SOUTHSIDE BANCSHARES INC
Form 10-K
March 26, 2012

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

Form 10-K
(Mark One)

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

For the fiscal year ended December 31, 2011
or

o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the Transition Period From _____ to _____

Commission file number 0-12247
Southside Bancshares, Inc.
(Exact name of registrant as specified in its charter)

Texas	75-1848732
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
1201 S. Beckham Avenue, Tyler, Texas	75701
(Address of Principal Executive Offices)	(Zip Code)

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

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

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

Securities registered pursuant to Section 12(g) of the Act:
NONE

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes o No x

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 o No x

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

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

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

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

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

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

The aggregate market value of the common stock held by non-affiliates of the registrant as of June 30, 2011 was $280,097,971.

As of March 15, 2012, 16,507,759 shares of common stock of Southside Bancshares, Inc. were outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Certain portions of the Registrant's proxy statement to be filed for the Annual Meeting of Shareholders to be held April 19, 2012 are incorporated by reference into Part III of this Annual Report on Form 10-K. Other than those portions of the proxy statement specifically incorporated by reference pursuant to Items 10-14 of Part III hereof, no other portions of the proxy statement shall be deemed so incorporated.

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IMPORTANT INFORMATION ABOUT THIS REPORT

In this report, the words "the Company," "we," "us," and "our" refer to the combined entities of Southside Bancshares, Inc and its subsidiaries. The words "Southside" and "Southside Bancshares" refer to Southside Bancshares, Inc. The words "Southside Bank" and "the Bank" refer to Southside Bank (which, subsequent to the internal merger of Fort Worth National Bank ("FWNB") with and into Southside Bank, includes FWNB). "FWBS" refers to Fort Worth Bancshares, Inc., a bank holding company acquired by Southside of which FWNB was a wholly-owned subsidiary. "SFG" refers to SFG Finance, LLC (formerly Southside Financial Group, LLC) which is a wholly-owned subsidiary of the Bank as of July 15, 2011. "SSI" refers to Southside Securities, Inc., which is a wholly-owned subsidiary of Southside Bancshares, Inc.

PART I

ITEM 1.BUSINESS

FORWARD-LOOKING INFORMATION

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

GENERAL

Southside Bancshares, Inc., incorporated in Texas in 1982, is a bank holding company for Southside Bank, a Texas state bank headquartered in Tyler, Texas that was formed in 1960. The Tyler metropolitan area has a population of approximately 203,000 and is located approximately 90 miles east of Dallas, Texas and 90 miles west of Shreveport, Louisiana.

At December 31, 2011, our total assets were $3.30 billion, total loans were $1.09 billion, deposits were $2.32 billion, and total equity was $258.9 million. For both the years ended December 31, 2011 and 2010, our net income was $39.1 million and diluted earnings per common share were $2.38 and $2.37, respectively. We have paid a cash dividend every year since 1970 (including dividends paid by Southside Bank prior to the incorporation of Southside Bancshares).

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

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

We offer a variety of deposit accounts with a wide range of interest rates and terms, including savings, money market, interest and noninterest bearing checking accounts and certificates of deposit ("CDs"). Our trust services include investment management, administration and advisory services, primarily for individuals and, to a lesser extent, partnerships and corporations. At December 31, 2011, our trust department managed approximately $718.5 million of trust assets.

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

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

RECENT DEVELOPMENTS

On March 10, 2011, we opened a full service branch in a leased space in a grocery store on the south side of Tyler, Texas. During 2011, one of the grocery stores in Tyler closed where we had a branch location, resulting in our closing that branch. We continue to explore opportunities to expand into either additional grocery stores or traditional branch locations.

During the second quarter of 2011, our application to change our Austin loan production office to a full service branch was authorized effective April 4, 2011. We also completed the construction of a new facility adjacent to our headquarters in Tyler, Texas to house our Trust department in the second quarter of 2011.

Southside Securities, Inc., which is a wholly-owned subsidiary of Southside Bancshares, Inc., began doing business as a broker-dealer during the second quarter. Southside Securities will concentrate on fixed income products primarily for financial institutions.

On July 15, 2011, we purchased the remaining 50% interest in SFG increasing our ownership to 100%. This acquisition was a direct result of new regulations adopted as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). The Dodd-Frank Act changed the manner in which we can do business through a nonbank entity. The purchase price was $4.8 million and resulted in a decrease to shareholders' equity of approximately $2.8 million and the elimination of the noncontrolling interest. Part of the consideration we paid to purchase the remaining 50% interest in SFG was our 50% interest in the office building SFG now leases in Arlington, Texas. SFG was already consolidated in our financial statements and this purchase will not limit or change our ability to allocate capital.

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

MARKET AREA

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

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

We serve our markets through 48 banking centers, 19 of which are located in grocery stores. The branches are located in and around Tyler, Longview, Lindale, Gresham, Jacksonville, Bullard, Chandler, Hawkins, Seven Points, Palestine, Forney, Gun Barrel City, Athens, Whitehouse, Fort Worth, Arlington and Austin. Our advertising is designed to target the market areas we serve. The type and amount of advertising done in each market area is directly attributable

to our market share in that market area combined with overall cost.

We also maintain 12 motor bank facilities. Additionally, our customers may access various banking services through our 50 automated teller machines ("ATMs") and ATMs owned by others, through debit cards, and through our automated telephone, internet and electronic banking products. These products allow our customers to apply for loans from their computers, access account information and conduct various other transactions from their telephones and computers.

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THE BANKING INDUSTRY IN TEXAS

The banking industry is affected by general economic conditions such as interest rates, inflation, recession, unemployment and other factors beyond our control. During the last twenty years the Texas economy has continued to diversify, decreasing the overall impact of fluctuations in oil and gas prices; however, the oil and gas industry is still a significant component of the Texas economy. Beginning in the fourth quarter of 2008, as oil prices declined significantly and consumers all across the United States were impacted even more severely by the economic slowdown, our market areas began to experience a greater slowdown in economic activity. During 2009 and continuing throughout 2010, our market areas experienced the effects of the housing-led slowdown that impacted the other regions of the United States. During 2011 our markets appeared to partially stabilize economically, exhibiting a combination of both modest growth in certain sectors as well as continued effects of the housing and unemployment downturn. Many economists predict growth for the U.S. economy during 2012; however, we are well aware that any economic growth could be uneven. We cannot predict whether current economic conditions will improve, remain the same or decline.

COMPETITION

The activities we are engaged in are highly competitive. Financial institutions such as savings and loan associations, credit unions, consumer finance companies, insurance companies, brokerage companies and other financial institutions with varying degrees of regulatory restrictions compete vigorously for a share of the financial services market. During 2011, the number of financial institutions in our market areas increased, a trend that we expect will continue. Brokerage and insurance companies continue to become more competitive in the financial services arena and pose an ever-increasing challenge to banks. Legislative changes also greatly affect the level of competition we face. Federal legislation allows credit unions to use their expanded membership capabilities, combined with tax-free status, to compete more fiercely for traditional bank business. The tax-free status granted to credit unions provides them with a significant competitive advantage. Many of the largest banks operating in Texas, including some of the largest banks in the country, have offices in our market areas with capital resources, broader geographic markets, and legal lending limits substantially in excess of those available to us. We face competition from institutions that offer products and services we do not or cannot currently offer. Some institutions we compete with offer interest rate levels on loan and deposit products that we are unwilling to offer due to interest rate risk and overall profitability concerns. We expect the level of competition to continue to increase.

EMPLOYEES

At March 15, 2012, we employed approximately 557 full time equivalent persons. None of our employees are represented by any unions or similar groups, and we have not experienced any type of strike or labor dispute. We consider the relationship with our employees to be good.

EXECUTIVE OFFICERS OF THE REGISTRANT

Our executive officers as of March 19, 2012 were as follows:

B. G. Hartley (Age 82), Chairman of the Board of Southside Bancshares, Inc. since 1982. He was Chief Executive Officer of Southside Bancshares, Inc. from 1983 until he retired on January 5, 2012. He also serves as Chairman of the Board of Southside Bank, having served in this capacity since 1984. He was also Chief Executive Officer of Southside Bank from the Bank's inception in 1960 until he retired on January 5, 2012.

Sam Dawson (Age 64), was elected Chief Executive Officer of both Southside Bancshares, Inc. and Southside Bank on January 5, 2012. He has also served as President, Secretary and Director of Southside Bancshares, Inc. since

1998. In addition, he also has served as President, Chief Operations Officer and Director of Southside Bank since 1996. He became an officer of Southside Bancshares, Inc. in 1982 and of Southside Bank in 1975.

Robbie N. Edmonson (Age 80), 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 60), Senior Executive Vice President of Southside Bancshares, Inc. since 2000, and Senior Executive Vice President - Loan Administration, Senior Lending Officer and Director of Southside Bank since 1996. He joined Southside Bank in 1979 as an officer in Loan Documentation.

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Lee R. Gibson (Age 55), Senior Executive Vice President and Chief Financial Officer of Southside Bancshares, Inc. and of Southside Bank since 2000. He is also a Director of Southside Bank. He became an officer of Southside Bancshares, Inc. in 1985 and Southside Bank in 1984.

Michael L. Coogan (Age 52), Executive Vice President and Treasurer of Southside Bank. He became an officer of Southside Bank in 2009 and an advisory director in 2012. He is the President of the Company's subsidiary, Southside Securities, Inc., a broker-dealer.

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

SUPERVISION AND REGULATION

General

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

In addition to the system of regulation and supervision outlined above, the Dodd-Frank Act, which is discussed in greater detail below, created the Consumer Financial Protection Bureau (the "Bureau"), a new federal regulatory body with broad authority to regulate the offering and provision of consumer financial products. The Bureau officially came into being on July 21, 2011, and rulemaking authority for a range of consumer financial protection laws (such as the Truth in Lending Act, the Electronic Funds Transfer Act and the Real Estate Settlement Procedures Act, among others) transferred from the federal prudential banking regulators to the Bureau on that date. The Dodd-Frank Act gives the Bureau authority to supervise and examine depository institutions with more than $10 billion in assets for compliance with these federal consumer laws. The authority to supervise and examine depository institutions with $10 billion or less in assets for compliance with federal consumer laws will remain largely with those institutions' primary regulators. However, the Bureau may participate in examinations of these smaller institutions on a "sampling basis" and may refer potential enforcement actions against such institutions to their primary regulators. The Bureau will also have supervisory and examination authority over certain nonbank institutions that offer consumer financial products. The Dodd-Frank Act identifies a number of covered nonbank institutions, and also authorizes the Bureau to identify additional institutions that will be subject to its jurisdiction. Accordingly, the Bureau may participate in examinations of Southside Bank, and could supervise and examine other direct or indirect subsidiaries of the Company that offer consumer financial products.

The earnings of Southside Bank and, therefore, the earnings of the Company, are affected by general economic conditions, changes in federal and state laws and regulations and actions of various regulatory authorities, including those referenced above. Additional changes to the laws and regulations applicable to us are frequently proposed at both the federal and state levels. The regulatory framework under which we operate will change substantially over the next several years as the result of the enactment of the Dodd-Frank Act on July 21, 2010, which calls for a variety of mandatory and permissive rulemakings to implement its requirements. The Dodd-Frank Act represents a significant overhaul of many aspects of the regulation of the financial services industry, addressing, among other things, systemic

risk, capital adequacy, deposit insurance assessments, consumer financial protection, interchange fees, derivatives, lending limits, mortgage lending practices, registration of investment advisors and changes among the bank regulatory agencies. Among the provisions that may affect the operations of the Company and Southside Bank are the following:

- Creation of the Bureau with centralized authority, including supervisory, examination and enforcement authority, for consumer protection in the banking industry;
- New limitations on federal preemption;
- New prohibitions and restrictions on the ability of a banking entity and nonbank financial company to engage in proprietary trading and have certain interests in, or relationships with, a hedge fund or private equity fund;

- Application of new regulatory capital requirements, including changes to leverage and risk-based capital standards and changes to the components of permissible tiered capital;
- Requirement that holding companies and their subsidiary banks be well capitalized and well managed in order to engage in activities permitted for financial holding companies;
- Changes to the assessment base for deposit insurance premiums;
- Permanently raising the FDIC's standard maximum deposit insurance amount to $250,000 and, through December 31, 2012, providing unlimited insurance coverage for noninterest-bearing transaction accounts;
- Repeal of the prohibition on the payment of interest on demand deposits, effective July 21, 2011, thereby permitting depository institutions to pay interest on business transaction and other accounts;
- Restrictions on compensation, including a prohibition on incentive-based compensation arrangements that encourage inappropriate risk taking by covered financial institutions and are deemed to be excessive, or that may lead to material losses;
- Requirement that sponsors of asset-backed securities retain a percentage of the credit risk underlying the securities; and
- Requirement that banking regulators remove references to and requirements of reliance upon credit ratings from their regulations and replace them with appropriate alternatives for evaluating creditworthiness.

Some of these and other major changes could materially impact the profitability of our business, the value of assets we hold or the collateral available for our loans, require changes to business practices, or force us to discontinue businesses and expose us to additional costs, taxes, liabilities, enforcement actions and reputational risk. Many of these provisions became effective upon enactment of the Dodd-Frank Act, while others are subject to further study, rulemaking, and the discretion of regulatory bodies. In light of these significant changes and the discretion afforded to federal regulators, we cannot fully predict the effect that compliance with the Dodd-Frank Act or any implementing regulations will have on the Company or Southside Bank's businesses or their ability to pursue future business opportunities. Additional regulations resulting from the Dodd-Frank Act may materially adversely affect the Company's business, financial condition or results of operations.

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

Holding Company Regulation

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

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

- banking or managing or controlling banks;
- furnishing services to or performing services for our subsidiaries; and

- any activity that the Federal Reserve determines to be so closely related to banking as to be a proper incident to the business of banking, including:
  - factoring accounts receivable;
  - making, acquiring, brokering or servicing loans and usual related activities;

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- o leasing personal or real property;
- o operating a nonbank depository institution, such as a savings association;
- o performing trust company functions;
- o conducting financial and investment advisory activities;
- o conducting discount securities brokerage activities;
- o underwriting and dealing in government obligations and money market instruments;
- o providing specified management consulting and counseling activities;
- o performing selected data processing services and support services;
- o acting as agent or broker in selling credit life insurance and other types of insurance in connection with credit transactions;
- o performing selected insurance underwriting activities;
- o providing certain community development activities (such as making investments in projects designed primarily to promote community welfare); and
- o issuing and selling money orders and similar consumer-type payment instruments.

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

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

In order to offer broker-dealer services through a newly established subsidiary, Southside Securities, Inc., on February 8, 2011, we filed with the Federal Reserve Bank of Dallas a declaration of financial holding company status and were granted financial holding company status on March 22, 2011. Election of financial holding company status is not automatic and it was granted based upon consideration of a number of factors, including that all of our depository institution subsidiaries satisfy the Federal Reserve's "well capitalized" and "well managed" standards and have at least a satisfactory rating under the Community Reinvestment Act (discussed below). Now that we have succeeded in attaining financial holding company status, that status could be impacted by the condition of Southside Bank and/or

other factors. For example, if Southside Bank ceases to be "well capitalized" or "well managed" under applicable regulatory standards, the Federal Reserve Board may, among other things, place limitations on our ability to conduct broader financial activities or, if the deficiencies persist, require us to divest Southside Bank. In addition, if Southside Bank were to receive a rating of less than satisfactory under the Community Reinvestment Act, we would be prohibited from engaging in any additional activities other than those permissible for bank holding companies that are not financial holding companies. If we undertake expanded financial activities (that are not permissible for a bank holding company) and we fail to continue to meet any of the prerequisites for "financial holding company" status, including those described above, the financial holding company would be required to enter into an agreement with the Federal Reserve Board to comply with all applicable capital and management requirements. If we do not return to compliance within 180 days, the Federal Reserve may order the financial holding company to divest its bank or the company may discontinue or divest investments in companies engaged in, activities permissible only for a bank holding company that has elected to be treated as a financial holding company. We began engaging in broker-dealer activities through Southside Securities, Inc. on June 16, 2011, as discussed above in "Item 1. Business – Recent Developments."

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

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

Risk-based capital ratios are calculated by dividing, as appropriate, total capital and Tier 1 capital by risk-weighted assets. Assets and off-balance sheet exposures are assigned to one of four categories of risk weights, based primarily on relative credit risk. Under the existing risk-based capital requirements, the Company and Southside Bank are each generally required to maintain a minimum ratio of total capital to risk-weighted assets of at least 8% and a minimum ratio of Tier 1 capital to risk-weighted assets of at least 4%. To the extent we engage in trading activities, we are required to adjust our risk-based capital ratios to take into consideration market risks that may result from movements in market prices of covered trading positions in trading accounts, or from foreign exchange or commodity positions, whether or not in trading accounts, including changes in interest rates, equity prices, foreign exchange rates or commodity prices. Any capital required to be maintained under these provisions may consist of Tier 3 capital.

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

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The ratios of Tier 1 capital and total capital to risk-weighted assets, and the leverage ratios of the Company and Southside Bank as of December 31, 2011, are shown in the following table.

	Capital Adequacy Ratios			
	Regulatory Minimums	Regulatory Minimums to be Well Capitalized	Southside Bancshares, Inc.	Southside Bank
Risk-based capital ratios:				
Tier 1 capital (1)	4.00 %	6.00 %	21.11 %	20.26 %
Total risk-based capital (2)	8.00 %	10.00 %	22.36 %	21.52 %
Tier 1 leverage ratio (3)	4.00 %	5.00 %	8.63 %	8.29 %

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

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

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

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

In addition, reflecting the importance that regulators place on managing capital and other risks, on June 16, 2011, the banking agencies also issued proposed guidance on stress testing for banking organizations with more than $10 billion in total consolidated assets; this proposed guidance outlines four “high-level” principles for stress testing practices that should be a part of a banking organization’s stress-testing framework. Specifically, the guidance calls for the framework to (i) include activities and exercises that are tailored to the activities of the organization; (ii) employ multiple conceptually sound activities and approaches; (iii) be forward-looking and flexible; and (iv) be clear, actionable, well-supported, and used in the decision-making process. Moreover, the federal bank regulators have issued a series of guidance and rulemakings applicable to “large banks.” While many of these do not currently apply to us due to our asset size, these issuances could impact industry capital standards and practices in many, potentially unforeseeable ways.

