SOUTHSIDE BANCSHARES INC
Form 10-Q
May 09, 2014
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q
(Mark One)
x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended March 31, 2014
OR
o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from ____________ to ____________

Commission file number: 0-12247
SOUTHSIDE BANCSHARES, INC.
(Exact name of registrant as specified in its charter)

TEXAS	75-1848732
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
1201 S. Beckham, Tyler, Texas	75701
(Address of principal executive offices)	(Zip Code)

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

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

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

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

Large accelerated filer o	Accelerated filer x
Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company o

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

The number of shares of the issuer's common stock, par value $1.25, outstanding as of April 30, 2014 was 18,825,948 shares.

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

	March 31, 2014	December 31, 2013
ASSETS		
Cash and due from banks	$52,195	$45,624
Interest earning deposits	5,197	8,807
Total cash and cash equivalents	57,392	54,431
Investment securities:		
Available for sale, at estimated fair value	259,662	337,429
Held to maturity, at carrying value (estimated fair value of $387,903 and $377,383, respectively)	390,889	391,552
Mortgage-backed securities:		
Available for sale, at estimated fair value	915,061	840,258
Held to maturity, at carrying value (estimated fair value of $266,006 and $271,836, respectively)	265,627	275,569
FHLB stock, at cost	27,331	34,065
Other investments, at cost	2,065	2,065
Loans held for sale	207	151
Loans:		
Loans	1,370,393	1,351,273
Less: Allowance for loan losses	(18,787)	(18,877)
Net Loans	1,351,606	1,332,396
Premises and equipment, net	52,554	52,060
Goodwill	22,034	22,034
Other intangible assets, net	149	178
Interest receivable	15,453	21,973
Deferred tax asset	15,727	18,415
Unsettled trades to sell securities	—	3,933
Other assets	58,587	59,154
TOTAL ASSETS	$3,434,344	$3,445,663
LIABILITIES AND SHAREHOLDERS’ EQUITY		
Deposits:		
Noninterest bearing	$554,497	$529,897
Interest bearing	1,992,346	1,997,911
Total deposits	2,546,843	2,527,808
Short-term obligations:		
Federal funds purchased and repurchase agreements	1,914	859
FHLB advances	19,697	73,445
Total short-term obligations	21,611	74,304
Long-term obligations:		
FHLB advances	506,560	499,349
Long-term debt	60,311	60,311
Total long-term obligations	566,871	559,660

Unsettled trades to purchase securities	1,032	973
Other liabilities	26,594	23,400
TOTAL LIABILITIES	3,162,951	3,186,145
Off-Balance-Sheet Arrangements, Commitments and Contingencies (Note 11)		
Shareholders' equity:		
Common stock ($1.25 par, 40,000,000 shares authorized, 21,295,292 shares issued at March 31, 2014 and 20,386,221 shares issued at December 31, 2013)	26,619	25,483
Paid-in capital	239,678	214,091
Retained earnings	56,997	78,673
Treasury stock (2,469,638 shares at cost)	(37,692)	(37,692)
Accumulated other comprehensive loss	(14,209)	(21,037)
TOTAL SHAREHOLDERS' EQUITY	271,393	259,518
TOTAL LIABILITIES AND SHAREHOLDERS’ EQUITY	$3,434,344	$3,445,663

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

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

	Three Months Ended March 31, 2014	2013
Interest income		
Loans	$18,363	$17,665
Investment securities – taxable	123	364
Investment securities – tax-exempt	5,958	4,488
Mortgage-backed securities	7,682	3,936
FHLB stock and other investments	70	65
Other interest earning assets	43	43
Total interest income	32,239	26,561
Interest expense		
Deposits	2,116	2,070
Short-term obligations	71	1,250
Long-term obligations	2,160	1,781
Total interest expense	4,347	5,101
Net interest income	27,892	21,460
Provision for loan losses	4,133	492
Net interest income after provision for loan losses	23,759	20,968
Noninterest income		
Deposit services	3,638	3,753
Net gain on sale of securities available for sale	11	4,345
Total other-than-temporary impairment losses	—	(52)
Portion of loss recognized in other comprehensive income (before taxes)	—	10
Net impairment losses recognized in earnings	—	(42)
Gain on sale of loans	80	319
Trust income	780	720
Bank owned life insurance income	314	254
Other	983	891
Total noninterest income	5,806	10,240
Noninterest expense		
Salaries and employee benefits	13,102	13,209
Occupancy expense	1,754	1,871
Advertising, travel & entertainment	543	641
ATM and debit card expense	317	381
Professional fees	927	640
Software and data processing expense	501	543
Telephone and communications	278	451
FDIC insurance	448	421
Other	2,312	2,162
Total noninterest expense	20,182	20,319
Income before income tax expense	9,383	10,889

