

SOUTHSIDE BANCSHARES INC

Form 10-Q

November 06, 2014

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

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2014

OR

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

For the transition period from _____ to _____

Commission file number: 0-12247

SOUTHSIDE BANCSHARES, INC.

(Exact name of registrant as specified in its charter)

TEXAS

(State or other jurisdiction of incorporation or
organization)

75-1848732

(I.R.S. Employer Identification No.)

1201 S. Beckham Avenue, Tyler, Texas

(Address of principal executive offices)

903-531-7111

(Registrant's telephone number, including area code)

75701

(Zip Code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes 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 whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer

Non-accelerated filer

(Do not check if a smaller reporting company)

Accelerated filer

Smaller reporting company

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

The number of shares of the issuer's common stock, par value \$1.25, outstanding as of November 3, 2014 was 18,917,402 shares.

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

| | September 30, 2014 | December 31, 2013 |
|---|-----------------------|----------------------|
| ASSETS | | |
| Cash and due from banks | \$49,937 | \$45,624 |
| Interest earning deposits | 19,284 | 8,807 |
| Total cash and cash equivalents | 69,221 | 54,431 |
| Investment securities: | | |
| Available for sale, at estimated fair value | 321,221 | 337,429 |
| Held to maturity, at carrying value (estimated fair value of \$398,386 and \$377,383, respectively) | 389,529 | 391,552 |
| Mortgage-backed securities: | | |
| Available for sale, at estimated fair value | 674,529 | 840,258 |
| Held to maturity, at carrying value (estimated fair value of \$260,695 and \$271,836, respectively) | 256,528 | 275,569 |
| FHLB stock, at cost | 24,435 | 34,065 |
| Other investments, at cost | 2,099 | 2,065 |
| Loans held for sale | 75,436 | 151 |
| Loans: | | |
| Loans | 1,398,674 | 1,351,273 |
| Less: Allowance for loan losses | (13,415) | (18,877) |
| Net Loans | 1,385,259 | 1,332,396 |
| Premises and equipment, net | 53,889 | 52,060 |
| Goodwill | 22,034 | 22,034 |
| Other intangible assets, net | 100 | 178 |
| Interest receivable | 14,221 | 21,973 |
| Deferred tax asset | 12,822 | 18,415 |
| Unsettled trades to sell securities | 5,120 | 3,933 |
| Other assets | 61,588 | 59,154 |
| TOTAL ASSETS | \$3,368,031 | \$3,445,663 |
| LIABILITIES AND SHAREHOLDERS' EQUITY | | |
| Deposits: | | |
| Noninterest bearing | \$585,415 | \$529,897 |
| Interest bearing | 1,858,149 | 1,997,911 |
| Total deposits | 2,443,564 | 2,527,808 |
| Short-term obligations: | | |
| Federal funds purchased and repurchase agreements | 2,116 | 859 |
| FHLB advances | 51,808 | 73,445 |
| Total short-term obligations | 53,924 | 74,304 |
| Long-term obligations: | | |
| FHLB advances | 476,004 | 499,349 |
| Long-term debt | 60,311 | 60,311 |
| Total long-term obligations | 536,315 | 559,660 |

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| | | |
|---|------------------|------------------|
| Unsettled trades to purchase securities | 15,224 | 973 |
| Other liabilities | 27,895 | 23,400 |
| TOTAL LIABILITIES | 3,076,922 | 3,186,145 |

Off-Balance-Sheet Arrangements, Commitments and Contingencies (Note 12)

Shareholders' equity:

| | | |
|---|--------------------|--------------------|
| Common stock (\$1.25 par, 40,000,000 shares authorized, 21,384,554 shares issued at September 30, 2014 and 20,386,221 shares issued at December 31, 2013) | 26,731 | 25,483 |
| Paid-in capital | 244,150 | 214,091 |
| Retained earnings | 65,409 | 78,673 |
| Treasury stock (2,469,638 shares at cost) | (37,692) | (37,692) |
| Accumulated other comprehensive loss | (7,489) | (21,037) |
| TOTAL SHAREHOLDERS' EQUITY | 291,109 | 259,518 |
| TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY | \$3,368,031 | \$3,445,663 |

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

SOUTHSIDE BANCSHARES, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF INCOME

(UNAUDITED)

(in thousands, except per share data)

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|-------------------------------------|----------|------------------------------------|----------|
| | 2014 | 2013 | 2014 | 2013 |
| Interest income | | | | |
| Loans | \$17,168 | \$18,625 | \$53,836 | \$54,680 |
| Investment securities – taxable | 210 | 139 | 476 | 672 |
| Investment securities – tax-exempt | 6,325 | 6,927 | 18,304 | 17,322 |
| Mortgage-backed securities | 6,070 | 5,069 | 21,309 | 13,685 |
| FHLB stock and other investments | 36 | 36 | 144 | 135 |
| Other interest earning assets | 31 | 15 | 96 | 93 |
| Total interest income | 29,840 | 30,811 | 94,165 | 86,587 |
| Interest expense | | | | |
| Deposits | 1,876 | 2,011 | 5,976 | 6,082 |
| Short-term obligations | 226 | 116 | 353 | 1,755 |
| Long-term obligations | 2,018 | 2,043 | 6,368 | 5,778 |
| Total interest expense | 4,120 | 4,170 | 12,697 | 13,615 |
| Net interest income | 25,720 | 26,641 | 81,468 | 72,972 |
| Provision for loan losses | 4,868 | 3,640 | 11,651 | 6,153 |
| Net interest income after provision for loan losses | 20,852 | 23,001 | 69,817 | 66,819 |
| Noninterest income | | | | |
| Deposit services | 3,860 | 4,005 | 11,292 | 11,662 |
| Net gain (loss) on sale of securities available for sale | 1,151 | (142) | 1,660 | 9,204 |
| Total other-than-temporary impairment losses | — | — | — | (52) |
| Portion of loss recognized in other comprehensive income (before taxes) | — | — | — | 10 |
| Net impairment losses recognized in earnings | — | — | — | (42) |
| Impairment of investment in SFG Finance, LLC | (2,239) | — | (2,239) | — |
| Gain on sale of loans | 108 | 130 | 269 | 690 |
| Trust income | 798 | 759 | 2,340 | 2,212 |
| Bank owned life insurance income | 320 | 327 | 941 | 845 |

