest margin and net interest spread during future quarters.

During the year ended December 31, 2007, average loans increased \$87.7 million, or 12.1% from \$722.3 million to \$809.9 million, compared to the same period in 2006. The average yield on loans increased from 6.70% at December 31, 2006 to 7.16% at December 31, 2007. The increase in the yield on loans was due to the increase in credit spreads, the repricing characteristics of Southside Bank's loan portfolio, the higher yielding automobile portfolios purchased during the second half of 2007 and the higher yielding Fort Worth National Bank loan portfolio acquired October 10, 2007. Due to the competitive loan pricing environment, we anticipate that we may be required 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 loan yield and, therefore profitability. The increase in interest income on loans of \$9.5 million, or 20.4%, resulted from the increase in average loans and the average yield on loans.

Average investment and mortgage-backed securities decreased \$40.6 million, or 4.1%, from \$989.1 million to \$948.5 million, for the year ended December 31, 2007 when compared to the same period in 2006. This decrease was attributable to the deleveraging strategy in place from June 2006 to June 2007. Southside began to releverage the balance sheet during the second half of 2007.

The overall yield on average investment and mortgage-backed securities increased to 5.21% during the year ended December 31, 2007 from 5.06% during the same period in 2006. Interest income on investment and mortgage-backed securities decreased \$579,000 in 2007, or 1.2%, compared to 2006 due to the decrease in the average balances while partially offset by the increase in overall yield. The increase in the average yield primarily reflects higher credit and swap spreads and decreased prepayment rates on mortgage-backed securities, which led to decreased amortization expense, combined with the reinvestment of proceeds from lower-yielding matured securities into higher yielding securities due to the overall higher credit and swap spreads. An overall housing slowdown nationwide during 2007 when compared to 2006 contributed to a decrease in residential mortgage refinancing nationwide and in our market area. A return to a lower long-term interest rate level similar to that experienced during 2003 could impact our net interest margin in the future due to increased prepayments and repricings.

Average FHLB stock and other investments decreased \$7.8 million, or 27.9%, to \$20.2 million, for the year ended December 31, 2007, when compared to \$28.0 million for 2006, primarily due to the average decrease in FHLB advances during 2007 when compared to 2006. Interest income from our FHLB stock and other investments decreased \$216,000, or 15.3%, during 2007, when compared to 2006, due to the decrease in average balance which was offset by the increase in average yield from 5.04% for the year ended December 31, 2006 compared to 5.91% for the same period in 2007. Average federal funds sold and other interest earning assets increased \$1.9 million, or 101.2%, to \$3.7 million, for the year ended December 31, 2007, when compared to \$1.8 million for 2006. Interest income from federal funds sold and other interest earning assets increased \$93,000, or 101.1%, for the year ended December 31, 2007, when compared to 2006, as a result of the increase in the average balance while the average yield remained at 5.00% for both 2006 and 2007.

During the year ended December 31, 2007, average loans increased while average securities decreased. As a result, the mix of our average interest earning assets reflected an increase in average total loans as a percentage of total average interest earning assets compared to the prior year as loans averaged 45.6% during 2007 compared to 41.6% during 2006, a direct result of loan growth, including the acquisition of Fort Worth National Bank and the investment in SFG. Average securities were 54.2% of average total interest earning assets and other interest earning asset categories averaged 0.2% for December 31, 2007. During 2006, the comparable mix was 58.3% in securities and 0.1% in the other interest earning asset categories.

Total interest expense increased \$6.6 million, or 11.9%, to \$61.9 million during the year ended December 31, 2007 as compared to \$55.3 million during the same period in 2006. The increase was primarily attributable to increased funding costs associated with an increase in average interest bearing liabilities, including an increase in deposits and FHLB advances of \$20.5 million, or 1.4%, and an increase in the average yield on interest bearing liabilities from 3.89% for 2006 to 4.30% for the year ended December 31, 2007.

Average interest bearing deposits increased \$163.7 million, or 18.9%, from \$867.3 million to \$1.03 billion, and the average rate paid increased from 3.54% for the year ended December 31, 2006 compared to 4.02% for the year ended December 31, 2007. Average time deposits increased \$97.4 million, or 20.9%, from \$467.2 million to \$564.6 million, and the average rate paid increased 51 basis points. Of the average increase in time deposits, \$42.1 million was attributable to the issuance of callable brokered CDs during 2006. Average interest bearing demand deposits increased \$64.9 million, or 18.6%, and the average rate paid increased 44 basis points. Average savings deposits increased \$1.3 million, or 2.6%, and the average rate paid increased three basis points. Interest expense for interest bearing deposits for the year ended December 31, 2007, increased \$10.8 million, or 35.1%, when compared to the same period in 2006 due to the increase in the average balance and yield. Average noninterest bearing demand deposits increased \$14.5 million, or 4.6%, during 2007. The latter three categories, which are considered the lowest cost deposits, comprised 58.5% of total average deposits during the year ended December 31, 2007 compared to 60.5% during 2006. The increase in our average total deposits is the result of overall bank growth and branch expansion and the acquisition of Fort Worth National Bank.

During the year ended December 31, 2007, we did not issue brokered CDs; however, our brokered CDs increased \$9.5 million through the acquisition of Fort Worth National Bank. At December 31, 2007, \$123.4 million of these brokered CDs had maturities from approximately one to four years and had calls that we control, all of which are currently six months or less. The \$9.5 million acquired through the Fort Worth National Bank transaction do not have calls and have a maturity of approximately one year. At December 31, 2007, we had \$132.9 million in brokered CDs that represented 8.7% of deposits compared to \$123.5 million, or 9.6% of deposits, at December 31, 2006. During 2006, we utilized long-term brokered CDs to a greater extent than long-term FHLB funding as the brokered CDs better matched overall ALCO objectives due to the calls we controlled. Our current policy allows for a maximum of \$150 million in brokered CDs. The potential higher interest cost and lack of customer loyalty are risks associated with the use of brokered CDs.

The following table sets forth our deposit averages by category for the years ended December 31, 2007, 2006 and 2005:

COMPOSITION OF DEPOSITS

	Years Ended December 31,					
	2007		2006		2005	
	AVG BALANCE	AVG YIELD	AVG BALANCE	AVG YIELD	AVG BALANCE	AVG YIELD
Noninterest Bearing Demand Deposits	\$ 328,711	N/A	\$ 314,241	N/A	\$ 280,036	N/A
Interest Bearing Demand Deposits	414,293	3.17%	349,375	2.73%	313,815	1.74%
Savings Deposits	52,106	1.30%	50,764	1.27%	50,502	1.04%
Time Deposits	564,613	4.90%	467,174	4.39%	354,360	3.17%
Total Deposits	\$ 1,359,723	3.05%	\$ 1,181,554	2.60%	\$ 998,713	1.72%

Average short-term interest bearing liabilities, consisting primarily of FHLB advances and federal funds purchased and repurchase agreements, were \$278.0 million, a decrease of \$98.7 million, or 26.2%, for the year ended December 31, 2007 when compared to the same period in 2006. Interest expense associated with short-term interest bearing liabilities decreased \$3.3 million, or 19.8%, while the average rate paid increased 38 basis points to 4.77% for the year ended December 31, 2007, when compared to 4.39% for the same period in 2006. The decrease in the interest expense was due to a decrease in the average balance which was more than offset the increase in the average yield for short-term interest bearing liabilities.

Average long-term interest bearing liabilities consisting of FHLB advances decreased \$59.7 million, or 38.5%, during the year ended December 31, 2007 to \$95.3 million as compared to \$155.0 million at December 31, 2006. Interest expense associated with long-term FHLB advances decreased \$2.0 million, or 31.7%, while the average rate paid increased 45 basis points to 4.57% for the year ended December 31, 2007 when compared to 4.12% for the same period in 2006. The decrease in interest expense was due to a decrease in the average balance of long-term interest bearing liabilities that more than offset the increase in the average rate paid. FHLB advances are collateralized by FHLB stock, securities and nonspecific real estate loans.

Average long-term debt, consisting of our junior subordinated debentures issued in 2003 and August 2007 and junior subordinated debenture acquired in the purchase of Fort Worth Bancshares, Inc., was \$35.8 million and \$20.6 million for the years ended December 31, 2007 and 2006, respectively. During the third quarter ended September 30, 2007, we issued \$36.1 million of junior subordinated debentures in connection with the issuance of trust preferred securities by our subsidiaries Southside Statutory Trusts IV and V. The \$36.1 million in debentures were issued to fund the purchase of Fort Worth Bancshares, Inc., which occurred on October 10, 2007. Interest expense increased \$1.1 million, or 65.7%, to \$2.8 million for the year ended December 31, 2007 when compared to \$1.7 million for the same period in 2006 primarily as a result of the increase in the average balance during 2007 when compared to 2006. The interest rate on the \$20.6 million of long-term debentures issued to Southside Statutory Trust III adjusts quarterly at a rate equal to three-month LIBOR plus 294 basis points. The \$23.2 million of long-term debentures issued to Southside Trust IV and the \$12.9 million of long-term debentures issued to Southside Trust V have fixed rates of 6.518% and 7.48%, respectively, for a period of five years. The interest rate on the \$3.6 million of long-term

debentures issued to Magnolia Trust Company I, assumed in the purchase of Fort Worth Bancshares, Inc., adjusts quarterly at a rate equal to three-month LIBOR plus 180 basis points.

AVERAGE BALANCES AND YIELDS

The following table presents average balance sheet amounts and average yields for the years ended December 31, 2007, 2006 and 2005. The information should be reviewed in conjunction with the consolidated financial statements for the same years then ended. Two major components affecting our earnings are the interest earning assets and interest bearing liabilities. A summary of average interest earning assets and interest bearing liabilities is set forth below, together with the average yield on the interest earning assets and the average cost of the interest bearing liabilities.