Provision for income tax expense	1,159	1,847
Net income	$8,224	$9,042
Earnings per common share – basic	$0.44	$0.48
Earnings per common share – diluted	$0.44	$0.48
Dividends paid per common share	$0.21	$0.20

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

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

	Three Months Ended March 31,	
	2014	2013
Net income	$8,224	$9,042
Other comprehensive income (loss):		
Unrealized holding gains (losses) on available for sale securities during the period	10,011	(5,744)
Change in net unrealized loss on securities transferred to held to maturity	276	—
Noncredit portion of other-than-temporary impairment losses on the AFS securities	—	(10)
Reclassification adjustment for net gain on sale of available for sale securities, included in net income	(11)	(4,345)
Reclassification of other-than-temporary impairment charges on available for sale securities, included in net income	—	42
Amortization of net actuarial loss, included in net periodic benefit cost	232	643
Amortization of prior service credit, included in net periodic benefit cost	(3)	(11)
Other comprehensive income (loss), before tax	10,505	(9,425)
Income tax (expense) benefit related to other items of comprehensive income	(3,677)	3,299
Other comprehensive income (loss), net of tax	6,828	(6,126)
Comprehensive income	$15,052	$2,916

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

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SOUTHSIDE BANCSHARES, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY
(UNAUDITED)
(in thousands, except share and per share data)

	Common Stock	Paid In Capital	Retained Earnings	Treasury Stock	Accumulated Other Comprehensive Income (Loss)	Total Shareholders' Equity
Balance at December 31, 2012	$24,308	$195,602	$70,708	$(35,793)	$2,938	$257,763
Net Income			9,042			9,042
Other comprehensive loss					(6,126)	(6,126)
Issuance of common stock (14,361 shares)	18	288				306
Purchase of common stock (90,300 shares)				(1,899)		(1,899)
Stock compensation expense		207				207
Net issuance of common stock under employee stock plan		62	(62)			—
Cash dividends paid on common stock ($0.20 per share)			(3,395)			(3,395)
Stock dividend declared	1,064	15,992	(17,056)			—
Balance at March 31, 2013	$25,390	$212,151	$59,237	$(37,692)	$(3,188)	$255,898
Balance at December 31, 2013	$25,483	$214,091	$78,673	$(37,692)	$(21,037)	$259,518
Net Income			8,224			8,224
Other comprehensive income					6,828	6,828
Issuance of common stock (8,325 shares)	10	247				257
Stock compensation expense		286				286
Tax benefits related to stock awards		1				1
Net issuance of common stock under employee stock plan	3	130	(91)			42
Cash dividends paid on common stock ($0.21 per share)			(3,763)			(3,763)
Stock dividend declared	1,123	24,923	(26,046)			—
Balance at March 31, 2014	$26,619	$239,678	$56,997	$(37,692)	$(14,209)	$271,393