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| | | | | |
|--------------------------------------|---------|---------|----------|----------|
| Other | 1,021 | 1,334 | 3,077 | 3,178 |
| Total noninterest income | 5,019 | 6,413 | 17,340 | 27,749 |
| Noninterest expense | | | | |
| Salaries and employee benefits | 12,798 | 13,167 | 38,992 | 39,777 |
| Occupancy expense | 1,773 | 1,922 | 5,313 | 5,690 |
| Advertising, travel & entertainment | 489 | 599 | 1,637 | 1,896 |
| ATM and debit card expense | 327 | 310 | 946 | 994 |
| Professional fees | 1,132 | 730 | 3,363 | 1,932 |
| Software and data processing expense | 543 | 528 | 1,530 | 1,515 |
| Telephone and communications | 292 | 383 | 890 | 1,218 |
| FDIC insurance | 437 | 433 | 1,319 | 1,263 |
| FHLB prepayment fees | — | — | — | 988 |
| Other | 2,226 | 2,192 | 6,635 | 6,476 |
| Total noninterest expense | 20,017 | 20,264 | 60,625 | 61,749 |
| Income before income tax expense | 5,854 | 9,150 | 26,532 | 32,819 |
| Income tax (benefit) expense | (243 |) 257 | 1,754 | 3,816 |
| Net income | \$6,097 | \$8,893 | \$24,778 | \$29,003 |
| Earnings per common share – basic | \$0.32 | \$0.47 | \$1.32 | \$1.54 |
| Earnings per common share – diluted | \$0.32 | \$0.47 | \$1.31 | \$1.54 |
| Dividends paid per common share | \$0.22 | \$0.20 | \$0.64 | \$0.60 |

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

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

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|--|-------------------------------------|---------|------------------------------------|-----------|
| | 2014 | 2013 | 2014 | 2013 |
| Net income | \$6,097 | \$8,893 | \$24,778 | \$29,003 |
| Other comprehensive income (loss): | | | | |
| Unrealized holding gains (losses) on available for sale securities during the period | 2,751 | (2,686) |) 21,070 | (46,966) |
| Change in net unrealized loss on securities transferred to held to maturity | 282 | 165 | 836 | 193 |
| Noncredit portion of other-than-temporary impairment losses on the AFS securities | — | — | — | (10) |
| Reclassification adjustment for net (gain) loss on sale of available for sale securities, included in net income | (1,151) |) 142 | (1,660) |) (9,204) |
| Reclassification of other-than-temporary impairment charges on available for sale securities, included in net income | — | — | — | 42 |
| Amortization of net actuarial loss, included in net periodic benefit cost | 260 | 697 | 781 | 2,091 |
| Amortization of prior service credit, included in net periodic benefit cost | (3) |) (10) |) (10) |) (32) |
| Other comprehensive income (loss), before tax | 2,139 | (1,692) |) 21,017 | (53,886) |
| Income tax (expense) benefit related to other items of comprehensive income | (862) |) 592 | (7,469) |) 18,860 |
| Other comprehensive income (loss), net of tax | 1,277 | (1,100) |) 13,548 | (35,026) |
| Comprehensive income (loss) | \$7,374 | \$7,793 | \$38,326 | \$(6,023) |

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

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SOUTHSIDE BANCSHARES, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY
(UNAUDITED)

(in thousands, except share and per share data)

| | Common Stock | Paid In Capital | Retained Earnings | Treasury Stock | Accumulated Other Comprehensive Income (Loss) | Total Shareholders' Equity |
|--|-----------------|--------------------|----------------------|-------------------|--|----------------------------------|
| Balance at December 31, 2012 | \$24,308 | \$195,602 | \$70,708 | \$(35,793) | \$2,938 | \$257,763 |
| Net Income | | | 29,003 | | | 29,003 |
| Other comprehensive loss | | | | | (35,026) | (35,026) |
| Issuance of common stock (43,733 shares) | 54 | 959 | | | | 1,013 |
| Purchase of common stock (90,300 shares) | | | | (1,899) | | (1,899) |
| Stock compensation expense | | 571 | | | | 571 |
| Tax benefits related to stock awards | | 43 | | | | 43 |
| Net issuance of common stock under employee stock plan | 24 | 72 | (68) | | | 28 |
| Cash dividends paid on common stock (\$0.60 per share) | | | (10,539) | | | (10,539) |
| Stock dividend declared | 1,065 | 15,995 | (17,060) | | | — |
| Balance at September 30, 2013 | \$25,451 | \$213,242 | \$72,044 | \$(37,692) | \$(32,088) | \$240,957 |
| Balance at December 31, 2013 | \$25,483 | \$214,091 | \$78,673 | \$(37,692) | \$(21,037) | \$259,518 |
| Net Income | | | 24,778 | | | 24,778 |
| Other comprehensive income | | | | | 13,548 | 13,548 |
| Issuance of common stock (26,894 shares) | 34 | 763 | | | | 797 |
| Stock compensation expense | | 842 | | | | 842 |
| Tax benefits related to stock awards | | 249 | | | | 249 |
| Net issuance of common stock under employee stock plan | 90 | 1,025 | (112) | | | 1,003 |
| Cash dividends paid on common stock (\$0.64 per share) | | | (11,865) | | | (11,865) |
| Impairment of investment in SFG Finance, LLC. | | 2,239 | | | | 2,239 |
| Stock dividend declared | 1,124 | 24,941 | (26,065) | | | — |
| Balance at September 30, 2014 | \$26,731 | \$244,150 | \$65,409 | \$(37,692) | \$(7,489) | \$291,109 |

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

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

| | Nine Months Ended September 30, | |
|---|------------------------------------|-------------|
| | 2014 | 2013 |
| OPERATING ACTIVITIES: | | |
| Net income | \$24,778 | \$29,003 |
| Adjustments to reconcile net income to net cash provided by operations: | | |
| Depreciation | 2,429 | 2,756 |
| Amortization of premium | 15,620 | 24,029 |
| Accretion of discount and loan fees | (2,763) | (4,462) |
| Provision for loan losses | 11,651 | 6,153 |
| Stock compensation expense | 842 | 571 |
| Deferred tax benefit | (2,322) | (202) |
| Excess tax benefits from stock-based compensation | (253) | (43) |
| Net gain on sale of securities available for sale | (1,660) | (9,204) |
| Net other-than-temporary impairment losses | — | 42 |
| Impairment of investment in SFG Finance, LLC. | 2,239 | — |
| Loss on premises and equipment | 14 | 4 |
| Loss (gain) on other real estate owned | 65 | (59) |
| Net change in: | | |
| Interest receivable | 7,752 | 2,235 |
| Other assets | (2,185) | (6,796) |
| Interest payable | (69) | (447) |
| Other liabilities | 4,943 | 2,661 |
| Loans originated for sale | (533) | 3,105 |
| Net cash provided by operating activities | 60,548 | 49,346 |
| INVESTING ACTIVITIES: | | |
| Securities held to maturity: | | |
| Purchases | — | (127,479) |
| Maturities, calls and principal repayments | 18,883 | 150,737 |
| Securities available for sale: | | |
| Purchases | (538,361) | (1,303,285) |
| Sales | 529,054 | 697,458 |
| Maturities, calls and principal repayments | 214,296 | 287,582 |
| Proceeds from redemption of FHLB stock | 11,437 | 5,819 |
| Purchases of FHLB stock and other investments | (1,841) | (10,711) |
| Net loans originated | (142,523) | (62,287) |
| Purchases of premises and equipment | (4,280) | (3,898) |
| Proceeds from sales of premises and equipment | 8 | — |
| Proceeds from sales of other real estate owned | 275 | 480 |
| Proceeds from sales of repossessed assets | 5,158 | 3,155 |
| Net cash provided by (used in) investing activities | 92,106 | (362,429) |

