

SOUTHSIDE BANCSHARES INC
Form 10-K
March 05, 2010

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, 2009

or

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

For the Transition Period From _____ to _____

Commission file number 0-12247

Southside Bancshares, Inc.
(Exact name of registrant as specified in its charter)

| | |
|---|---|
| Texas | 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 No

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

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

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

Indicate by check mark 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.

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 <input type="checkbox"/> | Accelerated |
| filer <input checked="" type="checkbox"/> | |
| Non-accelerated filer <input type="checkbox"/> (Do not check if a smaller reporting company) | Smaller reporting |
| company <input type="checkbox"/> | company <input type="checkbox"/> |

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

The aggregate market value of the common stock held by non-affiliates of the registrant as of June 30, 2009 was \$292,579,158.

As of February 12, 2010, 14,988,726 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 15, 2010 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 Southside Financial Group, LLC of which Southside owns a 50% interest and consolidates for financial reporting.

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 Information” in “Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations” of this Annual Report on Form 10-K and other cautionary statements set forth elsewhere in this report.

GENERAL

Southside Bancshares, Inc., incorporated in Texas in 1982, is a bank holding company for Southside Bank, a Texas state bank headquartered in Tyler, Texas that was formed in 1960. The Tyler metropolitan area has a population of approximately 198,000 and is located approximately 90 miles east of Dallas, Texas and 90 miles west of Shreveport, Louisiana.

At December 31, 2009, our total assets were \$3.02 billion, total loans were \$1.03 billion, deposits were \$1.87 billion, and total equity was \$202.2 million. For the years ended December 31, 2009 and 2008, our net income was \$44.4 million and \$30.7 million, respectively, and diluted earnings per common share were \$2.96 and \$2.06, 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 non-profit 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, 2009, our trust department managed approximately \$657 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.

On October 10, 2007, Southside completed the acquisition of FWBS and its wholly-owned subsidiaries, Fort Worth Bancorporation, Inc., FWNB and Magnolia Trust Company I. Southside purchased all of the outstanding capital stock of FWBS for approximately \$37 million. FWNB operated two banking offices in Fort Worth, one banking office in Arlington and a loan production office in Austin. At the time of purchase FWNB had approximately \$124 million in total assets, \$105 million in loans and \$103 million in deposits.

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 or the SEC's website, www.sec.gov, as soon as reasonably practicable after filing with the SEC.

RECENT DEVELOPMENTS

During July 2009, we opened a full service branch in Gresham, Texas, just south of Tyler, replacing a loan production office we have operated for several years in close proximity. We are in the process of building a full service branch on the west side of Tyler on Highway 64, which we anticipate will open during the second half of 2010. In addition, we are building a new facility adjacent to our headquarters in Tyler which will house our Trust department. It is anticipated to be completed during the second half of 2010. We are also in the process of opening a full service bank in a leased space in a grocery store in Tyler, Texas. It is anticipated to open during the second quarter of 2010. We continue to explore opportunities to expand into either additional grocery store or traditional branch locations. During the fourth quarter of 2009, we completed a core banking computer system conversion. This new system should provide for our core computer system needs for many years.

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 continue to grow in the future. In addition, we continue to explore new markets in which we believe we can expand successfully.

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

We serve our markets through 45 banking centers, 18 of which are located in grocery stores. The branches are located in and around Tyler, Longview, Lindale, Gresham, Jacksonville, Bullard, Chandler, Hawkins, Seven Points, Palestine, Forney, Gun Barrel City, Athens, Whitehouse, Fort Worth, 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. Our customers may also access various banking services through our 48 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.

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, our market areas experienced the effects of the housing-led slowdown that impacted the other regions of the United States. Some economists believe the national recession ended in the latter part of 2009. 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.

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 2009, 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. Many of these institutions have capital resources, broader geographic markets, and legal lending limits substantially in excess of those available to us. We face competition from institutions that offer products and services we do not or cannot currently offer. Some institutions we compete with offer interest rate levels on loan and deposit products that we are unwilling to offer due to interest rate risk and overall profitability concerns. We expect the level of competition to continue to increase.

EMPLOYEES

At February 12, 2010, we employed approximately 560 full time equivalent persons. None of the employees are represented by any unions or similar groups, and we have not experienced any type of strike or labor dispute. We consider the relationship with our employees to be good.