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

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

	Three Months Ended March 31, 2014	2013
OPERATING ACTIVITIES:		
Net income	$8,224	$9,042
Adjustments to reconcile net income to net cash provided by operations:		
Depreciation	790	895
Amortization of premium	5,482	8,543
Accretion of discount and loan fees	(887)	(1,363)
Provision for loan losses	4,133	492
Stock compensation expense	286	207
Deferred tax (benefit) expense	(989)	1,031
Excess tax benefits from stock-based compensation	(5)	—
Net gain on sale of securities available for sale	(11)	(4,345)
Net other-than-temporary impairment losses	—	42
Gain on premises and equipment	(7)	—
Loss (gain) on other real estate owned	55	(21)
Net change in:		
Interest receivable	6,520	5,326
Other assets	(3)	895
Interest payable	(35)	(244)
Other liabilities	3,332	(2,183)
Loans held for sale	(56)	463
Net cash provided by operating activities	26,829	18,780
INVESTING ACTIVITIES:		
Securities held to maturity:		
Purchases	—	(42,898)
Maturities, calls and principal repayments	9,863	57,275
Securities available for sale:		
Purchases	(165,673)	(448,973)
Sales	101,830	237,318
Maturities, calls and principal repayments	76,840	87,694
Proceeds from redemption of FHLB stock	6,766	5,242
Purchases of FHLB stock and other investments	(32)	(2,768)
Net increase in loans	(24,173)	(21,524)
Purchases of premises and equipment	(1,285)	(805)
Proceeds from sales of premises and equipment	8	—
Proceeds from sales of other real estate owned	194	266
Proceeds from sales of repossessed assets	1,730	1,778
Net cash provided by (used in) investing activities	6,068	(127,395)

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

	Three Months Ended March 31, 2014	2013
FINANCING ACTIVITIES:		
Net increase in demand and savings accounts	59,468	30,071
Net decrease in certificates of deposit	(40,463)	(44,734)
Net increase (decrease) in federal funds purchased and repurchase agreements	1,055	(127)
Proceeds from FHLB advances	5,064,879	942,466
Repayment of FHLB advances	(5,111,416)	(909,585)
Excess tax benefits from stock-based awards	5	—
Net issuance of common stock under employee stock plan	42	—
Purchase of common stock	—	(1,899)
Proceeds from the issuance of common stock	257	306
Cash dividends paid	(3,763)	(3,395)
Net cash (used in) provided by financing activities	(29,936)	13,103
Net increase (decrease) in cash and cash equivalents	2,961	(95,512)
Cash and cash equivalents at beginning of period	54,431	150,630
Cash and cash equivalents at end of period	$57,392	$55,118
SUPPLEMENTAL DISCLOSURES FOR CASH FLOW INFORMATION:		
Interest paid	$4,382	$5,345
Income taxes paid	$500	$—
SUPPLEMENTAL DISCLOSURES OF NONCASH INVESTING AND FINANCING ACTIVITIES:		
Loans transferred to other repossessed assets and real estate through foreclosure	$1,263	$1,410
Adjustment to pension liability	$(229)	$(632)
Declaration of 5% stock dividend	$26,046	$17,056
Unsettled trades to purchase securities	$(1,032)	$(71,757)
Unsettled trades to sell securities	$—	$1,857

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

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

1. Basis of Presentation

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

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

The consolidated balance sheet as of March 31, 2014, and the related consolidated statements of income, comprehensive income, changes in shareholders' equity and cash flows and notes to the financial statements for the three months period ended March 31, 2014 and 2013 are unaudited; in the opinion of management, all adjustments necessary for a fair statement of such financial statements have been included. Such adjustments consisted only of normal recurring items. All significant intercompany accounts and transactions are eliminated in consolidation. The preparation of these consolidated financial statements in conformity with U.S. generally accepted accounting principles ("GAAP") requires the use of management's estimates. These estimates are subjective in nature and involve matters of judgment. Actual amounts could differ from these estimates.

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

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

Subsequent Event

On April 28, 2014, the Company entered into an Agreement and Plan of Merger (the "Merger Agreement") with OmniAmerican Bancorp, Inc., a Maryland corporation ("OmniAmerican") and the holding company for OmniAmerican Bank, a federal savings association based in Fort Worth, Texas. As of March 31, 2014, OmniAmerican had $1.4 billion in assets. The Merger Agreement provides that, subject to the terms and conditions thereof, OmniAmerican will merge with and into the Company, with the Company as the surviving corporation. The Merger is expected to close during the fourth quarter of 2014, subject to receipt of regulatory approvals and approvals by both our and OmniAmerican's shareholders.