(continued)

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

| | Nine Months Ended September 30, | |
|--|------------------------------------|--------------|
| | 2014 | 2013 |
| FINANCING ACTIVITIES: | | |
| Net (decrease) increase in demand and savings accounts | (11,761) | 23,483 |
| Net (decrease) increase in certificates of deposit | (72,566) | 32,966 |
| Net increase (decrease) in federal funds purchased and repurchase agreements | 1,257 | (126) |
| Proceeds from FHLB advances | 6,485,983 | 13,062,172 |
| Repayment of FHLB advances | (6,530,965) | (12,885,012) |
| Excess tax benefits from stock-based awards | 253 | 43 |
| Net issuance of common stock under employee stock plan | 1,003 | 28 |
| Purchase of common stock | — | (1,899) |
| Proceeds from the issuance of common stock | 797 | 1,013 |
| Cash dividends paid | (11,865) | (10,539) |
| Net cash (used in) provided by financing activities | (137,864) | 222,129 |
| Net increase (decrease) in cash and cash equivalents | 14,790 | (90,954) |
| Cash and cash equivalents at beginning of period | 54,431 | 150,630 |
| Cash and cash equivalents at end of period | \$69,221 | \$59,676 |
| SUPPLEMENTAL DISCLOSURES FOR CASH FLOW INFORMATION: | | |
| Interest paid | \$12,766 | \$14,062 |
| Income taxes paid | \$4,300 | \$2,700 |
| SUPPLEMENTAL DISCLOSURES OF NONCASH INVESTING AND FINANCING ACTIVITIES: | | |
| Loans transferred to other repossessed assets and real estate through foreclosure | \$4,581 | \$3,931 |
| Loans transferred to held for sale from held for investment | \$74,752 | \$— |
| Transfer of available for sale securities to held to maturity securities | \$— | \$452,884 |
| Adjustment to pension liability | \$(771) | \$(2,059) |
| 5% stock dividend | \$26,065 | \$17,060 |
| Unsettled trades to purchase securities | \$(15,224) | \$(25,414) |
| Unsettled trades to sell securities | \$5,120 | \$— |

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

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

1. Basis of Presentation

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

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

The consolidated balance sheet as of September 30, 2014, and the related consolidated statements of income, comprehensive income, changes in shareholders' equity and cash flows and notes to the financial statements for the three- and nine-month periods ended September 30, 2014 and 2013 are unaudited; in the opinion of management, all adjustments necessary for a fair statement of such financial statements have been included. Such adjustments consisted only of normal recurring items. All significant intercompany accounts and transactions are eliminated in consolidation. The preparation of these consolidated financial statements in conformity with U.S. generally accepted accounting principles (“GAAP”) requires the use of management’s estimates. These estimates are subjective in nature and involve matters of judgment. Actual amounts could differ from these estimates.

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

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

Accounting Pronouncements

The Financial Accounting Standards Board (“FASB”) issued Accounting Standard Update (ASU) 2014-08 “Reporting Discontinued Operations and Disclosures of Disposals of Components of an Entity” in April 2014 to change the criteria used for accounting for dispositions and enhance the requirements for reporting a discontinued operation. Dispositions which represent a strategic shift that has or will have a major effect on the entity's financial condition or operating results are required to be reported as discontinued operations. ASU 2014-08 is effective for interim and annual periods beginning after December 15, 2014 with early adoption permitted. We early adopted ASU 2014-08 in September 2014 in connection with the SFG loans transferred to held for sale, which occurred during the third quarter of 2014. The adoption of ASU 2014-08 did not have a material impact on our consolidated financial statements.

The FASB issued ASU 2014-04 “Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans Upon Foreclosure” in January 2014 to clarify when an entity is considered to have obtained physical possession of a residential real estate property collateralizing a consumer mortgage loan. Upon physical possession (from an in-substance possession or foreclosure) of such real property, an entity is required to reclassify the nonperforming mortgage loan to other real estate owned. The ASU is effective for our interim and annual periods beginning after January 1, 2015. Early adoption is permitted. ASU 2014-04 is not expected to have a material impact on our consolidated financial statements.

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2. Pending Acquisition

On April 28, 2014, the Company entered into an Agreement and Plan of Merger (the "Merger Agreement") with OmniAmerican Bancorp, Inc., a Maryland corporation ("OmniAmerican") and the holding company for OmniAmerican Bank, a federal savings association based in Fort Worth, Texas. As of September 30, 2014, OmniAmerican had \$1.3 billion in assets. The Merger Agreement provides that, subject to the terms and conditions thereof, OmniAmerican will merge with and into the Company, with the Company as the surviving corporation. The merger is expected to close during the fourth quarter of 2014, subject to receipt of regulatory approvals and satisfaction of other customary closing conditions.

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

On October 14, 2014, the shareholders of the Company approved the issuance of shares of Company common stock to the stockholders of OmniAmerican, and the stockholders of OmniAmerican approved the merger and also approved, on an advisory basis, certain compensation that will or may become payable to OmniAmerican's named executive officers in connection with the merger.

3. Earnings Per Share

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

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|-------------------------------------|---------|------------------------------------|----------|
| | 2014 | 2013 | 2014 | 2013 |
| Basic and Diluted Earnings: | | | | |
| Net income | \$6,097 | \$8,893 | \$24,778 | \$29,003 |
| Basic weighted-average shares outstanding | 18,864 | 18,772 | 18,838 | 18,756 |
| Add: Stock options | 101 | 52 | 94 | 34 |
| Diluted weighted-average shares outstanding | 18,965 | 18,824 | 18,932 | 18,790 |
| Basic Earnings Per Share: | \$0.32 | \$0.47 | \$1.32 | \$1.54 |
| Diluted Earnings Per Share: | \$0.32 | \$0.47 | \$1.31 | \$1.54 |

For the three- and nine-month periods ended September 30, 2014, there were approximately 3,000 and 14,000 anti-dilutive shares, respectively. For the nine-month period ended September 30, 2013, there were approximately 6,000 anti-dilutive shares. For the three-month period ended September 30, 2013, there were no anti-dilutive shares.