EXECUTIVE OFFICERS OF THE REGISTRANT

Our executive officers as of December 31, 2009 and as of February 12, 2010 were as follows:

B. G. Hartley (Age 80), Chairman of the Board and Chief Executive Officer of Southside Bancshares, Inc. since 1983. He also serves as Chairman of the Board and Chief Executive Officer of Southside Bank, having served in these capacities since Southside Bank's inception in 1960.

Sam Dawson (Age 62), President, Secretary and Director of Southside Bancshares, Inc. since 1998. He also has served as President, Chief Operations Officer and Director of Southside Bank since 1996. He became an officer of Southside Bancshares, Inc. in 1982 and of Southside Bank in 1975.

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Robbie N. Edmonson (Age 78), 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 58), 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.

Lee R. Gibson (Age 53), 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 of Southside Bank in 1984.

Michael Coogan (Age 50), Executive Vice President and Treasurer of Southside Bank. He became an officer of Southside Bank in 2009.

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 bank holding companies under federal law, Southside Bancshares, Inc. (the “Company”) and its wholly-owned subsidiary, Southside Delaware Financial Corporation, (collectively, the “Holding Companies”) are subject to regulation, supervision and examination by the Board of Governors of the Federal Reserve System (“Federal Reserve”). As a Texas-chartered state bank, Southside Bank is subject to regulation, supervision and examination by the Texas Department of Banking (“TDB”), as its chartering authority, and by the Federal Deposit Insurance Corporation (“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.

The earnings of Southside Bank and, therefore, the earnings of the Holding Companies, are affected by general economic conditions, changes in federal and state laws and regulations and actions of various regulatory authorities, including those referenced above. Proposals to change the laws and regulations applicable to us are frequently introduced at both the federal and state levels. Current proposals include an extensive restructuring of the regulatory framework within which we operate. 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. 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 bank holding companies regulated under the Bank Holding Company Act of 1956 (“BHCA”), as amended, the Holding Companies are registered with and subject to regulation, supervision and examination by the Federal Reserve. The Holding Companies are required to file annual and other reports with, and furnish information to, the Federal Reserve, which makes periodic inspections of the Holding Companies.

Permitted Activities. Under the BHCA, a bank holding company is generally permitted to engage in, or acquire direct or indirect control of more than 5 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:

- o factoring accounts receivable;
- o making, acquiring, brokering or servicing loans and usual related activities;
- 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; and
- o performing selected insurance underwriting activities.

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." 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. The Holding Companies have not sought financial holding company status. However, there can be no assurance that they will not make such an election in the future. If the Holding Companies were to elect financial holding company status, Southside Bank and any other insured depository institution controlled by the Holding Companies would have to be well capitalized, well managed, and have at least a satisfactory rating under the Community Reinvestment Act (discussed below).

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 shareholder's equity less any amounts of goodwill, other intangible assets, interest-only strips receivables, deferred tax assets, non-financial equity investments and other items that are required to be deducted by the Federal Reserve. Perpetual, non-cumulative preferred stock, certain trust-preferred securities, and certain minority interests in consolidated subsidiaries also may be included in 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 these risk-based capital requirements, the Holding Companies and Southside Bank are each generally required to maintain a minimum ratio of total capital to risk-weighted assets 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.

In 2004, the Basel Committee on Banking Supervision published a new set of risk-based capital standards (“Basel II”) in order to update the original international capital standards that had been put in place in 1988 (“Basel I”). Basel II adopts a three-pillar framework comprised of minimum capital requirements, supervisory assessment of capital adequacy and market discipline. Basel II provides several options for determining capital requirements for credit and operational risk. In December 2007, the agencies adopted a final rule implementing Basel II’s advanced approach. The final rule became effective on April 1, 2008. Compliance with the final rule is mandatory only for “core banks” - U.S. banking organizations with over \$250 billion in banking assets or on-balance-sheet foreign exposures of at least \$10 billion. Other U.S. banking organizations that meet applicable qualification requirements may elect, but are not required, to comply with the final rule. The final rule also allows a banking organization’s primary federal regulator to determine that application of the rule would not be appropriate in light of the organization’s asset size, level of complexity, risk profile or scope of operations. In July 2008, in order to address the potential competitive inequalities resulting from the now bifurcated risk-based capital system in the United States, the agencies agreed to issue a proposed rule that would provide non-core banks with the option to adopt an approach consistent with Basel II’s standardized approach. At this time, U.S. banking organizations not subject to the final rule are required to continue to use the existing Basel I risk-based capital rules. The Holding Companies are not required, and have not elected, to comply with the final rule.