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

Accounting Pronouncements

In January 2014, the Financial Accounting Standards Board ("FASB") issued Accounting Standard Update (ASU) 2014-04 "Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans Upon Foreclosure" to clarify when an entity is considered to have obtained physical possession of a residential real estate property collateralizing a consumer mortgage loan. Upon physical possession (from an in-substance possession or foreclosure) of such real property, an entity is required to reclassify the nonperforming mortgage loan to other real estate owned. The ASU is effective for our interim and annual periods beginning after December 15, 2014. Early adoption is permitted. ASU 2014-04 is not expected to have a material impact on our consolidated financial statements.

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2. Earnings Per Share

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

	Three Months Ended March 31,	
	2014	2013
Basic and Diluted Earnings:		
Net income	$8,224	$9,042
Basic weighted-average shares outstanding	18,818	18,752
Add: Stock options	84	21
Diluted weighted-average shares outstanding	18,902	18,773
Basic Earnings Per Share:	$0.44	$0.48
Diluted Earnings Per Share:	$0.44	$0.48

For the three month periods ended March 31, 2014 and 2013, there were approximately 24,000 and 27,000 anti-dilutive shares, respectively.

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3. Accumulated Other Comprehensive (Loss) Income

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

	Three Months Ended March 31, 2014				
	Unrealized Gains (Losses) on Securities		Pension Plans		
	Other	OTTI	Net Prior Service (Cost) Credit	Net Gain (Loss)	Total
Beginning balance, net of tax	$(8,656)	$—	$(12)	$(12,369)	$(21,037)
Other comprehensive income (loss) before reclassifications	10,287	—	—	—	10,287
Reclassified to income	(11)	—	(3)	232	218
Income tax benefit (expense)	(3,597)	—	1	(81)	(3,677)
Net current-period other comprehensive income (loss), net of tax	6,679	—	(2)	151	6,828
Ending balance, net of tax	$(1,977)	$—	$(14)	$(12,218)	$(14,209)

	Three Months Ended March 31, 2013				
	Unrealized Gains (Losses) on Securities		Pension Plans		
	Other	OTTI	Net Prior Service (Cost) Credit	Net Gain (Loss)	Total
Beginning balance, net of tax	$30,500	$(1,140)	$248	$(26,670)	$2,938
Other comprehensive income (loss) before reclassifications	(5,356)	(398)	—	—	(5,754)
Reclassified to income	(4,345)	42	(11)	643	(3,671)
Income tax benefit (expense)	3,395	125	4	(225)	3,299
Net current-period other comprehensive (loss) income, net of tax	(6,306)	(231)	(7)	418	(6,126)
Ending balance, net of tax	$24,194	$(1,371)	$241	$(26,252)	$(3,188)

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

	Three Months Ended March 31, 2014	2013
Unrealized gains and losses on available for sale securities:		
Realized net (loss) gain on sale of securities [1]	$11	$4,345
Impairment losses [2]	—	(42)
Total before tax	11	4,303
Tax expense	(4)	(1,506)
Net of tax	$7	$2,797
Amortization of pension plan items:		
Net actuarial loss [3]	$(232)	$(643)
Prior service credit [3]	3	11
Total before tax	(229)	(632)
Tax benefit	80	221
Net of tax	$(149)	$(411)
Total reclassifications for the period, net of tax	$(142)	$2,386

(1) Listed as Net gain on sale of securities available for sale on the Statements of Income.
(2) Listed as Net impairment losses recognized in earnings on the Statements of Income.
(3) These accumulated other comprehensive income components are included in the computation of net periodic benefit cost presented in “Note 7 - Employee Benefit Plans.”

