

SOUTHSIDE BANCSHARES INC
Form 10-K
March 02, 2007

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

Form 10-K

(Mark One)

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

For the fiscal year ended December 31, 2006

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
COMMON STOCK, \$1.25 PAR VALUE

Name of each exchange on which registered
NASDAQ Global Select Market

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

NONE

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.
YES ☐ NO ☒

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

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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 30, 2006 was \$224,153,130.

As of February 15, 2007, 12,357,516 shares of common stock of Southside Bancshares, Inc. were outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Registrant's Proxy Statement to be filed for the Annual Meeting of Shareholders to be held April 19, 2007 are incorporated by reference into Part III of this Annual Report on Form 10-K.

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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. Tyler has a metropolitan area population of approximately 191,000 and is located approximately 90 miles east of Dallas, Texas and 90 miles west of Shreveport, Louisiana. We have the largest deposit base in the Tyler metropolitan area and are the largest bank based on asset size headquartered in East Texas.

At December 31, 2006, our total assets were \$1.89 billion, total loans were \$759.1 million, deposits were \$1.28 billion, and shareholders’ equity was \$110.6 million. Our net income was \$15.0 million and \$14.6 million and fully diluted earnings per common share were \$1.18 and \$1.15 for the years ended December 31, 2006 and 2005, 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 second quarter ended June 30, 2005, we embarked upon a new regional lending initiative. The goal of this initiative is to expand the regions in which we lend. During 2006, we made progress identifying market areas and relationship managers were hired. Management is continuing to identify market areas to target and relationship managers to service those regions.

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, 2006, our trust department managed approximately \$564 million of trust assets. During the first six months of 2006, we sold our interest in BSC Securities, LC. After the sale, we began offering full retail investment services to our customers utilizing the services of Raymond James Financial Services, Inc.

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

Our administrative offices are located at 1201 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.

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MARKET AREA

We consider our primary market area to be all of Smith, Gregg, Cherokee, Anderson, Kaufman and Henderson Counties in East Texas, and to a lesser extent, portions of adjoining counties. During 2006, we opened a traditional branch in Gun Barrel City and a full service grocery store branch in Athens, both in Henderson County, as well as a loan production office in Forney, in Kaufman County approximately 20 miles east of Dallas. During the second quarter of 2007, we will open 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 the Gregg, Cherokee, Anderson, Kaufman, and Henderson County market areas 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 area 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 and Longview are home to several nationally recognized health care systems that represent all major specialties.

We serve our markets through 27 branch locations, 16 of which are located in grocery stores. The branches are located in and around Tyler, Longview, Lindale, Gresham, Jacksonville, Bullard, Chandler, Seven Points, Palestine, Forney, Gun Barrel City, Athens and Whitehouse. Our television and radio advertising has extended into most of these 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.

We also maintain seven motor bank facilities. Our customers may also access various banking services through our 40 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 East 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 East Texas economy. During 2006, the economy in our market appeared to reflect continued stable growth. We cannot predict whether current economic conditions will improve, remain the same or decline.

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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 2006, the number of financial institutions in our market area 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. Additionally, we must compete against several institutions located in Texas and elsewhere in our market area which have capital resources 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 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, 2007, we employed approximately 460 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, 2006, were as follows:

B. G. Hartley (Age 77), 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 59), President, Secretary and Director of Southside Bancshares, Inc. since 1998. He also serves 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 74), Vice Chairman of the Board of Southside Bancshares, Inc. and Southside Bank since 1998. He joined Southside Bank as a vice president in 1968.

Jeryl Story (Age 55), 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 50), 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.

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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 and Texas state-chartered banks, these authorities include, but are not limited to, the Federal Reserve, the FDIC, the TDB, United States Department of Treasury (the “Treasury Department”), the Internal Revenue Service and state taxing authorities.

The primary goals of the bank regulatory scheme 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 funds, our depositors and the public, rather than our shareholders and creditors. The following summarizes some of the 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 (collectively, the “Holding Companies”) are registered with and subject to regulation by the Federal Reserve. The Holding Companies are both required to file quarterly and other reports with, and furnish information to, the Federal Reserve, which makes periodic inspections of the Holding Companies.

The BHCA provides that a bank holding company must obtain the prior approval of the Federal Reserve (i) for the acquisition of more than five percent of the voting stock in any bank or bank holding company, (ii) for the acquisition of substantially all the assets of any bank or bank holding company or (iii) in order to merge or consolidate with another bank holding company. 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 engaged in businesses that are closely related to banking or 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 BHCA 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 of 1999 (“GLBA”), which became effective on March 11, 2000, amended the BHCA 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.

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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 some 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. Neither Southside Bancshares, Inc. nor Southside Delaware Financial Corporation have elected to become a financial holding company. However, there can be no assurance that we will not make such an election in the future.

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. 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. 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 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 Southside Bank 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 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.

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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, both the Federal Reserve 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 Southside Bank as of December 31, 2006, are shown in the following table.

Capital Adequacy Ratios of Southside Bancshares, Inc. and Southside Bank				
	Regulatory Minimums	Regulatory Minimums to be Well- Capitalized	Southside Bancshares, Inc.	Southside Bank
Risk-based capital ratios:				
Tier 1 Capital (1)	4.0%	6.0%	16.93%	16.26%
Total risk-based capital (2)	8.0	10.0	17.76	17.09
Tier 1 leverage ratio (3)	4.0	5.0	7.68	7.37

(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 loan 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.

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The federal banking agencies, including the Federal Reserve and the FDIC, are required to take “prompt corrective action” in respect of depository institutions and their bank holding companies 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. Southside Bancshares, Inc. and Southside Bank are classified as “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. As a result, a bank holding company may be required to loan money 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.

The regulators are considering modifications to the current regulatory capital guidelines. It is unclear when or if such modifications will be adopted or what the impact on us of such modifications might be.

Dividends. As bank holding companies that do not, as entities, 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 Southside Bank. We must pay essentially all of our operating expenses from funds we receive from Southside Bank. Therefore, shareholders may receive dividends from us only to the extent that funds are available after payment of our operating expenses. 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 controls at least 25% of the voting securities or the power to direct management or policies of the bank holding company. 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 the voting securities.

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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 or immunize the acquisition from future challenge under the anti-monopolization provisions of the Sherman Act.

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 \$1.0 million 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 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.

Deposit Insurance. Our deposits are insured up to \$100,000 per depositor 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 on an annualized basis per \$100 in assessable deposits for the institutions the FDIC perceives to pose the least threat to the Deposit Insurance Fund, and 43 basis points for the highest risk institutions. In 2006, the range was from 0 basis points to 27 basis points. In addition to the insurance assessment, each insured bank is subject to an assessment on deposits to service debt issued by the Financing Corporation, a federal agency established to finance the recapitalization of the former Federal Savings and Loan Insurance Corporation. Our deposit 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.