Increases in regulatory capital requirements appear to be likely, but the federal regulators have not identified specific increases. In September 2009, the Treasury Department released a set of principles for financial regulatory reform, including a general recommendation for increased capital for banks and bank holding companies across the board (with even higher requirements for systemically risky banking organizations). In December 2009, the Basel Committee on Board Supervision issued proposals for regulatory capital changes, including greater emphasis on common equity as a component of Tier 1 capital. Both sets of proposals also recommend enhanced leverage and liquidity requirements.

The ratios of Tier 1 capital, total capital to risk-adjusted assets, and leverage capital of the Company and Southside Bank as of December 31, 2009, 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) | 4.0 | % 6.0 | % 17.87 | % 17.69 |
| Total risk-based capital (2) | 8.0 | 10.0 | 19.12 | 18.94 |
| Tier 1 leverage ratio (3) | 4.0 | 5.0 | 8.03 | 7.95 |

(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.

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. See also Bank Regulation - Prompt Corrective Action.

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 Southside Delaware Financial Corporation, the direct parent of Southside Bank, which in turn may affect the ability of Southside Delaware 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.

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, must give 60 days prior notice to the appropriate federal banking agency. With respect to the Holding Companies, “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.

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.

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 Holding Companies 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 Holding Companies and any nonbank affiliates, must undergo regular on-site examinations by the appropriate banking agency. 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 market 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 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.

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. 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 Holding Companies, 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. 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. In February 2009, the FDIC adopted a long-term DIF restoration plan, as well as an additional emergency assessment for 2009. The restoration plan increases base assessment rates for banks in all risk categories with the goal of raising the DIF reserve ratio from 0.40% to 1.15% within seven years. Banks in the best risk category, paid initial base rates ranging from 12 to 16 basis points of assessable deposits beginning April 1, 2009, partially up from the initial base rate range of 12 to 14 basis points. Additionally, the FDIC adopted a final rule imposing a special emergency assessment to all financial institutions of 5 basis points of insured deposits as of June 30, 2009. Our special emergency assessment totaled \$1.3 million and was collected on September 30, 2009. Currently, initial base rate assessments for all FDIC-insured institutions range from 12 to 45 basis points, with assessment rates of 12 to 16 basis points for banks in the best risk category.

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 is included in deposit insurance expense for 2009. The remaining \$9.3 million in prepaid deposit insurance is included in other assets in the accompanying consolidated balance sheet as of December 31, 2009.

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 are set quarterly, and in 2009 ranged from 114 basis points in the first quarter to 102 basis points in the fourth quarter. These assessments will continue until the FICO bonds mature in 2017 through 2019.

Effective November 21, 2008 and until December 31, 2009, the FDIC expanded deposit insurance limits for certain accounts under the FDIC's Temporary Liquidity Guarantee Program. Provided an institution has not opted out of the Temporary Liquidity Guarantee Program, the FDIC will fully guarantee funds deposited in noninterest bearing transaction accounts, including (i) interest on Lawyer Trust Accounts or IOLTA accounts, and (ii) negotiable order of withdrawal or NOW accounts with rates no higher than 0.50 percent if the institution has committed to maintain the interest rate at or below that rate. In conjunction with the increased deposit insurance coverage, insurance assessments also increase. Southside Bank has not opted out of the Temporary Liquidity Guarantee Program. In May 2009, the FDIC deposit insurance limits provision which was set to expire on December 31, 2009 was extended until December 31, 2013 under the Helping Families Save Their Homes Act of 2009.

Capital Adequacy. See Holding Company Regulation – Capital Adequacy.

Prompt Corrective Action. The Federal Deposit Insurance Improvement Act of 1991 ("FDICIA"), among other things, identifies five capital categories for insured depository institutions (well-capitalized, adequately capitalized,

undercapitalized, significantly undercapitalized and critically undercapitalized). FDICIA requires the federal banking agencies, including the FDIC, to implement systems for “prompt corrective action” for insured depository institutions that do not meet minimum capital requirements within these categories. Under such systems, federal banking regulators are required to rate insured depository institutions on the basis of the five capital categories described. The FDICIA imposes progressively more restrictive restraints on operations, management and capital distributions, as the classification of a bank or thrift deteriorates. Failure to meet the capital guidelines could also subject a depository institution to capital

raising requirements. An “undercapitalized” bank must develop a capital restoration plan and its parent holding company must guarantee the bank’s compliance with the plan. The liability of the parent holding company under any such guarantee is limited to the lesser of 5% of the bank’s assets at the time it became “undercapitalized” or the amount needed to comply with the plan. Furthermore, in the event of the bankruptcy of the parent holding company, such guarantee would take priority over the parent’s general unsecured creditors. The Bank currently meets the criteria for “well-capitalized.”