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4. Securities

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

	March 31, 2014						
		Recognized in OCI			Not recognized in OCI		
	Amortized	Gross Unrealized	Gross Unrealized	Carrying	Gross Unrealized	Gross Unrealized	Estimated
AVAILABLE FOR SALE	Cost	Gains	Losses	Value	Gains	Losses	Fair Value
Investment Securities:							
U.S. Government Agency Debentures	$11,609	$—	$1,080	$10,529			$10,529
State and Political Subdivisions	236,428	4,755	5,282	235,901			235,901
Other Stocks and Bonds	13,077	163	8	13,232			13,232
Mortgage-backed Securities: (1)							
Residential	785,270	14,788	2,449	797,609			797,609
Commercial	119,419	384	2,351	117,452			117,452
Total	$1,165,803	$20,090	$11,170	$1,174,723			$1,174,723
HELD TO MATURITY							
Investment Securities:							
State and Political Subdivisions	$395,822	$5,850	$10,783	$390,889	$4,386	$7,372	$387,903
Mortgage-backed Securities: (1)							
Residential	64,249	—	91	64,158	3,598	—	67,756
Commercial	208,405	—	6,936	201,469	1,591	4,810	198,250
Total	$668,476	$5,850	$17,810	$656,516	$9,575	$12,182	$653,909

	December 31, 2013						
		Recognized in OCI			Not recognized in OCI		
	Amortized	Gross Unrealized	Gross Unrealized	Carrying	Gross Unrealized	Gross Unrealized	Estimated
AVAILABLE FOR SALE	Cost	Gains	Losses	Value	Gains	Losses	Fair Value
Investment Securities:							
U.S. Government Agency Debentures	$11,612	$—	$1,483	$10,129			$10,129
State and Political Subdivisions	322,412	4,537	12,875	314,074			314,074
Other Stocks and Bonds	13,074	159	7	13,226			13,226

Mortgage-backed Securities:(1)							
Residential	760,418	14,940	3,273	772,085			772,085
Commercial	71,262	220	3,309	68,173			68,173
Total	$1,178,778	$19,856	$20,947	$1,177,687			$1,177,687
HELD TO MATURITY							
Investment Securities:							
State and Political Subdivisions	$396,549	$5,925	$10,922	$391,552	$1,207	$15,376	$377,383
Mortgage-backed Securities:(1)							
Residential	74,129	—	99	74,030	3,923	—	77,953
Commercial	208,667	—	7,128	201,539	—	7,656	193,883
Total	$679,345	$5,925	$18,149	$667,121	$5,130	$23,032	$649,219

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

During 2013, the Company transferred certain commercial mortgage-backed securities and state and political subdivision securities from available for sale ("AFS") to held to maturity ("HTM"). We transferred these securities due to overall balance sheet strategies, and our management has the current intent and ability to hold these securities until maturity. The net unrealized loss on the transferred securities included in accumulated other comprehensive income at the time of transfer will be amortized over the remaining life of the underlying security as an adjustment of the yield on those securities. There were no securities transferred from AFS to HTM during the three months ended March 31, 2014.

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The following table represents the unrealized loss on securities for the three months ended March 31, 2014 and year ended December 31, 2013 (in thousands):

	As of March 31, 2014					
	Less Than 12 Months		More Than 12 Months		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
AVAILABLE FOR SALE						
Investment Securities:						
U.S. Government Agency Debentures	$—	$—	$10,529	$1,080	$10,529	$1,080
State and Political Subdivisions	119,705	4,635	13,275	647	132,980	5,282
Other Stocks and Bonds	2,992	8	—	—	2,992	8
Mortgage-backed Securities:						
Residential	175,901	2,444	1,051	5	176,952	2,449
Commercial	82,527	2,351	—	—	82,527	2,351
Total	$381,125	$9,438	$24,855	$1,732	$405,980	$11,170
HELD TO MATURITY						
Investment Securities:						
State and Political Subdivisions	$275,802	$7,119	$11,046	$253	$286,848	$7,372
Mortgage-backed Securities:						
Commercial	110,240	4,810	—	—	110,240	4,810
Total	$386,042	$11,929	$11,046	$253	$397,088	$12,182

	As of December 31, 2013					
	Less Than 12 Months		More Than 12 Months		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
AVAILABLE FOR SALE						
Investment Securities:						
U.S. Government Agency Debentures	$—	$—	$10,129	$1,483	$10,129	$1,483
State and Political Subdivisions	191,117	11,757	18,408	1,118	209,525	12,875
Other Stocks and Bonds	2,992	7	—	—	2,992	7
Mortgage-backed Securities:						
Residential	126,965	3,266	1,351	7	128,316	3,273
Commercial	65,406	3,309	—	—	65,406	3,309
Total	$386,480	$18,339	$29,888	$2,608	$416,368	$20,947
HELD TO MATURITY						
Investment Securities:						
State and Political Subdivisions	$283,667	$15,311	$1,705	$65	$285,372	$15,376
Mortgage-backed Securities:						
Commercial	193,883	7,656	—	—	193,883	7,656
Total	$477,550	$22,967	$1,705	$65	$479,255	$23,032