FDIC Regulation. 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 a branch office facility thereof. FDIC supervision and regulation 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 Southside

Bank) 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.

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Activities and Investments of Insured State-Chartered Banks. 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. A state nonmember bank may seek FDIC approval to engage in activities that are not permissible for a national bank.

Loans-to-One-Borrower. The aggregate amount of loans that Southside Bank will be permitted to make under applicable FDIC regulations to any one borrower, including related entities, is the greater of 25% of unimpaired capital and certified surplus or \$500,000. Southside Bank's unimpaired capital and certified surplus at December 31, 2006 was \$100 million and the aggregate amount of loans that Southside Bank is permitted to make to any one borrower, including related entities, is \$25 million.

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 Southside Bank that furnish or receive information from consumer reporting agencies. The new duties relate primarily to situations in which a consumer could become the victim of an identity theft. The Federal Trade Commission, the Federal Reserve, the FDIC and other federal agencies are still in the process of developing regulations implementing the FACTA provisions.

Brokered Deposits. 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 BHCA 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 on the condition that (i) the customer obtain or provide some additional credit, property, or services from or to the bank, the bank holding company or subsidiaries thereof or (ii) the customer 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 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 Southside Bancshares, Inc., the sole indirect shareholder of Southside Bank, through Southside Delaware Financial Corporation. Our general dividend policy is to pay dividends at levels consistent with maintaining liquidity and preserving applicable capital ratios and servicing obligations. The dividend policy of Southside Bank is subject to the discretion of the board of directors of Southside Bank 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.

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

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

In addition, FDIC regulations generally prohibits an FDIC-insured depository institution 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, as well as to potentially onerous conditions under the prompt corrective action regime, described above.

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 and the FDIC will examine Southside Bank periodically for compliance with various regulatory requirements. Such examinations, however, are for the protection of the Deposit Insurance Fund 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 Southside Bank and its other subsidiaries. Various legal limitations restrict Southside Bank from lending or otherwise supplying funds to the Holding Companies or their non-bank subsidiaries. The Holding Companies and Southside Bank 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 aggregate 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. 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, Southside Bank is restricted in the loans that it may make to its 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.

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Standards for Safety and Soundness. The federal banking agencies have adopted regulations and Interagency Guidelines Prescribing Standards for Safety and Soundness (“Guidelines”) that set forth standards for internal controls and information systems, internal audit, loan documentation, credit underwriting, interest exposure, asset growth, asset quality, earnings, and compensation, fees, and benefits. The Guidelines set forth the safety and soundness standards that the federal banking agencies use to identify and address problems at insured depository institutions before capital becomes impaired. Under the regulations, if the FDIC determines that a bank fails to meet any standards prescribed by the Guidelines, the agency may require the bank to submit to the agency an acceptable plan to achieve compliance with the standard, as required by the FDIC. 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 (“CRA”), 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 CRA 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 require that a bank be rated based on its actual performance in meeting community credit needs. On a periodic basis, the FDIC is charged with preparing a written evaluation of our record of meeting the credit needs of the entire community and assigning a rating. 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” CRA rating may be used as the basis to deny an application to conduct certain business activities or to engage in transactions with other financial institutions. In addition, as discussed above, a bank holding company may not become a financial holding company unless each of its subsidiary banks has a CRA rating of at least satisfactory. We were last examined for compliance with the CRA on April 26, 2004 and received a rating of “outstanding.”

USA PATRIOT Act. 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 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.

Privacy. The Gramm-Leach Bliley 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. Southside Bank is subject to such standards, as well as standards for notifying consumers in the event of a security breach.

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.

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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.

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 is the appropriate regulatory agency for Southside 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.

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.

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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 "The 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.

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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.

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

We implemented a leverage strategy in 1998 for the purpose of enhancing overall profitability by maximizing the use of our capital. Risks to our leverage strategy include 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 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, 2006, approximately 59.0% of our loans have real estate as a primary or secondary component of collateral. The real estate in each case provides an alternate source of repayment in the event of default by the borrower and may deteriorate in value during the time the credit is extended. 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 ability to sell the collateral upon foreclosure. Furthermore, it is likely that, in a decreasing real estate market, we would be required to 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 could also be adversely impacted.

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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. In doing so, 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 and Gun Barrel City. 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.

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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 and continued consolidation. 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 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 13 - 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.

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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 or offer new products and services within existing lines 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 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 is unable to pay dividends to Southside Bancshares, Inc., Southside Bancshares, Inc. may not be able to service debt, pay obligations or pay dividends on common stock. The inability to receive dividends from Southside Bank could have a material adverse effect on Southside Bancshares, Inc.'s business, financial condition and results of operations. See the section captioned "Supervision and Regulation" in "Item 1. Business" and "Note 13 - Shareholders' Equity" in the notes to consolidated financial statements included in "Item 8. Financial Statements and Supplementary Data," which are located elsewhere in this report.

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. Our junior subordinated debentures mature in September 2033.

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.

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Potential acquisitions may disrupt our business and dilute stockholder value.

While we have never made an 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.

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. We do not currently have employment agreements or non-competition agreements with any of our senior officers.

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.

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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, 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 SOUTHSIDE BANCSHARES, INC. 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;

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- 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 such that 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 Board 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.

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RISKS ASSOCIATED WITH SOUTHSIDE BANCSHARES, INC.'S 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

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

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Southside Bank currently operates full service banks in leased space in 16 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;
- three in Longview, Texas;
- five in Tyler, Texas;
- Gresham loan production office at 16637 FM 2493, Tyler, Texas; and
- Forney loan production office at 413 North McGraw, Forney, 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, 2006, 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.

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PART II

ITEM MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND
5. 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, 2005 to December 31, 2006. During the first quarter of 2005 and 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, 2006	\$	20.75 - 19.13	\$	22.57 - 19.03	\$	26.82 - 22.67	\$	27.49 - 24.61
December 31, 2005	\$	21.12 - 19.03	\$	20.00 - 17.97	\$	20.69 - 18.12	\$	20.04 - 16.81

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, 2007.