AVERAGE BALANCES AND YIELDS

(dollars in thousands)

Years Ended

	December 31, 2007			December 31, 2006			December 31, 2005		
	AVG. BALANCE	AVG. INTEREST	AVG. YIELD	AVG. BALANCE	AVG. INTEREST	AVG. YIELD	AVG. BALANCE	AVG. INTEREST	AVG. YIELD
ASSETS									
INTEREST EARNING ASSETS:									
Loans(1) (2)	\$ 809,906	\$ 58,002	7.16%	\$ 722,252	\$ 48,397	6.70%	\$ 657,938	\$ 40,927	6.22%
Loans Held For Sale	3,657	191	5.22%	4,651	246	5.29%	4,469	212	4.74%
Securities:									
Inv. Sec. (Taxable)(4)	52,171	2,580	4.95%	54,171	2,498	4.61%	51,431	1,978	3.85%
Inv. Sec. (Tax-Exempt)(3)(4)	43,486	3,065	7.05%	43,931	3,134	7.13%	66,023	4,696	7.11%
Mortgage-backed and related Sec.(4)	852,880	43,767	5.13%	891,015	44,401	4.98%	773,973	34,584	4.47%
Total Securities	948,537	49,412	5.21%	989,117	50,033	5.06%	891,427	41,258	4.63%
FHLB stock and other investments, at cost	20,179	1,193	5.91%	27,969	1,409	5.04%	28,099	1,032	3.67%
Interest Earning Deposits	769	41	5.33%	692	35	5.06%	644	24	3.73%
Federal Funds Sold	2,933	144	4.91%	1,148	57	4.97%	995	30	3.02%
Total Interest Earning Assets	1,785,981	108,983	6.10%	1,745,829	100,177	5.74%	1,583,572	83,483	5.27%
NONINTEREST EARNING ASSETS:									
Cash and Due From Banks	42,724			42,906			42,280		
Bank Premises and Equipment	35,746			33,298			31,504		
Other Assets	51,968			42,716			45,625		
	(7,697)			(7,231)			(6,945)		

Less: Allowance for Loan Loss			
Total Assets	\$ 1,908,722	\$ 1,857,518	\$ 1,696,036

- (1) Interest on loans includes fees on loans that are not material in amount.
- (2) Interest income includes taxable-equivalent adjustments of \$2,289, \$2,230 and \$2,287 for the years ended December 31, 2007, 2006 and 2005, respectively.
- (3) Interest income includes taxable-equivalent adjustments of \$953, \$995 and \$1,515 for the years ended December 31, 2007, 2006 and 2005, respectively.
- (4) For the purpose of calculating the average yield, the average balance of securities is presented at historical cost.

Note: As of December 31, 2007, 2006 and 2005, loans totaling \$2,913, \$1,333 and \$1,731, respectively, were on nonaccrual status. The policy is to reverse previously accrued but unpaid interest on nonaccrual loans; thereafter, interest income is recorded to the extent received when appropriate.

AVERAGE BALANCES AND YIELDS

(dollars in thousands)

Years Ended

	December 31, 2007			December 31, 2006			December 31, 2005		
	AVG.	AVG.	YIELD	AVG.	AVG.	YIELD	AVG.	AVG.	YIELD
LIABILITIES AND SHAREHOLDERS' EQUITY	BALANCE	INTEREST	YIELD	BALANCE	INTEREST	YIELD	BALANCE	INTEREST	YIELD

**LIABILITIES AND
SHAREHOLDERS'
EQUITY**

**INTEREST
BEARING**

LIABILITIES:

Savings Deposits	\$ 52,106	\$ 676	1.30%	\$ 50,764	\$ 645	1.27%	\$ 50,502	\$ 524	1.04%
Time Deposits	564,613	27,666	4.90%	467,174	20,516	4.39%	354,360	11,221	3.17%
Interest Bearing Demand Deposits	414,293	13,116	3.17%	349,375	9,529	2.73%	313,815	5,476	1.74%
Total Interest Bearing Deposits	1,031,012	41,458	4.02%	867,313	30,690	3.54%	718,677	17,221	2.40%
Short-term Interest Bearing Liabilities	278,002	13,263	4.77%	376,696	16,534	4.39%	282,283	9,892	3.50%
Long-term Interest Bearing Liabilities - FHLB	95,268	4,357	4.57%	154,983	6,379	4.12%	274,673	10,004	3.64%
Long-term Debt (5)	35,802	2,785	7.78%	20,619	1,681	8.04%	20,619	1,305	6.24%
Total Interest Bearing Liabilities	1,440,084	61,863	4.30%	1,419,611	55,284	3.89%	1,296,252	38,422	2.96%

**NONINTEREST
BEARING**

LIABILITIES:

Demand Deposits	328,711			314,241			280,036		
Other Liabilities	20,997			12,403			14,649		
Total Liabilities	1,789,792			1,746,255			1,590,937		

**Minority Interest in
SFG**

Minority Interest in SFG	151			—			—		
SHAREHOLDERS' EQUITY	118,779			111,263			105,099		

TOTAL

**LIABILITIES AND
SHAREHOLDERS'
EQUITY**

Total Liabilities and Shareholders' Equity	\$ 1,908,722			\$ 1,857,518			\$ 1,696,036		
		\$ 47,120			\$ 44,893			\$ 45,061	

NET INTEREST INCOME NET YIELD ON AVERAGE EARNING ASSETS	2.64%	2.57%	2.85%
NET INTEREST SPREAD	1.80%	1.85%	2.31%

(5) Represents junior subordinated debentures issued by us to Southside Statutory Trust III, IV and V in connection with the issuance by Southside Statutory Trust III of \$20 million of trust preferred securities, Southside Statutory Trust IV of \$22.5 million of trust preferred securities on August 8, 2007 and Southside Statutory Trust V of \$12.5 million of Trust Preferred Securities on August 10, 2007 and junior subordinated debentures issued by Fort Worth Bancshares, Inc. to Magnolia Trust Company I in connection with the issuance by Magnolia Trust Company I of \$3.5 million of trust preferred securities, which we assumed on October 10, 2007.

ANALYSIS OF CHANGES IN INTEREST INCOME AND INTEREST EXPENSE

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

	Years Ended December 31, 2007 Compared to 2006		
	Average Volume	Average Yield	Increase (Decrease)
INTEREST INCOME:			
Loans (1)	\$ 6,131	\$ 3,474	\$ 9,605
Loans Held For Sale	(52)	(3)	(55)
Investment Securities (Taxable)	(85)	167	82
Investment Securities (Tax Exempt) (1)	(32)	(37)	(69)
Mortgage-backed Securities	(1,934)	1,300	(634)
FHLB stock and other investments	(434)	218	(216)
Interest Earning Deposits	4	2	6
Federal Funds Sold	88	(1)	87
Total Interest Income	3,686	5,120	8,806
INTEREST EXPENSE:			
Savings Deposits	17	14	31
Time Deposits	4,598	2,552	7,150
Interest Bearing Demand Deposits	1,923	1,664	3,587
Short-term Interest Bearing Liabilities	(4,615)	1,344	(3,271)
Long-term FHLB Advances	(2,670)	648	(2,022)
Long-term Debt	1,184	(80)	1,104
Total Interest Expense	437	6,142	6,579
Net Interest Income	\$ 3,249	\$ (1,022)	\$ 2,227

	Years Ended December 31, 2006 Compared to 2005		
	Average Volume	Average Yield	Increase (Decrease)
INTEREST INCOME:			
Loans (1)	\$ 4,173	\$ 3,297	\$ 7,470
Loans Held For Sale	9	25	34
Investment Securities (Taxable)	110	410	520
Investment Securities (Tax Exempt) (1)	(1,576)	14	(1,562)
Mortgage-backed Securities	5,572	4,245	9,817
FHLB stock and other investments	(5)	382	377
Interest Earning Deposits	2	9	11
Federal Funds Sold	5	22	27
Total Interest Income	8,290	8,404	16,694
INTEREST EXPENSE:			

Edgar Filing: SOUTHSIDE BANCSHARES INC - Form 10-K

Savings Deposits	3	118	121
Time Deposits	4,196	5,099	9,295
Interest Bearing Demand Deposits	679	3,374	4,053
Short-term Interest Bearing Liabilities	3,785	2,857	6,642
Long-term FHLB Advances	(4,796)	1,171	(3,625)
Long-term Debt	–	376	376
Total Interest Expense	3,867	12,995	16,862
Net Interest Income	\$ 4,423	\$ (4,591)	\$ (168)

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

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

PROVISION FOR LOAN LOSSES

The provision for loan losses for the year ended December 31, 2007 was \$2.4 million compared to \$1.1 million for December 31, 2006. Approximately \$933,000 of this increase is related to the loans that were purchased by SFG during 2007. Approximately \$152,000 of this increase is provision expense of Fort Worth National Bank. For the year ended December 31, 2007, net charge-offs of loans decreased \$277,000, or 28.4%, to \$700,000 when compared to \$977,000 for the same period in 2006.

The decrease in net charge-offs for 2007 was due to a combination of an increase in total recoveries of \$52,000 and a decrease in total charge-offs of \$225,000. Net charge-offs for commercial loans decreased \$161,000 from 2006 primarily as a result of an overall decrease in charge-offs and increase in recoveries. Net charge-offs for loans to individuals decreased \$46,000 during 2007 due to an overall increase in recoveries and decrease in charge-offs when compared to 2006.

As of December 31, 2007, our review of the loan portfolio indicated that a loan loss allowance of \$9.8 million was adequate to cover probable losses in the portfolio.

NONINTEREST INCOME

Noninterest income consists of revenues generated from a broad range of financial services and activities including fee based services. The following schedule lists the accounts from which noninterest income was derived, gives totals for these accounts for the year ended December 31, 2007 and the comparable year ended December 31, 2006 and indicates the percentage changes:

	Years Ended		Percent Change
	December 31, 2007	2006	
	(dollars in thousands)		
Deposit services	\$ 17,280	\$ 15,482	11.6%
Gain on securities available for sale	897	743	20.7%
Gain on sale of loans	1,922	1,817	5.8%
Trust income	2,106	1,711	23.1%
Bank owned life insurance income	1,142	1,067	7.0%
Other	3,071	2,661	15.4%
Total noninterest income	\$ 26,418	\$ 23,481	12.5%

Total noninterest income for the year ended December 31, 2007 increased 12.5%, or \$2.9 million, compared to 2006. During the year ended December 31, 2007, we had a gain on AFS securities of \$897,000 compared to \$743,000 for the same period in 2006. The market value of the AFS securities portfolio at December 31, 2007 was \$837.5 million with a net unrealized gain on that date of \$5.9 million. The net unrealized gain is comprised of \$8.7 million in unrealized gains and \$2.8 million in unrealized losses. We sold securities out of our AFS portfolio to accomplish ALCO and investment portfolio objectives aimed at repositioning a portion of the securities portfolio in an attempt to maximize the total return of the securities portfolio and reduce alternative minimum tax. During 2007, we primarily sold selected mortgage-backed securities where the risk reward profile had changed. We recorded an impairment charge of \$58,000 on \$4.8 million of whole loan collateralized mortgage obligations ("CMOs") at December 31,

2007. After the sale of these CMOs during January 2008, all of our remaining mortgage-backed securities are agency mortgage-backed securities ("MBSs").