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4. Accumulated Other Comprehensive (Loss) Income

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

| | Nine Months Ended September 30, 2014 | | | | |
|--|--|------|---------------|--------------|--------------|
| | Unrealized Gains (Losses) on Securities | | Pension Plans | | Total |
| | Other | OTTI | Net Prior | Net Gain | |
| Service (Cost) Credit | | | (Loss) | | |
| Beginning balance, net of tax | \$ (8,656) | \$ — | \$ (12) | \$ (12,369) | \$ (21,037) |
| Other comprehensive income (loss) before reclassifications | 21,906 | — | — | — | 21,906 |
| Reclassified to income | (1,660) | — | (10) | 781 | (889) |
| Income tax benefit (expense) | (7,016) | — | 4 | (457) | (7,469) |
| Net current-period other comprehensive income (loss), net of tax | 13,230 | — | (6) | 324 | 13,548 |
| Ending balance, net of tax | \$4,574 | \$— | \$ (18) | \$ (12,045) | \$ (7,489) |

| | Three Months Ended September 30, 2014 | | | | |
|--|--|------|---------------|--------------|-------------|
| | Unrealized Gains (Losses) on Securities | | Pension Plans | | Total |
| | Other | OTTI | Net Prior | Net Gain | |
| Service (Cost) Credit | | | (Loss) | | |
| Beginning balance, net of tax | \$3,281 | \$— | \$ (17) | \$ (12,030) | \$ (8,766) |
| Other comprehensive income (loss) before reclassifications | 3,033 | — | — | — | 3,033 |
| Reclassified to income | (1,151) | — | (3) | 260 | (894) |
| Income tax benefit (expense) | (589) | — | 2 | (275) | (862) |
| Net current-period other comprehensive income (loss), net of tax | 1,293 | — | (1) | (15) | 1,277 |
| Ending balance, net of tax | \$4,574 | \$— | \$ (18) | \$ (12,045) | \$ (7,489) |

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| | Nine Months Ended September 30, 2013 | | | | |
|--|--|-----------|--|--------------------|--------------|
| | Unrealized Gains (Losses) on Securities | | Pension Plans | | |
| | Other | OTTI | Net Prior Service (Cost) Credit | Net Gain (Loss) | Total |
| Beginning balance, net of tax | \$30,500 | \$(1,140) |) \$248 | \$(26,670) |) \$2,938 |
| Other comprehensive income (loss) before reclassifications | (46,960) |) 177 | — | — | (46,783) |
| Reclassified to income | (9,204) |) 42 | (32) |) 2,091 | (7,103) |
| Income tax benefit (expense) | 19,657 | (76) |) 11 | (732) |) 18,860 |
| Net current-period other comprehensive (loss) income, net of tax | (36,507) |) 143 | (21) |) 1,359 | (35,026) |
| Ending balance, net of tax | \$(6,007) |) \$(997) |) \$227 | \$(25,311) |) \$(32,088) |

| | Three Months Ended September 30, 2013 | | | | |
|--|--|-------------|--|--------------------|--------------|
| | Unrealized Gains (Losses) on Securities | | Pension Plans | | |
| | Other | OTTI | Net Prior Service (Cost) Credit | Net Gain (Loss) | Total |
| Beginning balance, net of tax | \$(4,446) |) \$(1,012) |) \$234 | \$(25,764) |) \$(30,988) |
| Other comprehensive income (loss) before reclassifications | (2,544) |) 23 | — | — | (2,521) |
| Reclassified to income | 142 | — | (10) |) 697 | 829 |
| Income tax benefit (expense) | 841 | (8) |) 3 | (244) |) 592 |
| Net current-period other comprehensive (loss) income, net of tax | (1,561) |) 15 | (7) |) 453 | (1,100) |
| Ending balance, net of tax | \$(6,007) |) \$(997) |) \$227 | \$(25,311) |) \$(32,088) |

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

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|-------------------------------------|-----------|------------------------------------|-------------|
| | 2014 | 2013 | 2014 | 2013 |
| Unrealized gains and losses on available for sale securities: | | | | |
| Realized net gain (loss) on sale of securities ⁽¹⁾ | \$1,151 | \$(142) |) \$1,660 | \$9,204 |
| Impairment losses ⁽²⁾ | — | — | — | (42) |
| Total before tax | 1,151 | (142) |) 1,660 | 9,162 |
| Tax (expense) benefit | (386) |) 50 | (564) |) (3,207) |
| Net of tax | \$765 | \$ (92) |) \$1,096 | \$5,955 |
| Amortization of pension plan items: | | | | |
| Net actuarial loss ⁽³⁾ | \$(260) |) \$(697) |) \$(781) |) \$(2,091) |
| Prior service credit ⁽³⁾ | 3 | 10 | 10 | 32 |
| Total before tax | (257) |) (687) |) (771) |) (2,059) |
| Tax benefit | 82 | 241 | 262 | 721 |
| Net of tax | \$(175) |) \$(446) |) \$(509) |) \$(1,338) |
| Total reclassifications for the period, net of tax | \$590 | \$ (538) |) \$587 | \$4,617 |

(1) Listed as Net gain (loss) on sale of securities available for sale on the Statements of Income.

(2) Listed as Net impairment losses recognized in earnings on the Statements of Income.

(3) These accumulated other comprehensive income components are included in the computation of net periodic benefit cost presented in "Note 8 - Employee Benefit Plans."

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5. Securities

The amortized cost, carrying value, and estimated fair value of investment and mortgage-backed securities as of September 30, 2014 and December 31, 2013 are reflected in the tables below (in thousands):

| | September 30, 2014 | | | Carrying Value | Not recognized in OCI | | Estimated Fair Value |
|--|--------------------|---|-------------------------|------------------|------------------------|-------------------------|----------------------|
| | Amortized Cost | Recognized in OCI Gross Unrealized Gains | Gross Unrealized Losses | | Gross Unrealized Gains | Gross Unrealized Losses | |
| AVAILABLE FOR SALE | | | | | | | |
| Investment Securities: | | | | | | | |
| U.S. Treasuries | \$34,814 | \$4 | \$47 | \$34,771 | | | \$34,771 |
| State and Political Subdivisions | 266,781 | 7,576 | 1,166 | 273,191 | | | 273,191 |
| Other Stocks and Bonds | 13,083 | 176 | — | 13,259 | | | 13,259 |
| Mortgage-backed Securities: ⁽¹⁾ | | | | | | | |
| Residential | 568,822 | 12,919 | 850 | 580,891 | | | 580,891 |
| Commercial | 93,921 | 389 | 672 | 93,638 | | | 93,638 |
| Total | \$977,421 | \$21,064 | \$2,735 | \$995,750 | | | \$995,750 |
| HELD TO MATURITY | | | | | | | |
| Investment Securities: | | | | | | | |
| State and Political Subdivisions | \$394,309 | \$5,265 | \$10,045 | \$389,529 | \$9,875 | \$1,018 | \$398,386 |
| Mortgage-backed Securities: ⁽¹⁾ | | | | | | | |
| Residential | 55,256 | — | 75 | 55,181 | 3,131 | — | 58,312 |
| Commercial | 207,890 | — | 6,543 | 201,347 | 3,197 | 2,161 | 202,383 |
| Total | \$657,455 | \$5,265 | \$16,663 | \$646,057 | \$16,203 | \$3,179 | \$659,081 |