We review securities in an unrealized loss position to evaluate if a classification of other-than-temporarily impaired is warranted. In estimating other-than-temporary impairment losses, management considers, among other things, the length of time and the extent to which the fair value has been less than cost and the financial condition and near-term prospects of the issuer. The Company considers an other-than-temporary impairment to have occurred when there is an adverse change in expected cash flows. When it is determined that a decline in fair value of HTM and AFS securities is other-

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than-temporary, the carrying value of the security is reduced to its estimated fair value, with a corresponding charge to earnings for the credit portion and to other comprehensive income for the noncredit portion.

The majority of the unrealized loss positions are comprised of highly rated municipal securities and U.S. Agency mortgage- backed securities ("MBS") where the unrealized loss is a direct result of the change in interest rates and spreads. Based upon the length of time and the extent to which fair value is less than cost, we believe the securities with an unrealized loss in accumulated other comprehensive income ("AOCI") are not other-than-temporarily impaired at March 31, 2014.

Prior to December 31, 2013, we held pooled trust preferred securities ("TRUPs"). The turmoil in the capital markets had a significant impact on our estimate of fair value of our TRUPs. These TRUPs were structured products with cash flows dependent upon securities issued by U.S. financial institutions, including banks and insurance companies. Given the facts and circumstances associated with the TRUPs, we reviewed the financial condition of each of the underlying issuing banks within the TRUP collateral pool that had not deferred and defaulted and we performed detailed cash flow modeling for each TRUP using an industry-accepted cash flow model. The cash flow model assumptions represented management's best estimate and considered a variety of qualitative factors, which include, among others, the credit rating downgrades, the severity and duration of the mark-to-market loss, and the structural nuances of each security. For the three months ended March 31, 2013, the additional write-down recognized in earnings was approximately $42,000.

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

	Three Months Ended March 31, 2013
Balance, beginning of period	$3,256
Additions for credit losses recognized on debt securities that had previously incurred impairment losses	42
Balance, end of period	$3,298

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

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

	Three Months Ended March 31,	
	2014	2013
U.S. Treasury	$—	$17
U.S. Government Agency Debentures	59	212
State and Political Subdivisions	5,970	4,578
Other Stocks and Bonds	52	45
Mortgage-backed Securities	7,682	3,936
Total interest income on securities	$13,763	$8,788

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Of the approximately $11,000 in net securities gains from the AFS portfolio for the three months ended March 31, 2014, there were $2.9 million in realized gains and $2.9 million in realized losses. Of the $4.3 million in net securities gains from the AFS portfolio for the three months ended March 31, 2013, there were $5.5 million in realized gains and approximately $1.2 million in realized losses. There were no sales from the HTM portfolio during the three months ended March 31, 2014 or 2013.

The amortized cost, carrying value and fair value of securities at March 31, 2014, are presented below by contractual maturity. Expected maturities may differ from contractual maturities because issuers may have the right to call or prepay obligations. MBS are presented in total by category due to the fact that MBS typically are issued with stated principal amounts, and the securities are backed by pools of mortgages that have loans with varying maturities. The characteristics of the underlying pool of mortgages, such as fixed-rate or adjustable-rate, as well as prepayment risk, are passed on to the security holder. The term of a mortgage-backed pass-through security thus approximates the term of the underlying mortgages and can vary significantly due to prepayments.