Deposit services income increased \$1.8 million, or 11.6%, for the year ended December 31, 2007, when compared to the same period in 2006, primarily as a result of increases in overdraft income, an increase in the number of deposit accounts and an increase in debit card income.

43

Edgar Filing: SOUTHSIDE BANCSHARES INC - Form 10-K

Trust income increased \$395,000, or 23.1%, for the year ended December 31, 2007, when compared to the same period in 2006 due to growth experienced in our trust department.

Gain on sale of loans increased \$105,000, or 5.8%, for the year ended December 31, 2007, when compared to the same period in 2006. The increase was primarily due to an increase in premiums on student loans and the sale of non-accrual loans from a pool of automobile loans purchased by SFG which was partially offset by a decrease in the mortgage loans sold during 2007 when compared to 2006.

Bank owned life insurance (“BOLI”) income increased \$75,000, or 7.0%, for the year ended December 31, 2007, when compared to the same period in 2006 primarily as a result of an increase in the average balance of cash surrender value associated with our BOLI.

Other noninterest income increased \$410,000, or 15.4%, for the year ended December 31, 2007, when compared to the same period in 2006. The increase was primarily a result of increases in brokerage services income, credit card fee income, and merchant banking income which was offset by decreases in other recoveries including a recovery of \$150,000 received during the second quarter of 2006 that was related to a loss on a check during 2005.

NONINTEREST EXPENSE

The following schedule lists the accounts which comprise noninterest expense, gives totals for these accounts for the years ended December 31, 2007 and 2006 and indicates the percentage changes:

	Years Ended		Percent Change
	December 31, 2007	2006	
	(dollars in thousands)		
Salaries and employee benefits	\$ 29,361	\$ 28,275	3.8%
Occupancy expense	4,881	4,777	2.2%
Equipment expense	1,017	899	13.1%
Advertising, travel and entertainment	1,812	1,742	4.0%
ATM and debit card expense	1,006	955	5.3%
Director fees	605	587	3.1%
Supplies	692	637	8.6%
Professional fees	1,268	1,386	(8.5%)
Postage	662	618	7.1%
Telephone and communications	800	723	10.7%
Other	5,181	4,368	18.6%
Total noninterest expense	\$ 47,285	\$ 44,967	5.2%

Noninterest expense for the year ended December 31, 2007 increased \$2.3 million, or 5.2%, when compared to the year ended December 31, 2006. Salaries and employee benefits expense increased \$1.1 million, or 3.8%, during the year ended December 31, 2007, when compared to the same period in 2006. Direct salary expense and payroll taxes increased \$1.2 million, or 5.1%, for the year ended December 31, 2007, when compared to the same period in 2006. These increases were the result of the addition of SFG and acquisition of Fort Worth National Bank.

Retirement expense, included in salary and benefits, decreased \$533,000, or 21.7%, for the year ended December 31, 2007, when compared to the same period in 2006, primarily as a result of the amendments to the Plan in the fourth quarter of 2005 that became effective in 2006. Our actuarial assumptions used to determine net periodic pension costs

for 2007 included an assumed long-term rate of return of 7.50% and an assumed discount rate of 6.05%. This compares to an assumed long-term rate of

return of 7.875% and an assumed discount rate of 5.625% for 2006. We will continue to evaluate the assumed long-term rate of return and the discount rate to determine if either should be changed in the future. If either of these assumptions were decreased, the cost and funding required for the retirement plan could increase.

Health and life insurance expense, included in salary and benefits, increased \$436,000, or 16.6%, for the year ended December 31, 2007, when compared to the same period in 2006 due to increased health claims expense during 2007. 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 2008.

Equipment expense increased \$118,000, or 13.1%, for the year ended December 31, 2007, compared to the same period in 2006 due primarily to various increases on equipment service contracts.

Telephone and communications expense increased \$77,000, or 10.7%, for the year ended December 31, 2007, compared to the same period in 2006 primarily due to the opening of two de novo branch locations in 2007 and the capture of a full year of expenses of three locations added in 2006. The addition of Fort Worth National Bank and SFG also contributed to the increase over last year.

Other expense increased \$813,000, or 18.6%, for the year ended December 31, 2007, compared to the same period in 2006. The increase occurred primarily due to increases in computer fees, bank analysis and exam fees, brokerage service expense, student loan origination and lender fee expense, FDIC insurance and the amortization expense related to the core deposit intangible that resulted from the acquisition during 2007.

INCOME TAXES

Pre-tax income for the year ended December 31, 2007 was \$20.7 million compared to \$19.1 million and \$17.9 million for the years ended December 31, 2006 and 2005, respectively.

Income tax expense was \$4.0 million for the year ended December 31, 2007 and represented a \$124,000, or 3.0%, decrease from the year ended December 31, 2006. The effective tax rate as a percentage of pre-tax income was 19.2% in 2007, 21.5% in 2006 and 18.4% in 2005. The decrease in the effective tax rate and income tax expense for 2007 was due to a one-time state tax credit resulting from a change in Texas tax law related to the new margin tax during the quarter ended June 30, 2007. The state tax credit was \$779,000, which was partially offset by an increase in our estimated margin tax of \$70,000, net of federal income tax. Excluding the effect of the state tax credit and estimated margin tax, the effective rate for the year ended December 31, 2007 would have been 22.6%.

The remaining alternative minimum tax position reversed during 2007. We will continue to review the appropriate level of tax free income so as to minimize any alternative minimum tax position in the future.

COMPARISON OF OPERATING RESULTS FOR THE YEARS ENDED DECEMBER 31, 2006 COMPARED TO DECEMBER 31, 2005

NET INTEREST INCOME

Net interest income for the year ended December 31, 2006 was \$41.7 million, an increase of \$409,000, or 1.0%, compared to the same period in 2005. The overall increase in net interest income was primarily the result of increases in interest income from loans, mortgage-backed and related securities and taxable investment securities and a decrease in interest expense on long-term obligations which was partially offset by an increase in interest expense on deposits and short-term obligations. During the year ended December 31, 2006, total interest income increased \$17.3 million, or 21.7%, from \$79.7 million to \$97.0 million. The increase in total interest income was the result of an increase in average interest earning assets of \$162.3 million, or 10.2%, from \$1.58 billion to \$1.75 billion, and the increase in average yield on average interest earning assets from 5.27% for the year ended December 31, 2005 to 5.74% for the year ended December 31, 2006. Total interest expense increased \$16.9 million, or 43.9%, to \$55.3 million during the year ended December 31, 2006 as compared to \$38.4 million during the same period in 2005. The increase was attributable to an increase in the average yield on interest bearing liabilities for the year ended December 31, 2006, to 3.89% from 2.96% for the same period in 2005 and an increase in average interest bearing liabilities of \$123.4 million, or 9.5% from \$1.30 billion to \$1.42 billion.

Net interest income increased as a result of increases in our average interest earning assets during 2006 when compared to 2005, which more than offset the decrease in our net interest margin and spread during the year ended December 31, 2006 to 2.57% and 1.85%, respectively, when compared to 2.85% and 2.31%, respectively, for the same period in 2005. The decreases in our net interest margin and spread were due primarily to the changing interest rate environment that began in mid-2004. Since mid-2004, short-term interest rates have increased significantly while long-term interest rates have increased less. This has caused our yield on our interest bearing liabilities to increase faster than the yield on our earning assets. During 2006, our net interest income trend continued to gradually decline due to the net interest spread and margin decreases which more than offset the increase in average interest earning assets by the end of 2006, and resulted in a slight decrease in net interest income during the fourth quarter ended December 31, 2006, of \$81,000, or 0.8%, when compared to the same period in 2005. Future changes in the interest rate environment or yield curve could also influence our net interest margin and spread during future quarters.

During the year ended December 31, 2006, average loans, funded by the growth in average deposits, increased \$64.3 million, or 9.8%, from \$657.9 million to \$722.3 million, compared to the same period in 2005. The average yield on loans increased from 6.22% at December 31, 2005 to 6.70% at December 31, 2006. The increase in the yield on loans was due to the overall increase in interest rates. The rate at which loan yields increased were partially impacted by repricing characteristics of the loans, interest rates at the time the loans repriced, and the competitive loan pricing environment. The increase in interest income on loans of \$7.6 million, or 19.5%, was the result of an increase in average loans and the average yield on loans.

Average investment and mortgage-backed securities increased \$97.7 million, or 11.0%, from \$891.4 million to \$989.1 million, for the year ended December 31, 2006 when compared to the same period in 2005. This increase was funded by the increase in average deposits which included brokered CDs we issued. The overall yield on average investment and mortgage-backed securities increased to 5.06% during the year ended December 31, 2006 from 4.63% during the same period in 2005. Interest income on investment and mortgage-backed securities increased \$9.3 million in 2006, or 23.4%, compared to 2005 due to the increase in the overall yield and average balances. The increase in the average yield primarily reflects decreased prepayment rates on mortgage-backed securities, which led to decreased amortization expense, combined with the reinvestment of proceeds from lower-yielding matured securities into higher yielding securities due to the overall higher interest rate environment. The higher overall interest rate environment during 2006 when compared to 2005 contributed to a decrease in residential mortgage refinancing nationwide and in

our market area. The decrease in prepayments on mortgage loans combined

46

with a previous restructuring of the securities portfolio reduced overall amortization expense which contributed to the increase in interest income.

Average FHLB stock and other investments decreased \$130,000, or 0.5%, to \$28.0 million, for the year ended December 31, 2006, when compared to \$28.1 million for 2005. Interest income from our FHLB stock and other investments increased \$377,000, or 36.5%, from \$1.0 million to \$1.4 million, during 2006, when compared to 2005, due to the increase in average yield from 3.67% for the year ended December 31, 2005 compared to 5.04% for the same period in 2006. Average federal funds sold and other interest earning assets increased \$201,000, or 12.3%, to \$1.8 million, for the year ended December 31, 2006, when compared to \$1.6 million for 2005. Interest income from federal funds sold and other interest earning assets increased \$38,000, or 70.4%, for the year ended December 31, 2006, when compared to 2005, as a result of the increase in the average balance and the average yield from 3.29% in 2005 to 5.00% in 2006, which was due to the higher average short-term interest rates.

During the year ended December 31, 2006, average securities increased more than average loans. As a result, the mix of our average interest earning assets reflected a slight decrease in average total loans as a percentage of total average interest earning assets compared to the prior year as loans averaged 41.6% during 2006 compared to 41.8% during 2005, a direct result of securities growth exceeding loan growth. Average securities were 58.3% of average total interest earning assets and other interest earning asset categories averaged 0.1% for December 31, 2006. During 2005, the comparable mix was 58.1% in securities and 0.1% in the other interest earning asset categories.