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| | December 31, 2013 | | | | | | |
|--|--------------------|-------------------|------------------|--------------------|-----------------------|------------------|--------------------|
| | Amortized | Recognized in OCI | | Carrying | Not recognized in OCI | | Estimated |
| Cost | Gross Unrealized | Gross Unrealized | Gross Unrealized | | Gross Unrealized | Gross Unrealized | |
| AVAILABLE FOR SALE | | | | | | | |
| Investment Securities: | | | | | | | |
| U.S. Government Agency Debentures | \$11,612 | \$— | \$1,483 | \$10,129 | | | \$10,129 |
| State and Political Subdivisions | 322,412 | 4,537 | 12,875 | 314,074 | | | 314,074 |
| Other Stocks and Bonds | 13,074 | 159 | 7 | 13,226 | | | 13,226 |
| Mortgage-backed Securities: ⁽¹⁾ | | | | | | | |
| Residential | 760,418 | 14,940 | 3,273 | 772,085 | | | 772,085 |
| Commercial | 71,262 | 220 | 3,309 | 68,173 | | | 68,173 |
| Total | \$1,178,778 | \$19,856 | \$20,947 | \$1,177,687 | | | \$1,177,687 |
| HELD TO MATURITY | | | | | | | |
| Investment Securities: | | | | | | | |
| State and Political Subdivisions | \$396,549 | \$5,925 | \$10,922 | \$391,552 | \$1,207 | \$15,376 | \$377,383 |
| Mortgage-backed Securities: ⁽¹⁾ | | | | | | | |
| Residential | 74,129 | — | 99 | 74,030 | 3,923 | — | 77,953 |
| Commercial | 208,667 | — | 7,128 | 201,539 | — | 7,656 | 193,883 |
| Total | \$679,345 | \$5,925 | \$18,149 | \$667,121 | \$5,130 | \$23,032 | \$649,219 |

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

During 2013, the Company transferred certain commercial mortgage-backed securities and state and political subdivision securities from available for sale (“AFS”) to held to maturity (“HTM”). We transferred these securities due to overall balance sheet strategies, and our management has the current intent and ability to hold these securities until maturity. The net unrealized loss on the transferred securities included in accumulated other comprehensive income at the time of transfer will be amortized over the remaining life of the underlying security as an adjustment of the yield on those securities. There were no securities transferred from AFS to HTM during the nine months ended September 30, 2014.

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The following table represents the unrealized loss on securities as of September 30, 2014 and December 31, 2013 (in thousands):

| | As of September 30, 2014 | | | | | |
|-----------------------------------|--------------------------|---------------------|------------|-----------------|------------|-----------------|
| | Less Than 12 Months | More Than 12 Months | Total | | | |
| | Fair Value | Unrealized Loss | Fair Value | Unrealized Loss | Fair Value | Unrealized Loss |
| AVAILABLE FOR SALE | | | | | | |
| Investment Securities: | | | | | | |
| U.S. Treasuries | \$29,805 | \$47 | \$— | \$— | \$29,805 | \$47 |
| State and Political Subdivisions | 27,890 | 53 | 59,584 | 1,113 | 87,474 | 1,166 |
| Mortgage-backed Securities: | | | | | | |
| Residential | 67,538 | 272 | 20,651 | 578 | 88,189 | 850 |
| Commercial | 59,826 | 388 | 9,928 | 284 | 69,754 | 672 |
| Total | \$185,059 | \$760 | \$90,163 | \$1,975 | \$275,222 | \$2,735 |
| HELD TO MATURITY | | | | | | |
| Investment Securities: | | | | | | |
| State and Political Subdivisions | \$5,925 | \$38 | \$90,535 | \$980 | \$96,460 | \$1,018 |
| Mortgage-backed Securities: | | | | | | |
| Commercial | 54,471 | 494 | 58,235 | 1,667 | 112,706 | 2,161 |
| Total | \$60,396 | \$532 | \$148,770 | \$2,647 | \$209,166 | \$3,179 |
| | | | | | | |
| | As of December 31, 2013 | | | | | |
| | Less Than 12 Months | More Than 12 Months | Total | | | |
| | Fair Value | Unrealized Loss | Fair Value | Unrealized Loss | Fair Value | Unrealized Loss |
| AVAILABLE FOR SALE | | | | | | |
| Investment Securities: | | | | | | |
| U.S. Government Agency Debentures | \$— | \$— | \$10,129 | \$1,483 | \$10,129 | \$1,483 |
| State and Political Subdivisions | 191,117 | 11,757 | 18,408 | 1,118 | 209,525 | 12,875 |
| Other Stocks and Bonds | 2,992 | 7 | — | — | 2,992 | 7 |
| Mortgage-backed Securities: | | | | | | |
| Residential | 126,965 | 3,266 | 1,351 | 7 | 128,316 | 3,273 |
| Commercial | 65,406 | 3,309 | — | — | 65,406 | 3,309 |
| Total | \$386,480 | \$18,339 | \$29,888 | \$2,608 | \$416,368 | \$20,947 |
| HELD TO MATURITY | | | | | | |
| Investment Securities: | | | | | | |
| State and Political Subdivisions | \$283,667 | \$15,311 | \$1,705 | \$65 | \$285,372 | \$15,376 |
| Mortgage-backed Securities: | | | | | | |
| Commercial | 193,883 | 7,656 | — | — | 193,883 | 7,656 |
| Total | \$477,550 | \$22,967 | \$1,705 | \$65 | \$479,255 | \$23,032 |

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

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

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The majority of the unrealized loss positions are comprised of highly rated municipal securities and U.S. Agency mortgage-backed securities ("MBS") where the unrealized loss is a direct result of the change in interest rates and spreads. Based upon the length of time and the extent to which fair value is less than cost, we believe the securities with an unrealized loss are not other-than-temporarily impaired at September 30, 2014.