	March 31, 2014	
	Amortized Cost	Fair Value
AVAILABLE FOR SALE	(in thousands)	
Investment Securities:		
Due in one year or less	$3,292	$3,356
Due after one year through five years	18,421	18,915
Due after five years through ten years	25,743	25,228
Due after ten years	213,658	212,163
	261,114	259,662
Mortgage-backed Securities:	904,689	915,061
Total	$1,165,803	$1,174,723

	March 31, 2014	
	Carrying Value	Fair Value
HELD TO MATURITY	(in thousands)	
Investment Securities:		
Due in one year or less	$—	$—
Due after one year through five years	329	329
Due after five years through ten years	17,591	17,307
Due after ten years	372,969	370,267
	390,889	387,903
Mortgage-backed Securities:	265,627	266,006
Total	$656,516	$653,909

Investment and MBS with book values of $1.10 billion and $1.14 billion were pledged as of March 31, 2014 and December 31, 2013, respectively, to collateralize Federal Home Loan Bank (“FHLB”) advances, repurchase agreements, and public funds or for other purposes as required by law.

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

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5. Loans and Allowance for Probable Loan Losses

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

	March 31, 2014	December 31, 2013
Real Estate Loans:		
Construction	$135,237	$125,219
1-4 Family Residential	395,809	390,499
Other	272,868	262,536
Commercial Loans	154,524	157,655
Municipal Loans	240,114	245,550
Loans to Individuals	171,841	169,814
Total Loans	1,370,393	1,351,273
Less: Allowance for Loan Losses	18,787	18,877
Net Loans	$1,351,606	$1,332,396

Real Estate Construction Loans

Our construction loans are collateralized by property located primarily in the market areas we serve. A majority of our construction loans will be owner-occupied. Construction loans for speculative projects are financed, but these typically have secondary sources of repayment and collateral. Our construction loans have both adjustable and fixed interest rates during the construction period. Construction loans to individuals are typically priced and made with the intention of granting the permanent loan on the property. Speculative and commercial construction loans are subject to underwriting standards similar to that of the commercial portfolio. Owner occupied 1-4 family residential construction loans are subject to the underwriting standards of the permanent loan.

Real Estate 1-4 Family Residential Loans

Residential loan originations are generated by our loan officers, in-house origination staff, marketing efforts, present customers, walk-in customers and referrals from real estate agents and builders. We focus our lending efforts primarily on the origination of loans secured by first mortgages on owner-occupied, 1-4 family residences. Substantially all of our 1-4 family residential loan originations are secured by properties located in or near our market areas.

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

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

Other Real Estate

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

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Commercial Loans

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

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

Municipal Loans

We have a specific lending department that makes loans to municipalities and school districts throughout the state of Texas. The majority of the loans to municipalities and school districts have tax or revenue pledges and in some cases are additionally supported by collateral. Municipal loans made without a direct pledge of taxes or revenues are usually made based on some type of collateral that represents an essential service.

Loans to Individuals

Substantially all originations of our loans to individuals are made to consumers in our market areas. The majority of loans to individuals are collateralized by titled equipment, which are primarily automobiles. Loan pools purchased through SFG are subjected to a modeling system that takes into consideration credit scores and estimated collateral values to determine expected defaults in each pool. SFG purchased loan pools of approximately $20.8 million and $21.8 million, net of discount, during the three months ended March 31, 2014 and March 31, 2013, respectively. Consumer loan terms vary according to the type and value of collateral, length of contract and creditworthiness of the borrower. The underwriting standards we employ for consumer loans include an application, a determination of the applicant's payment history on other debts, with the greatest weight being given to payment history with us, and an assessment of the borrower's ability to meet existing obligations and payments on the proposed loan. Although creditworthiness of the applicant is a primary consideration, the underwriting process also includes a comparison of the value of the collateral, if any, in relation to the proposed loan amount. Most of our loans to individuals are collateralized, which management believes should assist in limiting our exposure.

Allowance for Loan Losses

The allowance for loan losses is based on the most current review of the loan portfolio and is a result of multiple processes. First, the bank utilizes historical data to establish general reserve amounts for each class of loans. The historical charge off figure is further adjusted through qualitative factors that include general trends in past dues, nonaccruals and classified loans to more effectively and promptly react to both positive and negative movements. Second, our lenders have the primary responsibility for identifying problem loans and estimating necessary reserves based on customer financial stress and underlying collateral. These recommendations are reviewed by senior loan administration, the Special Assets department, and the Loan Review department. Third, the Loan Review department independently reviews the portfolio on an annual basis. The Loan Review department follows a board-approved annual loan review scope. The loan review scope encompasses a number of considerations including the size of the loan, the type of credit extended, the seasoning of the loan and the performance of the loan. The Loan Review scope, as it relates to size, focuses more on larger dollar loan relationships, typically, for example, aggregate debt of $500,000 or greater. The Loan Review officer also reviews specific reserves compared to general reserves to determine trends in comparative reserves as well as losses not reserved for prior to charge-off to determine the effectiveness of the specific reserve process.