Total interest expense increased \$16.9 million, or 43.9%, to \$55.3 million during the year ended December 31, 2006 as compared to \$38.4 million during the same period in 2005. The increase was primarily attributable to increased funding costs associated with an increase in average interest bearing liabilities, including deposits, brokered CDs and FHLB advances of \$123.4 million, or 9.5%, from \$1.30 billion to \$1.42 billion, and an increase in the average yield on interest bearing liabilities from 2.96% for 2005 to 3.89% for the year ended December 31, 2006.

Average interest bearing deposits increased \$148.6 million, or 20.7%, and the average rate paid increased from 2.40% for the year ended December 31, 2005 compared to 3.54% for the year ended December 31, 2006. Average time deposits increased \$112.8 million, or 31.8%, and the average rate paid increased 122 basis points from 3.17% to 4.39%. The largest increase in average time deposits resulted from the issuance of callable brokered CDs. Average interest bearing demand deposits increased \$35.6 million, or 11.3%, from \$313.8 million to \$349.4 million, and the average rate paid increased 99 basis points. Average savings deposits increased \$262,000, or 0.5%, and the average rate paid increased 23 basis points. Interest expense for interest bearing deposits for the year ended December 31, 2006 increased \$13.5 million, or 78.2%, from \$17.2 million to \$30.7 million, when compared to the same period in 2005 due to the increase in the average balance and yield. Average noninterest bearing demand deposits increased \$34.2 million, or 12.2%, from \$280.0 million to \$314.2 million, during 2006. The latter three categories, which are considered the lowest cost deposits, comprised 60.5% of total average deposits during the year ended December 31, 2006 compared to 64.5% during 2005. The increase in our average total deposits is the result of issuing callable brokered CDs, overall bank growth and branch expansion.

During the year ended December 31, 2006, we issued approximately \$104 million of callable brokered CDs, net of discount, where we control numerous options to call the CDs before the final maturity date. At December 31, 2006, these brokered CDs had maturities from 1.7 to five years and had calls that we controlled, all of which were six months or less. At December 31, 2006, we had \$123.5 million in brokered CDs that represented 9.6% of deposits compared to \$19.8 million, or 1.8% of deposits, at December 31, 2005. During 2006, we utilized long-term brokered CDs to a greater extent than long-term FHLB funding as the brokered CDs better matched overall ALCO objectives due to the calls we controlled. Our current policy allows for a maximum of \$150 million in brokered CDs. The potential higher interest cost and lack of customer loyalty are risks associated with the use of brokered CDs.

Average short-term interest bearing liabilities, consisting primarily of FHLB advances and federal funds purchased, were \$376.7 million, an increase of \$94.4 million, or 33.4%, for the year ended December 31, 2006 when compared to \$282.3 million for the same period in 2005. Interest expense associated with short-term interest bearing liabilities increased \$6.6 million, or 67.1%, and the average rate paid increased 89 basis points to 4.39% for the year ended December 31, 2006, when compared to 3.50% for the same period in 2005. The increase in the interest expense was due to an increase in the average balance and the average yield for short-term interest bearing liabilities.

Average long-term interest bearing liabilities consisting of FHLB advances decreased \$119.7 million, or 43.6%, during the year ended December 31, 2006 to \$155.0 million as compared to \$274.7 million at December 31, 2005. Interest expense associated with long-term FHLB advances decreased \$3.6 million, or 36.2%, while the average rate paid increased 48 basis points to 4.12% for the year ended December 31, 2006 when compared to 3.64% for the same period in 2005. The decrease in interest expense was due to the fact the decrease in the average balance of long-term interest bearing liabilities more than offset the increase in the average rate paid. FHLB advances are collateralized by FHLB stock, securities and nonspecific real estate loans.

Average long-term debt, consisting entirely of our junior subordinated debentures issued in 2003 in connection with the issuance of trust preferred securities by our subsidiary Southside Statutory Trust III, was \$20,619,000 for the years ended December 31, 2005 and 2006. Interest expense increased \$376,000, or 28.8%, to \$1.7 million for the year ended December 31, 2006 when compared to \$1.3 million for the same period in 2005 as a result of the increase in three-month LIBOR due to higher short-term interest rates during 2006 when compared to 2005. The long-term debt adjusts quarterly at a rate equal to three-month LIBOR plus 294 basis points.

PROVISION FOR LOAN LOSSES

The provision for loan losses for the year ended December 31, 2006 was \$1.1 million compared to \$1.5 million for December 31, 2005. For the year ended December 31, 2006, net charge-offs of loans decreased \$338,000, or 25.7%, to \$977,000 when compared to \$1.3 million for the same period in 2005.

The decrease in net charge-offs for 2006 was due to a combination of an increase in total recoveries of \$314,000 and a slight decrease in total charge-offs of \$24,000. Net charge-offs for commercial loans decreased \$226,000 from 2005 primarily as a result of an overall decrease in charge-offs. Net charge-offs for loans to individuals decreased \$113,000 during 2006 due to an overall increase in recoveries which more than offset the increase in charge-offs when compared to 2005.

As of December 31, 2006, our review of the loan portfolio indicated that a loan loss allowance of \$7.2 million was adequate to cover probable losses in the portfolio.

NONINTEREST INCOME

Noninterest income consists of revenues generated from a broad range of financial services and activities including fee based services. The following schedule lists the accounts from which noninterest income was derived, gives totals for these accounts for the year ended December 31, 2006 and the comparable year ended December 31, 2005 and indicates the percentage changes:

	Years Ended		Percent Change
	December 31, 2006	2005	
	(dollars in thousands)		
Deposit services	\$ 15,482	\$ 14,594	6.1%
Gain on securities available for sale	743	228	225.9%
Gain on sale of loans	1,817	1,807	0.6%
Trust income	1,711	1,422	20.3%
Bank owned life insurance income	1,067	951	12.2%
Other	2,661	2,246	18.5%
Total noninterest income	\$ 23,481	\$ 21,248	10.5%

Total noninterest income for the year ended December 31, 2006 increased 10.5%, or \$2.2 million, compared to 2005. During the year ended December 31, 2006, we had a gain on the sale of AFS securities of \$743,000 compared to \$228,000 for the same period in 2005. The market value of the AFS securities portfolio at December 31, 2006 was \$742.1 million with a net unrealized loss on that date of \$6.7 million. The net unrealized loss is comprised of \$9.9 million in unrealized losses and \$3.2 million in unrealized gains. We sold securities out of our AFS portfolio to accomplish ALCO and investment portfolio objectives aimed at repositioning a portion of the securities portfolio in an attempt to maximize the total return of the securities portfolio and reduce alternative minimum tax. During 2006, we primarily sold tax-free municipal securities to reduce alternative minimum tax and selected mortgage-backed securities where the risk reward profile had changed.

Deposit services income increased \$888,000, or 6.1%, for the year ended December 31, 2006, when compared to the same period in 2005, primarily as a result of increases in overdraft income and an increase in debit card income, which were offset by decreases in deposit account service charges due to increases in earnings credit rates.

Trust income increased \$289,000, or 20.3%, for the year ended December 31, 2006, when compared to the same period in 2005 due to growth experienced in our trust department.

Gain on sale of loans increased \$10,000, or 0.6%, for the year ended December 31, 2006, when compared to the same period in 2005. The slight increase was primarily due to an increase in residential mortgage loans sold during 2006 when compared to 2005. The increase was offset by a gain of \$248,000 from the sale of \$6.2 million in student loans during 2005.

BOLI income increased \$116,000, or 12.2%, for the year ended December 31, 2006, when compared to the same period in 2005 primarily as a result of an increase in the average balance of cash surrender value associated with our BOLI.

Other noninterest income increased \$415,000, or 18.5%, for the year ended December 31, 2006, when compared to the same period in 2005. The increase was primarily a result of increases in brokerage services income, credit card fee

income, merchant banking and Travelers Express income, and a recovery of \$150,000 received during the second quarter of 2006 that was related to a loss on a check during 2005. The increases were partially offset by a special distribution of \$286,000 received during 2005 as a result of the merger of the Pulse EFT Association with Discover Financial Services.

NONINTEREST EXPENSE

The following schedule lists the accounts which comprise noninterest expense, gives totals for these accounts for the years ended December 31, 2006 and 2005 and indicates the percentage changes:

	Years Ended December 31,		Percent Change
	2006	2005	
	(dollars in thousands)		
Salaries and employee benefits	\$ 28,275	\$ 27,479	2.9%
Occupancy expense	4,777	4,257	12.2%
Equipment expense	899	847	6.1%
Advertising, travel and entertainment	1,742	1,967	(11.4%)
ATM and debit card expense	955	648	47.4%
Director fees	587	677	(13.3%)
Supplies	637	628	1.4%
Professional fees	1,386	1,339	3.5%
Postage	618	572	8.0%
Telephone and communications	723	593	21.9%
Other	4,368	4,152	5.2%
Total noninterest expense	\$ 44,967	\$ 43,159	4.2%

Noninterest expense for the year ended December 31, 2006 increased \$1.8 million, or 4.2%, when compared to the year ended December 31, 2005. Salaries and employee benefits expense increased \$796,000, or 2.9%, during the year ended December 31, 2006, when compared to the same period in 2005. Direct salary expense and payroll taxes increased \$1.6 million, or 7.4%, for the year ended December 31, 2006, when compared to the same period in 2005. These increases were the result of normal salary increases and higher staffing levels associated with both the opening of four de novo branch locations since September 30, 2005, and our regional lending initiative.

During the third quarter of 2006, department managers completed an evaluation of work flow in their respective departments, with the primary objective of identifying any opportunities to increase productivity primarily through the use of technology investments with less personnel expense. In certain departments the evaluations identified the ability to utilize part-time employees to better staff for peak customer transaction times in lieu of full-time employees. In addition, management is utilizing productivity gains to not fill certain vacancies created by normal attrition. The combination of these initiatives resulted in salary and employee benefit expense savings and improved productivity gains.

Retirement expense decreased \$825,000, or 25.2%, for the year ended December 31, 2006, when compared to the same period in 2005, primarily as a result of the amendments to the Plan in the fourth quarter of 2005 that became effective in 2006. Our actuarial assumptions used to determine net periodic pension costs were reduced for 2006 when compared to 2005. Specifically, the assumed long-term rate of return was 7.875% and the assumed discount rate was 5.625%. On November 3, 2005, our board of directors approved amendments to the Plan which affected future participation in the Plan and reduced the accrual of future benefits. A summary of the amendments to the Plan are presented in "Note 14 – Employee Benefits" to our consolidated financial statements.