Complying with these new capital requirements will likely affect our operations, and the extent to which we will be affected will be known with more certainty once additional clarity is provided on the underlying details of these new requirements. These new requirements have been endorsed by the U.S. banking regulators, but have not yet been translated by the regulators into official regulation for U.S. financial institutions. It is anticipated that the regulators will adopt new regulatory capital requirements similar to those proposed by the BCBS, and the new requirements are anticipated to be phased-in for U.S. financial institutions beginning in 2013. Furthermore, it is widely anticipated that the capital requirements for most bank and financial holding companies, as well as for most insured depository institutions, will increase, although the nature and amounts of the increase have not yet been specified.

Source of Strength. Federal Reserve policy requires a bank holding company to act as a source of financial strength and to take measures to preserve and protect bank subsidiaries in situations where additional investments in a troubled bank may not otherwise be warranted. As a result, a bank holding company may be required to contribute additional capital to its subsidiaries in the form of capital notes or other instruments which qualify as capital under regulatory rules. Any loans from the holding company to its subsidiary banks likely will be unsecured and subordinated to the bank's depositors and perhaps to other creditors of the bank. Notably, the Dodd-Frank Act codified the Federal Reserve's "source of strength" policy; this statutory change became effective July 21, 2011. In addition to the foregoing requirements, the Dodd-Frank Act's new provisions authorize the Federal Reserve and other federal banking regulators to require a company that directly or indirectly controls a bank to submit reports that are designed both to assess the ability of such company to comply with its "source of strength" obligations and to enforce the company's compliance with these obligations. As of March 19, 2012 the Federal Reserve and other federal banking regulators have not yet issued rules implementing this requirement.

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

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

Among other things, the ability of banks and bank holding companies to pay dividends, and the contents of their respective dividend policies, could be impacted by a range of changes imposed by the Dodd-Frank Act, many of which will require implementing rules to become effective. See also Bank Regulation – Dividends for additional information.

Change in Control. Subject to certain exceptions, under the BHCA and the Change in Bank Control Act ("CBCA"), and the regulations promulgated thereunder, persons who intend to acquire direct or indirect control of a depository institution or a bank holding company are required to obtain the approval of the Federal Reserve Board prior to acquiring control. With respect to the Company, "control" is conclusively presumed to exist where an acquiring party

directly or indirectly owns, controls or has the power to vote at least 25% of our voting securities. Under the Federal Reserve's CBCA regulations, a rebuttable presumption of control would arise with respect to an acquisition where, after the transaction, the acquiring party owns, controls or has the power to vote at least 10% (but less than 25%) of our voting securities. In certain cases, a company may also be presumed to have control under the Bank Holding Company Act if it acquires five percent or more of any class of voting securities.

On September 22, 2008, the Federal Reserve issued a policy statement on minority equity investments in banks and bank holding companies, that permits investors to (1) acquire up to 33 percent of the total equity of a target bank or bank holding company, subject to certain conditions, including that the acquiring investor does not acquire 15 percent or more of any class of voting securities, and (2) designate at least one director, without triggering the various regulatory requirements associated with control.

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

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

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

Bank Regulation

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

Permitted Activities and Investments. Under the Federal Deposit Insurance Act ("FDIA"), the activities and investments of state nonmember banks are generally limited to those permissible for national banks, notwithstanding state law. With FDIC approval, a state nonmember bank may engage in activities not permissible for a national bank if the FDIC determines that the activity does not pose a significant risk to the DIF and that the bank meets its minimum capital requirements. Similarly, under Texas law, a state bank may engage in those activities permissible for national banks domiciled in Texas. The TDB may permit a Texas state bank to engage in additional activities so long as the

performance of the activity by the bank would not adversely affect the safety and soundness of the bank.

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

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

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

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

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

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

In addition, all FDIC-insured institutions are required to pay a pro rata portion of the interest due on bonds issued by the Financing Corporation ("FICO") to fund the closing and disposal of failed thrift institutions by the Resolution Trust Corporation. FICO assessments, which are calculated off the new assessment base established by the Dodd-Frank

Act, are set quarterly, and in 2011 ranged from 1.020 (annual) basis points in the first quarter to .680 (annual) basis points in the fourth quarter. These assessments will continue until the FICO bonds mature in 2017 through 2019.

The Dodd-Frank Act provides temporary, unlimited deposit insurance for all noninterest-bearing transaction accounts. In January 2011, the FDIC issued final rules implementing this provision of the Dodd-Frank Act by including interest on Lawyer Trust Accounts (or IOLTA accounts) within the definition of a noninterest-bearing transaction account. Per the FDIC's final rules, all funds held in IOLTA accounts, together with all other noninterest-bearing transaction account deposits, are fully insured, without limit, from December 31, 2010, through December 31, 2012.

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Capital Adequacy. See Holding Company Regulation – Capital Adequacy.

Prompt Corrective Action and Undercapitalization. The Federal Deposit Insurance Corporation Improvement Act (the "FDICIA") established a system of prompt corrective action to resolve the problems of undercapitalized insured depository institutions. Under this system, the federal banking regulators are required to rate insured depository institutions on the basis of five capital categories as described below. The federal banking regulators are also required to take mandatory supervisory actions and are authorized to take other discretionary actions, with respect to insured depository institutions in the three undercapitalized categories, the severity of which will depend upon the capital category in which the insured depository institution is assigned. Generally, subject to a narrow exception, the FDICIA requires the banking regulator to appoint a receiver or conservator for an insured depository institution that is critically undercapitalized. The federal banking agencies have specified by regulation the relevant capital level for each category. Under the regulations, all insured depository institutions are assigned to one of the following capital categories:

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

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

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

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

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

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

we and our bank subsidiary have the requisite capital levels to qualify as well capitalized institutions under the FDICIA regulations.

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If an institution fails to remain well capitalized, it will be subject to a variety of enforcement remedies that increase as the capital condition worsens. For instance, the FDICIA generally prohibits a depository institution from making any capital distribution, including payment of a dividend, or paying any management fee to its holding company if the depository institution would thereafter be undercapitalized as a result. Undercapitalized depository institutions are subject to restrictions on borrowing from the Federal Reserve System. In addition, undercapitalized depository institutions may not accept brokered deposits absent a waiver from the FDIC, are subject to growth limitations and are required to submit capital restoration plans for regulatory approval. A depository institution's holding company must guarantee the any required capital restoration plan, up to an amount equal to the lesser of 5 percent of the depository institution's assets at the time it becomes undercapitalized or the amount of the capital deficiency when the institution fails to comply with the plan. Federal banking agencies may not accept a capital plan without determining, among other things, that the plan is based on realistic assumptions and is likely to succeed in restoring the depository institution's capital. If a depository institution fails to submit an acceptable plan, it is treated as if it is significantly undercapitalized.

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

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

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

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

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

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

Transactions with Affiliates. Southside Bank is subject to sections 23A and 23B of the Federal Reserve Act ("FRA") and the Federal Reserve's Regulation W, as made applicable to state nonmember banks by section 18(j) of the FDIA. Sections 23A and 23B of the FRA restrict a bank's ability to engage in certain transactions with its affiliates. An affiliate of a bank is any company or entity that controls, is controlled by or is under common control with the bank. In a holding company context, the parent bank holding company and any companies controlled by such parent holding company are generally affiliates of the bank.

Specifically, section 23A places limits on the amount of "covered transactions," which include loans or extensions of credit to, and investments in or certain other transactions with, affiliates. It also limits the amount of any advances to third parties that are collateralized by the securities or obligations of affiliates. The aggregate of all covered transactions is limited to 10 percent of the bank's capital and surplus for any one affiliate and 20 percent for all affiliates. Additionally, within the foregoing limitations, each covered transaction must meet specified collateral requirements ranging from 100 to 130 percent of the loan amount, depending on the type of collateral. Further, banks are prohibited from purchasing low quality assets from an affiliate. Section 608 of the Dodd-Frank Act broadens the definition of "covered transactions" to include derivative transactions and the borrowing or lending of securities if the transaction will cause a bank to have credit exposure to an affiliate. The revised definition also includes the acceptance of debt obligations of an affiliate as collateral for a loan or extension of credit to a third party. Furthermore, reverse repurchase transactions will be viewed as extensions of credit (instead of asset purchases) and thus become subject to collateral requirements. These expanded definitions take effect on July 21, 2012.

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

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

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

On a periodic basis, the FDIC is charged with preparing a written evaluation of our record of meeting the credit needs of the entire community and assigning a rating – outstanding, satisfactory, needs to improve or substantial noncompliance. Banks are rated based on their actual performance in meeting community credit needs. The FDIC will take that rating into account in its evaluation of any application made by the bank for, among other things,

approval of the acquisition or establishment of a branch or other deposit facility, an office relocation, a merger or the acquisition of shares of capital stock of another financial institution. A bank's CRA rating may be used as the basis to deny or condition an application. In addition, as discussed above, a bank holding company may not become a financial holding company unless each of its subsidiary banks has a CRA rating of at least "Satisfactory." Southside Bank was last examined for compliance with the CRA and received a rating of "Outstanding" on April 26, 2010.

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

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

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

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

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

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

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

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

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

Deposit operations also are subject to:

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

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

- the Electronic Funds Transfer Act and Regulation E issued by the Federal Reserve, which governs automatic deposits to and withdrawals from deposit accounts and customers' rights and liabilities arising from the use of automated teller machines and other electronic banking services.

Many of the foregoing laws and regulations are subject to change resulting from the provisions in the Dodd-Frank Act and other developments, which in many cases call for revisions to implementing regulations. For example, the Bureau is in the process of republishing the transferred regulations in a new section of the Code of Federal Regulations but has not yet made substantive changes to these rules. It is anticipated that the Bureau will be making substantive changes to a number of consumer protection regulations and associated disclosures in the near term.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Bank regulators routinely examine institutions for compliance with these obligations and have been active in imposing "cease and desist" and other regulatory orders and money penalty sanctions against institutions found to be violating these obligations.

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

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

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

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

Regulatory Examination. See Holding Company Regulation – Regulatory Examination.

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

other actions determined to be appropriate by the ordering agency. The federal banking agencies also may remove a director or officer from an insured depository institution (or bar them from the industry) if a violation is willful or reckless.

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

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Capital Purchase Program. Under Title I of the Emergency Economic Stabilization Act ("EESA") enacted in October 2008, as amended by the America Recovery and Reinvestment Act ("ARRA") in February 2009, the U.S. Treasury Department ("Treasury") established the Troubled Asset Relief Program ("TARP"), which includes the Capital Purchase Program ("CPP"). Under the CPP, the Treasury, upon application by a bank holding company and approval by the Federal Reserve Board and the primary federal regulator of the subsidiary bank or banks, purchased senior preferred stock from the company. Because of our sound financial condition and the conditions that are or may be imposed on use of the CPP funds or on the institutions that received CPP funds, we chose not to apply for such funds.

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

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

ITEM 1A. RISK FACTORS

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

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

RISKS RELATED TO OUR BUSINESS

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

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

- increases in loan delinquencies;

- increases in nonperforming assets and foreclosures;

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- decreases in demand for our products and services, which could adversely affect our liquidity position;
- decreases in the value of the collateral securing our loans, especially real estate, which could reduce customers' borrowing power;
- decreases in the credit quality of our non-U.S. Government and non-U.S. agency investment securities, especially our trust preferred, corporate and municipal securities;
- an adverse or unfavorable resolution of the Fannie Mae or Freddie Mac receivership; and
- decreases in the real estate values subject to ad-valorem taxes by municipalities that impact such municipalities' ability to repay their debt, which could adversely affect our municipal loans or debt securities.

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

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

The capital and credit markets have been experiencing volatility and disruption for more than three years. While volatility in, and disruption of, these markets no longer remain at unprecedented levels, in some cases, the markets have produced downward pressure on stock prices and credit capacity without regard to an issuer's underlying financial strength. If current levels of market disruption and volatility continue or worsen, there can be no assurance that we will not experience adverse effects, which may be material, on our ability to access capital and on our results of operations and financial condition, including our liquidity position.

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

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

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

Since 2008, various legislative and regulatory actions have been implemented in response to the financial crises affecting the banking system and financial markets and to the recession. Many of these programs have or will soon expire. The wind-down of these programs may have a direct adverse effect on us or a broader adverse impact on the financial sector. TARP was established pursuant to EESA, as amended by ARRA, whereby the Treasury has the authority to, among other things, spend up to $700 billion to purchase equity in financial institutions, purchase mortgages, mortgage-backed securities and certain other financial instruments from financial institutions for the purpose of stabilizing and providing liquidity to the U.S. financial markets. Though TARP was scheduled to expire on December 31, 2009, the Treasury extended TARP until October 3, 2010, in order to retain an adequate financial stability reserve if financial conditions worsen and threaten the economy. On October 21, 2009, the FDIC voted to end the Debt Guarantee Program portion of the Temporary Liquidity Guarantee Program, which guarantees certain

"newly-issued unsecured debt" of banks and certain holding companies. The Debt Guarantee Program expired on October 31, 2009, with the guarantee period on such debt expiring on December 30, 2012. The Transaction Account Guarantee portion of the program, which guarantees noninterest bearing bank transaction accounts on an unlimited basis expired December 31, 2010. However, provisions in the Dodd-Frank Act that amend the FDIA provide temporary unlimited deposit insurance coverage for noninterest-bearing transaction accounts (including Interest on Lawyer Trust Accounts or IOLTAs) beginning December 31, 2010, for a two-year period.

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The Transaction Account Guarantee program has been utilized by a number of our customers and we anticipate some deposit rolloff will occur when this program expires. We did not utilize the other programs and as such we believe the expiration of these programs will have significantly less, if any, direct impact. However, we cannot predict the effect that the wind-down of these various governmental programs will have on current financial market conditions, or on our business, financial condition, results of operations, access to credit and the trading price of our common stock.

We are subject to interest rate risk.

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

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

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

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

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

We have and continue to purchase MBS at significant premiums due to the low interest rate environment. Our prepayment assumptions take into account Bloomberg consensus speeds, current trends and past experience. On October 24, 2011, the Federal Housing Finance Agency (the “FHFA”) announced expanded initiatives to assist homeowners that might not otherwise have been able to qualify for a new mortgage to refinance their mortgage. The FHFA announced changes to the guidelines related to loan-to-value, appraisals, and certain fees, among other things, subject to a variety of qualifications and the extension of the end date for the Home Affordable Refinance Program (“HARP”) until December 31, 2013. It does not change the time period which these loans were originated, maintaining

the requirement that the loans must have been guaranteed by Fannie Mae or Freddie Mac on or before May 31, 2009. These changes could cause MBS prepayments to significantly exceed our projections. If actual prepayments exceed our projections, the amortization expense associated with these MBS will increase, thereby decreasing our net income. The increase in amortization expense and the corresponding decrease in net income could have a material adverse effect on our financial condition and results of operations.

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

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

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

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

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

A significant portion of our loan portfolio is dependent on real estate. In addition to the financial strength and cash flow characteristics of the borrower in each case, often loans are secured with real estate collateral. At December 31, 2011, approximately 52.0% of our loans have real estate as a primary or secondary component of collateral. The real estate in each case provides an alternate source of repayment in the event of default by the borrower and may deteriorate in value during the time the credit is extended. Beginning in the third quarter of 2007 and continuing throughout 2008, 2009 and 2010, there were well-publicized developments in the credit markets, beginning with a decline in the sub-prime mortgage lending market, which later extended to the markets for collateralized mortgage obligations, mortgage-backed securities and the lending markets generally. This decline has continued to result in restrictions in the resale markets during 2011 for non-conforming loans and has had an adverse effect on retail mortgage lending operations in many markets. A further decline in the credit markets generally could adversely affect our financial condition and results of operations if we are unable to extend credit or sell loans in the secondary market. An adverse change in the economy affecting values of real estate generally or in our primary markets specifically could significantly impair the value of collateral and our ability to sell the collateral upon foreclosure. Furthermore, it is likely that, in a declining real estate market, we would be required to further increase our allowance for loan losses. If we are required to liquidate the collateral securing a loan to satisfy the debt during a period of reduced real estate values or to increase our allowance for loan losses, our profitability and financial condition could be adversely impacted.

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

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

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

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

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

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

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

operations.

We operate in a highly competitive industry and market area.

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

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

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

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

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

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

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

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

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

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

We maintain a portfolio of securities that can be used as a secondary source of liquidity. There are other sources of liquidity available to us should they be needed. These sources include sales or securitizations of loans, our ability to acquire additional national market, noncore deposits, additional collateralized borrowings such as Federal Home Loan Bank advances, the issuance and sale of debt securities, and the issuance and sale of preferred or common securities in public or private transactions. Southside Bank also can borrow from the Federal Reserve's discount window.

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

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

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

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

- potential exposure to unknown or contingent liabilities of the target company;
- exposure to potential asset quality issues of the target company;
- difficulty and expense of integrating the operations and personnel of the target company;
- potential disruption to our business;
- potential diversion of our management's time and attention;

- the possible loss of key employees and customers of the target company;
- difficulty in estimating the value of the target company; and
- potential changes in banking or tax laws or regulations that may affect the target company.

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

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

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

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

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

We continually encounter technological change.

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

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

Severe weather, natural disasters, climate change, acts of war or terrorism and other adverse external events could have a significant impact on our ability to conduct business. Such events could affect the stability of our deposit base, impair the ability of borrowers to repay outstanding loans, impair the value of collateral securing loans, cause

significant property damage, result in loss of revenue and/or cause us to incur additional expenses. For example, because of our location and the location of the market areas we serve, severe weather is more likely than in other areas of the country. Although management has established disaster recovery policies and procedures, there can be no assurance of the effectiveness of such policies and procedures, and the occurrence of any such event could have a material adverse effect on our business, financial condition and results of operations.