DIVIDENDS

Cash dividends declared and paid were \$0.47 and \$0.46 per share for the years ended December 31, 2006 and 2005, respectively. Stock dividends of 5% were also declared and paid during each of the years ended December 31, 2006, 2005 and 2004. 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

Year Ended	1st Quarter		2nd Quarter		3rd Quarter		4th Quarter	
December 31, 2006	\$	0.11	\$	0.11	\$	0.11	\$	0.14
December 31, 2005	\$	0.11	\$	0.11	\$	0.11	\$	0.13

STOCK-BASED COMPENSATION PLANS

Information regarding stock-based compensation awards outstanding and available for future grants as of December 31, 2006, 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 12 — Employee Benefits 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 2006, we did not approve any additional funding for our stock repurchase plan. No common stock was purchased during the fourth quarter or twelve months ended December 31, 2006.

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FINANCIAL PERFORMANCE

The following performance graph does not constitute soliciting material and should not be deemed filed 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 Company specifically incorporates the performance graph by reference therein.

Southside Bancshares, Inc.

<i>Index</i>	<i>Period Ending</i>					
	12/31/01	12/31/02	12/31/03	12/31/04	12/31/05	12/31/06
Southside Bancshares, Inc.	100.00	126.66	169.59	224.65	213.21	291.16
Russell 2000	100.00	79.52	117.09	138.55	144.86	171.47
Southside Bancshares Peer Group*	100.00	114.30	157.02	183.04	192.93	213.66

*Southside Bancshares Peer Group contains the following Texas banks: Cullen/Frost Bancshares, Inc., First Financial Bankshares, Inc., Guaranty Bancshares, 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
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www.snl.com

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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, 2006. 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.

	2006	As of and For the Years Ended December 31,				2002				
		2005	2004	2003						
		(in thousands, except per share data)								
Balance Sheet Data:										
Investment Securities	\$	100,303	\$	121,240	\$	133,535	\$	144,876	\$	151,509
Mortgage-backed and Related Securities	\$	869,326	\$	821,756	\$	720,533	\$	590,963	\$	489,015
Loans, Net of Allowance for Loan Losses	\$	751,954	\$	673,274	\$	617,077	\$	582,721	\$	564,265
Total Assets	\$	1,890,976	\$	1,783,462	\$	1,619,643	\$	1,454,952	\$	1,349,186
Deposits	\$	1,282,475	\$	1,110,813	\$	940,986	\$	872,529	\$	814,486
Long-term Obligations	\$	149,998	\$	229,032	\$	351,287	\$	272,694	\$	265,365
Income Statement Data:										
Interest & Deposit Service Income	\$	112,434	\$	94,275	\$	80,793	\$	73,958	\$	79,959
Net Income	\$	15,002	\$	14,592	\$	16,099	\$	13,564	\$	13,325
Per Share Data:										
Net Income Per Common Share:										
Basic	\$	1.22	\$	1.21	\$	1.33	\$	1.30	\$	1.32
Diluted	\$	1.18	\$	1.15	\$	1.26	\$	1.10	\$	1.10
Cash Dividends Paid Per Common Share	\$	0.47	\$	0.46	\$	0.42	\$	0.36	\$	0.33

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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, 2006, 2005, and 2004 and financial condition as of December 31, 2006 and 2005. 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 declared and paid.

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 or regulatory changes that adversely affect the businesses in which we are engaged;
- adverse changes in Government Sponsored Enterprises (the "GSE") status or financial condition impacting the GSE 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 which 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; and
 - the costs and effects of unanticipated litigation.

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.

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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. This list for 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, 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.

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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.

Defined Benefit Pension Plan. The plan obligations and related assets of the defined benefit pension plan (the “Plan”) are presented in “Note 12 - 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, 2006. 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, 2006, the weighted-average actuarial assumptions of the Plan were: a discount rate of 6.05%; a long-term rate of return on plan assets of 7.875%; 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.

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.

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OVERVIEW

OPERATING RESULTS

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 increased \$0.03, or 2.6% to \$1.18, for the year ended December 31, 2006, from \$1.15 for the same period in 2005.

During the year ended December 31, 2005, our net income decreased \$1.5 million, or 9.4%, to \$14.6 million, from \$16.1 million for the same period in 2004. The decrease in net income was primarily attributable to the decrease in gains on sale of AFS securities. Noninterest expense also increased due primarily to increases in salaries and employee benefits due to normal payroll increases, staff increases due to branch expansion and the new regional lending initiative, and higher benefit costs. Earnings per fully diluted share were \$1.15 and \$1.26, respectively, for the years ended December 31, 2005 and 2004.

FINANCIAL CONDITION

Our total assets increased \$107.5 million, or 6.0%, to \$1.89 billion at December 31, 2006 from \$1.78 billion at December 31, 2005. The increase was primarily attributable to a \$78.7 million increase in our net loans and a \$23.5 million increase in our securities portfolio. At December 31, 2006, net loans were \$752.0 million compared to \$673.3 million at December 31, 2005. The securities portfolio totaled \$996.1 million at December 31, 2006 compared to \$972.6 million at December 31, 2005. Our increase in loans and securities was funded by increases in deposits.

Our nonperforming assets at December 31, 2006 decreased to \$2.1 million, and represented 0.11% of total assets, compared to \$3.1 million, or 0.17%, of total assets at December 31, 2005. Nonaccruing loans decreased to \$1.3 million and the ratio of nonaccruing loans to total loans decreased to 0.18% at December 31, 2006 as compared to \$1.7 million and 0.25% at December 31, 2005. Approximately \$560,000 of the nonaccrual loans at December 31, 2006, are loans that have an average SBA guarantee of 75% to 85%. OREO increased to \$351,000 at December 31, 2006 from \$145,000 at December 31, 2005. Loans 90 days past due at December 31, 2006 decreased to \$128,000 compared to \$945,000 at December 31, 2005. Repossessed assets increased to \$78,000 at December 31, 2006 from \$10,000 at December 31, 2005. Restructured loans at December 31, 2006 decreased slightly to \$220,000 compared to \$226,000 at December 31, 2005.

Our deposits increased \$171.7 million to \$1.28 billion at December 31, 2006 from \$1.11 billion at December 31, 2005. During 2006, we issued additional callable brokered CDs, where we control the call, which represented approximately \$104 million of the increase in our deposits. The remaining \$67.8 million increase was primarily due to branch expansion and increased market penetration. Due to the increase in deposits during 2006, FHLB advances decreased \$69.1 million to \$451.6 million at December 31, 2006, from \$520.7 million at December 31, 2005. Short-term FHLB advances increased \$10.0 million to \$322.2 million at December 31, 2006 from \$312.3 million at December 31, 2005. Long-term FHLB advances decreased \$79.0 million to \$129.4 million at December 31, 2006 from \$208.4 million at December 31, 2005. Other borrowings at December 31, 2006 and 2005 totaled \$27.9 million and \$25.2 million, respectively, and at December 31, 2006 consisted of \$7.3 million of short-term borrowings and \$20.6 million of long-term debt.