Prior to December 31, 2013, we held pooled trust preferred securities ("TRUPs"). The turmoil in the capital markets had a significant impact on our estimate of fair value of our TRUPs. These TRUPs were structured products with cash flows dependent upon securities issued by U.S. financial institutions, including banks and insurance companies. Given the facts and circumstances associated with the TRUPs, we reviewed the financial condition of each of the underlying issuing banks within the TRUP collateral pool that had not deferred and defaulted and performed detailed cash flow modeling for each TRUP. During the nine months ended September 30, 2013, the additional write-down recognized in earnings was approximately \$42,000.

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

| | Three Months Ended September 30, 2013 | Nine Months Ended September 30, 2013 |
|--|--|---|
| Balance, beginning of period | \$3,298 | \$3,256 |
| Additions for credit losses recognized on debt securities that had previously incurred impairment losses | — | 42 |
| Balance, end of period | \$3,298 | \$3,298 |

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

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

| | Nine Months Ended September 30, | |
|-------------------------------------|-------------------------------------|----------|
| | 2014 | 2013 |
| U.S. Treasury | \$191 | \$17 |
| U.S. Government Agency Debentures | 100 | 378 |
| State and Political Subdivisions | 18,333 | 17,447 |
| Other Stocks and Bonds | 156 | 152 |
| Mortgage-backed Securities | 21,309 | 13,685 |
| Total interest income on securities | \$40,089 | \$31,679 |
| | Three Months Ended September 30, | |
| | 2014 | 2013 |
| U.S. Treasury | \$150 | \$— |
| U.S. Government Agency Debentures | — | 73 |
| State and Political Subdivisions | 6,332 | 6,940 |
| Other Stocks and Bonds | 53 | 53 |
| Mortgage-backed Securities | 6,070 | 5,069 |

| | | |
|-------------------------------------|----------|----------|
| Total interest income on securities | \$12,605 | \$12,135 |
|-------------------------------------|----------|----------|

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Of the approximately \$1.7 million in net securities gains from the AFS portfolio for the nine months ended September 30, 2014, there were \$6.8 million in realized gains and \$5.2 million in realized losses. Of the \$9.2 million in net securities gains from the AFS portfolio for the nine months ended September 30, 2013, there were \$13.0 million in realized gains and approximately \$3.8 million in realized losses. There were no sales from the HTM portfolio during the nine months ended September 30, 2014 or 2013.

The amortized cost, carrying value and fair value of securities at September 30, 2014, are presented below by contractual maturity. Expected maturities may differ from contractual maturities because issuers may have the right to call or prepay obligations. MBS are presented in total by category due to the fact that MBS typically are issued with stated principal amounts, and the securities are backed by pools of mortgages that have loans with varying maturities. The characteristics of the underlying pool of mortgages, such as fixed-rate or adjustable-rate, as well as prepayment risk, are passed on to the security holder. The term of a mortgage-backed pass-through security thus approximates the term of the underlying mortgages and can vary significantly due to prepayments.

| | September 30, 2014 | |
|--|--------------------|------------|
| | Amortized Cost | Fair Value |
| | (in thousands) | |
| AVAILABLE FOR SALE | | |
| Investment Securities: | | |
| Due in one year or less | \$3,619 | \$3,652 |
| Due after one year through five years | 53,593 | 54,048 |
| Due after five years through ten years | 32,624 | 33,315 |
| Due after ten years | 224,842 | 230,206 |
| | 314,678 | 321,221 |
| Mortgage-backed Securities: | 662,743 | 674,529 |
| Total | \$977,421 | \$995,750 |

| | September 30, 2014 | |
|--|--------------------|------------|
| | Carrying Value | Fair Value |
| | (in thousands) | |
| HELD TO MATURITY | | |
| Investment Securities: | | |
| Due in one year or less | \$— | \$— |
| Due after one year through five years | 2,917 | 2,915 |
| Due after five years through ten years | 33,464 | 33,696 |
| Due after ten years | 353,148 | 361,775 |
| | 389,529 | 398,386 |
| Mortgage-backed Securities: | 256,528 | 260,695 |
| Total | \$646,057 | \$659,081 |

Investment and MBS with carrying values of \$918.6 million and \$1.14 billion were pledged as of September 30, 2014 and December 31, 2013, respectively, to collateralize Federal Home Loan Bank (“FHLB”) advances, repurchase agreements, and public funds or for other purposes as required by law.

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

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6. Loans and Allowance for Probable Loan Losses

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

| | September 30, 2014 | December 31, 2013 |
|-------------------------------------|--------------------|-------------------|
| Real Estate Loans: | | |
| Construction | \$ 178,127 | \$ 125,219 |
| 1-4 Family Residential | 394,889 | 390,499 |
| Other | 332,519 | 262,536 |
| Commercial Loans | 162,356 | 157,655 |
| Municipal Loans | 256,319 | 245,550 |
| Loans to Individuals ⁽¹⁾ | 74,464 | 169,814 |
| Total Loans | 1,398,674 | 1,351,273 |
| Less: Allowance for Loan Losses | 13,415 | 18,877 |
| Net Loans | \$ 1,385,259 | \$ 1,332,396 |

At September 30, 2014, SFG purchased loans, totaling approximately \$74.8 million, were transferred to loans held (1) for sale, and therefore, are not included in the loan tables presented in this note to the consolidated financial statements.

Real Estate Construction Loans

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

Real Estate 1-4 Family Residential Loans

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

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

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

Other Real Estate

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

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Commercial Loans

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

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

Municipal Loans

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

Loans to Individuals

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

Loan pools purchased through SFG were subjected to a modeling system that considered credit scores and estimated collateral values to determine expected defaults in each pool. SFG purchased loan pools of approximately \$6.1 million and \$36.5 million, net of discount, during the three and nine months ended September 30, 2014, respectively. There have been no material loan pool purchases since August 2014 and there will be no additional loan pool purchases through SFG. For the three and nine months ended September 30, 2013, SFG purchased loan pools of approximately \$16.3 million and \$61.6 million, net of discount, respectively.

On October 3, 2014, we announced that we intended to sell all of our subprime automobile loans purchased through SFG, as well as the repossessed assets SFG holds and that we were endeavoring to complete such a sale in the fourth quarter of 2014. As a result of this decision, SFG loans totaling \$74.8 million were transferred to held for sale and are therefore not included in our loan portfolio as of September 30, 2014.