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RISKS ASSOCIATED WITH THE BANKING INDUSTRY

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

Southside Bancshares, Inc., primarily through Southside Bank, and certain nonbank subsidiaries, is subject to extensive federal and state regulation and supervision. Banking regulations are primarily intended to protect depositors' funds, federal deposit insurance funds and the banking system as a whole, not shareholders. These regulations affect our lending practices, capital structure, investment practices and dividend policy and growth, among other things. The statutory and regulatory framework under which we operate will change substantially over the next several years as the result of the enactment of the Dodd-Frank Act. The Dodd-Frank Act represents a significant overhaul of many aspects of the regulation of the financial services industry, addressing, among other things, systemic risk, capital adequacy, deposit insurance assessments, consumer financial protection, as implemented through the Bureau, interchange fees, derivatives, lending limits, mortgage lending practices, registration of investment advisors and changes among bank regulatory authorities. To date, there are a number of provisions of the Dodd-Frank Act that have not taken effect and many important provisions require implementing rules to become effective. In addition to these developments, Congress and federal and state regulatory agencies continually review banking laws, regulations and policies for possible changes. Changes to statutes, regulations or regulatory policies, including changes in interpretation or implementation of statutes, regulations or policies, could affect us in substantial and unpredictable ways. Such changes could subject us to additional costs, limit deposit fees and other types of fees we charge, limit the types of financial services and products we may offer and/or increase the ability of nonbanks to offer competing financial services and products, among other things. While we cannot predict the impact caused by the Dodd-Frank Act and forthcoming implementing rules, or the impact of any additional regulatory changes that may arise out of the current financial and economic environment, any regulatory changes or increased regulatory scrutiny could increase costs directly related to complying with new regulatory requirements. Failure to comply with laws, regulations or policies could result in sanctions by regulatory agencies, civil money penalties and/or reputation damage, which could have a material adverse effect on our business, financial condition and results of operations. While our policies and procedures are designed to prevent any such violations, there can be no assurance that such violations will not occur. See the section captioned "Supervision and Regulation" in "Item 1. Business" and "Note 15 – Shareholders' Equity" to our consolidated financial statements included in this report.

We may become subject to increased regulatory capital requirements.

The capital requirements applicable to Southside Bancshares, Inc. and Southside Bank are subject to change as a result of the Dodd-Frank Act, the international regulatory capital initiative known as Basel III and any other future government actions. In particular, the Dodd-Frank Act eliminates Tier 1 capital treatment for most trust preferred securities after a three-year phase-in period that begins January 1, 2013. Furthermore, in December 2010, the BCBS finalized the Basel III regulatory capital standards. The standards, which mandate a higher minimum level of common equity to be held by financial institutions, along with a capital conservation buffer to withstand future periods of stress, are subject to individual adoption by member nations, including the United States. It is anticipated that U.S. regulators will adopt new regulatory capital requirements similar to those proposed by the BCBS to be phased-in for U.S. financial institutions beginning in 2013. Furthermore, it is widely anticipated that the capital requirements for most bank and financial holding companies, as well as for most insured depository institutions, will increase, although the nature and amounts of the increase have not yet been specified. Complying with any higher capital requirements mandated by the Dodd-Frank Act and new capital standards brought about by Basel III implementation may affect our operations, including our asset portfolios and financial performance.

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

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

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

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

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

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

The soundness of other financial institutions could adversely affect us.

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

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

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

RISKS ASSOCIATED WITH OUR COMMON STOCK

Our stock price can be volatile.

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

- actual or anticipated variations in quarterly results of operations;
- recommendations by securities analysts;
- operating and stock price performance of other companies that investors deem comparable to us;
- news reports relating to trends, concerns and other issues in the financial services industry;
- perceptions in the marketplace regarding us and/or our competitors;
- new technology used, or services offered, by competitors;

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- significant acquisitions or business combinations, strategic partnerships, joint ventures or capital commitments by or involving us or our competitors;
- failure to integrate acquisitions or realize anticipated benefits from acquisitions;
- changes in government regulations; and
- geopolitical conditions such as acts or threats of terrorism or military conflicts.

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

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

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

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

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

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

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

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

or all of your investment.

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

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

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

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

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

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ITEM 1B.UNRESOLVED STAFF COMMENTS

None

ITEM 2.PROPERTIES

Southside Bank owns and operates the following properties:

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

- 50 ATM’s located throughout our market areas.

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

- one in Bullard, Texas;
- one in Lindale, Texas;
- one in Flint, Texas;

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- one in Whitehouse, Texas;
- one in Chandler, Texas;
- one in Seven Points, Texas;
- one in Palestine, Texas;
- one in Athens, Texas;
- one in Hawkins, Texas;
- three in Longview, Texas;
- seven in Tyler, Texas;
- Fort Worth branch and motor bank facility at 701 West Magnolia, Fort Worth, Texas;
- Fort Worth branch at 707 West Magnolia, Fort Worth, Texas;
- Forney branch at 413 North McGraw, Forney, Texas; and
- Austin branch at 8200 North Mopac, Suite 130, Austin, Texas.

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

- 700 West Arkansas Lane, Arlington, Texas.

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

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

ITEM 3.LEGAL PROCEEDINGS

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

ITEM 4.MINE SAFETY DISCLOSURES

Not applicable.

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PART II

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

MARKET INFORMATION

Our common stock trades on the NASDAQ Global Select Market under the symbol "SBSI." Set forth below are the high and low sales prices on the NASDAQ Global Select Market for each full quarterly period from January 1, 2010 to December 31, 2011. During the first quarters of 2011 and 2010, we declared and paid a 5% stock dividend. Stock prices listed below have been adjusted to give retroactive recognition to such stock dividends.

Year Ended December 31,		1st Quarter		2nd Quarter		3rd Quarter		4th Quarter
2011	$	21.51 – 18.74	$	21.83 – 18.38	$	20.44 – 17.84	$	22.52 – 17.63
2010	$	19.75 – 16.28	$	20.86 – 17.78	$	18.72 – 16.71	$	20.40 – 17.42

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

SHAREHOLDERS

There were approximately 1,000 holders of record of our common stock, the only class of equity securities currently issued and outstanding, as of March 15, 2012.

DIVIDENDS

Cash dividends declared and paid were $0.90 and $0.85 per share for the years ended December 31, 2011 and 2010, respectively. Stock dividends of 5% were also declared and paid during each of the years ended December 31, 2011 and 2010. We have paid a cash dividend at least once every year since 1970 (including dividends paid by Southside Bank prior to the incorporation of Southside Bancshares). Future dividends will depend on our earnings, financial condition and other factors that our board of directors considers to be relevant. In addition, we must make payments on our junior subordinated debentures before any dividends can be paid on the common stock. For additional discussion relating to restrictions that limit our ability to pay dividends refer to "Item 1. Business – Supervision and Regulation" and "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations – Capital Resources." The cash dividends were paid quarterly each year as listed below.

Quarterly Cash Dividends Paid

Year Ended December 31,		1st Quarter		2nd Quarter		3rd Quarter		4th Quarter
2011	$	0.17	$	0.17	$	0.18	$	0.38
2010	$	0.17	$	0.17	$	0.17	$	0.34

ISSUER SECURITY REPURCHASES

During 2011, we did not approve any additional funding for our stock repurchase plan. No common stock was purchased during the quarter ended December 31, 2011.

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FINANCIAL PERFORMANCE

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

Southside Bancshares, Inc.

				Period Ending		
Index	12/31/06	12/31/07	12/31/08	12/31/09	12/31/10	12/31/11
Southside Bancshares, Inc.	100.00	85.52	106.02	96.39	113.41	127.86
Russell 2000	100.00	98.43	65.18	82.89	105.14	100.75
SBSI 2010 Peer Group	100.00	87.01	86.75	89.99	104.35	105.87
SBSI 2011 Peer Group	100.00	87.00	90.95	95.49	109.17	109.69

SBSI 2010 Peer Group consist of Cullen/Frost Bankers, Inc. (CFR), First Financial Bankshares, Inc. (FFIN), International Bancshares Corporation (IBOC), MetroCorp Bancshares, Inc. (MCBI), Prosperity Bancshares, Inc. (PB), Texas Capital Bancshares, Inc. (TCBI), Encore Bancshares, Inc. (EBTX), Sterling Bancshares, Inc. (SBIB - This is now historical)

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

Source : SNL Financial LC, Charlottesville, VA
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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, 2011. This information should be read in conjunction with "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations" and "Item 8. Financial Statements and Supplementary Data," as set forth in this report.

	As of and For the Years Ended December 31,				
	2011	2010	2009	2008	2007
	(in thousands, except per share data)				
Balance Sheet Data:					
Investment Securities	$284,452	$300,839	$266,553	$278,856	$110,403
Mortgage-backed and Related Securities	$1,729,516	$1,364,117	$1,480,847	$1,183,800	$917,518
Loans, Net of Allowance for Loan Losses	$1,068,690	$1,057,209	$1,013,680	$1,006,437	$951,477
Total Assets	$3,303,817	$2,999,759	$3,024,288	$2,700,238	$2,196,322
Deposits	$2,321,671	$2,134,428	$1,870,421	$1,556,131	$1,530,491
Long-term Obligations	$321,035	$433,790	$592,830	$715,800	$146,558
Shareholders' Equity	$258,927	$214,461	$201,781	$160,617	$132,328
Income Statement Data:					
Interest Income	$131,038	$131,374	$145,193	$136,176	$105,741
Interest Expense	$35,631	$45,307	$52,672	$60,363	$61,863
Deposit Service Income	$15,943	$16,819	$17,629	$18,395	$17,280
Gain on Sale of Securities Available for Sale	$11,795	$25,789	$33,446	$12,334	$897
Noninterest Income	$35,322	$50,798	$56,674	$40,302	$26,418
Noninterest Expense	$72,348	$71,314	$71,630	$60,352	$47,287
Net Income Attributable to Southside Bancshares, Inc.	$39,133	$39,103	$44,396	$30,696	$16,684
Per Share Data:					
Earnings Per Common Share:					
Basic	$2.38	$2.37	$2.71	$1.91	$1.05

Diluted	$2.38	$2.37	$2.68	$1.87	$1.02
Cash Dividends Paid Per Common Share	$0.90	$0.85	$0.75	$0.60	$0.50

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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, 2011, 2010, and 2009 and financial condition as of December 31, 2011 and 2010. This discussion should be read in conjunction with the financial statements and related notes included elsewhere in this report. All share data has been adjusted to give retroactive recognition to stock splits and stock dividends.

CAUTIONARY NOTICE REGARDING FORWARD-LOOKING STATEMENTS

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

- general economic conditions, either globally, nationally, in the State of Texas, or in the specific markets in which we operate, including, without limitation, the deterioration of the commercial real estate, residential real estate, construction and development, credit and liquidity markets, which could cause an adverse change in our net interest margin, or a decline in the value of our assets, which could result in realized losses;

- legislation, regulatory changes or changes in monetary or fiscal policy that adversely affect the businesses in which we are engaged, including the impact of the Dodd-Frank Act, the Federal Reserve’s actions with respect to interest rates and other regulatory responses to current economic conditions;

- adverse changes in the status or financial condition of the Government-Sponsored Enterprises (the “GSEs”) impacting the GSEs’ guarantees or ability to pay or issue debt;

- adverse changes in the credit portfolio of other U.S. financial institutions relative to the performance of certain of our investment securities;

- economic or other disruptions caused by acts of terrorism in the United States, Europe or other areas;

- changes in the interest rate yield curve such as flat, inverted or steep yield curves, or changes in the interest rate environment that impact interest margins and may impact prepayments on the mortgage-backed securities portfolio;

- increases in our nonperforming assets;
- our ability to maintain adequate liquidity to fund operations and growth;
- the failure of our assumptions underlying allowance for loan losses and other estimates;

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- unexpected outcomes of, and the costs associated with, existing or new litigation involving us;
- changes impacting our balance sheet and leverage strategy;
- risks related to actual U.S. agency mortgage-backed securities prepayments exceeding projected prepayment levels;
- risks related to U.S. agency mortgage-backed securities prepayments increasing due to U.S. Government programs designed to assist homeowners to refinance their mortgage that might not otherwise have qualified;
- our ability to monitor interest rate risk;
- significant increases in competition in the banking and financial services industry;
- changes in consumer spending, borrowing and saving habits;
- technological changes;
- our ability to increase market share and control expenses;
- the effect of changes in federal or state tax laws;
- the effect of compliance with legislation or regulatory changes;
- the effect of changes in accounting policies and practices;
- risks of mergers and acquisitions including the related time and cost of implementing transactions and the potential failure to achieve expected gains, revenue growth or expense savings;
- credit risks of borrowers, including any increase in those risks due to changing economic conditions; and
- risks related to loans secured by real estate, including the risk that the value and marketability of collateral could decline.

All written or oral forward-looking statements made by us or attributable to us are expressly qualified by this cautionary notice. We disclaim any obligation to update any factors or to announce publicly the result of revisions to any of the forward-looking statements included herein to reflect future events or developments.

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IMPACT OF DODD-FRANK ACT

On July 21, 2010, the Dodd-Frank Act was signed into law. The Dodd-Frank Act represents a significant overhaul of many aspects of the regulation of the financial services industry, although some of its provisions apply to companies that are significantly larger than us. The Dodd-Frank Act directs applicable regulatory authorities to promulgate regulations implementing its provisions, and its effect on us and the financial services industry as a whole will be clarified as those regulations are issued. Major elements of the Dodd-Frank Act include:

- A permanent increase in deposit insurance coverage to $250,000 per account, unlimited deposit insurance on noninterest bearing transaction accounts beginning December 31, 2010 through December 31, 2012, and an increase in the minimum Deposit Insurance Fund reserve requirement from 1.15% to 1.35%, with assessments to be based on assets as opposed to deposits;
- New disclosure and other requirements relating to executive compensation and corporate governance;
- New prohibitions and restrictions on the ability of a banking entity and nonbank financial company to engage in proprietary trading and have certain interests in, or relationships with, a hedge fund or private equity fund;
- Amendments to the Truth in Lending Act aimed at improving consumer protections with respect to mortgage originations, including originator compensation, minimum repayment standards, and prepayment considerations;
- The establishment of the Financial Stability Oversight Council, which will be responsible for identifying and monitoring systemic risks posed by financial firms, activities, and practices;
- The development of regulations to limit debit card interchange fees;
- The future elimination of newly issued trust preferred securities as a permitted element of Tier 1 capital;
- The creation of a special regime to allow for the orderly liquidation of systemically important financial companies, including the establishment of an orderly liquidation fund;
- The development of regulations to address derivatives markets, including clearing and exchange trading requirements and a framework for regulating derivatives-market participants;
- Enhanced supervision of credit rating agencies through the Office of Credit Ratings within the SEC;
- Increased regulation of asset-backed securities, including a requirement that issuers of asset-backed securities retain at least 5% of the risk of the asset backed securities; and
- The establishment of a Bureau of Consumer Financial Protection with centralized authority, including examination and enforcement authority, for consumer protection in the banking industry.

Regulatory agencies are still in the process of issuing regulations, rules and reporting requirements as mandated by the Dodd-Frank Act. As a result, we are continuing to evaluate the potential impact of the Dodd-Frank Act on our business, financial condition and results of operations and expect that some provisions may have adverse effects on us, such as the cost of complying with the numerous new regulations and reporting requirements mandated by the Dodd-Frank Act.

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CRITICAL ACCOUNTING ESTIMATES

Our accounting and reporting estimates conform with U.S. generally accepted accounting principles (“GAAP”) and general practices within the financial services industry. The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates. We consider our critical accounting policies to include the following:

Allowance for Losses on Loans. The allowance for losses on loans represents our best estimate of probable losses inherent in the existing loan portfolio. The allowance for losses on loans is increased by the provision for losses on loans charged to expense and reduced by loans charged-off, net of recoveries. The provision for losses on loans is determined based on our assessment of several factors: reviews and evaluations of specific loans, changes in the nature and volume of the loan portfolio, current economic conditions and the related impact on specific borrowers and industry groups, historical loan loss experience, the level of classified and nonperforming loans and the results of regulatory examinations.

The loan loss allowance is based on the most current review of the loan portfolio and is validated by multiple processes. The servicing officer has the primary responsibility for updating significant changes in a customer's financial position. Each officer prepares status updates on any credit deemed to be experiencing repayment difficulties which, in the officer's opinion, would place the collection of principal or interest in doubt. Our internal loan review department is responsible for an ongoing review of our loan portfolio with specific goals set for the loans to be reviewed on an annual basis.

At each review, a subjective analysis methodology is used to grade the respective loan. Categories of grading vary in severity from loans that do not appear to have a significant probability of loss at the time of review to loans that indicate a probability that the entire balance of the loan will be uncollectible. If full collection of the loan balance appears unlikely at the time of review, estimates of future expected cash flows or appraisals of the collateral securing the debt are used to allocate the necessary allowances. The internal loan review department maintains a list of all loans or loan relationships that are graded as having more than the normal degree of risk associated with them. In addition, a list of specifically reserved loans or loan relationships of $50,000 or more is updated on a quarterly basis in order to properly allocate necessary allowance and keep management informed on the status of attempts to correct the deficiencies noted with respect to the loan.

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

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

As of December 31, 2011, our review of the loan portfolio indicated that a loan loss allowance of $18.5 million was adequate to cover probable losses in the portfolio.

Refer to “Loan Loss Experience and Allowance for Loan Losses” and “Note 7 – Loans and Allowance for Probable Loan Losses” to our consolidated financial statements included in this report for a detailed description of our estimation process and methodology related to the allowance for loan losses.

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Estimation of Fair Value. The estimation of fair value is significant to a number of our assets and liabilities. In addition, GAAP requires disclosure of the fair value of financial instruments as a part of the notes to the consolidated financial statements. Fair values for securities are volatile and may be influenced by a number of factors, including market interest rates, prepayment speeds, discount rates and the shape of yield curves. Fair values for most investment and mortgage-backed securities are based on quoted market prices, where available. If quoted market prices are not available, fair values are based on the quoted prices of similar instruments or estimates from independent pricing services. Where there are price variances outside certain ranges from different pricing services for specific securities, those pricing variances are reviewed with other market data to determine which of the price estimates is appropriate for that period. For securities carried at fair value through income, the change in fair value from the prior period is recorded on our income statement as fair value gain (loss) – securities.