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Shareholders' equity at December 31, 2006 totaled \$110.6 million compared to \$109.3 million at December 31, 2005. The increase primarily reflects the net income recorded for the year ended December 31, 2006, and the increase in the common stock issued of \$1.8 million as a result of our incentive stock option and dividend reinvestment plans. These increases more than offset an increase in the accumulated other comprehensive loss of \$10.0 million and the payment of cash dividends to our shareholders of \$5.7 million. The increase in accumulated other comprehensive loss is composed of an increase of \$8.1 million, net of tax, related to the change in the unfunded status of our defined benefit plan and a \$1.9 million, net of tax, unrealized loss on securities, net of reclassification adjustment. See "Note 3 - Comprehensive Income (Loss)" to our consolidated financial statements.

During 2006 the economy in our market area appeared to reflect continued stable growth. 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, when determined appropriate, issuing brokered CDs. These funds are invested primarily in mortgage-backed securities, and to a lesser extent, long-term municipal securities. Although 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 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 2005, the overnight Fed Funds rate increased significantly while interest rates on long-term, two to ten year U.S. Treasury notes increased less, creating a relatively flat yield curve at the end of 2005. During 2006, the interest rate yield curve inverted. An inverted yield curve is defined as shorter term interest rates at a higher level than longer term interest rates. The Federal Reserve increased the overnight Fed Funds rate by 100 basis points during 2006. Despite that increase, during 2006, the yield on the two year treasury notes only increased 41 basis points and the yield on the 10 year treasury notes only increased 31 basis points. During the second half of 2006, the inversion in the yield curve became more pronounced as the overnight Fed Funds rate did not change while the yield on the two year treasury notes decreased 34 basis points and the yield on the ten year treasury notes decreased 43 basis points. Should the inverted yield curve continue or should the yield curve invert more, our net interest margin and spread could continue to decrease. Our asset structure, net interest spread and net interest margin requires 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.

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In conjunction with the leverage strategy, we will attempt to manage the securities portfolio as a percentage of earning assets in combination with adequate quality loan growth. 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 adjust the level of securities through proceeds from maturities, principal payments on mortgage-backed securities or sales. During the year ended December 31, 2006, our loan growth was sufficient to allow the securities portfolio as a percentage of total assets to decrease. At December 31, 2006, the securities portfolio as a percentage of total assets decreased to 52.7% from 54.5% at December 31, 2005. Due to the current interest rate environment, we anticipate we will continue to reduce the securities portfolio during the first quarter of 2007, by reinvesting only a portion of cash flows received. Should the interest rate environment cause the overall economics associated with reinvesting to deteriorate, we might accelerate the pace at which we reduce the securities portfolio and thereby the leverage. During the fourth quarter of 2006, we reduced our investment and mortgage-backed securities approximately \$8.9 million as investment and mortgage-backed securities not including the net unrealized loss on available securities decreased from \$985.2 million at September 30, 2006 to \$976.3 million at December 31, 2006. The \$976.3 million at December 31, 2006 included \$13.9 million of short-term U. S. Treasury securities and GSE debentures we were required to purchase to collateralize year-end public funds deposits. We do not consider this to be a part of our core securities portfolio as this increase is temporary and will last less than three months. Subtracting the \$13.9 million temporary increase in securities from the December 31, 2006 total of \$976.3 million, during the fourth quarter our core investment and mortgage-backed securities portfolio decreased approximately \$22.8 million. Our treasury strategy will be reevaluated as market conditions warrant. The leverage strategy is dynamic and requires ongoing management. As interest rates, yield curves, mortgage-backed securities prepayments, funding costs and security spreads change, our determination of the proper types and maturities of securities to own, proper amount of securities to own and funding needs and funding sources will continue to be reevaluated.

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 objectives of the ALCO. Our FHLB borrowings at December 31, 2006, decreased 13.3%, or \$69.1 million, to \$451.6 million from \$520.7 million at December 31, 2005. During the year ended December 31, 2006, we issued an additional \$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, our total callable brokered CDs were \$123.5 million. These brokered CDs have maturities from 1.7 to 5.0 years and have calls that we control, all of which are currently six months or less. We are currently utilizing long-term brokered CDs to a greater extent than long-term FHLB funding because the brokered CDs better match overall ALCO objectives by utilizing a long-term funding vehicle that assists in protecting Southside Bank should interest rates increase, but provides 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. The FHLB funding and the brokered CDs represent our wholesale funding sources. Due to the dollar amount of brokered CDs issued during the year ended December 31, 2006 and the fact that the increase in brokered CDs exceeded non-brokered deposit growth, our total wholesale funding as a percentage of deposits, not including brokered CDs, increased slightly to 49.6% at December 31, 2006, from 49.5% at December 31, 2005.

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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, 2006 COMPARED TO
DECEMBER 31, 2005

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 mix changes in interest earning assets and interest bearing liabilities, materially impact 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%, as a result of an increase in average interest earning assets of \$162.3 million, or 10.2%, 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%.

Net interest income increased during 2006 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. Future changes in interest rates could impact prepayment speeds on our mortgage-backed securities, which could influence our net interest margin and spread during the coming quarters.

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During the year ended December 31, 2006, average loans, funded by the growth in average deposits, increased \$64.3 million, or 9.8%, 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 are increasing has been partially impacted by repricing characteristics of the loans, interest rates at the time the loans repriced, and the competitive loan pricing environment. Due to the competitive loan pricing environment, we anticipate that we may be required to continue to offer lower interest rate loans that compete with those offered by other financial institutions in order to retain quality loan relationships. Offering lower interest rate loans could impact the overall loan yield and, therefore profitability. 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%, 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 with a previous restructuring of the securities portfolio reduced overall amortization expense which contributed to the increase in interest income. 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 \$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%, 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 less loan growth when compared to the growth in securities. 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%, 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.

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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. 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%, 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%, 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%, 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 control, all of which are currently 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 match overall ALCO objectives due to the calls we control. 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, 2006, 2005 and 2004:

COMPOSITION OF DEPOSITS

	2006		Years Ended December 31, 2005		2004	
	AVG. BALANCE	AVG. YIELD	AVG. BALANCE	AVG. YIELD	AVG. BALANCE	AVG. YIELD
(dollars in thousands)						
Noninterest Bearing						
Demand Deposits	\$ 314,241	N/A	\$ 280,036	N/A	\$ 246,477	N/A
Interest Bearing						
Demand Deposits	349,375	2.73%	313,815	1.74%	281,452	0.72%
Savings Deposits	50,764	1.27%	50,502	1.04%	48,456	0.48%
Time Deposits	467,174	4.39%	354,360	3.17%	319,083	2.46%
Total Deposits	\$ 1,181,554	2.60%	\$ 998,713	1.72%	\$ 895,468	1.13%

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 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.