Health and life insurance expense increased \$19,000, or 0.7%, for the year ended December 31, 2006, when compared to the same period in 2005 due to increased health claims expense in the last quarter of 2006. We have a self-insured health plan which is supplemented with stop loss insurance policies.

Occupancy expense increased \$520,000, or 12.2%, for the year ended December 31, 2006, compared to the same period in 2005 due primarily to the opening of four de novo branch locations since September 30, 2005, combined with higher utility costs incurred during 2006 at existing locations.

Advertising, travel and entertainment decreased \$225,000, or 11.4%, for the year ended December 31, 2006, compared to the same period in 2005, due to a coordinated effort to reduce costs in this area.

ATM and debit card expense increased \$307,000, or 47.4%, for the year ended December 31, 2006, compared to the same period in 2005. The increase was primarily due to an increase in combined use of ATM and debit cards, point of sale activity and a new billing system from our service provider.

Director fees decreased \$90,000, or 13.3%, for the year ended December 31, 2006, compared to the same period in 2005 due to a decrease in the number of directors and a decrease in the amount paid to holding company directors during 2006.

Telephone and communications expense increased \$130,000, or 21.9%, for the year ended December 31, 2006, compared to the same period in 2005, primarily due to the opening of four de novo branch locations since September 30, 2005 and the addition of disaster recovery communication capabilities at a separate branch facility.

Other expense increased \$216,000, or 5.2%, for the year ended December 31, 2006, compared to the same period in 2005. The increase occurred primarily due to increases in computer fees, taxes other than real estate, losses on OREO, bank analysis fees, student loan origination and lender fee expense, and stored value card expense that were partially offset by decreases in other losses and liability insurance expense.

INCOME TAXES

Pre-tax income for the year ended December 31, 2006 was \$19.1 million compared to \$17.9 million and \$20.1 million for the years ended December 31, 2005 and 2004, respectively.

Income tax expense was \$4.1 million for the year ended December 31, 2006 and represented an \$807,000, or 24.5%, increase from the year ended December 31, 2005. The effective tax rate as a percentage of pre-tax income was 21.5% in 2006, 18.4% in 2005 and 19.7% in 2004. The increase in the effective tax rate and income tax expense for 2006 was due to the decrease in our tax-exempt income as a percentage of pre-tax income for the year ended December 31, 2006 when compared to December 31, 2005.

We decreased our municipal securities portfolio during 2006 to balance the overall level of tax-free income from the municipal investment securities and municipal loan portfolios. We continue to review the appropriate level of tax-free income so as to minimize any alternative minimum tax position in the future.

LENDING ACTIVITIES

One of our main objectives is to seek attractive lending opportunities in Texas, primarily in the counties in which we operate. Substantially all of our loan originations are made to borrowers who live in and conduct business in the counties in Texas in which we operate, with the exception of municipal loans and purchases of automobile loan portfolios throughout the United States. Municipal loans are made to municipalities, counties, school districts, and colleges throughout the state of Texas. Through SFG, we purchase portfolios of automobile loans from a variety of lenders throughout the United States. We look forward to the possibility that our loan growth will continue to accelerate in the future as we work to identify and develop additional markets and strategies that will allow us to expand our lending territory. Total loans as of December 31, 2007 increased \$202.1 million, or 26.6%, and the average loan balance was up \$87.7 million, or 12.1%, when compared to 2006.

Construction loans increased \$56.8 million, or 143.4%, from December 31, 2006. 1-4 Family residential loans increased \$10.5 million, or 4.6%, from December 31, 2006. Other real estate loans increased \$30.2 million, or 16.7%, from December 31, 2006 to December 31, 2007. Commercial loans increased \$35.2 million, or 29.6%, from December 31, 2006. Loans to individuals increased \$63.0 million, or 73.2%, from December 31, 2006. Municipal loans as of December 31, 2007 increased \$6.4 million, or 6.0%, from December 31, 2006.

The increase in real estate loans was due to our acquisition of Fort Worth National Bank, our expanding markets, economic growth in our existing market areas, the continued strong commitment to real estate lending and less refinancing of real estate loans on our books during 2007 when compared to 2006. The increase in our commercial loans is reflective of our acquisition of Fort Worth National Bank, our expanding markets and economic growth in our market area. The increase in loans to individuals reflects automobile loan portfolios purchased by SFG and to a much lesser extent, success in penetrating this competitive market in our market areas. In our loan portfolio, loans dependent upon private household income represent a significant concentration. Due to the number of customers involved who work in all sectors of the numerous local, state and national economies, we believe the risk in this portion of the portfolio is adequately spread throughout the economic community, which assists in mitigating this concentration.

The aggregate amount of loans that we are permitted to make under applicable bank regulations to any one borrower, including non affiliate related entities, for Southside Bank is 25% of Tier 1 capital and for Fort Worth National Bank is 15% of Total capital .. Our legal lending limit at December 31, 2007, was approximately \$37 million at Southside Bank and approximately \$2.5 million at Fort Worth National Bank. Our largest loan relationship at December 31, 2007 was approximately \$15.0 million.

The average yield on loans for the year ended December 31, 2007, increased to 7.16% from 6.70% for the year ended December 31, 2006. This increase was reflective of Fort Worth National Bank loans acquired, SFG loans, the repricing characteristics of the loans and interest rates at the time loans repriced.

LOAN PORTFOLIO COMPOSITION AND ASSOCIATED RISK

The following table sets forth loan totals by category for the years presented:

	December 31,				
	2007	2006	2005	2004	2003
	(in thousands)				
Real Estate Loans:					
Construction	\$ 96,356	\$ 39,588	\$ 35,765	\$ 32,877	\$ 35,306
1-4 Family Residential	237,888	227,354	199,812	168,784	143,460
Other	211,280	181,047	162,147	153,998	144,668
Commercial Loans	154,171	118,962	91,456	80,808	76,432
Municipal Loans	112,523	106,155	109,003	103,963	96,135
Loans to Individuals	149,012	86,041	82,181	83,589	93,134
Total Loans	\$ 961,230	\$ 759,147	\$ 680,364	\$ 624,019	\$ 589,135

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

REAL ESTATE LOANS

Real estate loans represent our greatest concentration of loans. However, the amount of risk associated with this group of loans is mitigated in part due to the type of loans involved and geographic distribution. At December 31, 2007, the majority of our real estate loans were collateralized by properties located in our market areas. Of the \$545.5 million in real estate loans, \$237.9 million, or 43.6%, represent loans collateralized by residential dwellings that are primarily owner occupied. Historically, the amount of losses suffered on this type of loan has been significantly less than those on other properties. Beginning in the third quarter of 2007, there were well-publicized developments in the credit markets, beginning with a decline in the sub-prime mortgage lending market, which later extended to the markets for collateralized mortgage obligations, mortgage-backed securities and the lending markets generally. We believe our markets have been relatively resilient and we have not experienced effects associated with these market trends; however, a continued decline in credit markets generally could adversely effect our financial condition and results of operation if we are unable to extend credit or sell loans into the secondary market. Our loan policy requires an appraisal or evaluation on the property, based on the size and complexity of the transaction, prior to funding any real estate loan and also outlines the requirements for appraisals on renewals.

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

Real estate loans are divided into three categories: 1-4 Family Residential Mortgage Loans, Construction Loans and Other. The Other category consists of \$205.1 million of commercial real estate loans, \$3.3 million of loans secured by multifamily properties and \$2.9 million of loans secured by farm land. The Commercial Real Estate portion of Other will be discussed in more detail below.

1-4 Family Residential Mortgage Loans

Residential loan originations are generated by our loan officers, in-house origination staff, marketing efforts, present customers, walk-in customers and referrals from real estate agents and builders. We focus our lending efforts primarily on the origination of loans secured by first mortgages on owner-occupied, 1-4 family residences. Substantially all of our 1-4 family residential mortgage originations are secured by properties located in our market area. Historically, we have originated a portion of our residential mortgage loans for sale into the secondary market. These loans are reflected on the balance sheet as loans held for sale. These secondary market investors typically pay us a service release premium in addition to a predetermined price based on the interest rate of the loan originated. We retain liabilities related to early prepayments, defaults, failure to adhere to origination and processing guidelines and other issues. We have internal controls in place to mitigate many of these liabilities and historically our realized liability has been extremely low. In addition, many of the retained liabilities expire inside of one year from the date a loan is sold. We warehouse these loans until they are transferred to the secondary market investor, which usually occurs within 45 days.

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

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

We also make home equity loans, which are included as part of the 1-4 Family Residential Mortgage Loans, and at December 31, 2007, these loans totaled \$66.8 million. Under Texas law, these loans are capped at 80% of appraised value.

Construction Loans

Our commercial construction loans and construction loans to individuals are collateralized by property located primarily in the market areas we serve. A majority of our construction loans are directed toward properties that will be owner occupied. Construction loans for projects built on speculation are financed, but these typically have secondary sources of repayment. 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.

Commercial Real Estate Loans

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

COMMERCIAL LOANS

Our commercial loans are diversified to meet most business needs. Loan types include short-term working capital loans for inventory and accounts receivable and short and medium-term loans for equipment or other business capital expansion. Management does not consider there to be any material 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. The medical community represents a concentration of risk in our Commercial loan and Commercial Real Estate loan portfolio. See “Item 1. Business – Market Area.” See “Item 1A. Risk Factors – We have a high concentration of

loans directly related to the medical community in our market area, primarily in Smith and Gregg Counties.” We believe that risk in the medical community is mitigated because it is spread among multiple practice types and multiple specialties. Should the government change the amount it pays the medical community through the various government health insurance programs or if new government regulation impacts the profitability of the medical community, the medical community could be adversely impacted, which in turn could result in higher default rates by borrowers in the medical industry.

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

MUNICIPAL LOANS

We have a specific lending department that makes loans to municipalities and school districts throughout the state of Texas. The majority of the loans to municipalities and school districts have tax or revenue pledges and in some cases, are additionally supported by collateral. Municipal loans made without a direct pledge of taxes or revenues are usually made based on some type of collateral that represents an essential service. Lending money directly to these municipalities allows us to earn a higher yield for similar durations than we could if we purchased municipal securities. Total loans to municipalities and school districts as of December 31, 2007 increased \$6.4 million when compared to 2006. At December 31, 2007, we had total loans to municipalities and school districts of \$112.5 million.