At September 30, 2008 and continuing at December 31, 2011, the valuation inputs for our available for sale ("AFS") trust preferred securities ("TRUPs") became unobservable as a result of the significant market dislocation and illiquidity in the marketplace. Although we continue to rely on nonbinding prices compiled by third party vendors, the visibility of the observable market data (Level 2) to determine the values of these securities has become less clear. Fair values of financial assets are determined in an orderly transaction and not a forced liquidation or distressed sale at the measurement date. While we feel the financial market conditions at December 31, 2011 reflect the market illiquidity from forced liquidation or distressed sales for these TRUPs, we determined that the fair value provided by our pricing service continues to be an appropriate fair value for financial statement measurement and therefore, as we verified the reasonableness of that fair value, we have not otherwise adjusted the fair value provided by our vendor. However, the severe decline in estimated fair value is caused by the significant illiquidity in this market which contrasts sharply with our assessment of the fundamental performance of these securities. Therefore, we believe the estimate of fair value is still not clearly based on observable market data and will be based on a range of fair value data points from the market place as a result of the illiquid market specific to this type of security. Accordingly, we determined that the TRUPs security valuation is based on Level 3 inputs.

Impairment of Investment Securities and Mortgage-backed Securities. Investment and mortgage-backed securities classified as AFS are carried at fair value and the impact of changes in fair value are recorded on our consolidated balance sheet as an unrealized gain or loss in "Accumulated other comprehensive income (loss)," a separate component of shareholders' equity. Securities classified as AFS or held to maturity ("HTM") are subject to our review to identify when a decline in value is other-than-temporary. Factors considered in determining whether a decline in value is other-than-temporary include: whether the decline is substantial; the duration of the decline; the reasons for the decline in value; whether the decline is related to a credit event, a change in interest rate or a change in the market discount rate; and the financial condition and near-term prospects of the issuer. Additionally, we do not currently intend to sell the security and it is not more likely than not that we will be required to sell the security before the anticipated recovery of its amortized cost basis. When it is determined that a decline in value is other-than-temporary, the carrying value of the security is reduced to its estimated fair value, with a corresponding charge to earnings for the credit portion and the noncredit portion to other comprehensive income. For certain assets we consider expected cash flows of the investment in determining if impairment exists.

The turmoil in the capital markets had a significant impact on our estimate of fair value for certain of our securities. We believe the fair values are reflective of a combination of illiquidity and credit impairment. At December 31, 2011 we have in AFS Other Stocks and Bonds $2.9 million amortized cost basis in pooled TRUPs. Those securities are structured products with cash flows dependent upon securities issued by U.S. financial institutions, including banks and insurance companies. Our estimate of fair value at December 31, 2011 for the TRUPs is approximately $499,000 and reflects the market illiquidity. With the exception of the TRUPs, to the best of management's knowledge and based on our consideration of the qualitative factors associated with each security, there were no securities in our investment and mortgage-backed securities portfolio at December 31, 2011 with an other-than-temporary impairment. Given the facts and circumstances associated with the TRUPs, we performed

detailed cash flow modeling for each TRUP using an industry accepted model. Prior to loading the required assumptions into the model, we reviewed the financial condition of the underlying issuing banks within the TRUP collateral pool that had not deferred or defaulted as of December 31, 2011.

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Management's best estimate of a default assumption, based on a third party method, was assigned to each issuing bank based on the category in which it fell. Our analysis of the underlying cash flows contemplated various default, deferral and recovery scenarios to arrive at our best estimate of cash flows. Based on that detailed analysis, we have concluded that the other-than-temporary impairment which captures the credit component in compliance with the Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") Topic 320, "Investments – Debt and Equity Securities," was estimated at $3.1 million at both December 31, 2011 and 2010, respectively. The noncredit charge to other comprehensive income was estimated at $2.4 million and $2.7 million at December 31, 2011 and 2010, respectively. The carrying amount of the TRUPs was written down with $75,000 recognized in earnings for the year ended December 31, 2010. There was no write-down required during the year ended December 31, 2011. The cash flow model assumptions represent management's best estimate and consider a variety of qualitative factors, which include, among others, the credit rating downgrades, severity and duration of the mark-to-market loss, and structural nuances of each TRUP. Management believes the detailed review of the collateral and cash flow modeling support the conclusion that the TRUPs had an other-than-temporary impairment at December 31, 2011. We will continue to update our assumptions and the resulting analysis each reporting period to reflect changing market conditions. Additionally, we do not currently intend to sell the TRUPs and it is not more likely than not that we will be required to sell the TRUPs before the anticipated recovery of their amortized cost basis.

Defined Benefit Pension Plan. The plan obligations and related assets of our defined benefit pension plan (the "Plan") are presented in "Note 13 – Employee Benefits" to our consolidated financial statements included in this report. Entry into the Plan by new employees was frozen effective December 31, 2005. Plan assets, which consist primarily of marketable equity and debt instruments, are valued using observable market quotations. Plan obligations and the annual pension expense are determined by independent actuaries and through the use of a number of assumptions that are reviewed by management. Key assumptions in measuring the plan obligations include the discount rate, the rate of salary increases and the estimated future return on plan assets. In determining the discount rate, we utilized a cash flow matching analysis to determine a range of appropriate discount rates for our defined benefit pension and restoration plans. In developing the cash flow matching analysis, we constructed a portfolio of high quality noncallable bonds (rated AA or better) to match as close as possible the timing of future benefit payments of the plans at December 31, 2011. 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, 2011, the weighted-average actuarial assumptions of the Plan were: a discount rate of 4.84%; a long-term rate of return on Plan assets of 7.25%; and assumed salary increases of 4.50%. Material changes in pension benefit costs may occur in the future due to changes in these assumptions. Future annual amounts could be impacted by changes in the number of Plan participants, changes in the level of benefits provided, changes in the discount rates, changes in the expected long-term rate of return, changes in the level of contributions to the Plan and other factors.

Long-term Advance Commitments. During 2011 and 2010, we entered into the option to fund between one and a half and two years forward from the advance commitment date, $200 million par in long-term advance commitments from the FHLB at the FHLB rates on the date the option was purchased. A table detailing the optional advance commitment terms is presented in "Note 12 – Long-Term Obligations" to our consolidated financial statements included in this report. In order to obtain these commitments from the FHLB we paid fees of $11.0 million, which at December 31, 2011 had been impaired and the carrying value on the balance sheet was $2.0 million. The remaining fee, included in other assets in our consolidated balance sheet will be amortized over the term of the advance upon exercise of the advance commitments. If any of the options are impaired, then the amount of the impairment on that

option will be charged against income during the period it occurs. In determining if it is still probable that we will exercise the advance commitments quarterly, we compare all the costs of the advance commitment with the current advance rate available from the FHLB. If the current advance rate is reasonably close to or greater than the advance commitment rate then it is probable we will exercise our option. If the current rate is less, then we review the slope of the yield curve to determine if the forward yield curve supports our assumption that it is probable we will exercise the advance commitments. If the current rate is less and the forward yield curve does not support our assumption that it is probable we will exercise the advance commitments, then we value the option to determine if it is impaired and if so record the impairment in that period.

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OVERVIEW

OPERATING RESULTS

During the year ended December 31, 2011, our net income increased $30,000, or 0.1%, to $39.1 million, from $39.1 million for the same period in 2010. The increase in net income was primarily attributable to the increase in net interest income and a decrease in the provision for loan losses. These items were partially offset by a decrease in the gain on sale of securities available for sale and an impairment charge of $8.9 million to our FHLB advance option fee which has been written down to $2.0 million at December 31, 2011. Noninterest expense increased slightly primarily due to an increase in salaries and employee benefits due to our overall growth and expansion while offset by a decrease in FDIC insurance. Earnings per diluted share increased $0.01, or 0.4%, to $2.38 for the year ended December 31, 2011, from $2.37 for the same period in 2010.

During the year ended December 31, 2010, our net income decreased $5.3 million, or 11.9%, to $39.1 million, from $44.4 million for the same period in 2009. The decrease in net income was primarily attributable to the decrease in net interest income and noninterest income and was partially offset by a decrease in the provision for losses, income tax expense and noninterest expense. The decrease in noninterest income was driven primarily by a decrease in gain on sale of AFS securities. Noninterest expense decreased slightly primarily due to a decrease in FDIC insurance and other expense which was offset by an increase in salaries and employee benefits due to our overall growth and expansion. Earnings per diluted share decreased $0.31, or 11.6%, to $2.37 for the year ended December 31, 2010, from $2.68 for the same period in 2009.

FINANCIAL CONDITION

Our total assets increased $304.1 million, or 10.1%, to $3.30 billion at December 31, 2011 from $3.00 billion at December 31, 2010. This increase was attributable to an increase in our mortgage-backed securities and, to a lesser extent, loan growth. Our securities portfolio increased by $349.0 million, or 21.0%, to $2.01 billion compared to $1.66 billion at December 31, 2010. At December 31, 2011, loans were $1.09 billion compared to $1.08 billion at December 31, 2010. The increase in our securities was comprised entirely of mortgage-backed and related securities. The increase in loans was funded by increases in deposits.

Our nonperforming assets at December 31, 2011 decreased to $13.2 million, and represented 0.40% of total assets, compared to $17.7 million, or 0.59% of total assets at December 31, 2010. Nonaccruing loans decreased $4.2 million, to $10.3 million and the ratio of nonaccruing loans to total loans decreased to 0.95% at December 31, 2011 compared to $14.5 million and 1.35% at December 31, 2010. Other Real Estate Owned (“OREO”) increased to $453,000 at December 31, 2011 from $220,000 at December 31, 2010. Accruing loans past due more than 90 days at December 31, 2011 decreased to $5,000 compared to $7,000 at December 31, 2010. Repossessed assets decreased to $322,000 at December 31, 2011 from $638,000 at December 31, 2010. Restructured performing loans at December 31, 2011 decreased to $2.1 million compared to $2.3 million at December 31, 2010.

Our deposits increased $187.2 million to $2.32 billion at December 31, 2011 from $2.13 billion at December 31, 2010. The increase in our deposits during 2011 was primarily due to an increase in deposits from branch expansion and increased market penetration, and to a lesser extent, an increase in public fund deposits. During 2011, our public fund deposits increased $63.2 million. During 2011 brokered deposits increased $2.5 million. Our deposits, net of brokered deposits, increased $184.8 million. FHLB advances increased $60.0 million to $622.5 million at December 31, 2011, from $562.6 million at December 31, 2010. Short-term FHLB advances increased $172.7 million to $361.8 million at December 31, 2011 from $189.1 million at December 31, 2010. Long-term FHLB advances decreased $112.8 million to $260.7 million at December 31, 2011 from $373.5 million at December 31, 2010. During 2010 and 2011 we entered into the option to purchase, between one and a half and two years forward from the advance

commitment date $200 million par in long-term advance commitments from FHLB at the FHLB rates on the date option was purchased. Other borrowings at December 31, 2011 and 2010 totaled $63.5 million and $66.8 million, respectively, and at December 31, 2011 consisted of $3.2 million of short-term borrowings and $60.3 million of long-term debt.

Assets under management in our trust department increased slightly during 2011 and were approximately $718.5 million at December 31, 2011 compared to $718 million at December 31, 2010.

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Shareholders' equity at December 31, 2011 totaled $258.9 million compared to $214.5 million at December 31, 2010. The increase primarily reflects the net income of $39.1 million recorded for the year ended December 31, 2011, the common stock issued of $1.5 million as a result of our dividend reinvestment and incentive stock option plans and the increase in the accumulated other comprehensive income of $21.0 million, which were partially offset by the payment of cash dividends to our shareholders of $14.7 million and the purchase of a noncontrolling interest in SFG of $2.8 million. The increase in accumulated other comprehensive income is comprised of an increase of $26.5 million, net of tax, in the unrealized gain on securities, net of reclassification adjustment and a decrease of $5.4 million, net of tax, related to the change in the unfunded status of our defined benefit plan. See "Note 4 – Comprehensive Income (Loss)" to our consolidated financial statements included in this report.

Our market areas to date, have not experienced the level of downturn in the economy and real estate prices that some of the harder hit areas of the country have experienced. However, we have experienced weakening conditions associated with the real estate led downturn. Many economists predict growth for the economy during 2012, however we are well aware that any economic recovery could be uneven. We cannot predict whether current economic conditions will improve, remain the same or decline.

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

BALANCE SHEET STRATEGY

We utilize wholesale funding and securities to enhance our profitability and balance sheet composition by determining acceptable levels of credit, interest rate and liquidity risk consistent with prudent capital management. This balance sheet strategy consists of borrowing a combination of long and short-term funds from the FHLB and, when determined appropriate, issuing brokered CDs. These funds are invested primarily in U.S. agency mortgage-backed securities, and to a lesser extent, long-term municipal securities. Although U.S. agency mortgage-backed securities often carry lower yields than traditional mortgage loans and other types of loans we make, these securities generally (i) increase the overall quality of our assets because of either the implicit or explicit guarantees of the U.S. Government, (ii) are more liquid than individual loans, and (iii) may be used to collateralize our borrowings or other obligations. While the strategy of investing a substantial portion of our assets in U.S. agency mortgage-backed securities and to a lesser extent municipal securities has historically resulted in lower interest rate spreads and margins, we believe that the lower operating expenses and reduced credit risk combined with the managed interest rate risk of this strategy have enhanced our overall profitability over the last several years. At this time, we utilize this balance sheet strategy with the goal of enhancing overall profitability by maximizing the use of our capital.

Risks associated with the asset structure we maintain include a lower net interest rate spread and margin when compared to our peers, changes in the slope of the yield curve, which can reduce our net interest rate spread and margin, increased interest rate risk, the length of interest rate cycles, changes in volatility spreads associated with the mortgage-backed securities and municipal securities, the unpredictable nature of mortgage-backed securities prepayments and credit risks associated with the municipal securities. See "Part I - Item 1A. Risk Factors – Risks Related to Our Business" for a discussion of risks related to interest rates. Our asset structure, net interest spread and net interest margin require us to closely monitor our interest rate risk. An additional risk is the change in fair value of the AFS securities portfolio as a result of changes in interest rates. Significant increases in interest rates, especially long-term interest rates, could adversely impact the fair value of the AFS securities portfolio, which could also significantly impact our equity capital. Significant increases in interest rates could also adversely impact the fair value of our securities carried at fair value through income, which could significantly impact our net income. 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.

Determining the appropriate size of the balance sheet is one of the critical decisions any bank makes. Our balance sheet is not merely the result of a series of micro-decisions, but rather the size is controlled based on the economics of assets compared to the economics of funding. For several quarters up to and ending June 30, 2007, the size of our balance sheet was in a period of no growth or actual shrinkage due to the flat to inverted yield curve and tight volatility spreads during that time period. Beginning with the third quarter of 2007 we began deliberately increasing the size of our balance sheet taking advantage of the increasingly attractive economics of financial intermediation, due to the extraordinary volatility in the capital markets. As the volatility in the capital markets has moderated, the current investment and economic landscape makes it uncertain whether we will experience asset growth driven by an increase in the securities portfolio over the near term.

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The management of our securities portfolio as a percentage of earning assets is guided by changes in our overall loan and deposit levels, combined with changes in our wholesale funding levels. If adequate quality loan growth is not available to achieve our goal of enhancing profitability by maximizing the use of capital, as described above, then we could purchase additional securities, if appropriate, which could cause securities as a percentage of earning assets to increase. Should we determine that increasing the securities portfolio or replacing the current securities maturities and principal payments is not an efficient use of capital, we could decrease the level of securities through proceeds from maturities, principal payments on mortgage-backed securities or sales. Our balance sheet strategy is designed such that our securities portfolio should help mitigate financial performance associated with slower loan growth and higher credit costs.

The year ended December 31, 2011 was marked by proactive management of the securities portfolio which included restructuring a portion of our securities portfolio. This restructuring resulted in a gain on the sale of securities available for sale of $11.8 million during 2011. During the quarter ended December 31, 2011, as interest rates remained low, we continued to sell primarily lower yielding, longer duration municipal securities and lower coupon or more prepayment volatile mortgage-backed securities and replaced them with primarily shorter duration municipal securities and higher coupon and less prepayment volatile mortgage-backed securities that might perform better in both the current and potentially higher interest rate environment in the future. During the quarter ended December 31, 2011, we increased the size of the securities portfolio slightly due to continued global economic concerns, U.S. deficit concerns, and the Federal Reserve signaling an extended period of low short-term interest rates. The net result was an increase in our investment and U.S. agency mortgage-backed securities from $1.97 billion at September 30, 2011, to $2.01 billion at December 31, 2011. The average coupon of the mortgage-backed securities portfolio increased to 6.12% at December 31, 2011 from 5.90% at December 31, 2010. At December 31, 2011, securities as a percentage of assets decreased to 61.0%, as compared to 61.3% at September 30, 2011 and increased compared to 55.5% at December 31, 2010. Our balance sheet management strategy is dynamic and will be continually reevaluated as market conditions warrant. As interest rates, yield curves, mortgage-backed securities prepayments, funding costs, security spreads and loan and deposit portfolios change, our determination of the proper types and maturities of securities to own, proper amount of securities to own and funding needs and funding sources will continue to be reevaluated. Should the economics of asset accumulation decrease, we might allow the balance sheet to shrink through run-off or asset sales. However, should the economics become more attractive, we will strategically increase the balance sheet.

Subsequent to year end, we began selling our securities carried at fair value through income as management decided it did not want potentially significant swings in net income associated with fair value changes for these securities. Securities carried at fair value through income were $647.8 million on December 31, 2011. As of March 8, 2012 there were less than $30 million of these securities that had not been sold.

With respect to liabilities, we will continue to utilize a combination of FHLB advances and deposits to achieve our strategy of minimizing cost while achieving overall interest rate risk objectives as well as the liability management objectives of the ALCO. FHLB funding and brokered CDs represent wholesale funding sources we are currently utilizing. Our FHLB borrowings at December 31, 2011 increased 10.7%, or $60.0 million, to $622.5 million from $562.6 million at December 31, 2010 primarily as a result of an increase in the securities portfolio that exceeded the increase in funding available from deposits. During 2011 and 2010 we entered into the option to purchase, between one and a half and two years forward from the advance commitment date, $200 million par in long-term advance commitments from FHLB at the FHLB rates on the date the option was purchased. As of December 31, 2011 we had $163.8 million in brokered CDs of which all were long-term. All of the long-term brokered CDs, except for one $5.0 million CD, have short-term calls that we control. We utilized long-term callable brokered CDs because the brokered CDs better matched overall ALCO objectives at the time of issuance by protecting us with fixed rates should interest rates increase, while providing us options to call the funding should interest rates decrease. We are actively evaluating the callable brokered CDs and may exercise the call option if there is an economic benefit. Our wholesale

funding policy currently allows maximum brokered CDs of $180 million; however, this amount could be increased to match changes in ALCO objectives. The potential higher interest expense and lack of customer loyalty are risks associated with the use of brokered CDs. During 2011, the overall growth in deposits resulted in a decrease in our total wholesale funding as a percentage of deposits, not including brokered CDs, to 36.4% at December 31, 2011, from 36.7% at December 31, 2010.