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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.

AVERAGE BALANCES AND YIELDS

The following table presents average balance sheet amounts and average yields for the years ended December 31, 2006, 2005 and 2004. 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, 2006			December 31, 2005			December 31, 2004		
AVG.	AVG.		AVG.	AVG.		AVG.	AVG.	
BALANCE	INTEREST	YIELD	BALANCE	INTEREST	YIELD	BALANCE	INTEREST	YIELD

ASSETSINTEREST
EARNING
ASSETS:

Loans(1) (2)	\$ 722,252	\$ 48,397	6.70%	\$ 657,938	\$ 40,927	6.22%	\$ 604,658	\$ 36,921	6.11%
Loans Held For Sale	4,651	246	5.29%	4,469	212	4.74%	3,570	180	5.04%
Securities:									
Inv. Sec.									
(Taxable)(4)	54,171	2,498	4.61%	51,431	1,978	3.85%	45,400	1,072	2.36%
Inv. Sec.									
(Tax-Exempt)(3)(4)	43,931	3,134	7.13%	66,023	4,696	7.11%	75,048	5,333	7.11%
Mortgage-backed									
Sec.(4)	891,015	44,401	4.98%	773,973	34,584	4.47%	643,323	26,845	4.17%
Total Securities	989,117	50,033	5.06%	891,427	41,258	4.63%	763,771	33,250	4.35%
FHLB stock and									
other investments, at									
cost	27,969	1,409	5.04%	28,099	1,032	3.67%	24,309	477	1.96%
Interest Earning									
Deposits	692	35	5.06%	644	24	3.73%	634	8	1.26%
Federal Funds Sold	1,148	57	4.97%	995	30	3.02%	6,886	67	0.97%
Total Interest									
Earning Assets	1,745,829	100,177	5.74%	1,583,572	83,483	5.27%	1,403,828	70,903	5.05%

NONINTEREST
EARNING

ASSETS:

Cash and Due From Banks	42,906	42,280	37,881
Bank Premises and Equipment	33,298	31,504	30,576
Other Assets	42,716	45,625	40,376
Less: Allowance for Loan Losses	(7,231)	(6,945)	(6,597)
Total Assets	\$ 1,857,518	\$ 1,696,036	\$ 1,506,064

- (1) Interest on loans includes fees on loans which are not material in amount.
- (2) Interest income includes taxable-equivalent adjustments of \$2,230, \$2,287 and \$2,216 for the years ended December 31, 2006, 2005 and 2004, respectively.
- (3) Interest income includes taxable-equivalent adjustments of \$995, \$1,515 and \$1,687 for the years ended December 31, 2006, 2005 and 2004, 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, 2006, 2005 and 2004, loans totaling \$1,333, \$1,731 and \$2,248, 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.

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AVERAGE BALANCES AND YIELDS

(dollars in thousands)

Years Ended

December 31, 2006				December 31, 2005				December 31, 2004			
AVG.		AVG.		AVG.		AVG.		AVG.		AVG.	
BALANCE	INTEREST	YIELD		BALANCE	INTEREST	YIELD		BALANCE	INTEREST	YIELD	

LIABILITIES AND SHAREHOLDERS'EQUITY

INTEREST

BEARING

LIABILITIES:

Savings Deposits	\$ 50,764	645	1.27%	\$ 50,502	524	1.04%	\$ 48,456	234	0.48%
Time Deposits	467,174	20,516	4.39%	354,360	11,221	3.17%	319,083	7,847	2.46%
Interest Bearing									
Demand Deposits	349,375	9,529	2.73%	313,815	5,476	1.74%	281,452	2,027	0.72%
Total Interest									
Bearing Deposits	867,313	30,690	3.54%	718,677	17,221	2.40%	648,991	10,108	1.56%
Short-term Interest									
Bearing Liabilities	376,696	16,534	4.39%	282,283	9,892	3.50%	181,779	6,499	3.58%
Long-term Interest									
Bearing									
Liabilities-FHLB	154,983	6,379	4.12%	274,673	10,004	3.64%	293,499	10,076	3.43%
Long-term Debt (5)	20,619	1,681	8.04%	20,619	1,305	6.24%	20,619	923	4.40%
Total Interest									
Bearing Liabilities	1,419,611	55,284	3.89%	1,296,252	38,422	2.96%	1,144,888	27,606	2.41%

NONINTEREST

BEARING

LIABILITIES:

Demand Deposits	314,241			280,036			246,477		
Other Liabilities	12,403			14,649			9,534		
Total Liabilities	1,746,255			1,590,937			1,400,899		

SHAREHOLDERS'

EQUITY

TOTAL

LIABILITIES AND

SHAREHOLDERS'

EQUITY

	\$ 1,857,518			\$ 1,696,036			\$ 1,506,064		
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NET INTEREST

INCOME

NET YIELD ON

AVERAGE

EARNING ASSETS

		2.57%			2.85%			3.08%	
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NET INTEREST

SPREAD

		1.85%			2.31%			2.64%	
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(5) Represents junior subordinated debentures issued by us to Southside Statutory Trust III in connection with the issuance of Southside Statutory Trust III of \$20 million of trust preferred securities.

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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, 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:			
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)

	Years Ended December 31, 2005 Compared to 2004		
	Average Volume	Average Yield	Increase (Decrease)
INTEREST INCOME:			
Loans (1)	\$ 3,304	\$ 702	\$ 4,006
Loans Held For Sale	43	(11)	32
Investment Securities (Taxable)	158	748	906
Investment Securities (Tax Exempt) (1)	(642)	5	(637)
Mortgage-backed Securities	5,738	2,001	7,739
FHLB stock and other investments	84	471	555
Interest Earning Deposits	-	16	16
Federal Funds Sold	(92)	55	(37)
Total Interest Income	8,593	3,987	12,580
INTEREST EXPENSE:			
Savings Deposits	10	280	290
Time Deposits	937	2,437	3,374

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Interest Bearing Demand Deposits	258	3,191	3,449
Short-term Interest Bearing Liabilities	3,524	(131)	3,393
Long-term FHLB Advances	(666)	594	(72)
Long-term Debt	-	382	382
Total Interest Expense	4,063	6,753	10,816
Net Interest Income	\$ 4,530	\$ (2,766)	\$ 1,764

(1) Interest yields on loans and securities which are nontaxable for Federal Income Tax purposes are presented on a taxable equivalent basis.