LOANS TO INDIVIDUALS

Substantially all of our consumer loan originations are made to consumers in our market areas. The majority of consumer loans outstanding are collateralized by titled equipment, primarily vehicles, which accounted for approximately \$108.8 million, or 73.0%, of total loans to individuals at December 31, 2007. Home equity loans, which are included in 1-4 family residential loans, have replaced some of the traditional loans to individuals.

In addition, we make loans for a full range of other consumer purposes, which may be secured or unsecured depending on the credit quality and purpose of the loan. Automobile loans purchased by SFG are also included in this category. The total of SFG automobile loans included in loans to individuals at December 31, 2007 was \$56.4 million. These high yield loans represent existing subprime automobile loans with payment histories that are primarily collateralized by used automobiles. Loan pools purchased through SFG are subjected to a modeling system to determine the risk associated with the expected defaults. Among other things, the model takes into consideration, credit scores and estimated collateral values to determine the risk inherent in each pool.

Management believes that the economy in our market areas appears to remain relatively resilient amidst the housing and credit market developments in other regions of the country. Most of our loans to individuals are collateralized, which management believes should assist in limiting our exposure.

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.

LOAN MATURITIES AND SENSITIVITY TO CHANGES IN INTEREST RATES

The following table represents loan maturities and sensitivity to changes in interest rates. The amounts of total loans outstanding at December 31, 2007, which, based on remaining scheduled repayments of principal, are due in (1) one year or less, (2) more than one year but less than five years, and (3) more than five years, are shown in the following table. The amounts due after one year are classified according to the sensitivity to changes in interest rates.

	Due in One Year or Less*	After One but within Five Years (in thousands)	After Five Years
Real Estate Loans – Construction	\$ 68,511	\$ 13,651	\$ 14,194
Real Estate Loans – 1-4 Family Residential	58,006	75,885	103,997
Real Estate Loans – Other	58,966	64,184	88,130
Commercial Loans	86,021	61,866	6,284
Municipal Loans	7,263	21,468	83,792
Loans to Individuals	56,010	86,580	6,422
Total Loans	\$ 334,777	\$ 323,634	\$ 302,819

Loans with Maturities After

One Year for Which:	Interest Rates are Fixed or Predetermined	\$ 365,340
	Interest Rates are Floating or Adjustable	\$ 261,113

*The volume of commercial loans due within one year reflects our general policy of attempting to limit a majority of these loans to a short-term maturity. Nonaccrual loans totaling \$2.9 million are reflected in the due after five years column.

LOANS TO AFFILIATED PARTIES

In the normal course of business, we make loans to certain of our own executive officers and directors and their related interests. As of December 31, 2007 and 2006, these loans totaled \$2.2 million and \$2.6 million, or 1.6% and 2.3% of Shareholders' Equity, respectively. Such loans are made in the normal course of business at normal credit terms, including interest rate and collateral requirements and do not represent more than normal credit risks contained in the rest of the loan portfolio for loans of similar types.

LOAN LOSS EXPERIENCE AND ALLOWANCE FOR LOAN LOSSES

The loan loss allowance is based on the most current review of the loan portfolio. Several methods are used to maintain the review in the most current manner. First, the servicing officer has the primary responsibility for updating significant changes in a customer's financial position. Accordingly, 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. Second, 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 or appraisals of the collateral securing the debt are used to allocate the necessary allowances. The internal loan review department maintains a list of all loans or loan relationships that are graded as having more than the normal degree of

risk associated with them. In addition, a list of loans and loan relationships of \$50,000 or more is updated on a periodic basis in order to properly allocate necessary allowances and keep management informed on the status of attempts to correct the deficiencies noted with respect to the loan.

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

As of December 31, 2007, our review of the loan portfolio indicated that a loan loss allowance of \$9.8 million was adequate to cover probable losses in the portfolio.

The following table presents information regarding the average amount of net loans outstanding, changes in the allowance for loan losses, the ratio of net loans charged-off to average net loans outstanding and an allocation of the allowance for loan losses.

LOAN LOSS EXPERIENCE AND ALLOWANCE FOR LOAN LOSSES

	2007	Years Ended December 31,			2003
		2006	2005	2004	
		(dollars in thousands)			
Average Net Loans Outstanding	\$ 809,906	\$ 722,252	\$ 657,938	\$ 604,658	\$ 570,122
Balance of Allowance for Loan Losses at Beginning of Period	\$ 7,193	\$ 7,090	\$ 6,942	\$ 6,414	\$ 6,195
Loan Charge-Offs:					
Real Estate-Construction	–	–	–	–	(17)
Real Estate-1-4 Family Residential	(33)	(59)	(36)	(142)	(63)
Real Estate-Other	(7)	(18)	(53)	(3)	–
Commercial Loans	(95)	(245)	(438)	(375)	(693)
Loans to Individuals	(2,612)	(2,650)	(2,469)	(523)	(703)
Total Loan Charge-Offs	(2,747)	(2,972)	(2,996)	(1,043)	(1,476)
Recovery of Loans Previously Charged-off:					
Real Estate-Construction	–	–	–	–	–
Real Estate-1-4 Family Residential	30	7	20	–	–
Real Estate-Other	10	–	–	27	3
Commercial Loans	98	87	54	323	179
Loans to Individuals	1,909	1,901	1,607	296	304
Total Recovery of Loans Previously Charged-Off	2,047	1,995	1,681	646	486
Net Loan Charge-Offs	(700)	(977)	(1,315)	(397)	(990)
Allowance for Loan Losses Acquired	909	–	–	–	–
Provision for Loan Losses	2,351	1,080	1,463	925	1,209
Balance of Allowance for Loan Losses at End of Period	\$ 9,753	\$ 7,193	\$ 7,090	\$ 6,942	\$ 6,414

Edgar Filing: SOUTHSIDE BANCSHARES INC - Form 10-K

Reserve for Unfunded Loan Commitments at Beginning of Period	\$	–	\$	–	\$	–	\$	–	\$	–
Provision for Losses on Unfunded Loan Commitments		50		–		–		–		–
Reserve for Unfunded Loan Commitments at End of Period	\$	50	\$	–	\$	–	\$	–	\$	–
Ratio of Net Charge-Offs to Average Net Loans Outstanding		0.09%		0.14%		0.20%		0.07%		0.17%

58

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

	Years Ended December 31,									
	2007		2006		2005		2004		2003	
	Percent of Loans to Total Amount	Percent of Loans to Total Loans	Percent of Loans to Total Amount	Percent of Loans to Total Loans	Percent of Loans to Total Amount	Percent of Loans to Total Loans	Percent of Loans to Total Amount	Percent of Loans to Total Loans	Percent of Loans to Total Amount	Percent of Loans to Total Loans
Real Estate										
Construction	\$ 1,031	10.0%	\$ 366	5.2%	\$ 329	5.3%	\$ 518	5.3%	\$ 510	6.0%
1-4 Family Residential	1,313	24.8%	1,221	30.0%	1,101	29.4%	909	27.0%	906	24.3%
Other	2,594	22.0%	2,327	23.8%	2,397	23.8%	2,186	24.6%	1,798	24.6%
Commercial Loans	2,126	16.0%	1,536	15.7%	1,482	13.4%	1,485	13.0%	1,339	13.0%
Municipal Loans	277	11.7%	262	14.0%	269	16.0%	318	16.7%	238	16.3%
Loans to Individuals	2,391	15.5%	1,394	11.3%	1,498	12.1%	1,516	13.4%	1,622	15.8%
Unallocated	21	0.0%	87	0.0%	14	0.0%	10	0.0%	1	0.0%
Ending Balance	\$ 9,753	100.0%	\$ 7,193	100.0%	\$ 7,090	100.0%	\$ 6,942	100.0%	\$ 6,414	100.0%

See "Consolidated Financial Statements - Note 7. Loans and Allowance for Probable Loan Losses."

NONPERFORMING ASSETS

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

Total nonperforming assets at December 31, 2007 were \$3.9 million, representing an increase of \$1.8 million, or 87.0%, from \$2.1 million at December 31, 2006. OREO decreased \$198,000, or 56.4%, to \$153,000 from December 31, 2006 to December 31, 2007. We are actively marketing all properties and none are being held for investment purposes. From December 31, 2006 to December 31, 2007, nonaccrual loans increased \$1.6 million, or 118.5%, to \$2.9 million. Of this total, 4.5% are residential real estate loans, 17.0% are commercial real estate loans, 5.4% are commercial loans, 72.7% are loans to individuals and 0.4% are construction loans. Not including the \$2.0 million increase in nonperforming assets attributable to the SFG automobile loans, nonperforming assets for Southside would have decreased by \$148,000. Restructured loans increased \$5,000, or 2.3%, to \$225,000. Loans 90 days past due or more increased \$272,000, or 212.5%, to \$400,000 and include residential mortgage loans and loans to individuals. Repossessed assets increased \$177,000, or 226.9%, to \$255,000.

The following table presents information on nonperforming assets:

NONPERFORMING ASSETS
Years Ended December 31,

	2007	2006	2005	2004	2003
	(dollars in thousands)				
Loans 90 Days Past Due:					
Real Estate	\$ 286	\$ 64	\$ 912	\$ 785	\$ 248
Loans to Individuals	114	64	33	22	20
Commercial	-	-	-	20	4
	400	128	945	827	272
Loans on Nonaccrual:					
Real Estate	636	975	970	753	775
Loans to Individuals	2,119	262	381	432	354
Commercial	158	96	380	1,063	418
	2,913	1,333	1,731	2,248	1,547
Restructured Loans:					
Real Estate	94	97	99	102	109
Loans to Individuals	120	105	127	85	97
Commercial	11	18	-	6	13
	225	220	226	193	219
Total Nonperforming Loans	3,538	1,681	2,902	3,268	2,038
Other Real Estate Owned	153	351	145	214	195
Repossessed Assets	255	78	10	41	48
Total Nonperforming Assets	\$ 3,946	\$ 2,110	\$ 3,057	\$ 3,523	\$ 2,281
Percentage of Total Assets	0.18%	0.11%	0.17%	0.22%	0.16%
Percentage of Loans and Leases, Net of Unearned Discount					
	0.41%	0.28%	0.45%	0.56%	0.39%

Nonperforming assets at December 31, 2007, as a percentage of total assets increased to 0.18% from the previous year and as a percentage of loans increased to 0.41%. Nonperforming assets hinder our ability to earn money. Decreases in earnings can result from both the loss of interest income and the costs associated with maintaining the OREO, for taxes, insurance and other operating expenses. In addition to the nonperforming assets, at December 31, 2007 in the opinion of management, we had \$279,000 of loans identified as potential problem loans. A potential problem loan is a loan where information about possible credit problems of the borrower is known, causing management to have serious doubts about the ability of the borrower to comply with the present loan repayment terms and which may result in a future classification of the loan in one of the nonperforming asset categories.