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

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.

Dividends. All dividends paid by Southside Bank are paid to the Company, as the sole indirect shareholder of Southside Bank, through Southside Delaware Financial Corporation. 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.

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 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 nonaffiliated 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 on March 12, 2007 and received a rating of “Outstanding.”

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.

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

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

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.

In addition, Southside Bank also may be subject to certain state laws and regulations designed to protect consumers.

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, 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 institutions 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.

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
 - 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” 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 has sent, and will continue to send, bank regulatory agencies lists of names of persons and organizations suspected of aiding, harboring or engaging in terrorist acts, known as Specially Designated Nationals and Blocked Persons. If we find a name on any transaction, account or wire transfer that is on an OFAC list, we must freeze such account, file a suspicious activity report and 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 non-public 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.

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.

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, and may include wide-ranging changes to the structures, regulations and competitive relationships of financial institutions. In December 2009, the House of Representatives approved legislation that would make wide-ranging changes to the framework and substance of federal bank regulation, and the U.S. Senate is now considering comparable regulation. If approved, the proposed legislation could substantially change the financial institution regulatory system and expand or contract the powers of banking institutions and bank holding companies. Such legislation may change existing bank statutes and regulations, as well as our current operating environment significantly. Specifically, the Federal Reserve’s regulation of bank holding companies may increase and a new consumer protection agency may be created that would oversee the retail business of banks. We cannot predict whether new legislation will be enacted and, if enacted, the effect that it, or any regulations, would have on our business, financial condition or results of operations.

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:

- increase in loan delinquencies;
- increases in nonperforming assets and foreclosures;
- 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;

- decrease 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, could adversely affect our financial condition and results of operations;
- an adverse or unfavorable resolution of the Fannie Mae or Freddie Mac receivership could adversely affect our financial condition and results of operation; and
- decrease in the real estate values subject to ad-valorem taxes by municipalities that impact the municipalities ability to repay its debt, could adversely affect our municipal loans or debt securities and adversely affect our financial condition and results of operations.

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 two 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.

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 are beginning to 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, Treasury announced that it will extend TARP until October 3, 2010, in order to retain an adequate financial stability reserve if financial conditions worsen and threaten the economy. Treasury has stated that any new TARP commitments in 2010 will be limited to the purposes of foreclosure mitigation, stabilizing the housing market, and providing capital to small and community banks as a source of credit for businesses. 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 non-interest bearing bank transaction accounts on an unlimited basis, is scheduled to continue until June 30, 2010. The Federal Reserve will begin to sell off its portfolio of mortgage-backed securities, which it previously purchased in order to stabilize the residential mortgage market.

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 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, market value of securities and profitability are subject to risks associated with the successful implementation of our balance sheet and leverage strategy.

We implemented a balance sheet and leverage strategy in 1998 for the purpose of enhancing overall profitability by maximizing the use of our capital. The effectiveness of our balance sheet and leverage strategy, and therefore our profitability, may be adversely affected by a number of factors, including reduced net interest margin and spread, adverse market value changes to the investment and Agency mortgage-backed and related securities, adverse changes in the market liquidity of our 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 leverage program. If our balance sheet and leverage strategy is flawed or poorly implemented, we may incur significant losses. See the section captioned “Balance Sheet and Leverage Strategy” in “Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations.”

We have a high concentration of loans secured by real estate and a 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, 2009, approximately 51.8% of our loans have real estate as a primary or secondary component of collateral. The real estate in each case provides an alternate source of repayment in the event of default by the borrower and may deteriorate in value during the time the credit is extended. Beginning in the third quarter of 2007 and continuing throughout 2008 and 2009, 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 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.

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, 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.

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.

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. 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. Additionally, proposed legislation affecting the regulation of banking institutions may be enacted in 2010, but the specific terms of such legislation are difficult to foresee. While we cannot predict the 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 changes.

In September 2009, the Treasury recommended, among other things, that regulatory capital requirements for all banks be increased. The federal bank regulators and Congress have discussed changes in the capital rules as well. Although it is uncertain whether any changes will be made, any such changes likely would result in higher capital requirements which would affect our asset portfolios and financial performance.