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

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PROVISION FOR LOAN LOSSES

The provision for loan losses for the year ended December 31, 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 December 31,		Percent Change
	2006	2005	
	(dollars in thousands)		
Deposit services	\$ 15,482	\$ 14,594	6.1%
Gain on sale of 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. Assets under management in our trust department exceeded \$500 million for the first time during 2006 and were approximately \$564 million at December 31, 2006.

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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.

Bank owned life insurance ("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, Mastercard income 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, 2006 2005 (dollars in thousands)		Percent Change
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. While continued expansion has and will continue to impact short-term earnings, we believe the potential long-term benefits should outweigh the short-term expense.

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.

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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%. 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. 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 12- 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. Health insurance costs are rising nationwide and these costs may increase during 2007.

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.

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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. We believe the remaining alternative minimum tax position is realizable in the future and no valuation allowance against the related deferred tax asset is deemed necessary at this time.

COMPARISON OF OPERATING RESULTS FOR THE YEARS ENDED DECEMBER 31, 2005 COMPARED TO
DECEMBER 31, 2004

NET INTEREST INCOME

Net interest income for the year ended December 31, 2005 was \$41.3 million, an increase of \$1.9 million, or 4.7%, compared to the same period in 2004. 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 which more than offset the increase in interest expense on deposits and long and short-term obligations. During the year ended December 31, 2005, total interest income increased \$12.7 million, or 18.9%, as a result of an increase in average interest earning assets of \$179.7 million, or 12.8%, and the increase in average yield on average interest earning assets from 5.05% at December 31, 2004 to 5.27% at December 31, 2005. Total interest expense increased \$10.8 million, or 39.2%, to \$38.4 million during the year ended December 31, 2005 as compared to \$27.6 million during the same period in 2004. The increase was attributable to an increase in the average yield on interest bearing liabilities at December 31, 2005, to 2.96% from 2.41% for the same period in 2004 and an increase in average interest bearing liabilities of \$151.4 million, or 13.2%.

Net interest income increased during 2005 as a result of increases in our average interest earning assets during 2005 when compared to 2004, which more than offset the decrease in our net interest margin and spread during the year ended December 31, 2005 to 2.85% and 2.31%, respectively, when compared to 3.08% and 2.64%, respectively, for the same period in 2004. 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 increased significantly while long-term interest rates increased less. This caused our yield on our interest bearing liabilities to increase faster than the yield on our earning assets.

During the year ended December 31, 2005, average loans, funded by the growth in average deposits, increased \$53.3 million, or 8.8%, compared to the same period in 2004. The average yield on loans increased from 6.11% during the year ended December 31, 2004 to 6.22% during the year ended December 31, 2005. The increase in the yield on loans was due to the overall increase in interest rates. The rate at which loan yields were increasing was 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 \$4.0 million, or 11.4%, was the result of an increase in the

average yield on loans and an increase in average loans.

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Average investment and mortgage-backed securities increased \$127.7 million, or 16.7%, for the year ended December 31, 2005 when compared to the same period in 2004. This increase was primarily funded by an increase in average deposits. The overall yield on average investment and mortgage-backed securities increased to 4.63% during the year ended December 31, 2005 from 4.35% during the same period in 2004, due to decreased prepayment rates on mortgage-backed securities which led to decreased amortization expense. The higher overall interest rate environment during 2005 when compared to 2004, contributed to a decrease in residential mortgage refinancing nationwide and in our market area. This decrease in prepayments on mortgage loans combined with a restructuring of the securities portfolio reduced overall amortization expense which contributed to the increase in interest income. In addition, securities purchased during 2005 were at overall higher yields. Interest income on investment and mortgage-backed securities increased \$8.2 million in 2005, or 25.9%, compared to 2004 due to an increase in both the average yield and the average balance on securities during 2005.

Interest income from FHLB stock and other investments, federal funds sold and other interest earning assets increased \$534,000, or 96.7%, for the year ended December 31, 2005 when compared to 2004, primarily as a result of higher average dividends paid on FHLB stock during 2005.

During the year ended December 31, 2005, average securities increased more than average loans. As a result, the mix of our average interest earning assets reflected a decrease in average total loans as a percentage of total average interest earning assets compared to the prior year as loans averaged 41.8% during 2005 compared to 43.3% during 2004, a direct result of less loan growth when compared to the growth in securities. Securities averaged 58.1% of average total interest earning assets and other interest earning asset categories averaged 0.1% for December 31, 2005. During 2004, the comparable mix was 56.1% in securities and 0.6% in the other interest earning asset categories.

Total interest expense increased \$10.8 million, or 39.2%, to \$38.4 million during the year ended December 31, 2005 as compared to \$27.6 million during the same period in 2004. The increase was attributable to an increase in the average yield on interest bearing liabilities and an increase in average interest bearing liabilities of \$151.4 million, or 13.2%. Average interest bearing deposits increased \$69.7 million, or 10.7%, and the average rate paid increased from 1.56% during the year ended December 31, 2004 to 2.40% during the year ended December 31, 2005. Average time deposits increased \$35.3 million, or 11.1%, and the average rate paid increased 71 basis points. Average interest bearing demand deposits increased \$32.4 million, or 11.5%, and the average rate paid increased 102 basis points. Average savings deposits increased \$2.0 million, or 4.2%, and the average rate paid increased 56 basis points. Average noninterest bearing demand deposits increased \$33.6 million, or 13.6%, during 2005. The latter three categories, which are considered the lowest cost deposits, comprised 64.5% of total average deposits during the year ended December 31, 2005 compared to 64.4% during 2004 and 60.2% during 2003. The increase in average total deposits is reflective of overall bank growth and branch expansion.

During the fourth quarter ended December 31, 2005, we issued \$19.8 million of callable brokered CDs, where we retained the right to call the CDs before the final maturity date, to replace a portion of the FHLB short-term funding. These brokered CDs had maturities from three to five years and calls from three months to one year. At December 31, 2005, we had \$19.8 million in brokered CDs that represented 1.8% of deposits. We utilized long-term brokered CDs in place of long-term FHLB funding as the brokered CDs better matched overall ALCO objectives. At December 31, 2004, we had no 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 \$282.3 million, an increase of \$100.5 million, or 55.3%, for the year ended December 31, 2005 when compared to the same period in 2004. Interest expense associated with short-term interest bearing liabilities increased \$3.4 million, or 52.2%, while the average rate paid decreased 8 basis points for the year ended December 31, 2005 when compared to the same period in 2004 due primarily to long-term FHLB advances becoming short-term during 2005.