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

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a probability that the entire balance of the loan will be uncollectible. If full collection of the loan balance appears unlikely at the time of review, estimates of future expected cash flows or appraisals of the collateral securing the debt are used to determine the necessary allowances. The internal loan review department maintains a list of all loans or loan relationships that are graded as having more than the normal degree of risk associated with them. In addition, a list of specifically reserved loans or loan relationships of $50,000 or more is updated on a quarterly basis in order to properly determine necessary allowances and keep management informed on the status of attempts to correct the deficiencies noted with respect to the loan.

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

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

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

Credit Quality Indicators

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

- Pass (Rating 1 – 4) – This rating is assigned to all satisfactory loans. This category, by definition, consists of acceptable credit. Credit and collateral exceptions should not be present, although their presence would not necessarily prohibit a loan from being rated Pass, if deficiencies are in process of correction. These loans are not included in the Watch List.
- Pass Watch (Rating 5) – Special Treatment Required – These loans require some degree of special treatment, but not due to credit quality. This category does not include loans specially mentioned or adversely classified by Loan Review; however, particular attention must be accorded such credits due to characteristics such as:
- A lack of, or abnormally extended payment, program;
- A heavy degree of concentration of collateral without sufficient margin;
- A vulnerability to competition through lesser or extensive financial leverage; and
-

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

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- Special Mention (Rating 6) – A Special Mention asset has potential weaknesses that deserve management’s close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the asset or in the institution’s credit position at some future date. Special Mention assets are not adversely classified and do not expose an institution to sufficient risk to warrant adverse classification.
- Substandard (Rating 7) – Substandard loans are inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Loans so classified must have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the Bank will sustain some loss if the deficiencies are not corrected.
- Doubtful (Rating 8) – Loans classified as Doubtful have all the weaknesses inherent in those classified Substandard with the added characteristic that the weaknesses make collection or liquidation, in full, on the basis of currently known facts, conditions and values, highly questionable and improbable.

Loans that are accruing and not considered troubled debt restructurings ("TDR") are reserved for as a group of similar type credits and included in the general portion of the allowance for loan losses.

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

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

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

	Three Months Ended March 31, 2014							
	Real Estate							
	Construction	1-4 Family Residential	Other	Commercial Loans	Municipal Loans	Loans to Individuals	Unallocated	Total
Balance at beginning of period	$2,142	$3,277	$2,572	$1,970	$668	$8,248	$—	$18,877
Provision (reversal) for loan losses	(10)	536	(164)	3	109	3,659	—	4,133
Loans charged off	(14)	(22)	—	—	—	(4,732)	—	(4,768)
Recoveries of loans charged off	12	6	3	58	—	466	—	545
Balance at end of period	$2,130	$3,797	$2,411	$2,031	$777	$7,641	$—	$18,787

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	Three Months Ended March 31, 2013							
	Real Estate							
	Construction	1-4 Family Residential	Other	Commercial Loans	Municipal Loans	Loans to Individuals	Unallocated	Total
Balance at beginning of period	$2,355	$3,545	$2,290	$3,158	$633	$7,373	$1,231	$20,585
Provision (reversal) for loan losses	(125)	167	(247)	(290)	(12)	1,344	(345)	492
Loans charged off	—	(228)	(46)	(71)	—	(2,807)	—	(3,152)
Recoveries of loans charged off	17	4	5	50	—	541	—	617
Balance at end of period	$2,247	$3,488	$2,002	$2,847	$621	$6,451	$886	$18,542

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

As of March 31, 2014					
Real Estate					
Construction	1-4 Family Residential	Other	Commercial Loans	Municipal Loans	Loans to Individuals