Allowance for Loan Losses

The allowance for loan losses is based on the most current review of the loan portfolio and is a result of multiple processes. First, the bank utilizes historical data to establish general reserve amounts for each class of loans. The historical charge off figure is further adjusted through qualitative factors that include general trends in past dues, nonaccruals and classified loans to more effectively and promptly react to both positive and negative movements. Second, our lenders have the primary responsibility for identifying problem loans and estimating necessary reserves based on customer financial stress and underlying collateral. These recommendations are reviewed by senior loan administration, the Special Assets department, and the Loan Review department. Third, the Loan Review department independently reviews the portfolio on an annual basis. The Loan Review department follows a board-approved annual

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loan review scope. The loan review scope encompasses a number of considerations including the size of the loan, the type of credit extended, the seasoning of the loan and the performance of the loan. The Loan Review scope, as it relates to size, focuses more on larger dollar loan relationships, typically, for example, aggregate debt of \$500,000 or greater. The Loan Review officer also reviews specific reserves compared to general reserves to determine trends in comparative reserves as well as losses not reserved for prior to charge-off to determine the effectiveness of the specific reserve process.

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

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

Prior to September 30, 2014, SFG loans included in loans to individuals that experienced past due status or extension of maturity characteristics were reserved for at higher levels based on the circumstances associated with each specific loan. In general, the reserves for SFG were calculated based on the past due status of the loan. For reserve purposes, the portfolio was segregated by past due status and by the remaining term variance from the original contract. During repayment, loans that paid late took longer to repay than the original contract. Additionally, some loans may have been granted extensions for extenuating payment circumstances and evaluated for troubled debt classification. The remaining term extensions increased the risk of collateral deterioration and, accordingly, reserves were increased to recognize this risk.

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

Credit Quality Indicators

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

-

Pass (Rating 1 – 4) – This rating is assigned to all satisfactory loans. This category, by definition, consists of acceptable credit. Credit and collateral exceptions should not be present, although their presence would not necessarily prohibit a loan from being rated Pass, if deficiencies are in process of correction. These loans are not included in the Watch List.

Pass Watch (Rating 5) – Special Treatment Required – These loans require some degree of special treatment, but not due to credit quality. This category does not include loans specially mentioned or adversely classified; however, particular attention must be accorded such credits due to characteristics such as:

▲ A lack of, or abnormally extended payment program;

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- ▲ heavy degree of concentration of collateral without sufficient margin;
- ▲ vulnerability to competition through lesser or extensive financial leverage; and
- ▲ dependence on a single or few customers or sources of supply and materials without suitable substitutes or alternatives.

Special Mention (Rating 6) – A Special Mention asset has potential weaknesses that deserve management’s close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the asset or in the institution’s credit position at some future date. Special Mention assets are not adversely classified and do not expose an institution to sufficient risk to warrant adverse classification.

Substandard (Rating 7) – Substandard loans are inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Loans so classified must have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the Bank will sustain some loss if the deficiencies are not corrected.

Doubtful (Rating 8) – Loans classified as Doubtful have all the weaknesses inherent in those classified Substandard with the added characteristic that the weaknesses make collection or liquidation, in full, on the basis of currently known facts, conditions and values, highly questionable and improbable.

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

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

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

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

| | Nine Months Ended September 30, 2014 | | | | | | Total |
|--------------------------------------|--------------------------------------|---------------------------|---------|---------------------|--------------------|--|-----------|
| | Real Estate | | | Commercial Loans | Municipal Loans | Loans to Individuals ⁽¹⁾ | |
| | Construction | 1-4 Family Residential | Other | | | | |
| Balance at beginning of period | \$2,142 | \$3,277 | \$2,572 | \$1,970 | \$668 | \$ 8,248 | \$18,877 |
| Provision (reversal) for loan losses | 47 | 206 | (245) | 1,525 | 45 | 10,073 | 11,651 |
| Loans charged off | (14) | (22) | — | (65) | — | (18,630) | (18,731) |
| Recoveries of loans charged off | 107 | 77 | 6 | 139 | — | 1,289 | 1,618 |
| Balance at end of period | \$2,282 | \$3,538 | \$2,333 | \$3,569 | \$713 | \$ 980 | \$13,415 |

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Three Months Ended September 30, 2014

Real Estate

| | Construction | 1-4 Family Residential | Other | Commercial Loans | Municipal Loans | Loans to Individuals ⁽¹⁾ | Total |
|--------------------------------------|--------------|------------------------|---------|------------------|-----------------|-------------------------------------|-----------|
| Balance at beginning of period | \$2,496 | \$3,915 | \$2,436 | \$1,757 | \$663 | \$7,141 | \$18,408 |
| Provision (reversal) for loan losses | (262) | (422) | (105) | 1,844 | 50 | 3,763 | 4,868 |
| Loans charged off | — | — | — | (60) | — | (10,357) | (10,417) |
| Recoveries of loans charged off | 48 | 45 | 2 | 28 | — | 433 | 556 |
| Balance at end of period | \$2,282 | \$3,538 | \$2,333 | \$3,569 | \$713 | \$980 | \$13,415 |

(1) Of the \$18.6 million and \$10.4 million in charge-offs recorded in the Loans to Individuals category for the nine and three months ended September 30, 2014, respectively, approximately \$6.0 million of these amounts relate to the write-down of SFG loans to fair value in connection with the transfer of SFG loans to held for sale.

Nine Months Ended September 30, 2013

Real Estate

| | Construction | 1-4 Family Residential | Other | Commercial Loans | Municipal Loans | Loans to Individuals | Unallocated | Total |
|--------------------------------------|--------------|------------------------|---------|------------------|-----------------|----------------------|-------------|----------|
| Balance at beginning of period | \$2,355 | \$3,545 | \$2,290 | \$3,158 | \$633 | \$7,373 | \$1,231 | \$20,585 |
| Provision (reversal) for loan losses | (214) | 246 | 108 | (628) | (21) | 7,846 | (1,184) | 6,153 |
| Loans charged off | — | (228) | (67) | (292) | — | (8,784) | — | (9,371) |
| Recoveries of loans charged off | 49 | 85 | 338 | 190 | — | 1,327 | — | 1,989 |
| Balance at end of period | \$2,190 | \$3,648 | \$2,669 | \$2,428 | \$612 | \$7,762 | \$47 | \$19,356 |

Three Months Ended September 30, 2013

Real Estate

| | Construction | 1-4 Family Residential | Other | Commercial Loans | Municipal Loans | Loans to Individuals | Unallocated | Total |
|--------------------------------------|--------------|------------------------|---------|------------------|-----------------|----------------------|-------------|----------|
| Balance at beginning of period | \$2,100 | \$3,609 | \$2,104 | \$2,450 | \$633 | \$6,901 | \$573 | \$18,370 |
| Provision (reversal) for loan losses | 63 | (35) | 237 | (8) | (21) | 3,930 | (526) | 3,640 |
| Loans charged off | — | — | — | (94) | — | (3,420) | — | (3,514) |
| Recoveries of loans charged off | 27 | 74 | 328 | 80 | — | 351 | — | 860 |
| Balance at end of period | \$2,190 | \$3,648 | \$2,669 | \$2,428 | \$612 | \$7,762 | \$47 | \$19,356 |