The decrease in the average rate paid was due primarily to lower interest rate long-term FHLB advances being reclassified to short-term. Average long-term interest bearing liabilities consisting of FHLB advances decreased \$18.8 million, or 6.4%, during the year ended December 31, 2005 to \$274.7 million as compared to \$293.5 million at December 31, 2004. Interest expense associated with long-term FHLB advances decreased \$72,000, or 0.7%, while the average rate paid increased 21 basis points for the year ended December 31, 2005 when compared to the same period in 2004. The long-term advances were obtained from the FHLB primarily to fund long-term securities and loans. FHLB advances are collateralized by FHLB stock, securities and nonspecific loans.

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PROVISION FOR LOAN LOSSES

The provision for loan losses for the year ended December 31, 2005 was \$1.5 million compared to \$925,000 for December 31, 2004. For the year ended December 31, 2005, we had net charge-offs of loans of \$1.3 million, an increase of 231.2% compared to December 31, 2004. For the year ended December 31, 2004, net charge-offs of loans were \$397,000.

The increase in net charge-offs for 2005 was due to an increase in total charge-offs that exceeded the increase in total recoveries. Net charge-offs for commercial loans increased \$332,000 from December 31, 2004 primarily as a result of a large recovery on one loan during the third quarter of 2004. Net charge-offs for loans to individuals increased \$635,000 due primarily to an increase in net charge-offs of overdraft accounts from December 31, 2004. These increases in net charge-offs were partially offset by a decrease in net charge-offs of real estate loans of \$49,000.

As of December 31, 2005, our review of the loan portfolio indicated that a loan loss allowance of \$7.1 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, 2005 and the comparable year ended December 31, 2004 and indicates the percentage changes:

	Years Ended December 31,		Percent Change
	2005	2004	
	(dollars in thousands)		
Deposit services	\$ 14,594	\$ 13,793	5.8%
Gain on sale of securities available for sale	228	2,759	(91.7%)
Gain on sale of loans	1,807	1,644	9.9%
Trust income	1,422	1,248	13.9%
Bank owned life insurance income	951	812	17.1%
Other	2,246	1,647	36.4%
Total noninterest income	\$ 21,248	\$ 21,903	(3.0%)

Total noninterest income for the year ended December 31, 2005 decreased 3.0%, or \$655,000, compared to 2004. Securities gains decreased \$2.5 million, or 91.7%, from 2004. We had fewer securities we wanted to sell during 2005 due to the repositioning of the securities portfolio during 2003 and 2004. In addition the higher overall interest rate environment during 2005 caused prepayments on premium mortgage-backed securities to slow, which reduced the number of these securities sold. Of the \$0.2 million in net securities gains from the AFS portfolio in 2005, there were \$1.4 million in realized losses and \$1.6 million in realized 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 reduce the overall duration of the securities portfolio, maximize the total return of the securities portfolio, reduce alternative minimum tax and minimize our exposure to prepayments on mortgage-backed securities. Sales of AFS securities were the result of changes in economic conditions and a change in the desired mix of the securities portfolio. During 2005, the yield curve flattened as short-term interest rates increased significantly and long-term interest rates increased less. 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 and, or long duration municipal securities were sold and, in some circumstances, partially replaced with municipal loans or better call protected municipal securities.

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Gain on sale of loans increased \$163,000, or 9.9%, due to the premium earned of \$248,000 from the sale of \$6.2 million in student loans during the second quarter ended June 30, 2005, which more than offset the decrease in gains from mortgage loans sold during 2005 as compared to 2004. Trust income increased \$174,000, or 13.9%, as a result of growth in managed assets experienced in the Trust department. BOLI increased \$139,000, or 17.1%, as a result of an increase in average BOLI assets and an increase in the average rate paid on BOLI during 2005 when compared to 2004. Other noninterest income increased \$599,000, or 36.4%, during 2005 as compared to 2004. The largest single factor for the increase in other noninterest income was the result of a \$286,000 special distribution as a result of the merger of the Pulse EFT Association with Discover Financial Services received during the first six months of 2005. Other increases in other income included increases in Southside Select fee income, Home Banking fee income, stored value card fees, credit card fee income, Traveler's Express income and gains on sale of assets.

NONINTEREST EXPENSE

The following schedule lists the accounts which comprise noninterest expense, gives totals for these accounts for the year ended December 31, 2005 and the comparable year ended December 31, 2004 and indicates the percentage changes:

	Years Ended December 31,		Percent Change
	2005	2004	
	(dollars in thousands)		
Salaries and employee benefits	\$ 27,479	\$ 25,395	8.2%
Occupancy expense	4,257	4,120	3.3%
Equipment expense	847	759	11.6%
Advertising, travel and entertainment	1,967	1,852	6.2%
ATM and debit card expense	648	628	3.2%
Director fees	677	646	4.8%
Supplies	628	608	3.3%
Professional fees (1)	1,339	1,239	8.1%
Postage	572	561	2.0%
Telephone and communications	593	522	13.6%
Other	4,152	3,991	4.0%
Total noninterest expense	\$ 43,159	\$ 40,321	7.0%

(1) Historically we included legal fees as "other" noninterest expense, but believe that it is more appropriate to include legal fees with "Professional Fees."

Noninterest expense for the year ended December 31, 2005 increased \$2.8 million, or 7.0%, when compared to the year ended December 31, 2004. Salaries and employee benefits increased \$2.1 million, or 8.2%, when compared to the same period in 2004. Direct salary expense and payroll taxes increased \$2.3 million, or 12.1%, as a result of overall bank growth, new branches opened since second quarter 2004, hiring associated with plans to expand the regions in which we lend, and normal payroll increases. Retirement expense increased \$682,000, or 26.3%, for the year ended December 31, 2005 primarily as a result of the increase in the number of participants, level of performance of retirement plan assets and actuarial assumptions. Our actuarial assumption used to determine net periodic pension costs were reduced for 2005 when compared to 2004 and the assumed long-term rate of return for 2005 was 8.5% and the assumed discount rate for 2005 was 5.75%.

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.

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Health and life insurance expense decreased \$925,000, or 26.2%, for the year ended December 31, 2005 due to decreased health claims expense and reinsurance costs. We have a self-insured health plan which is supplemented with stop loss insurance policies.

Equipment expense increased \$88,000, or 11.6%, for the year ended December 31, 2005 due to increases in various maintenance contracts and branch expansions.

Professional fees increased \$100,000, or 8.1%, due to legal fees associated with litigation resulting from the normal course of business.

Telephone and communications expense increased \$71,000, or 13.6%, for the year ended December 31, 2005 primarily due to the addition of three new locations during 2005 and an increase in communication costs.

Other expense increased \$161,000, or 4.0%, during the year ended December 31, 2005 compared to 2004. The increase was primarily due to increases in bank examination fees and other losses.