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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, 2011 COMPARED TO DECEMBER 31, 2010

Certain financial statement components for the year ended December 31, 2010 were required to be revised to show comparative financial statements with 2011 which reflect securities carried at fair value through income. Throughout this discussion we will footnote tables that have been revised for 2010 to reflect the impact of this revision.

NET INTEREST INCOME

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

	Years ended December 31,			
	2011	2010	Amount Change	Percent Change
	(dollars in thousands)			
Interest income				
Loans	$66,736	$69,973	$(3,237)	(4.6%)
Investment securities – taxable	64	91	(27)	(29.7%)
Investment securities - tax exempt	12,520	10,889	1,631	15.0%
Mortgage-backed and related securities	51,467	50,130	1,337	2.7%
FHLB stock and other investments	233	259	(26)	(10.0%)
Other interest earning assets	18	32	(14)	(43.8%)
Total interest income	131,038	131,374	(336)	(0.3%)
Interest expense				
Deposits	15,647	18,969	(3,322)	(17.5%)
Short-term obligations	6,577	7,563	(986)	(13.0%)
Long-term obligations	13,407	18,775	(5,368)	(28.6%)
Total interest expense	35,631	45,307	(9,676)	(21.4%)
Net interest income	$95,407	$86,067	$9,340	10.9%

Net interest income for the year ended December 31, 2011 increased $9.3 million, or 10.9%, compared to the same period in 2010. The overall increase in net interest income was primarily the result of a decrease in total interest expense and increases in interest income from tax-exempt investment securities and mortgage-backed and related

securities. This was partially offset by a decrease in interest income from loans.

During the year ended December 31, 2011, total interest income decreased $336,000, or 0.3%. The decrease in total interest income was the result of a decrease in the average yield on average interest earning assets from 5.01% for the year ended December 31, 2010 to 4.82% for the year ended December 31, 2011 which more than offset the increase in average interest earning assets of $126.4 million, or 4.5%, from $2.80 billion to $2.93 billion. The decrease in the yield on interest earning assets is reflective of a 41 basis point decrease in the yield on loans and a 6 basis point decrease in the yield on our securities portfolio due to lower overall interest rates. Total interest expense decreased $9.7 million, or 21.4%, during the year ended December 31, 2011. The decrease was attributable to a decrease in the average yield on interest bearing liabilities for the year ended December 31, 2011, to 1.48% from 1.94% for the same period in 2010 which was partially offset by an increase in average interest bearing liabilities of $64.1 million, or 2.7%, from $2.34 billion to $2.40 billion. The decrease in the average yield on interest bearing liabilities of 46 basis points is a result of overall lower interest rates. For the year ended December 31, 2011, our net interest spread increased to 3.34% from 3.07%, and our net interest margin increased to 3.60% from 3.39% when compared to the same period in 2010.

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

Average investment and mortgage-backed securities increased $118.1 million, or 6.9%, from $1.72 billion to $1.83 billion, for the year ended December 31, 2011 when compared to the same period in 2010. This increase was the result of securities purchased due to buying opportunities available throughout most of 2011. At December 31, 2011, virtually all of our mortgage-backed securities were fixed rate securities with less than one percent variable rate mortgage-backed securities. The overall yield on average investment and mortgage-backed securities decreased to 3.83% during the year ended December 31, 2011 from 3.89% during the same period in 2010. The decrease in the average yield primarily reflects tighter spreads on mortgage-backed and municipal securities and overall lower interest rates. Interest income on investment and mortgage-backed securities increased $2.9 million in 2011, or 4.8%, due to an increase in the average balance which was partially offset by a decrease in the average yield. A further decrease in long-term interest rate levels combined with lower volatility and credit spreads could negatively impact our net interest margin in the future due to increased prepayments and repricings.

Average FHLB stock and other investments decreased $7.0 million, or 18.5%, to $30.9 million, for the year ended December 31, 2011, when compared to $38.0 million for 2010 due to the decrease in average FHLB advances during 2011 and the corresponding requirement to hold stock associated with those advances. Interest income from our FHLB stock and other investments decreased $26,000, or 10.0%, during 2011, due to a decrease in the average balance while partially offset by an increase in the average yield from 0.68% for the year ended December 31, 2010 compared to 0.75% for the same period in 2011. The FHLB stock is a variable instrument with the rate typically tied to the federal funds rate. We are required as a member of FHLB to own a specific amount of stock that changes as the level of our FHLB advances and asset size change.

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

During the year ended December 31, 2011, our average securities increased more than our average loans. As a result, the mix of our average interest earning assets reflected an increase in average total securities as a percentage of total average interest earning assets compared to the prior year as securities averaged 63.6% during 2011 compared to 62.5% during 2010, a direct result of securities purchases. Average loans were 36.1% of average total interest earning assets and other interest earning asset categories averaged 0.3% for December 31, 2011. During 2010, the comparable mix was 37.0% in loans and 0.5% in the other interest earning asset categories.

Total interest expense decreased $9.7 million, or 21.4%, during the year ended December 31, 2011. The decrease was primarily attributable to decreased funding costs as the average yield on interest bearing liabilities decreased from 1.94% for 2010 to 1.48% for the year ended December 31, 2011, which more than offset an increase in average interest bearing liabilities. The increase in average interest bearing liabilities included an increase in deposits of $214.7 million, or 13.9% that was partially offset by a decrease in FHLB advances and other short-term obligations of $150.6 million, or 20.3%.

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The following table sets forth our deposit averages by category for the years ended December 31, 2011, 2010 and 2009:

COMPOSITION OF DEPOSITS

	Years Ended December 31,								
	2011			2010			2009		
	Average Balance	Average Yield		Average Balance	Average Yield		Average Balance	Average Yield	
	(dollars in thousands)								
Interest Bearing Demand Deposits	$807,344	0.52	%	$723,315	0.71	%	$573,937	1.02	%
Savings Deposits	86,417	0.25	%	74,668	0.43	%	65,896	0.67	%
Time Deposits	860,614	1.30	%	741,712	1.82	%	688,854	2.37	%
Total Interest Bearing Deposits	1,754,375	0.89	%	1,539,695	1.23	%	1,328,687	1.71	%
Noninterest Bearing Demand Deposits	459,594	N/A		415,162	N/A		379,991	N/A	
Total Deposits	$2,213,969	0.71	%	$1,954,857	0.97	%	$1,708,678	1.33	%

Average interest bearing deposits increased $214.7 million, or 13.9%, from $1.54 billion to $1.75 billion, while the average rate paid decreased from 1.23% for the year ended December 31, 2010 to 0.89% for the year ended December 31, 2011. Average time deposits increased $118.9 million, or 16.0%, from $741.7 million to $860.6 million while the average rate paid decreased 52 basis points. Average interest bearing demand deposits increased $84.0 million, or 11.6%, while the average rate paid decreased 19 basis points. Average savings deposits increased $11.7 million, or 15.7%, while the average rate paid decreased 18 basis points. Interest expense for interest bearing deposits for the year ended December 31, 2011, decreased $3.3 million, or 17.5%, when compared to the same period in 2010 due to the decrease in the average yield which more than offset the increase in the average balance. Average noninterest bearing demand deposits increased $44.4 million, or 10.7%, during 2011. The latter three categories, which are considered the lowest cost deposits, comprised 61.1% of total average deposits during the year ended December 31, 2011 compared to 62.1% during 2010. The increase in our average total deposits during 2011 is primarily the result of an increase in deposits from municipalities and to a lesser extent, deposit growth due to branch expansion, and continued market penetration.

At December 31, 2011, total brokered CDs issued were $163.8 million of which all were long-term. This represented an increase of $2.5 million, or 1.5% from 2010. All of the long-term brokered CDs, except for one $5.0 million CD, have short-term calls that we control. We utilize long-term callable brokered CDs because the brokered CDs better match overall ALCO objectives at the time of issuance by protecting us with fixed rates should interest rates increase, while providing us options to call the funding should interest rates decrease. At December 31, 2011, brokered CDs represented 7.1% of deposits compared to 7.6% of deposits, at December 31, 2010. At December 31, 2011, all of the brokered CDs had maturities of less than six years. Our wholesale funding policy currently allows maximum brokered CDs of $180 million; however, this amount could be increased to match changes in ALCO objectives. The potential higher interest cost and lack of customer loyalty are risks associated with the use of brokered CDs.

Average short-term interest bearing liabilities, consisting primarily of FHLB advances and federal funds purchased and repurchase agreements, were $298.0 million, a decrease of $11.7 million, or 3.8%, for the year ended December 31, 2011 when compared to the same period in 2010. Interest expense associated with short-term interest bearing liabilities decreased $986,000, or 13.0%, and the average rate paid decreased 23 basis points to 2.21% for the year ended December 31, 2011, when compared to 2.44% for the same period in 2010. The decrease in the average rate paid reflects the lower interest rate environment in 2011 when compared to 2010. The decrease in the interest expense was due to a decrease in the average rate paid and average balance.

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Average long-term interest bearing liabilities consisting of FHLB advances decreased $138.9 million, or 32.3%, during the year ended December 31, 2011 to $291.6 million as compared to $430.5 million at December 31, 2010. The decrease in the average long-term FHLB advances is due primarily to advances classified as long-term at December 31, 2010 rolling into the short-term category, the use of more short-term FHLB advances during the period and the decision to enter into $200 million par in long-term advance commitments from the FHLB. During 2011 and 2010, we entered into the option to fund between one and a half and two years forward from the advance commitment date, $200 million par in long-term advance commitments from the FHLB at the FHLB rates on the date the option was purchased. In order to obtain these commitments from the FHLB we paid fees of $11.0 million. During the third quarter of 2011, the value of the FHLB advance option fees became impaired. They were further impaired during the fourth quarter of 2011 resulting in a total 2011 impairment charge of $8.9 million. At December 31, 2011, the remaining FHLB advance option fees on the balance sheet were $2.0 million. The remaining FHLB advance option fee, included in other assets in our consolidated balance sheet, will be amortized over the term of the advance when we exercise the advance commitments. Should we determine the advance commitments will not be exercised or they are further impaired, the remaining fee will be expensed in the period determination is made. Interest expense associated with long-term FHLB advances decreased $5.4 million, or 34.6%, and average rate paid decreased 12 basis points to 3.48% for the year ended December 31, 2011 when compared to 3.60% for the same period in 2010. The decrease in interest expense was due to the decrease in the average balance of long-term interest bearing liabilities and the decrease in the average rate paid. FHLB advances are collateralized by FHLB stock, securities and nonspecific real estate loans.

Average long-term debt, consisting of our junior subordinated debentures issued in 2003 and August 2007 and the junior subordinated debentures acquired in the purchase of FWBS, was $60.3 million for both of the years ended December 31, 2011 and 2010. Interest expense associated with long-term debt decreased $9,000, or 0.3%, to $3.3 million for the year ended December 31, 2011 when compared to $3.3 million for the same period in 2010 as a result of the slight decrease in the average yield of one basis point. The interest rate on the $20.6 million of long-term debentures issued to Southside Statutory Trust III adjusts quarterly at a rate equal to three-month LIBOR plus 294 basis points. The $23.2 million of long-term debentures issued to Southside Statutory Trust IV and the $12.9 million of long-term debentures issued to Southside Statutory Trust V have fixed rates of 6.518% through October 30, 2012 and 7.48% through December 15, 2012, respectively, and thereafter, adjusts quarterly. The interest rate on the $3.6 million of long-term debentures issued to Magnolia Trust Company I, assumed in the purchase of FWBS, adjusts quarterly at a rate equal to three-month LIBOR plus 180 basis points.

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AVERAGE BALANCES AND YIELDS

The following table presents average balance sheet amounts and average yields for the years ended December 31, 2011, 2010 and 2009. 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, 2011			December 31, 2010			December 31, 2009		
	Average Balance	Interest	Avg. Yield	Average Balance	Interest	Avg. Yield	Average Balance	Interest	Avg. Yield
ASSETS									
INTEREST EARNING ASSETS:									
Loans(1)(2)	$1,054,882	$70,533	6.69%	$1,031,858	$73,230	7.10%	$1,021,770	$73,654	7.21%
Loans Held For Sale	3,415	133	3.89%	5,123	189	3.69%	4,098	161	3.93%
Securities:									
Inv. Sec. (Taxable)(4)	6,056	64	1.06%	9,156	91	0.99%	42,598	1,055	2.48%
Inv. Sec. (Tax Exempt)(3)(4)	293,044	18,776	6.41%	245,874	16,515	6.72%	174,003	12,203	7.01%
Mortgage-backed and related Sec.(4)	1,534,837	51,467	3.35%	1,460,785	50,130	3.43%	1,320,766	65,463	4.96%
Total Securities	1,833,937	70,307	3.83%	1,715,815	66,736	3.89%	1,537,367	78,721	5.12%
FHLB stock and other investments, at cost	30,937	233	0.75%	37,973	259	0.68%	40,786	235	0.58%
Interest Earning Deposits	7,833	18	0.23%	13,880	32	0.23%	21,243	137	0.64%
Federal Funds Sold	–	–	–	–	–	–	3,925	17	0.43%
Total Interest Earning Assets	2,931,004	141,224	4.82%	2,804,649	140,446	5.01%	2,629,189	152,925	5.82%
NONINTEREST EARNING ASSETS:									
Cash and Due From Banks	41,280			43,881			43,504		
	50,627			48,709			45,231		

Bank Premises and Equipment			
Other Assets	137,166	124,052	112,702
Less: Allowance for Loan Losses	(18,965)	(19,135)	(17,622)
Total Assets	$3,141,112	$3,002,156	$2,813,004

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

(2) Interest income includes taxable-equivalent adjustments of $3,930, $3,446 and $3,136 for the years ended December 31, 2011, 2010 and 2009, respectively.

(3) Interest income includes taxable-equivalent adjustments of $6,256, $5,626 and $4,596 for the years ended December 31, 2011, 2010 and 2009, 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, 2011, 2010 and 2009, loans totaling $10,299, $14,524 and $18,629, 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, 2011			December 31, 2010			December 31, 2009		
	Average Balance	Interest	Avg. Yield	Average Balance	Interest	Avg. Yield	Average Balance	Interest	Avg. Yield
LIABILITIES AND SHAREHOLDERS' EQUITY									
INTEREST BEARING LIABILITIES:									
Savings Deposits	$86,417	$215	0.25%	$74,668	$324	0.43%	$65,896	$442	0.67%
Time Deposits	860,614	11,229	1.30%	741,712	13,514	1.82%	688,854	16,360	2.37%
Interest Bearing Demand Deposits	807,344	4,203	0.52%	723,315	5,131	0.71%	573,937	5,880	1.02%
Total Interest Bearing Deposits	1,754,375	15,647	0.89%	1,539,695	18,969	1.23%	1,328,687	22,682	1.71%
Short-term Interest Bearing Liabilities	297,960	6,577	2.21%	309,649	7,563	2.44%	209,048	4,696	2.25%
Long-term Interest Bearing Liabilities-FHLB Dallas	291,586	10,141	3.48%	430,485	15,500	3.60%	604,425	21,885	3.62%
Long-term Debt (5)	60,311	3,266	5.42%	60,311	3,275	5.43%	60,311	3,409	5.65%
Total Interest Bearing Liabilities	2,404,232	35,631	1.48%	2,340,140	45,307	1.94%	2,202,471	52,672	2.39%
NONINTEREST BEARING LIABILITIES:									
Demand Deposits	459,594			415,162			379,991		
Other Liabilities	34,614			28,132			42,318		
Total Liabilities	2,898,440			2,783,434			2,624,780		
SHAREHOLDERS' EQUITY (6)	242,672			218,722			188,224		
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	$3,141,112			$3,002,156			$2,813,004		
NET INTEREST INCOME		$105,593			$95,139			$100,253	
NET INTEREST MARGIN ON			3.60%			3.39%			3.81%

AVERAGE EARNING ASSETS			
NET INTEREST SPREAD	3.34 %	3.07 %	3.43 %

(5) Represents junior subordinated debentures issued by us to Southside Statutory Trust III, IV and V in connection with the issuance by Southside Statutory Trust III of $20 million of trust preferred securities, Southside Statutory Trust IV of $22.5 million of trust preferred securities, Southside Statutory Trust V of $12.5 million of trust preferred securities and junior subordinated debentures issued by FWBS to Magnolia Trust Company I in connection with the issuance by Magnolia Trust Company I of $3.5 million of trust preferred securities.

(6) Includes average equity of noncontrolling interest of $1,112, $1,248 and $815 for the years ended December 31, 2011, 2010 and 2009, respectively.