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.

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.

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

The availability and cost of funds may increase as a result of general economic conditions, increased interest rates and competitive pressures and we may be unable to obtain funds on terms that are favorable to us. We chose not to participate in the CPP, which was effectively closed in December 2009, and in the future if we need to obtain additional funds, we may not be able to obtain them on terms as favorable to us as they may have been had we participated in the CPP. If we are unable to obtain funds, we could be restricted in our ability to extend credit, and may not be able to obtain sufficient funds to support growth through branching or acquisition initiatives.

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

On September 4, 2003, we issued \$20.6 million of floating rate junior subordinated debentures in connection with a \$20.0 million trust preferred securities issuance by our subsidiary, Southside Statutory Trust III. 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.

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.

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

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

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

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

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

We continually encounter technological change.

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

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

From time to time, customers make claims and take legal action pertaining to our performance of our fiduciary responsibilities. Whether customer claims and legal action related to our performance of our fiduciary responsibilities are founded or unfounded, defending claims is costly and diverts management's attention, and if such claims and legal actions are not resolved in a manner favorable to us, they may result in significant financial liability and/or adversely

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

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

Severe weather, natural disasters, acts of war or terrorism and other adverse external events could have a significant impact on our ability to conduct business. Such events could affect the stability of our deposit base, impair the ability of borrowers to repay outstanding loans, impair the value of collateral securing loans, cause significant property damage, result in loss of revenue and/or cause us to incur additional expenses. For example, 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.

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 increasing foreclosures and 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.

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, non-core deposits, and short- and long-term debt. Southside Bank is also a member of the Federal Home Loan Bank 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, non-core 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 the 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.

RISKS ASSOCIATED WITH OUR COMMON STOCK

Our stock price can be volatile.

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

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

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

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

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

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

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

or all of your investment.

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

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

Any individual, acting alone or with other individuals, who 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.

RISKS ASSOCIATED WITH THE BANKING INDUSTRY

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

Our operations and profitability are impacted by general business and economic conditions in the United States and abroad. These conditions include short-term and long-term interest rates, inflation, money supply, political issues, legislative and regulatory changes, fluctuations in both debt and equity capital markets, broad trends in industry and finance, and the strength of the U.S. economy and the local economies in which we operate, all of which are beyond our control. A deterioration in economic conditions could result in an increase in loan delinquencies and 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.

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.

ITEM 1B. UNRESOLVED STAFF COMMENTS

None

ITEM 2. PROPERTIES

Southside Bank owns and operates the following properties:

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

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

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

- one in Whitehouse, Texas;
- one in Chandler, Texas;
- one in Seven Points, Texas;
- one in Palestine, Texas;
- one in Athens, Texas;
- one in Hawkins, Texas;
- three in Longview, Texas;
 - six in Tyler, Texas;
- 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 loan production office at 413 North McGraw, Forney, Texas; and
 - Austin loan production office at 8200 North Mopac, Suite 130, Austin, Texas.

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

- 1600 East Pioneer Parkway, Suite 300, Arlington, Texas.

We are in the process of building a full service branch at 3815 State Highway 64 West, Tyler, Texas, which we anticipate will open during the second half of 2010. In addition, we are building a new facility adjacent to our headquarters at 1305 South Beckham, Tyler, Texas, which will house our Trust department. It is anticipated to be completed during the second half of 2010. We are also in the process of opening a full service bank in a leased space in a grocery store in Tyler, Texas. It is anticipated to open during the second quarter of 2010. We will continue to explore opportunities to expand either into additional grocery store or traditional branch locations.

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.

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." The high/low prices shown below represent the daily weighted average prices on the NASDAQ Global Select Market for the period from January 1, 2008 to December 31, 2009. During the second quarter of 2009 and the first quarter of 2008, 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 | 1st Quarter | 2nd Quarter | 3rd Quarter | 4th Quarter |
|-------------------|------------------|------------------|------------------|------------------|
| December 31, 2009 | \$ 21.98 – 13.26 | \$ 25.22 – 18.38 | \$ 25.31 – 20.52 | \$ 22.45 – 19.81 |
| December 31, 2008 | \$ 21.88 – 17.21 | \$ 23.22 – 17.55 | \$ 24.28 – 14.81 | \$ 23.36 – 18.13 |

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 February 12, 2010.