INCOME TAXES

Income tax expense was \$3.3 million for the year ended December 31, 2005 and represented a \$659,000, or 16.7%, decrease from the year ended December 31, 2004. The effective tax rate as a percentage of pre-tax income was 18.4% in 2005, 19.7% in 2004 and 16.0% in 2003. The decrease in the effective tax rate and income tax expense for 2005 was due to the increase in tax-exempt income as a percentage of pre-tax income for the year ended December 31, 2005 when compared to December 31, 2004. During 2005, we were in an alternative minimum tax position due to a large contribution to our defined benefit plan. During 2004, we had the ability to address the appropriate level of tax free income to avoid an alternative minimum tax position for 2004.

We decreased our municipal securities portfolio during 2005 to reduce the overall level of tax-free income from the securities portfolio and to allow us the opportunity to grow our municipal loan portfolio. We have the ability to and are addressing the appropriate level of tax-free income so as to minimize any alternative minimum tax position in the future.

On October 22, 2004, President Bush signed the American Jobs Creation Act of 2004 (the "Act"), which includes numerous provisions that may affect business practices and accounting for income taxes. The Act did not impact our income tax expense during 2005.

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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 loans 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. Municipal loans are made to municipalities, school districts, and colleges throughout the state of Texas. 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, 2006 increased \$78.8 million, or 11.6%, and the average loan balance was up \$64.3 million, or 9.8%, when compared to 2005.

Our real estate loans increased \$50.3 million, or 12.6%, from December 31, 2005 to December 31, 2006. Commercial loans increased \$27.5 million, or 30.1%, from December 31, 2005. Loans to individuals increased \$3.9 million, or 4.7%, from December 31, 2005. Municipal loans as of December 31, 2006 decreased \$2.8 million, or 2.6%, from December 31, 2005.

The increase in real estate loans was due to our expanding markets and economic growth in our market area, the continued strong commitment to real estate lending and less refinancing of real estate loans on our books during 2006 when compared to 2005. The increase in our commercial loans is reflective of our expanding markets and economic growth in our market area. The increase in loans to individuals reflects success in penetrating this competitive market. 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 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 related entities, is 25% of unimpaired certified capital and surplus. Our legal lending limit at December 31, 2006, was \$25 million. Our largest loan relationship at December 31, 2006, was approximately \$13 million.

The average yield on loans for the year ended December 31, 2006, increased to 6.70% from 6.22% for the year ended December 31, 2005. This increase was reflective of the repricing characteristics of the loans, interest rates at the time loans repriced, and the overall higher interest rate environment during 2006, when compared to 2005.

LOAN PORTFOLIO COMPOSITION AND ASSOCIATED RISK

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

	2006	2005	December 31, 2004 (in thousands)	2003	2002
Real Estate Loans:					
Construction	\$ 39,588	\$ 35,765	\$ 32,877	\$ 35,306	\$ 33,286
1-4 Family Residential	227,354	199,812	168,784	143,460	145,159
Other	181,047	162,147	153,998	144,668	145,299
Commercial Loans	118,962	91,456	80,808	76,432	77,629
Municipal Loans	106,155	109,003	103,963	96,135	76,918
Loans to Individuals	86,041	82,181	83,589	93,134	92,169
Total Loans	\$ 759,147	\$ 680,364	\$ 624,019	\$ 589,135	\$ 570,460

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

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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. At December 31, 2006, the majority of our real estate loans were collateralized by properties located in Smith and Gregg Counties. Of the \$448.0 million in real estate loans, \$227.4 million, or 50.7%, 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. 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 \$177.5 million of commercial real estate loans, \$2.3 million of loans secured by multifamily properties and \$1.2 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, 2006, these loans totaled \$64.8 million.

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.

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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 medical, in this loan category. Medical loan types 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." 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 are generally granted 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, 2006 decreased \$2.8 million when compared to 2005. At December 31, 2006, we had total loans to municipalities and school districts of \$106.2 million.

LOANS TO INDIVIDUALS

Substantially all of our consumer loans are made to consumers in our market area. The majority of consumer loans outstanding are collateralized by titled equipment, primarily vehicles, which accounted for approximately \$49.7 million, or 57.8%, of total loans to individuals at December 31, 2006. Home equity 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.

Management believes that the economy in our market area appears to reflect continued stable growth. Most of our loans to individuals are collateralized, which management believes should assist in limiting our exposure.

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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, 2006, 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	\$ 19,578	\$ 12,373	\$ 7,637
Real Estate Loans - 1-4 Family Residential	61,598	71,104	94,652
Real Estate Loans - Other	48,929	56,182	75,936
Commercial Loans	73,433	33,690	11,839
Municipal Loans	7,986	20,879	77,290
Loans to Individuals	54,207	28,785	3,049
Total Loans	\$ 265,731	\$ 223,013	\$ 270,403

Loans with Maturities

After

One Year for Which:	Interest Rates are Fixed or Predetermined	\$ 300,326
	Interest Rates are Floating or Adjustable	\$ 193,090

*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 \$1.3 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, 2006 and 2005, these loans totaled \$2.6 million and \$3.7 million, or 2.3% and 3.4% 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.

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At each review, a subjective analysis methodology is used to grade the respective loan. Categories of grading vary in severity from loans that do not appear to have a significant probability of loss at the time of review to loans that indicate a probability that the entire balance of the loan will be uncollectible. If full collection of the loan balance appears unlikely at the time of review, estimates 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. This list is for loan and loan relationships of \$50,000 or more and 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, 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.

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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

	Years Ended December 31,				
	2006	2005	2004	2003	2002
	(dollars in thousands)				
Average Net Loans Outstanding	\$ 722,252	\$ 657,938	\$ 604,658	\$ 570,122	\$ 547,829
Balance of Allowance for Loan Losses at Beginning of Period	\$ 7,090	\$ 6,942	\$ 6,414	\$ 6,195	\$ 5,926
Loan Charge-Offs:					
Real Estate-Construction	-	-	-	(17)	(215)
Real Estate-1-4 Family Residential	(59)	(36)	(142)	(63)	(170)
Real Estate-Other	(18)	(53)	(3)	-	-
Commercial Loans	(245)	(438)	(375)	(693)	(610)
Loans to Individuals	(2,650)	(2,469)	(523)	(703)	(1,144)
Total Loan Charge-Offs	(2,972)	(2,996)	(1,043)	(1,476)	(2,139)
Recovery of Loans Previously Charged-off:					
Real Estate-Construction	-	-	-	-	4
Real Estate-1-4 Family Residential	7	20	-	-	13
Real Estate-Other	-	-	-	-	-