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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, 2011 Compared to 2010		
	Average Volume	Average Yield	Increase (Decrease)
INTEREST INCOME:			
Loans (1)	$ 1,608	$ (4,305)	$ (2,697)
Loans Held For Sale	(66)	10	(56)
Investment Securities (Taxable)	(32)	5	(27)
Investment Securities (Tax Exempt) (1)	3,051	(790)	2,261
Mortgage-backed and related Securities	2,501	(1,164)	1,337
FHLB stock and other investments	(51)	25	(26)
Interest Earning Deposits	(14)	–	(14)
Total Interest Income	6,997	(6,219)	778
INTEREST EXPENSE:			
Savings Deposits	45	(154)	(109)
Time Deposits	1,944	(4,229)	(2,285)
Interest Bearing Demand Deposits	548	(1,476)	(928)
Short-term Interest Bearing Liabilities	(278)	(708)	(986)
Long-term FHLB Advances	(4,847)	(512)	(5,359)
Long-term Debt	–	(9)	(9)
Total Interest Expense	(2,588)	(7,088)	(9,676)
Net Interest Income	$ 9,585	$ 869	$ 10,454

	Years Ended December 31, 2010 Compared to 2009		
	Average Volume	Average Yield	Increase (Decrease)
INTEREST INCOME:			
Loans (1)	$ 723	$ (1,147)	$ (424)
Loans Held For Sale	38	(10)	28
Investment Securities (Taxable)	(547)	(417)	(964)
Investment Securities (Tax Exempt) (1)	4,847	(535)	4,312
Mortgage-backed and related Securities	6,393	(21,726)	(15,333)
FHLB stock and other investments	(17)	41	24
Interest Earning Deposits	(37)	(68)	(105)
Federal Funds Sold	(17)	–	(17)
Total Interest Income	11,383	(23,862)	(12,479)
INTEREST EXPENSE:			
Savings Deposits	53	(171)	(118)
Time Deposits	1,183	(4,029)	(2,846)
Interest Bearing Demand Deposits	1,315	(2,064)	(749)

Short-term Interest Bearing Liabilities	2,427	440	2,867
Long-term FHLB Advances	(6,264)	(121)	(6,385)
Long-term Debt	–	(134)	(134)
Total Interest Expense	(1,286)	(6,079)	(7,365)
Net Interest Income	$ 12,669	$ (17,783)	$ (5,114)

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

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

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PROVISION FOR LOAN LOSSES

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

The decrease in net charge-offs for 2011 was due to a combination of a decrease in total charge-offs of $3.9 million while partially offset by a decrease in total recoveries of $681,000. Net charge-offs for loans to individuals decreased $1.3 million, to $8.3 million and net charge-offs for commercial loans decreased $944,000, to $805,000 for the year ended December 31, 2011. Net charge-offs of construction loans decreased $723,000, resulting in net recoveries of $15,000. Net charge-offs of other real estate loans decreased $581,000, resulting in net recoveries of $4,000.

As of December 31, 2011, our review of the loan portfolio indicated that a loan loss allowance of $18.5 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 deposit related 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, 2011 and the comparable year ended December 31, 2010 and indicates the percentage changes:

	Years Ended December 31, (dollars in thousands)		Percent
	2011	2010 (1)	Change
Deposit services	$15,943	$16,819	(5.2 %)
Gain on sale of securities available for sale	11,795	25,789	(54.3 %)
Gain on sale of securities carried at fair value through income	937	–	100.0 %
Total other-than-temporary impairment losses	–	(39)	100.0 %
Portion of loss recognized in other comprehensive income (before taxes)	–	(36)	100.0 %
Net impairment losses recognized in earnings	–	(75)	100.0 %
Fair value gain (loss) – securities	6,693	(598)	1,219.2 %
FHLB advance option impairment charge	(8,923)	–	(100.0 %)
Gain on sale of loans	1,230	1,751	(29.8 %)
Trust income	2,610	2,368	10.2 %
Bank owned life insurance income	1,087	1,155	(5.9 %)
Other	3,950	3,589	10.1 %
Total noninterest income	$35,322	$50,798	(30.5 %)

(1) Two lines in this table have been revised for 2010. The line item “fair value gain (loss) – securities” has been revised to reflect a loss of $598,000. The previously filed financial statements did not reflect this loss for 2010. The line item “Total noninterest income” has been revised to include the $598,000 loss in 2010.

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Total noninterest income for the year ended December 31, 2011 decreased 30.5%, or $15.5 million, compared to 2010. During the year ended December 31, 2011, we had gains on sale of AFS securities of $11.8 million compared to gains of $25.7 million for the same period in 2010. The fair value of the AFS securities portfolio at December 31, 2011 was $999.1 million with a net unrealized gain on that date of $55.2 million. The net unrealized gain is comprised of $58.5 million in unrealized gains and $3.3 million in unrealized losses. The fair value of HTM securities portfolio at December 31, 2011 was $383.3 million with a net unrealized gain on that date of $16.2 million. The net unrealized gain is comprised of $16.2 million in unrealized gains and $54,000 in unrealized losses. The year ended December 31, 2011 was marked by proactive management of the securities portfolio which included restructuring a portion of our securities portfolio. This restructuring resulted in a gain on the sale of securities available for sale of $11.8 million during 2011. During the quarter ended December 31, 2011, as interest rates remained low, we continued to sell primarily lower yielding, longer duration municipal securities and lower coupon or more prepayment volatile mortgage-backed securities and replaced them with primarily shorter duration municipal securities and higher coupon and less prepayment volatile mortgage-backed securities that might perform better in both the current and potentially higher interest rate environment in the future. During the quarter ended December 31, 2011, we increased the size of the securities portfolio slightly due to increased global economic concerns, U.S. deficit concerns, and the Federal Reserve signaling an extended period of low short-term interest rates. There can be no assurance that the level of security gains reported during the year ended December 31, 2011, will continue in future periods.

During 2011, the fair value of our securities carried at fair value through income increased $6.7 million and is recorded in noninterest income. During 2011, the value of the FHLB advance option fees became impaired resulting in an $8.9 million impairment charge. At December 31, 2011, the carrying value of the FHLB advance option fees on the balance sheet was $2.0 million.

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

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

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

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

NONINTEREST EXPENSE

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

	Years Ended December 31,		Percent
	2011	2010	Change
	(dollars in thousands)		

Salaries and employee benefits	$45,421	$43,957	3.3 %
Occupancy expense	7,205	6,780	6.3 %
Equipment expense	2,055	1,899	8.2 %
Advertising, travel and entertainment	2,414	2,319	4.1 %
ATM and debit card expense	987	825	19.6 %
Director fees	914	950	(3.8 %)
Supplies	746	902	(17.3 %)
Professional fees	2,160	2,015	7.2 %
Postage	725	800	(9.4 %)
Telephone and communications	1,325	1,443	(8.2 %)
FDIC insurance	1,817	2,909	(37.5 %)
Other	6,579	6,515	1.0 %
Total noninterest expense	$72,348	$71,314	1.4 %

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Noninterest expense for the year ended December 31, 2011 increased $1.0 million, or 1.4%, when compared to the year ended December 31, 2010. Salaries and employee benefits expense increased $1.5 million, or 3.3%, during the year ended December 31, 2011, when compared to the same period in 2010. Direct salary expense and payroll taxes increased $1.3 million, or 3.4%, for the year ended December 31, 2011, when compared to the same period in 2010. These increases were the result of the increases in personnel associated with our overall growth and expansion, including SFG and normal salary increases for existing personnel.

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

Health and life insurance expense, included in salary and benefits, decreased $249,000, or 6.5%, for the year ended December 31, 2011, when compared to the same period in 2010 due to decreased health claims expense and plan administrative cost during 2011. We have a self-insured health plan which is supplemented with stop loss insurance policies. Health insurance costs are rising nationwide and these costs may increase during 2012.

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

Supplies decreased $156,000, or 17.3%, for the year ended December 31, 2011, compared to the same period in 2010 due primarily to the printing of our 50th anniversary logo on supplies purchased during 2010.

FDIC insurance decreased $1.1 million, or 37.5%, for the year ended December 31, 2011, compared to the same period in 2010 due to a change in the FDIC assessment calculation effective for the second quarter of 2011.

INCOME TAXES

Pre-tax income for the year ended December 31, 2011 was $50.9 million compared to $51.8 million for the year ended December 31, 2010.

Income tax expense was $10.4 million for the year ended December 31, 2011 and represented a decrease of $1.4 million, or 11.6%, when compared to the year ended December 31, 2010. The effective tax rate as a percentage of pre-tax income was 20.4% in 2011 and 22.7% in 2010. The decrease in the income tax expense and effective tax rate for the year ended December 31, 2011 was due to an increase in tax exempt income as a percentage of taxable income as compared to the same period in 2010. Net deferred liability totaled $3.5 million at December 31, 2011 as compared to net deferred tax asset of $6.6 million in 2010.

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COMPARISON OF OPERATING RESULTS FOR THE YEARS ENDED DECEMBER 31, 2010 COMPARED TO DECEMBER 31, 2009

NET INTEREST INCOME

Net interest income for the year ended December 31, 2010 decreased $6.5 million, or 7.0%, compared to the same period in 2009. The overall decrease in net interest income was primarily the result of decreases in interest income from mortgage-backed and related securities which was due to the increased amortization expense that resulted primarily from the Fannie Mae and Freddie Mac repurchase of delinquent loans during the first and second quarters of 2010 and an overall increase in prepayments on mortgage-backed securities and to a lesser extent a decrease in interest income from loans and taxable investment securities along with an increase in interest expense on short-term obligations. This was partially offset by decreases in interest expense on deposits and long-term obligations and increases in interest income from tax-exempt investment securities.

During the year ended December 31, 2010, total interest income decreased $13.8 million, or 9.5%. The decrease in total interest income was the result of a decrease in the average yield on average interest earning assets from 5.82% for the year ended December 31, 2009 to 5.01% for the year ended December 31, 2010 which more than offset the increase in average interest earning assets of $175.5 million, or 6.7%, from $2.63 billion to $2.80 billion. The decrease in the yield on interest earning assets is reflective of an 11 basis point decrease in the yield on loans due to lower overall interest rates and a 123 basis point decrease in the yield on our securities portfolio due to a combination of increased prepayments in the mortgage-backed securities portfolio which increased amortization expense and lower overall interest rates. Total interest expense decreased $7.4 million, or 14.0%, during the year ended December 31, 2010. The decrease was attributable to a decrease in the average yield on interest bearing liabilities for the year ended December 31, 2010, to 1.94% from 2.39% for the same period in 2009 which was partially offset by an increase in average interest bearing liabilities of $137.7 million, or 6.3%, from $2.20 billion to $2.34 billion. The decrease in the average yield on interest bearing liabilities of 45 basis points is a result of an overall decrease in interest rates. For the year ended December 31, 2010, our net interest spread decreased to 3.07% from 3.43%, and our net interest margin decreased to 3.39% from 3.81% when compared to the same period in 2009.

During the year ended December 31, 2010, average loans increased $10.1 million, or 1.0%, from $1.02 billion to $1.03 billion, compared to the same period in 2009. Automobile loans purchased through SFG and municipal loans represent a large part of this increase. The average yield on loans decreased from 7.21% for the year ended December 31, 2009 to 7.10% for the year ended December 31, 2010. The decrease in interest income on loans of $706,000, or 1.0%, for the year ended December 31, 2010 was the result of a decrease in the average yield which more than offset the increase in the average balance. The decrease in the yield on loans was due to overall lower interest rates.

Average investment and mortgage-backed securities increased $178.4 million, or 11.6%, from $1.54 billion to $1.72 billion, for the year ended December 31, 2010 when compared to the same period in 2009. This increase was the result of securities purchased due primarily to market volatility related to buying opportunities available throughout most of 2009 and early 2010. At December 31, 2010, virtually all of our mortgage-backed securities were fixed rate securities with less than one percent variable rate mortgage-backed securities. The overall yield on average investment and mortgage-backed securities decreased to 3.89% during the year ended December 31, 2010 from 5.12% during the same period in 2009. The decrease in the average yield primarily reflects increased amortization expense associated with increased mortgage-backed securities prepayments due to Freddie Mac and Fannie Mae repurchases of mortgage loans delinquent 120 days or more from mortgage-backed security pools, increased prepayments due to lower interest rates creating refinancing alternatives, tighter spreads on mortgage-backed securities and overall lower interest rates. Interest income on investment and mortgage-backed securities decreased $13.0 million in 2010, or 17.6%, due to a decrease in the average yield which was partially offset by the increase in the average balance. A further decrease in long-term interest rate levels combined with lower volatility and credit spreads could negatively

impact our net interest margin in the future due to increased prepayments and repricings.

Average FHLB stock and other investments decreased $2.8 million, or 6.9%, to $38.0 million, for the year ended December 31, 2010, when compared to $40.8 million for 2009 due to the decrease in FHLB advances during 2010 and the corresponding requirement to hold stock associated with those advances. Interest income from our FHLB stock and other investments increased $24,000, or 10.2%, during 2010, due to the increase in average yield from 0.58% for the year ended December 31, 2009 compared to 0.68% for the same period in 2010 which more than offset the decrease in the average balance. The FHLB stock is a variable instrument with the rate typically tied to the federal funds rate. We are required as a member of FHLB to own a specific amount of stock that changes as the level of our FHLB advances and asset size change.

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We had no federal funds sold during the year ended December 31, 2010 therefore, average federal funds sold decreased $3.9 million, or 100%, when compared to 2009. Interest income from federal funds sold decreased $17,000, or 100%, for the year ended December 31, 2010 when compared to the same period in 2009. Average interest earning deposits decreased $7.4 million, or 34.7%, to $13.9 million, for the year ended December 31, 2010, when compared to $21.2 million for 2009. Interest income from interest earning deposits decreased $105,000, or 76.6%, for the year ended December 31, 2010, when compared to 2009, as a result of the decrease in the average balance and the average yield from 0.64% in 2009 to 0.23% in 2010.

During the year ended December 31, 2010, our average securities increased more than our average loans. As a result, the mix of our average interest earning assets reflected an increase in average total securities as a percentage of total average interest earning assets compared to the prior year as securities averaged 62.5% during 2010 compared to 60.0% during 2009, a direct result of securities purchases. Average loans were 37.0% of average total interest earning assets and other interest earning asset categories averaged 0.5% for December 31, 2010. During 2009, the comparable mix was 39.0% in loans and 1.0% in the other interest earning asset categories.

Total interest expense decreased $7.4 million, or 14.0%, during the year ended December 31, 2010. The decrease was primarily attributable to decreased funding costs as the average yield on interest bearing liabilities decreased from 2.39% for 2009 to 1.94% for the year ended December 31, 2010, which more than offset an increase in average interest bearing liabilities. The increase in average interest bearing liabilities included an increase in deposits of $211.0 million, or 15.9% that was partially offset by a decrease in FHLB advances and other short-term obligations of $73.3 million, or 9.0%.

Average interest bearing deposits increased $211.0 million, or 15.9%, from $1.33 billion to $1.54 billion, while the average rate paid decreased from 1.71% for the year ended December 31, 2009 to 1.23% for the year ended December 31, 2010. Average time deposits increased $52.9 million, or 7.7%, from $688.9 million to $741.7 million while the average rate paid decreased 55 basis points. Average interest bearing demand deposits increased $149.4 million, or 26.0%, while the average rate paid decreased 31 basis points. Average savings deposits increased $8.8 million, or 13.3%, while the average rate paid decreased 24 basis points. Interest expense for interest bearing deposits for the year ended December 31, 2010, decreased $3.7 million, or 16.4%, when compared to the same period in 2009 due to the decrease in the average yield which more than offset the increase in the average balance. Average noninterest bearing demand deposits increased $35.2 million, or 9.3%, during 2010. The latter three categories, which are considered the lowest cost deposits, comprised 62.1% of total average deposits during the year ended December 31, 2010 compared to 59.7% during 2009. The increase in our average total deposits during 2010 is primarily the result of an increase in deposits from municipalities and to a lesser extent, deposit growth due to branch expansion, continued market penetration, and an increase in brokered CDs issued.

At December 31, 2010, total brokered CDs issued were $161.3 million of which $20.0 million were short-term and $141.3 million were long-term. This represented an increase of $30.1 million, or 22.9% from 2009. All of the long-term brokered CDs have short-term calls that we control. At December 31, 2010, brokered CDs represented 7.6% of deposits compared to 7.0% of deposits, at December 31, 2009. At December 31, 2010, all of the brokered CDs had maturities of less than six years.

Average short-term interest bearing liabilities, consisting primarily of FHLB advances and federal funds purchased and repurchase agreements, were $309.6 million, an increase of $100.6 million, or 48.1%, for the year ended December 31, 2010 when compared to the same period in 2009. Interest expense associated with short-term interest bearing liabilities increased $2.9 million, or 61.1%, and the average rate paid increased 19 basis points to 2.44% for the year ended December 31, 2010, when compared to 2.25% for the same period in 2009. The increase in the average rate paid was due to the higher rate long-term FHLB advances rolling into the short-term FHLB advances. The increase in the interest expense was due to an increase in the average rate paid and in the average

balance of short-term interest bearing liabilities.

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Average long-term interest bearing liabilities consisting of FHLB advances decreased $173.9 million, or 28.8%, during the year ended December 31, 2010 to $430.5 million as compared to $604.4 million at December 31, 2009. The decrease in the average long-term FHLB advances is due primarily to advances classified as long-term at December 31, 2009 rolling into the short-term category, an increase in the issuance of long-term callable brokered CDs, the use of more short-term FHLB advances during the period and the decision to enter into $150 million par in long-term advance commitments from the FHLB. During the third and fourth quarters of 2010, we entered into the option to fund between one and a half years and two years forward from the advance commitment date, $150 million par in long-term advance commitments from the FHLB at the FHLB rates on the date the option was purchased. In order to obtain these commitments from the FHLB we paid fees, which at December 31, 2010, were $7.6 million. Interest expense associated with long-term FHLB advances decreased $6.4 million, or 29.2%, and average rate paid decreased 2 basis points to 3.60% for the year ended December 31, 2010 when compared to 3.62% for the same period in 2009. The decrease in interest expense was due to the decrease in the average balance of long-term interest bearing liabilities and the decrease in the average rate paid.

Average long-term debt was $60.3 million for both of the years ended December 31, 2010 and 2009. Interest expense associated with long-term debt decreased $134,000, or 3.9%, to $3.3 million for the year ended December 31, 2010 when compared to $3.4 million for the same period in 2009 as a result of the decrease in the average yield of 22 basis points.

PROVISION FOR LOAN LOSSES

The provision for loan losses for the year ended December 31, 2010 was $13.7 million compared to $15.1 million for the year ended December 31, 2009. For the year ended December 31, 2010, net charge-offs of loans increased $1.6 million, to $12.9 million when compared to $11.3 million for the same period in 2009.

The increase in net charge-offs for 2010 was due to a combination of an increase in total charge-offs of $3.3 million while offset by an increase in total recoveries of $1.7 million. Net charge-offs for loans to individuals increased $1.8 million, to $9.6 million for the year ended December 31, 2010 which included $8.4 million in net charge-offs from the SFG automobile loan portfolio.

As of December 31, 2010, our review of the loan portfolio indicated that a loan loss allowance of $20.7 million was adequate to cover probable losses in the portfolio.