DIVIDENDS

Cash dividends declared and paid were \$0.75 and \$0.60 per share for the years ended December 31, 2009 and 2008, respectively. Stock dividends of 5% were also declared and paid during each of the years ended December 31, 2009, 2008 and 2007. 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 "Supervision and Regulation" in "Item 1. Business" and in "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations –Capital Resources." The cash dividends were paid quarterly each year as listed below.

Quarterly Cash Dividends Paid

| Year Ended | 1st Quarter | 2nd Quarter | 3rd Quarter | 4th Quarter |
|-------------------|-------------|-------------|-------------|-------------|
| December 31, 2009 | \$ 0.13 | \$ 0.14 | \$ 0.14 | \$ 0.34 |
| December 31, 2008 | \$ 0.12 | \$ 0.13 | \$ 0.16 | \$ 0.19 |

STOCK-BASED COMPENSATION PLANS

Information regarding stock-based compensation awards outstanding and available for future grants as of December 31, 2009, is presented in “Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters” of this Annual Report on Form 10-K. Additional information regarding stock-based compensation plans is presented in “Note 13 – Employee Benefits” to our consolidated financial statements included in this report.

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

During 2009, we did not approve any additional funding for our stock repurchase plan. No common stock was purchased during the fourth quarter ended December 31, 2009.

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.

| Index | Period Ending | | | | | |
|--|---------------|----------|----------|----------|----------|----------|
| | 12/31/04 | 12/31/05 | 12/31/06 | 12/31/07 | 12/31/08 | 12/31/09 |
| Southside Bancshares, Inc. | 100.00 | 94.90 | 129.60 | 110.83 | 137.41 | 124.92 |
| Russell 2000 | 100.00 | 104.55 | 123.76 | 121.82 | 80.66 | 102.58 |
| Southside Bancshares Peer Group 2009* | 100.00 | 105.93 | 117.16 | 101.94 | 101.63 | 105.43 |

*Southside Bancshares Peer Group 2009 contains the following Texas banks: Cullen/Frost Bankers, Inc., First Financial Bankshares, Inc., International Bancshares Corporation, MetroCorp Bancshares, Inc., Prosperity Bancshares, Inc., Sterling Bancshares, Inc., Texas Capital Bancshares, Inc. and Encore Bancshares, Inc.

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, 2009. 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. Please refer to "Item 1. Business" for a discussion of our acquisition of FWBS in 2007.

| | As of and For the Years Ended December 31, | | | | |
|---|--|-------------|-------------|-------------|-------------|
| | 2009 | 2008 | 2007 | 2006 | 2005 |
| | (in thousands, except per share data) | | | | |
| Balance Sheet Data: | | | | | |
| Investment Securities | \$266,553 | \$278,856 | \$110,403 | \$100,303 | \$121,240 |
| Mortgage-backed and Related Securities | \$1,480,847 | \$1,183,800 | \$917,518 | \$869,326 | \$821,756 |
| Loans, Net of Allowance for Loan Losses | \$1,013,680 | \$1,006,437 | \$951,477 | \$751,954 | \$673,274 |
| Total Assets | \$3,024,288 | \$2,700,238 | \$2,196,322 | \$1,890,976 | \$1,783,462 |
| Deposits | \$1,870,421 | \$1,556,131 | \$1,530,491 | \$1,282,475 | \$1,110,813 |
| Long-term Obligations | \$592,830 | \$715,800 | \$146,558 | \$149,998 | \$229,032 |
| Income Statement Data: | | | | | |
| Interest & Deposit Service Income | \$162,822 | \$154,571 | \$123,021 | \$112,434 | \$94,275 |
| Net Income attributable to Southside Bancshares, Inc. | \$44,396 | \$30,696 | \$16,684 | \$15,002 | \$14,592 |
| Per Share Data: | | | | | |
| Earnings Per Common Share: | | | | | |
| Basic | \$2.98 | \$2.10 | \$1.16 | \$1.06 | \$1.05 |
| Diluted | \$2.96 | \$2.06 | \$1.12 | \$1.02 | \$1.00 |
| Cash Dividends Paid Per Common Share | \$0.75 | \$0.60 | \$0.50 | \$0.47 | \$0.46 |

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, 2009, 2008, and 2007 and financial condition as of December 31, 2009 and 2008. 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 the Company's net interest margin, or a decline in the value of the Company's 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 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;
- impact of future legislation including but not limited to the financial reform legislation being considered and additional increases in depositors insurance premiums due to FDIC regulation changes;

- 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 the Company's nonperforming assets;