The following is a summary of our recorded investment in loans (primarily nonaccrual loans) for which impairment has been recognized in accordance with SFAS 114 (in thousands):

	Total	Valuation Allowance	Carrying Value
Real Estate Loans	\$ 636	\$ 92	\$ 544
Loans to Individuals	2,230	396	1,834
Commercial Loans	170	65	105
Balance at December 31, 2007	\$ 3,036	\$ 553	\$ 2,483

	Total	Valuation Allowance	Carrying Value
Real Estate Loans	\$ 975	\$ 102	\$ 873
Loans to Individuals	357	109	248
Commercial Loans	114	14	100
Balance at December 31, 2007	\$ 1,446	\$ 225	\$ 1,221

The balances of impaired loans included above with no valuation allowances were approximately \$14,000 and \$65,000 at December 31, 2007 and 2006, respectively.

For the years ended December 31, 2007 and 2006, the average recorded investment in impaired loans was approximately \$1,749,000 and \$1,519,000, respectively.

The amount of interest recognized on loans that were nonaccruing or restructured during the year was \$102,000, \$113,000 and \$80,000 for the years ended December 31, 2007, 2006 and 2005, respectively. If these loans had been accruing interest at their original contracted rates, related income would have been \$231,000, \$142,000 and \$177,000 for the years ended December 31, 2007, 2006 and 2005, respectively.

For the years ended December 31, 2007, 2006 and 2005 we did not have an allowance for losses on OREO.

SECURITIES ACTIVITY

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

We account for debt and equity securities as follows:

- **Held to Maturity (“HTM”).** Debt securities that management has the current intent and ability to hold until maturity are classified as HTM and are carried at their remaining unpaid principal balance, net of unamortized premiums or unaccreted discounts. Premiums are amortized and discounts are accreted using the level interest yield method over the estimated remaining term of the underlying security.
- **Available for Sale (“AFS”).** Debt and equity securities that will be held for indefinite periods of time, including securities that may be sold in response to changes in market interest or prepayment rates, needs for liquidity and changes in the availability of and the yield of alternative investments are classified as AFS. These assets are carried at market value. Market value is determined using quoted market prices, where available. If quoted market prices are not available, fair values are based on quoted market prices for similar securities or estimates from independent pricing services. Unrealized gains and losses on AFS securities are excluded from earnings and reported net of tax as a separate component of shareholders' equity until realized.

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

Securities with limited marketability, such as FHLB stock and other investments, are carried at cost, which approximates its fair value.

Management attempts to deploy investable funds into instruments that are expected to provide a reasonable overall return on the portfolio given the current assessment of economic and financial conditions, while maintaining acceptable levels of capital, interest rate and liquidity risk. At December 31, 2007, the securities portfolio as a percentage of total assets was 47.8% and was larger than loans, which were 43.8% of total assets. For a discussion of our strategy in relation to the securities portfolio, see “Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations – Leverage Strategy.”

The following table sets forth the carrying amount of investment securities and mortgage-backed securities at December 31, 2007, 2006 and 2005:

Available for Sale:	2007	December 31, 2006	2005
	(in thousands)		
Investment Securities:			
U.S. Treasury	\$ 4,886	\$ 26,383	\$ 23,770
Government Sponsored Enterprise Debentures	31,759	9,923	21,525
State and Political			
Subdivisions	66,244	55,135	68,339
Other Stocks and Bonds	7,039	7,511	7,606
Mortgage-backed Securities:			
U.S. Government Agencies	89,720	71,399	69,732
Government Sponsored			
Enterprises	633,060	564,650	519,396
Other Private Issues	4,773	7,115	3,307
Total	\$ 837,481	\$ 742,116	\$ 713,675

Held to Maturity:	2007	December 31, 2006	2005
	(in thousands)		
Investment Securities:			
Other Stocks and Bonds	\$ 475	\$ 1,351	\$ —
Mortgage-backed Securities:			
U.S. Government Agencies	25,965	30,788	35,400
Government Sponsored			
Enterprises	164,000	195,374	193,921
Total	\$ 190,440	\$ 227,513	\$ 229,321

We invest in mortgage-backed and related securities, including mortgage participation certificates, which are insured or guaranteed by U.S. Government agencies and GSEs, and collateralized mortgage obligations (“CMOs”) and real estate mortgage investment conduits (“REMICs”). Mortgage-backed securities (which also are known as mortgage participation certificates or pass-through certificates) represent a participation interest in a pool of single-family or multi-family mortgages, the principal and interest payments on which are passed from the mortgage originators, through intermediaries (generally U.S. Government agencies, GSEs, and direct whole loans) that pool and repackage the participation interests in the form of securities, to investors such as us. U.S. Government agencies, primarily Government National Mortgage Association (“GNMA”) and GSEs, primarily Freddie Mac, and Federal National Mortgage Association (“FNMA”) guarantee the payment of principal and interest to investors. GSEs are not backed by the full faith and credit of the United States government. Freddie Mac, FNMA and FHLB are the primary GSEs with which we purchase securities. The whole loans we purchase are all AAA rated CMO and REMIC tranches that are rated AAA due to credit support and/or insurance coverage.

Mortgage-backed securities typically are issued with stated principal amounts, and the securities are backed by pools of mortgages that have loans with varying maturities. The characteristics of the underlying pool of mortgages, such as fixed-rate or adjustable-rate, as well as prepayment risk, are passed on to the certificate holder. The term of a mortgage-backed pass-through security thus approximates the term of the underlying mortgages and can vary

significantly due to prepayments.

Our mortgage-backed securities include CMOs, which include securities issued by entities that have qualified under the Internal Revenue Code of 1986, as amended, as REMICs. CMOs and REMICs (collectively CMOs) were developed in response to investor concerns regarding the uncertainty of cash flows associated with the prepayment option of the underlying mortgagor and are typically issued by governmental agencies, GSEs and special purpose entities, such as trusts, corporations or partnerships,

63

established by financial institutions or other similar institutions. A CMO can be collateralized by loans or securities which are insured or guaranteed by FNMA, Freddie Mac, GNMA, or whole loans which, in our case, are all currently rated AAA. In contrast to pass-through mortgage-backed securities, in which cash flow is received pro rata by all security holders, the cash flow from the mortgages underlying a CMO is segmented and paid in accordance with a predetermined priority to investors holding various CMO classes. By allocating the principal and interest cash flows from the underlying collateral among the separate CMO classes, different classes of bonds are created, each with its own stated maturity, estimated average life, coupon rate and prepayment characteristics.

Like most fixed-income securities, mortgage-backed and related securities are subject to interest rate risk. However, unlike most fixed-income securities, the mortgage loans underlying a mortgage-backed or related security generally may be prepaid at any time without penalty. The ability to prepay a mortgage loan generally results in significantly increased price and yield volatility (with respect to mortgage-backed and related securities) than is the case with non-callable fixed income securities. Furthermore, mortgage-backed derivative securities often are more sensitive to changes in interest rates and prepayments than traditional mortgage-backed securities and are, therefore, even more volatile.

The combined investment securities, mortgage-backed securities, and FHLB stock and other investments portfolio increased to \$1.05 billion at December 31, 2007, compared to \$996.1 million at December 31, 2006, an increase of \$53.7 million, or 5.4%. This is a result of an increase in mortgage-backed securities of \$48.2 million, or 5.5%, during 2007 when compared to 2006. Another change in our securities portfolio during 2007 included an \$11.1 million, or 20.1%, increase in our ownership of securities issued by state and political subdivisions. FHLB stock decreased \$5.8 million, or 22.5%, due to stock buybacks by FHLB as our FHLB advances decreased. The changes in U. S. Treasury and U. S. Government agency securities were related to collateral needs for public fund deposits.

During 2007, short-term interest rates increased while long-term interest rates increased less, creating an inverted yield curve. We used this interest rate environment to reposition a portion of the securities portfolio in an attempt to slightly reduce the overall duration and minimize prepayment of premium mortgage-backed securities. Higher coupon premium mortgage-backed securities were replaced as they prepaid with mortgage-backed securities that had characteristics which potentially might reduce the prepayment exposure. Specific low selling yield or long duration municipal securities were sold due to the anticipated growth of our municipal loan portfolio and the amount of tax free income we can support without being subject to alternative minimum tax long-term.

The market value of the securities portfolio at December 31, 2007 was \$1.03 billion, which represented a net unrealized gain as of that date of \$5.9 million. The net unrealized gain was comprised of \$9.2 million in unrealized gains and \$3.3 million of unrealized losses. Management determined that \$4.8 million of whole loan mortgage-backed securities, which represented the only non agency collateralized mortgage-backed securities, had an other-than-temporary impairment due to credit concerns at December 31, 2007. The impairment charge recognized was \$58,000 and is reflected in gain (loss) on securities available for sale. To the best of management's knowledge, none of the remaining securities in Southside's investment and mortgage-backed securities portfolio at December 31, 2007 had an other-than-temporary impairment. The market value of the AFS securities portfolio at December 31, 2007 was \$837.5 million, which represented a net unrealized gain as of that date of \$5.9 million. The net unrealized gain was comprised of \$8.7 million of unrealized gains and \$2.8 million of unrealized losses. Net unrealized gains and losses on AFS securities, which is a component of shareholders' equity on the consolidated balance sheet, can fluctuate significantly as a result of changes in interest rates. Because management cannot predict the future direction of interest rates, the effect on shareholders' equity in the future cannot be determined; however, this risk is monitored closely through the use of shock tests on the AFS securities portfolio using an array of interest rate assumptions.

There were no securities transferred from AFS to HTM during 2005, 2006 and 2007. There were no sales from the HTM portfolio during the years ended December 31, 2007, 2006 or 2005. There were \$190.4 million and \$227.5 million of securities classified as HTM for the years ended December 31, 2007 and 2006, respectively.

The maturities classified according to the sensitivity to changes in interest rates of the December 31, 2007 securities portfolio and the weighted yields are presented below. Tax-exempt obligations are shown on a taxable equivalent basis. Mortgage-backed securities are included in maturity categories based on their stated maturity date. Expected maturities may differ from contractual maturities because issuers may have the right to call or prepay obligations.