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NONINTEREST INCOME

Noninterest income consists of revenues generated from a broad range of financial services and activities including deposit related fee based services. The following schedule lists the accounts from which noninterest income was derived, gives totals for these accounts for the year ended December 31, 2010 and the comparable year ended December 31, 2009 and indicates the percentage changes:

	Years Ended December 31,		Percent
	2010 (1)	2009	Change
	(dollars in thousands)		
Deposit services	$16,819	$17,629	(4.6 %)
Gain on sale of securities available for sale	25,789	33,446	(22.9 %)
Total other-than-temporary impairment losses	(39)	(5,730)	99.3 %
Portion of loss recognized in other comprehensive income (before taxes)	(36)	2,730	(101.3 %)
Net impairment losses recognized in earnings	(75)	(3,000)	97.5 %
Fair value gain (loss) – securities	(598)	–	(100.0 %)
Gain on sale of loans	1,751	1,240	41.2 %
Trust income	2,368	2,456	(3.6 %)
Bank owned life insurance income	1,155	1,724	(33.0 %)
Other	3,589	3,179	12.9 %
Total noninterest income	$50,798	$56,674	(10.4 %)

(1) Two lines in this table have been revised for 2010. The line item “fair value gain (loss) – securities” has been revised to reflect a loss of $598,000. The previously filed financial statements did not reflect this loss for 2010. The line item “Total noninterest income” has been revised to include the $598,000 loss in 2010.

Total noninterest income for the year ended December 31, 2010 decreased 10.4%, or $5.9 million, compared to 2009. During the year ended December 31, 2010, we had gains on sale of AFS securities, net of impairment charges of $25.7 million compared to gains of $30.4 million for the same period in 2009. The fair value of the AFS securities portfolio at December 31, 2010 was $1.19 billion with a net unrealized gain on that date of $14.7 million. The net unrealized gain is comprised of $25.8 million in unrealized gains and $11.1 million in unrealized losses. The fair value of HTM securities portfolio at December 31, 2010 was $415.4 million with a net unrealized gain on that date of $8.6 million. The net unrealized gain is comprised of $9.2 million in unrealized gains and $644,000 in unrealized losses. The year ended December 31, 2010 was marked by proactive management of the securities portfolio which included restructuring a portion of our securities portfolio. This restructuring resulted in a gain on the sale of securities available for sale of $25.8 million during 2010. In February of 2010, Fannie Mae and Freddie Mac announced a change in practice when an individual mortgage holder becomes delinquent on their obligation. This was not a credit event, but rather a change in the cash flows of the mortgage-backed securities. Consequently, we embarked on a strategy to identify mortgage-backed securities with cash flows that might become significantly more volatile as a result of this announcement, attempted to liquidate those securities, and replace them with securities with income and cash flow characteristics that were potentially more stable.

During June and July we decided to liquidate substantially all municipal securities located outside the State of Texas due to growing municipal concerns. During the third quarter and early parts of the fourth quarter interest rates decreased causing us to restructure a portion of the securities portfolio, selling securities to replace them with

potentially better risk/reward securities. As interest rates increased significantly during the fourth quarter we sold selected securities and replaced them with securities that might perform better in the higher interest rate environment.

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During 2010, the fair value of our securities carried at fair value through income decreased $598,000 and is recorded in noninterest income.

Gain on sale of loans increased $511,000, or 41.2%, for the year ended December 31, 2010, when compared to the same period in 2009. This is primarily a result of the gains on sales of mortgage loans and reflects an increase in the volume of loans sold.

Bank owned life insurance ("BOLI") income decreased $569,000, or 33.0%, for the year ended December 31, 2010, when compared to the same period in 2009 primarily as a result of a decrease in death proceeds related to death benefits received in 2009.

Other income increased $410,000, or 12.9%, for the year ended December 31, 2010, when compared to the same period in 2009 as a result of increases in face value of written loan commitments, credit life income, check printing fees and brokerage service income.

NONINTEREST EXPENSE

The following schedule lists the accounts which comprise noninterest expense, gives totals for these accounts for the years ended December 31, 2010 and 2009 and indicates the percentage changes:

	Years Ended December 31,		Percent Change
	2010	2009	
	(dollars in thousands)		
Salaries and employee benefits	$43,957	$42,505	3.4 %
Occupancy expense	6,780	6,372	6.4 %
Equipment expense	1,899	1,718	10.5 %
Advertising, travel and entertainment	2,319	2,344	(1.1 %)
ATM and debit card expense	825	1,296	(36.3 %)
Director fees	950	785	21.0 %
Supplies	902	863	4.5 %
Professional fees	2,015	2,218	(9.2 %)
Postage	800	872	(8.3 %)
Telephone and communications	1,443	1,424	1.3 %
FDIC insurance	2,909	3,943	(26.2 %)
Other	6,515	7,290	(10.6 %)
Total noninterest expense	$71,314	$71,630	(0.4 %)

Noninterest expense for the year ended December 31, 2010 decreased $316,000, or 0.4%, when compared to the year ended December 31, 2009. Salaries and employee benefits expense increased $1.5 million, or 3.4%, during the year ended December 31, 2010, when compared to the same period in 2009. Direct salary expense and payroll taxes increased $2.0 million, or 5.7%, for the year ended December 31, 2010, when compared to the same period in 2009. These increases were the result of the increases in personnel associated with our overall growth and expansion, including SFG and normal salary increases for existing personnel.

Retirement expense, included in salary and benefits, decreased $706,000, or 18.9%, for the year ended December 31, 2010, when compared to the same period in 2009. The decrease was primarily related to the decrease in the defined benefit plan expense due to an increase in the fair value of the plan assets. The actuarial assumptions used to

determine net periodic pension costs for 2010 assumed a long-term rate of return of 7.5% and a discount rate of 6.1%. These assumptions remained unchanged from 2009.

Health and life insurance expense, included in salary and benefits, increased $168,000, or 4.6%, for the year ended December 31, 2010, when compared to the same period in 2009 due to increased health claims expense and plan administrative cost during 2010.

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Equipment expense increased $181,000, or 10.5%, for the year ended December 31, 2010, when compared to the same period in 2009 as a result of increases in equipment service contracts and bank growth.

ATM and debit card expense decreased $471,000, or 36.3% for the year ended December 31, 2010, compared to the same period in 2009 due to cost savings in relation to our new core banking system which allowed us to bring our ATM and debit card processing in house during the fourth quarter of 2009.

Director fees increased $165,000, or 21.0%, for the year ended December 31, 2010, compared to the same period in 2009 due primarily to an increase in the number of directors.

FDIC insurance decreased $1.0 million, or 26.2%, for the year ended December 31, 2010, compared to the same period in 2009 due to a special FDIC assessment of $1.3 million during the second quarter of 2009.

Other expenses decreased $775,000, or 10.6%, for the year ended December 31, 2010 compared to the same period in 2009 due primarily to a decrease in the losses on ORE property and computer fees while partially offset by increases in ORE and repossessed asset expense.

INCOME TAXES

Pre-tax income for the year ended December 31, 2010 was $51.8 million compared to $62.5 million for the year ended December 31, 2009.

Income tax expense was $11.8 million for the year ended December 31, 2010 and represented a decrease of $4.9 million, or 29.2%, when compared to the year ended December 31, 2009. The effective tax rate as a percentage of pre-tax income was 22.7% in 2010 and 26.6% in 2009. The decrease in the income tax expense and effective tax rate for the year ended December 31, 2010 was due to an increase in tax exempt income as a percentage of taxable income as compared to the same period in 2009. Net deferred assets totaled $6.6 million at December 31, 2010 as compared to $1.6 million in 2009.

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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 loan originations are made to borrowers who live in and conduct business in the counties in Texas in which we operate, with the exception of municipal loans which are made almost entirely in Texas, and purchases of automobile loan portfolios throughout the United States. Municipal loans are made to municipalities, counties, school districts, and colleges primarily throughout the state of Texas. Through SFG, we purchase portfolios of automobile loans from a variety of lenders throughout the United States. These high yield loans represent existing subprime automobile loans with payment histories that are collateralized by new and used automobiles. At December 31, 2011, the SFG loans totaled approximately $68.4 million.

Total loans as of December 31, 2011 increased $9.3 million, or 0.9%, and the average loan balance was up $23.0 million, or 2.2%, when compared to 2010.

Our market areas to date have not experienced the level of downturn in the economy and real estate prices that some of the harder hit areas of the country have experienced. However, we have experienced weakening conditions associated with the real estate led downturn and have strengthened our underwriting standards, especially related to all aspects of real estate lending. Our real estate loan portfolio does not have Alt-A or subprime mortgage exposure.

Municipal loans as of December 31, 2011 increased $10.7 million, or 5.4%, from December 31, 2010. The increase in municipal loans is due in part to the overall market volatility related to credit markets, including municipal credits. This, along with increased demand, provided additional opportunities for us to lend to municipalities during 2011. 1-4 Family residential loans increased $28.4 million, or 13.0%, from December 31, 2010. Other real estate loans increased $5.8 million, or 2.9%, while commercial loans decreased $5.2 million, or 3.5%, from December 31, 2010 to December 31, 2011, respectively. Loans to individuals decreased $26.7 million, or 13.5%, from December 31, 2010. Construction loans decreased $3.7 million, or 3.2%, from December 31, 2010.

The decrease in our construction loans and our commercial loans is reflective of decreased loan demand for these types of loans in our market areas. The increase in other real estate loans is due to an increase in loan demand for this type of loan. The decrease in loans to individuals reflects a decrease in automobile loan portfolios purchased by SFG. In our loan portfolio, loans dependent upon private household income represent a significant concentration. Due to the number of customers involved who work in all sectors of the numerous local, state and national economies, we believe the risk in this portion of the portfolio is adequately spread throughout the economic communities we serve, which assists in mitigating this concentration.

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

The aggregate amount of loans that we are permitted to make under applicable bank regulations to any one borrower, including non-affiliate related entities is 25% of Tier 1 capital. Our legal lending limit at December 31, 2011, was approximately $67.2 million. Our largest loan relationship at December 31, 2011 was approximately $16.5 million.

The average yield on loans for the year ended December 31, 2011, decreased to 6.69% from 7.10% for the year ended December 31, 2010. This decrease was reflective of the overall lower interest environment during 2011.

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LOAN PORTFOLIO COMPOSITION AND ASSOCIATED RISK

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

	December 31,				
	2011	2010	2009	2008	2007
Real Estate Loans:					
Construction	$111,361	$115,094	$105,268	$132,666	$117,046
1-4 Family Residential	247,479	219,031	217,677	226,180	228,330
Other	206,519	200,723	212,731	184,629	200,148
Commercial Loans	143,552	148,761	159,529	165,558	154,171
Municipal Loans	207,261	196,594	150,111	134,986	112,523
Loans to Individuals	171,058	197,717	188,260	178,530	149,012
Total Loans	$1,087,230	$1,077,920	$1,033,576	$1,022,549	$961,230

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

REAL ESTATE LOANS

Real estate loans represent our greatest concentration of loans. We attempt to mitigate the amount of risk associated with this group of loans through the type of loans originated and geographic distribution. At December 31, 2011, the majority of our real estate loans were collateralized by properties located in our market areas. Of the $565.4 million in real estate loans, $247.5 million, or 43.8%, represent loans collateralized by residential dwellings that are primarily owner occupied. Historically, the amount of losses suffered on this type of loan has been significantly less than those on other properties. Beginning in the third quarter of 2007, there were well-publicized developments in the credit markets, beginning with a decline in the sub-prime mortgage lending market, which later extended to the markets for collateralized mortgage obligations, mortgage-backed securities and the lending markets generally. Initially our markets appeared to have been relatively resilient, not experiencing the significant effects associated with these market trends; however, beginning in the later half of 2008 as consumers all across the United States were impacted by the economic slowdown, our market areas began to experience more of a slowdown in economic activity. From 2009 and continuing through 2011, our markets did experience a slowdown as a result of the real estate led downturn across the country. A continued or more severe decline in credit markets generally could adversely affect our financial condition and results of operation if we are unable to extend credit or sell loans into the secondary market. Our loan policy requires an appraisal or evaluation on the property, based on the size and complexity of the transaction, prior to funding any real estate loan and also outlines the requirements for appraisals on renewals.

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

Real estate loans are divided into 1-4 Family Residential Mortgage Loans, Construction Loans and Other. The Other real estate consists of $199.9 million of commercial real estate loans, $4.9 million of loans secured by multi-family properties and $1.7 million of loans secured by farm land. The Commercial Real Estate portion of Other is discussed in more detail below.

1-4 Family Residential Mortgage Loans

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

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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, 2011, these loans totaled $66.6 million. Under Texas law, these loans, when combined with all other mortgage indebtedness for the property, are capped at 80% of appraised value.

Construction Loans

Our commercial construction loans and construction loans to individuals are collateralized by property located primarily in the market areas we serve. A majority of our construction loans are directed toward properties that will be owner occupied. Construction loans for projects built on speculation are financed, but these typically have secondary sources of repayment and collateral. Our construction loans have both adjustable and fixed interest rates during the construction period. Construction loans to individuals are typically priced and made with the intention of granting the permanent loan on the property. During 2010 our construction loans experienced additional stress due to the general downturn in market conditions associated with this type of lending. Construction loans did not appear to deteriorate further in 2011.

Commercial Real Estate Loans

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

COMMERCIAL LOANS

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

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

MUNICIPAL LOANS

We have a specific lending department that makes loans to municipalities and school districts throughout the state of Texas. The majority of the loans to municipalities and school districts has 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, 2011 increased $10.7 million when compared to 2010. At December 31, 2011, we had total loans to municipalities and school districts of $207.3 million.

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LOANS TO INDIVIDUALS

Substantially all of our consumer loan originations are made to consumers in our market areas. The majority of loans to individuals outstanding are collateralized by titled equipment, which are primarily vehicles, and automobile loans purchased by SFG. At December 31, 2011, these types of loans accounted for approximately $138.6 million, or 81.0%, of total loans to individuals.

The total of SFG automobile loans included in loans to individuals at December 31, 2011 was $68.4 million. These high yield loans represent existing subprime automobile loans with payment histories that are primarily collateralized by used automobiles. Loan pools purchased through SFG are subjected to a modeling system to determine the risk associated with the expected defaults. Among other things, the model takes into consideration credit scores and estimated collateral values to determine the risk inherent in each pool.

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

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

LOAN MATURITIES AND SENSITIVITY TO CHANGES IN INTEREST RATES

The following table represents loan maturities and sensitivity to changes in interest rates for our real estate construction, commercial and municipal loans. The amounts of these loans outstanding at December 31, 2011, 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	$ 31,670	$ 41,277	$ 38,414
Commercial Loans	78,997	58,949	5,606
Municipal Loans	19,347	68,307	119,607
Total	$ 130,014	$ 168,533	$ 163,627

Loans with Maturities After One Year for Which:	
Interest Rates are Fixed or Predetermined	$ 220,529
Interest Rates are Floating or Adjustable	$ 111,631

* 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 $5.2 million are reflected in the due after five years column.

LOANS TO AFFILIATED PARTIES

In the normal course of business, we make loans to certain of our own executive officers and directors and their related interests. As of December 31, 2011 and 2010, these loans totaled $4.1 million and $4.7 million, respectively. These loans represented 1.6% and 2.2% of shareholders' equity as of December 31, 2011 and 2010, respectively. Such loans are made in the normal course of business at normal credit terms, including interest rate and collateral requirements and do not represent more than normal credit risks contained in the rest of the loan portfolio for loans of similar types.

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LOAN LOSS EXPERIENCE AND ALLOWANCE FOR LOAN LOSSES

Our allowance for loan losses was $18.5 million at December 31, 2011, or 1.7% of loans. The decrease in the allowance for loan losses is due primarily to a 25.5% decrease in nonperforming assets and a change in the loan mix as SFG, commercial and construction loans which require larger allowance for loan loss accruals, declined. The increase in loans during 2011 occurred primarily in 1-4 family residential and municipal loans which require smaller allowance for loan loss accruals.

The allowance for loan losses is based on the most current review of the loan portfolio and is validated by multiple processes. First, the bank utilizes historical data to establish general reserve amounts for each class of loans. While we track several years of data, we primarily review one year data because we have found that longer periods will not respond quickly enough to market conditions. Second, our lenders have the primary responsibility for identifying problem loans and estimating necessary reserves based on customer financial stress and underlying collateral. These recommendations are reviewed by the Senior lender, the Special Assets department, and the Loan Review department and are reviewed by the President. Third, the Loan Review department does independent reviews of the portfolio on an annual basis. The Loan Review department follows a board-approved annual loan review scope. The loan review scope encompasses a number of metrics that takes into consideration the size of the loan, the type of credit extended, the seasoning of the loan along with the performance of the loan. The loan review scope as it relates to size, focuses more on larger dollar loan relationships, typically, for example, aggregate debt of $500,000 or greater. The Loan Review officer also tracks specific reserves for loans by type compared to general reserves to determine trends in comparative reserves as well as losses not reserved for prior to charge off to determine the efficiency of the specific reserve process.

At each review, a subjective analysis methodology is used to grade the respective loan. Categories of grading vary in severity from loans that do not appear to have a significant probability of loss at the time of review to loans that indicate a probability that the entire balance of the loan will be uncollectible. If full collection of the loan balance appears unlikely at the time of review, estimates of future expected cash flows or appraisals of the collateral securing the debt are used to allocate the necessary allowances. The internal loan review department maintains a list of all loans or loan relationships that are graded as having more than the normal degree of risk associated with them. In addition, a list of specifically reserved loans or loan relationships of $50,000 or more is updated on a quarterly basis in order to properly allocate necessary allowances and keep management informed on the status of attempts to correct the deficiencies noted with respect to the loan.

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

Industry 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.

Consumer loans at SFG are reserved for based on general estimates of loss at the time of purchase for current loans. SFG loans experiencing past due status or extension of maturity characteristics are reserved at significantly

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

For loans originated after August 1, 2010, additional reserve methods have been added. New pools purchased are reserved at their estimated annual loss. Thereafter, the reserve is adjusted based on the actual performance versus projected performance. Additionally, beginning with the fourth quarter of 2010, data mining measures were further enhanced to track migration within risk tranches. Reserves are adjusted quarterly to match the migration metrics.

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After all of the data in the loan portfolio is accumulated the reserve allocations are separated into various loan classes detailed in the table below. At December 31, 2011, the unallocated portion of the allowance for loan loss was $1.2 million or 0.1% of loans.

As of December 31, 2011, our review of the loan portfolio indicated that a loan loss allowance of $18.5 million was adequate to cover probable losses in the portfolio. Changes in economic and other conditions may require future adjustments to the allowance for loan losses.

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

LOAN LOSS EXPERIENCE AND ALLOWANCE FOR LOAN LOSSES

	Years Ended December 31,				
	2011	2010	2009	2008	2007
Average Net Loans Outstanding	$1,054,882	$1,031,858	$1,021,770	$983,336	$809,906
Balance of Allowance for Loan Losses at Beginning of Period	$20,711	$19,896	$16,112	$9,753	$7,193
Loan Charge-Offs:					
Real Estate-Construction	(46)	(873)	(932)	(111)	–
Real Estate-1-4 Family Residential	(675)	(288)	(267)	(11)	(33)
Real Estate-Other	(271)	(577)	(322)	–	(7)
Commercial Loans	(1,254)	(2,603)	(2,037)	(505)	(95)
Loans to Individuals	(10,231)	(12,072)	(9,589)	(8,570)	(2,612)
Total Loan Charge-Offs	(12,477)	(16,413)	(13,147)	(9,197)	(2,747)
Recovery of Loans Previously Charged-off:					
Real Estate-Construction	61	165	2	–	–
Real Estate-1-4 Family Residential	98	13	5	1	30
Real Estate-Other	275	–	–	6	10
Commercial Loans	449	854	104	32	98
Loans to Individuals	1,927	2,459	1,727	1,842	1,909
Total Recovery of Loans Previously Charged-Off	2,810	3,491	1,838	1,881	2,047
Net Loan Charge-Offs	(9,667)	(12,922)	(11,309)	(7,316)	(700)
Allowance for Loan Losses Acquired	–	–	–	–	909
Provision for Loan Losses	7,496	13,737	15,093	13,675	2,351
	$18,540	$20,711	$19,896	$16,112	$9,753

Balance of Allowance for Loan Losses at End of Period					
Reserve for Unfunded Loan Commitments at Beginning of Period	$30	$5	$7	$50	$–
Provision for Losses on Unfunded Loan Commitments	(4)	25	(2)	(43)	50
Reserve for Unfunded Loan Commitments at End of Period	$26	$30	$5	$7	$50
Net Charge-Offs to Average Net Loans Outstanding	0.92 %	1.25 %	1.11 %	0.74 %	0.09 %
Allowance for Loan Losses to Nonaccruing Loans	180.02	142.60	106.80	112.76	334.81
Allowance for Loan Losses to Nonperforming Assets	140.58	116.95	84.83	102.10	247.16
Allowance for Loan Losses to Total Loans	1.71	1.92	1.92	1.58	1.01

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

	Years Ended December 31,									
	2011		2010		2009		2008		2007	
	Amount	Percent of Loans To Total Loans	Amount	Percent of Loans To Total Loans	Amount	Percent of Loans To Total Loans	Amount	Percent of Loans To Total Loans	Amount	Percent of Loans To Total Loans
Real Estate										
Construction	$2,620	10.2 %	$2,585	10.7 %	$3,080	10.2 %	$2,757	12.9 %	$1,031	12.2 %
1-4 Family Residential	1,957	22.8 %	1,988	20.3 %	1,460	21.1 %	1,567	22.1 %	1,313	23.8 %
Other	3,051	19.0 %	3,354	18.6 %	3,175	20.6 %	2,701	18.1 %	2,594	20.8 %
Commercial Loans	2,877	13.2 %	3,746	13.8 %	3,184	15.4 %	2,496	16.2 %	2,126	16.0 %
Municipal Loans	619	19.1 %	607	18.3 %	400	14.5 %	341	13.2 %	277	11.7 %
Loans to Individuals	6,244	15.7 %	7,978	18.3 %	7,321	18.2 %	6,206	17.5 %	2,391	15.5 %
Unallocated	1,172	0.0 %	453	0.0 %	1,276	0.0 %	44	0.0 %	21	0.0 %
Ending Balance	$18,540	100.0%	$20,711	100.0%	$19,896	100.0%	$16,112	100.0%	$9,753	100.0%

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

NONPERFORMING ASSETS

Nonperforming assets consist of delinquent loans 90 days or more past due, nonaccrual loans, OREO, repossessed assets and restructured loans. Nonaccrual loans are those loans which are 90 days or more delinquent and collection in full of both the principal and interest is in doubt. Additionally, some loans that are not delinquent may be placed on nonaccrual status due to doubts about full collection of principal or interest. When a loan is categorized as nonaccrual, the accrual of interest is discontinued and the accrued balance is reversed for financial statement purposes. Restructured loans represent loans that have been renegotiated to provide a reduction or deferral of interest or principal because of deterioration in the financial position of the borrowers. The restructuring of a loan is considered a “troubled debt restructuring” if both (i) the borrower is experiencing financial difficulties and (ii) the creditor has granted a concession. Concessions may include interest rate reductions or below market interest rates, principal forgiveness, restructuring amortization schedules and other actions intended to minimize potential losses. Categorization of a loan as nonperforming is not in itself a reliable indicator of potential loan loss. Other factors, such as the value of collateral securing the loan and the financial condition of the borrower must be considered in judgments as to potential loan loss. OREO represents real estate taken in full or partial satisfaction of debts previously contracted. The dollar amount of OREO is based on a current evaluation of the OREO at the time it is recorded on our books, net of estimated selling costs. Updated valuations are obtained as needed and any additional impairments are recognized.

Total nonperforming assets at December 31, 2011 were $13.2 million, representing a decrease of $4.5 million, or 25.5%, from $17.7 million at December 31, 2010. From December 31, 2010 to December 31, 2011, nonaccrual loans decreased $4.2 million, or 29.1%, to $10.3 million. Of this total, 22.9% are residential real estate loans, 7.6% are commercial real estate loans, 13.2% are commercial loans, 18.5% are loans to individuals, primarily SFG automobile

loans, and 37.8% are construction loans. OREO increased $233,000, or 105.9%, to $453,000 from December 31, 2010 to December 31, 2011. We are actively marketing all properties and none are being held for investment purposes. Accruing loans past due more than 90 days decreased $2,000, or 28.6% to $5,000 at December 31, 2011 from $7,000 at December 31, 2010. Restructured loans decreased $211,000, or 9.1%, to $2.1 million. Repossessed assets decreased $316,000, or 49.5%, to $322,000.

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

	NONPERFORMING ASSETS Years Ended December 31,				
	2011	2010	2009	2008	2007
Accruing Loans Past Due More Than 90 Days:					
Real Estate	$–	$–	$289	$404	$286
Loans to Individuals	5	7	34	53	114
Commercial	–	–	–	136	–
	5	7	323	593	400
Loans on Nonaccrual:					
Real Estate	7,037	8,511	8,930	7,469	636
Loans to Individuals	1,909	4,214	7,461	5,976	2,119
Commercial	1,353	1,799	2,238	844	158
	10,299	14,524	18,629	14,289	2,913
Restructured Loans:					
Real Estate	762	36	87	91	94
Loans to Individuals	1,206	2,243	1,831	39	120
Commercial	141	41	54	18	11
	2,109	2,320	1,972	148	225
Total Nonperforming Loans	12,413	16,851	20,924	15,030	3,538
Other Real Estate Owned	453	220	1,875	318	153
Repossessed Assets	322	638	654	433	255
Total Nonperforming Assets	$13,188	$17,709	$23,453	$15,781	$3,946
Nonperforming Assets to Total Assets	0.40 %	0.59 %	0.78 %	0.58 %	0.18 %
Nonperforming Assets to Total Loans	1.21	1.64	2.27	1.54	0.41
Nonaccrual Loans to Total Loans	0.95	1.35	1.80	1.40	0.30
Loans 90 Days Past Due to Total Loans	–	–	0.03	0.06	0.04

Nonperforming assets at December 31, 2011, as a percentage of total assets decreased to 0.40% from the previous year and as a percentage of loans decreased to 1.21%. Nonperforming assets hinder our ability to earn money. Decreases in earnings can result from both the loss of interest income and the costs associated with maintaining the OREO, for taxes, insurance and other operating expenses. In addition to the nonperforming assets, at December 31, 2011 in the opinion of management, we had $356,000 of loans identified as potential problem loans. A potential problem loan is a loan where information about possible credit problems of the borrower is known, causing management to have serious doubts about the ability of the borrower to comply with the present loan repayment terms and which may result in a future classification of the loan in one of the nonperforming asset categories.

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

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

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

	December 31, 2010		
	Total	Valuation Allowance	Carrying Value
Real Estate Loans	$ 8,512	$ 1,167	$ 7,345
Loans to Individuals	6,457	1,978	4,479
Commercial Loans	1,799	719	1,080
Total	$ 16,768	$ 3,864	$ 12,904

The balances of impaired loans included above with no valuation allowances were approximately $4,000 and $69,000 at December 31, 2011 and 2010, respectively.

For the years ended December 31, 2011 and 2010, the average recorded investment in impaired loans was approximately $14.4 million and $18.6 million, respectively.

The amount of interest recognized on loans that were nonaccruing or restructured during the year was $943,000, $1.1 million and $1.2 million for the years ended December 31, 2011, 2010 and 2009, respectively. If these loans had been accruing interest at their original contracted rates, related income would have been $1.8 million, $2.2 million and $1.7 million for the years ended December 31, 2011, 2010 and 2009, respectively.

SECURITIES ACTIVITY

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

We account for debt and equity securities as follows:

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

- Available for Sale ("AFS"). Debt and equity securities that will be held for indefinite periods of time, including securities that may be sold in response to changes in market interest or prepayment rates, needs for liquidity and changes in the availability of and the yield of alternative investments are classified as AFS. These assets are carried at fair value. Fair value is determined using quoted market prices, where available. If quoted market prices are not

available, fair values are based on quoted market prices for similar securities or estimates from independent pricing services. Unrealized gains and losses on AFS securities are excluded from earnings and reported net of tax as a separate component of shareholders' equity until realized.

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

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

Securities with limited marketability, such as FHLB stock and other investments, are carried at cost, which approximates its fair value and assessed for other-than-temporary impairment.

Management attempts to deploy investable funds into instruments that are expected to provide a reasonable overall return on the portfolio given the current assessment of economic and financial conditions, while maintaining acceptable levels of capital, interest rate and liquidity risk. At December 31, 2011, the securities portfolio as a percentage of total assets was 62.0% and was larger than loans, which were 32.9% of total assets. For a discussion of our strategy in relation to the securities portfolio, see “Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations – Balance Sheet Strategy.”

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The following tables set forth the carrying amount of investment securities and mortgage-backed securities at December 31, 2011, 2010 and 2009 (in thousands):

	December 31,		
Available for Sale:	2011	2010	2009
Investment Securities:			
U.S. Treasury	$–	$4,700	$4,899
State and Political Subdivisions	282,457	294,262	259,526
Other Stocks and Bonds	499	382	635
Mortgage-backed Securities:			
U.S. Government Agencies (1)	107,052	150,273	129,582
Government Sponsored Enterprises (2)	609,074	736,301	1,108,600
Total (3)	$999,082	$1,185,918	$1,503,242

	December 31,		
Securities Carried at Fair Value through Income:	2011	2010	2009
Mortgage-backed Securities:			
U.S. Government Agencies (1)(4)	$30,413	$5,392	$–
Government-Sponsored Enterprises (2)(5)	617,346	66,784	–
Total (3)	$647,759	$72,176	$–

	December 31,		
Held to Maturity:	2011	2010	2009
Investment Securities:			
State and Political Subdivisions	$1,010	$1,012	$1,013
Other Stocks and Bonds	486	483	480
Mortgage-backed Securities:			
U.S. Government Agencies (4)	22,999	20,821	16,677
Government Sponsored Enterprises (5)	342,632	384,546	225,988
Total (3)	$367,127	$406,862	$244,158

(1) This line has been revised for 2010. The AFS line has been reduced by $4.3 million from $154.5 million in the previously filed financial statements. We have reclassed this $4.3 million to securities carried at fair value through income.

(2) This line has been revised for 2010. The AFS line has been reduced by $55.2 million from $791.5 million in the previously filed financial statements. We have reclassed this $55.2 million to securities carried at fair value through income.

(3) All of the total lines for 2010 have been revised to reflect the reclasses discussed.

(4) This line has been revised for 2010. The HTM line has been reduced by $1.1 million from $21.9 million in the previously filed financial statements. We have reclassed this $1.1 million to securities carried at fair value through income along with the fair value change on the HTM security not previously reported of $65,000.

(5) This line has been revised for 2010. The HTM line has been reduced by $11.4 million from $396.0 million in the previously filed financial statements. We have reclassed this $11.4 million to securities carried at fair value through income along with the fair value change on the HTM security not previously reported of $146,000.

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We invest in mortgage-backed and related securities, including mortgage participation certificates, which are insured or guaranteed by U.S. Government agencies and GSEs, and CMOs and real estate mortgage investment conduits (“REMICs”). Mortgage-backed securities (which also are known as mortgage participation certificates or pass-through certificates) represent a participation interest in a pool of single-family or multi-family mortgages, the principal and interest payments on which are passed from the mortgage originators, through intermediaries (generally U.S. Government agencies and GSEs) that pool and re-package the participation interests in the form of securities, to investors such as us. U.S. Government agencies, primarily Government National Mortgage Association (“GNMA”) and GSEs, primarily Freddie Mac, and Fannie Mae guarantee the payment of principal and interest to investors. GSEs are not backed by the full faith and credit of the U.S. government. Freddie Mac, Fannie Mae and FHLB are the primary GSEs with which we purchase securities. At December 31, 2011 all of our mortgage-backed securities were collateralized by U.S. Government agencies or GSEs.

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

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

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

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

Debt securities purchased at a significant premium that contain an embedded derivative where the embedded derivative is not readily identifiable and measurable and as such cannot be bifurcated, are classified as securities carried at fair value through income. As such, mortgage-backed securities purchased at a significant premium, which we describe as any mortgage-backed security purchase at a price in excess of 111.111%, are classified as securities

carried at fair value through income. At December 31, 2011 we had $647.8 million of securities carried at fair value through income compared to $72.2 million at December 31, 2010. The low interest rate environment combined with relatively stable prepays for higher coupon, seasoned mortgage-backed securities caused the price of these securities with certain coupons or structure, to increase in purchase price above 111.111%. Since management favored the higher coupon trades during 2011, this category increased. Subsequent to year end we began selling our securities carried at fair value through income as management determined it did not want additional potentially significant swings in net income associated with fair value changes for these securities. As of March 8, 2012 there were less than $30 million of these securities that had not been sold.

The combined investment securities, mortgage-backed securities, and FHLB stock and other investments portfolio increased to $2.05 billion at December 31, 2011, compared to $1.70 billion at December 31, 2010, an increase of $348.2 million, or 20.5%. This is primarily a result of an increase in mortgage-backed securities of $365.4 million, or 26.8%, during 2011 when compared to 2010 which was partially offset by a $16.5 million, or 5.5%, decrease in our ownership of securities issued by state and political subdivisions and U.S. Treasury securities. The change in U.S. Treasury securities was related to securities that matured during 2011.

During 2011, the interest rate yield curve remained steep while at the same time credit and volatility spreads continued to tighten. We used this environment to reposition a portion of the securities portfolio. Through this process, we were able to decrease the overall average duration, increase the average MBS coupon, and increase the size of the overall securities portfolio.

The combined fair value of the AFS and HTM securities portfolio at December 31, 2011 was $1.38 billion, which represented a net unrealized gain as of that date of $71.4 million. The net unrealized gain was comprised of $74.7 million in unrealized gains and $3.3 million of unrealized losses. The fair value of the AFS securities portfolio at December 31, 2011 was $999.1 million, which represented a net unrealized gain as of that date of $55.2 million. The net unrealized gain was comprised of $58.5 million of unrealized gains and $3.3 million of unrealized losses. The $3.3 million of unrealized losses is primarily resulting from our investment in three tranches of TRUPs and securities issued by government sponsored enterprises. Net unrealized gains and losses on AFS securities, which is a component of shareholders' equity on the consolidated balance sheet, can fluctuate significantly as a result of changes in interest rates. Because management cannot predict the future direction of interest rates, the effect on shareholders' equity in the future cannot be determined; however, this risk is monitored through the use of shock tests on the AFS securities portfolio using an array of interest rate assumptions.

The fair value of the securities carried at fair value through income was $647.8 million at December 31, 2011, which represented a $6.7 million change from the fair value at December 31, 2010 and was recorded in income during 2011. Future changes in fair values will be recorded in income. Because management cannot predict the future direction of interest rates, the effect on income in the future cannot be determined. During the first quarter of 2012, management reduced the dollar amount of these securities through sales, with less than $30 million remaining at March 8, 2012 and intends to limit purchases of additional mortgage-backed securities acquired at a premium greater than 111.111%.

There were no securities transferred from AFS to HTM during 2011, 2010 and 2009. There were no sales from the HTM portfolio during the years ended December 31, 2011, 2010 or 2009. There were $367.1 million and $406.9 million of securities classified as HTM at December 31, 2011 and 2010, respectively. In conjunction with correcting errors in the first three quarters of 2011 that will be restated related to securities carried at fair value through income, on October 1, 2010 we corrected $13.9 million in HTM securities which should have been originally classified as securities carried at fair value through income.

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The maturities classified according to the sensitivity to changes in interest rates of the December 31, 2011 securities portfolio and the weighted yields are presented below. Tax-exempt obligations are shown on a taxable equivalent basis. Mortgage-backed securities are included in maturity categories based on their stated maturity date. Expected maturities may differ from contractual maturities because issuers may have the right to call or prepay obligations.

	MATURING											
	Within 1 Year			After 1 But Within 5 Years			After 5 But Within 10 Years			After 10 Years		
Available For Sale:	Amount	Yield		Amount	Yield		Amount	Yield		Amount	Yield	
	(dollars in thousands)											
Investment Securities:												
State and Political Subdivisions	$1,714	6.56	%	$7,408	5.73	%	$29,870	5.32	%	$243,465	5.91	%
Other Stocks and Bonds	–	–		–	–		–	–		499	–	
Mortgage-backed Securities:												
U.S. Government Agencies	–	–		146	4.96	%	1,465	5.59	%	105,441	4.14	%
Government Sponsored Enterprises	25	4.02	%	6,003	3.70	%	37,558	2.94	%	565,488	3.32	%