Available For Sale:	MATURING							
	Within 1 Year		After 1 But Within 5 Years		After 5 But Within 10 Years		After 10 Years	
	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield
	(dollars in thousands)							
Investment Securities:								
U.S. Treasury Government Sponsored Enterprise Debentures	\$ 4,886	3.75%	\$ -	-	\$ -	-	\$ -	-
State and Political Subdivisions	31,759	4.31%	-	-	-	-	-	-
Other Stocks and Bonds	4,437	4.80%	11,922	6.38%	22,846	6.00%	27,039	6.66%
Mortgage-backed Securities:								
U.S. Government Agencies	-	-	-	-	7,798	4.63%	81,922	5.65%
Government Sponsored Enterprises	221	4.13%	15,066	4.61%	108,884	5.05%	508,889	5.46%
Other Private Issues	-	-	-	-	-	-	4,773	5.48%
Total	\$ 41,303	4.30%	\$ 26,988	5.39%	\$ 139,528	5.18%	\$ 629,662	5.56%

Held to Maturity:	MATURING							
	Within 1 Year		After 1 But Within 5 Years		After 5 But Within 10 Years		After 10 Years	
	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield
	(dollars in thousands)							
Investment Securities:								
Other Stocks and Bonds	\$ -	-	\$ -	-	\$ -	-	\$ 475	6.78%
Mortgage-backed Securities:								
U.S. Government Agencies	-	-	-	-	2,004	4.54%	23,961	4.98%
Government Sponsored Enterprises	-	-	11,938	4.48%	102,915	4.78%	49,147	5.30%

Edgar Filing: SOUTHSIDE BANCSHARES INC - Form 10-K

Total	\$	-	-	\$	11,938	4.48%	\$	104,919	4.78%	\$	73,583	5.21%
-------	----	---	---	----	--------	-------	----	---------	-------	----	--------	-------

At December 31, 2007, there were no holders of any one issuer, other than the U. S. government and its agencies in an amount greater than 10% of our shareholders' equity.

65

DEPOSITS AND BORROWED FUNDS

Deposits provide us with our primary source of funds. The increase of \$248.0 million, or 19.3%, in total deposits during 2007 provided us with funds for the growth in loans. Deposits increased during 2007 primarily due to branch expansion, increased market penetration and the acquisition of Fort Worth National Bank which accounted for approximately \$109.0 million of the increase. Time deposits increased a total of \$98.2 million, or 18.7%, during 2007 when compared to 2006. Noninterest bearing demand deposits increased \$31.3 million, or 9.6%, during 2007. Interest bearing demand deposits increased \$116.0 million, or 30.3%, and saving deposits increased \$2.5 million, or 5.0%, during 2007. The latter three categories, which are considered the lowest cost deposits, comprised 59.3% of total deposits at December 31, 2007 compared to 59.1% at December 31, 2006.

The following table sets forth deposits by category at December 31, 2007, 2006, and 2005:

	Years Ended December 31,		
	2007	2006	2005
	(in thousands)		
Noninterest Bearing Demand Deposits	\$ 357,083	\$ 325,771	\$ 310,541
Interest Bearing Demand Deposits	498,221	382,265	360,250
Savings Deposits	52,975	50,454	48,835
Time Deposits	622,212	523,985	391,187
Total Deposits	\$ 1,530,491	\$ 1,282,475	\$ 1,110,813

During the year ended December 31, 2007, total time deposits of \$100,000 or more increased \$55.3 million, or 27.4% from December 31, 2006.

The table below sets forth the maturity distribution of time deposits of \$100,000 or more at December 31, 2007 and 2006:

	December 31, 2007			December 31, 2006		
	Time Certificates of Deposit	Other Time Deposits	Total	Time Certificates of Deposit	Other Time Deposits	Total
	(in thousands)					
Three months or less	\$ 79,461	\$ 21,000	\$ 100,461	\$ 48,529	\$ 28,000	\$ 76,529
Over three to six months	44,919	21,000	65,919	35,770	21,000	56,770
Over six to twelve months	46,458	7,000	53,458	38,534	7,000	45,534
Over twelve months	37,257	–	37,257	22,973	–	22,973
Total	\$ 208,095	\$ 49,000	\$ 257,095	\$ 145,806	\$ 56,000	\$ 201,806

At December 31, 2007, we had a total of \$132.9 million in brokered CDs that represented 8.7% of our deposits. During the year ended December 31, 2007, we did not issue any brokered CDs; however, our brokered CDs

increased \$9.5 million through the acquisition of Fort Worth National Bank. We have used long-term brokered CDs more than long-term FHLB funding as the brokered CDs better matched overall ALCO objectives due to the calls we controlled. These brokered CDs have maturities from approximately one to four years and are callable by Southside at any time in six months or less. During the first quarter of 2008, due to the significant decrease in interest rates since December 31, 2007, we have called approximately \$91.3 million of our brokered CDs. At December 31, 2006, we had \$123.5 million in brokered CDs and at December 31, 2005, we had \$19.8 million in brokered CDs. Our current policy allows for a maximum of \$150 million in brokered CDs. The potential higher interest cost and lack of customer loyalty are risks associated with the use of brokered CDs.

Short-term obligations, consisting primarily of FHLB advances and federal funds purchased and repurchase agreements, increased \$33.8 million, or 10.3%, during 2007 when compared to 2006. FHLB advances are collateralized by FHLB stock, nonspecified loans and securities. Short-term obligations are summarized as follows:

	Years Ended December 31,		
	2007	2006	2005
	(dollars in thousands)		
Federal funds purchased and repurchase agreements			
Balance at end of period	\$ 7,023	\$ 5,675	\$ 2,400
Average amount outstanding during the period (1)	4,519	8,727	6,485
Maximum amount outstanding during the period (3)	10,250	13,775	9,875
Weighted average interest rate during the period (2)	5.3%	5.2%	3.6%
Interest rate at end of period	4.7%	5.5%	4.3%
FHLB advances			
Balance at end of period	\$ 353,792	\$ 322,241	\$ 312,271
Average amount outstanding during the period (1)	272,711	367,068	274,689
Maximum amount outstanding during the period (3)	383,059	396,416	337,808
Weighted average interest rate during the period (2)	4.8%	4.4%	3.5%
Interest rate at end of period	4.1%	4.7%	3.7%
Other obligations			
Balance at end of period	\$ 2,500	\$ 1,605	\$ 2,174
Average amount outstanding during the period (1)	772	901	1,109
Maximum amount outstanding during the period (3)	2,500	2,500	2,500
Weighted average interest rate during the period (2)	5.0%	4.8%	3.0%
Interest rate at end of period	3.6%	5.0%	4.0%

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

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

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

Long-term obligations are summarized as follows:

	December 31, 2007	December 31, 2006
	(in thousands)	
Federal Home Loan Bank Advances (1)		
Varying maturities to 2017	\$ 86,247	\$ 129,379
Long-term Debt (2)		
Southside Statutory Trust III Due 2033		
(3)	20,619	20,619
Southside Statutory Trust IV Due 2037		
(4)	23,196	—
Southside Statutory Trust V Due 2037		
(5)	12,887	—
Magnolia Trust Company I Due 2035		
(6)	3,609	—
Total Long-term Debt	60,311	20,619
Total Long-term Obligations	\$ 146,558	\$ 149,998

(1) At December 31, 2007, the weighted average cost of these advances was 4.77%.

(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 7.77% through March 30, 2008 and adjusts quarterly at a rate equal to three-month LIBOR plus 294 basis points.

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

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

(6) This debt carries an adjustable rate of 6.815% through February 24, 2008 and adjusts quarterly at a rate equal to three-month LIBOR plus 180 basis points.

Long-term FHLB advances decreased \$43.1 million, or 33.3%, during 2007 to \$86.2 million when compared to \$129.4 million in 2006. The decrease was the result of a decrease in long-term FHLB advances purchased and long-term advances rolling into the short-term category.

Long-term debt increased \$39.7 million, or 192.5%, for the year ended December 31, 2007 and consisted of our junior subordinated debentures issued in 2003 and August 2007 in connection with the issuance of trust preferred securities by Southside Statutory Trusts III, IV and V and the assumption in October 2007 of \$3.6 million of junior subordinated debentures issued by Fort Worth Bancshares, Inc. to Magnolia Trust Company I in October 2007. In August 2007, we issued \$36.1 million of junior subordinated debentures in connection with the issuance of trust preferred securities by our subsidiaries Southside Statutory Trusts IV and V.

CAPITAL RESOURCES

Our total shareholders' equity at December 31, 2007 of \$132.3 million increased 19.6%, or \$21.7 million, from December 31, 2006 and represented 6.0% of total assets at December 31, 2007 compared to 5.8% at December 31,

2006.

Net income for 2007 of \$16.7 million was the major contributor to the increase in shareholders' equity at December 31, 2007 along with the issuance of \$1.6 million in common stock (168,543 shares) through our incentive stock option and dividend reinvestment plans, and a decrease of \$9.8 million in accumulated other comprehensive loss which more than offset \$6.5 million in cash dividends paid. The decrease in accumulated other comprehensive loss is composed of an \$8.7 million, net of tax, unrealized gain on securities, net of reclassification adjustment (see "Note 4 – Comprehensive Income (Loss)") and a decrease of \$1.1 million, net of tax, related to the change in the unfunded status of our defined benefit plans. Our dividend policy requires that any cash dividend payments may not exceed consolidated earnings for that year. Shareholders should not anticipate a continuation of the cash dividend simply because of the existence of a dividend reinvestment program. The payment of dividends will depend upon future earnings, our financial condition, and other related factors including the discretion of the board of directors.

68

We are subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory and possibly additional discretionary actions by regulators that, if undertaken, could have a direct material effect on our financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, we must meet specific capital guidelines that involve quantitative measures of our assets, liabilities, and certain off-balance-sheet items as calculated under regulatory accounting practices. Our capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.

Quantitative measures established by regulation to ensure capital adequacy require us to maintain minimum amounts and ratios (set forth in the table below) of Total and Tier 1 capital (as defined in the regulations) to risk-weighted assets (as defined), and of Tier 1 capital (as defined) to average assets (as defined). Tier 1 Capital is defined as the sum of shareholders' equity and qualifying subordinated debt, excluding unrealized gains or losses on debt securities available for sale, unrealized gains on equity securities available for sale and unrealized gains or losses on cash flow hedges, net of deferred income taxes; plus certain mandatorily redeemable capital securities, less nonqualifying intangible assets net of applicable deferred income taxes, and certain nonfinancial equity investments. Total capital is defined as the sum of Tier 1 Capital, a qualifying portion of the allowance for loan losses, and qualifying subordinated debt. Management believes, as of December 31, 2007, that we meet all capital adequacy requirements to which we are subject.

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:

Amount	Actual	For Capital Adequacy Purposes	To Be Well Capitalized Under Prompt Corrective Action Provisions
--------	--------	----------------------------------	---