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

| | As of September 30, 2014 | | | | | | |
|--|--------------------------|------------------------|---------|------------------|-----------------|----------------------|----------|
| | Real Estate | | | | | | |
| | Construction | 1-4 Family Residential | Other | Commercial Loans | Municipal Loans | Loans to Individuals | Total |
| Ending balance – individually evaluated for impairment | \$20 | \$100 | \$24 | \$368 | \$14 | \$92 | \$618 |
| Ending balance – collectively evaluated for impairment | 2,262 | 3,438 | 2,309 | 3,201 | 699 | 888 | 12,797 |
| Balance at end of period | \$2,282 | \$3,538 | \$2,333 | \$3,569 | \$713 | \$980 | \$13,415 |

| | As of December 31, 2013 | | | | | | |
|--|-------------------------|------------------------|---------|------------------|-----------------|----------------------|----------|
| | Real Estate | | | | | | |
| | Construction | 1-4 Family Residential | Other | Commercial Loans | Municipal Loans | Loans to Individuals | Total |
| Ending balance – individually evaluated for impairment | \$103 | \$161 | \$73 | \$240 | \$15 | \$173 | \$765 |
| Ending balance – collectively evaluated for impairment | 2,039 | 3,116 | 2,499 | 1,730 | 653 | 8,075 | 18,112 |
| Balance at end of period | \$2,142 | \$3,277 | \$2,572 | \$1,970 | \$668 | \$8,248 | \$18,877 |

The following tables present the recorded investment in loans by portfolio segment based on impairment method (in thousands):

| | September 30, 2014 | | | | | | |
|---|--------------------|------------------------|-----------|------------------|-----------------|----------------------|-------------|
| | Real Estate | | | | | | |
| | Construction | 1-4 Family Residential | Other | Commercial Loans | Municipal Loans | Loans to Individuals | Total |
| Loans individually evaluated for impairment | \$794 | \$4,394 | \$1,643 | \$1,209 | \$699 | \$304 | \$9,043 |
| Loans collectively evaluated for impairment | 177,333 | 390,495 | 330,876 | 161,147 | 255,620 | 74,160 | 1,389,631 |
| Total ending loan balance | \$178,127 | \$394,889 | \$332,519 | \$162,356 | \$256,319 | \$74,464 | \$1,398,674 |

| | December 31, 2013 | | | | | | |
|--|-------------------|------------------------|-------|------------------|-----------------|----------------------|-------|
| | Real Estate | | | | | | |
| | Construction | 1-4 Family Residential | Other | Commercial Loans | Municipal Loans | Loans to Individuals | Total |

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| | | Residential | | Loans | Loans | Individuals | |
|--|-----------|-------------|-----------|-----------|-----------|-------------|-------------|
| Loans individually evaluated for impairment | \$1,472 | \$2,624 | \$1,778 | \$1,369 | \$759 | \$559 | \$8,561 |
| Loans collectively evaluated for impairment | 123,747 | 387,875 | 260,758 | 156,286 | 244,791 | 169,255 | 1,342,712 |
| Total ending loan balance | \$125,219 | \$390,499 | \$262,536 | \$157,655 | \$245,550 | \$169,814 | \$1,351,273 |

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The following tables set forth loans by credit quality indicator for the periods presented (in thousands):

| | September 30, 2014 | | | | | |
|------------------------|--------------------|------------|--------------------|-------------|----------|--------------|
| | Pass | Pass Watch | Special Mention | Substandard | Doubtful | Total |
| Real Estate Loans: | | | | | | |
| Construction | \$ 171,892 | \$ 2,709 | \$ 1,177 | \$ 2,320 | \$ 29 | \$ 178,127 |
| 1-4 Family Residential | 385,158 | 1,464 | 1,724 | 5,489 | 1,054 | 394,889 |
| Other | 321,834 | 2,499 | 2,593 | 5,593 | — | 332,519 |
| Commercial Loans | 141,512 | 797 | — | 19,845 | 202 | 162,356 |
| Municipal Loans | 255,370 | — | — | 949 | — | 256,319 |
| Loans to Individuals | 73,905 | 21 | — | 384 | 154 | 74,464 |
| Total | \$ 1,349,671 | \$ 7,490 | \$ 5,494 | \$ 34,580 | \$ 1,439 | \$ 1,398,674 |

| | December 31, 2013 | | | | | |
|------------------------|-------------------|------------|--------------------|-------------|----------|--------------|
| | Pass | Pass Watch | Special Mention | Substandard | Doubtful | Total |
| Real Estate Loans: | | | | | | |
| Construction | \$ 121,280 | \$ — | \$ 1,419 | \$ 2,454 | \$ 66 | \$ 125,219 |
| 1-4 Family Residential | 380,741 | 1,626 | 3,025 | 4,901 | 206 | 390,499 |
| Other | 249,381 | 2,553 | 4,698 | 5,887 | 17 | 262,536 |
| Commercial Loans | 150,683 | 836 | 9 | 5,826 | 301 | 157,655 |
| Municipal Loans | 244,505 | — | — | 1,045 | — | 245,550 |
| Loans to Individuals | 168,764 | 27 | 2 | 719 | 302 | 169,814 |
| Total | \$ 1,315,354 | \$ 5,042 | \$ 9,153 | \$ 20,832 | \$ 892 | \$ 1,351,273 |

The following table sets forth nonperforming assets for the periods presented (in thousands):

| | At September 30, 2014 | At December 31, 2013 |
|---|-----------------------------|----------------------------|
| Nonaccrual loans | \$ 4,685 | \$ 8,088 |
| Accruing loans past due more than 90 days | 1 | 3 |
| Restructured loans | 4,388 | 3,888 |
| Other real estate owned | 383 | 726 |
| Repossession assets | 407 | 901 |
| Total Nonperforming Assets ⁽¹⁾ | \$ 9,864 | \$ 13,606 |

At September 30, 2014, there were \$2.0 million in SFG nonaccrual loans and \$40,000 in SFG restructured loans (1) that were transferred to held for sale and not included in the nonperforming assets presented above. At September 30, 2014, total nonperforming assets, including loans held for sale, were \$11.9 million.

Nonaccrual and Past Due Loans

Nonaccrual loans are loans 90 days or more delinquent and collection in full of both the principal and interest is not expected. Additionally, some loans that are not delinquent may be placed on nonaccrual status due to doubts about

full collection of principal or interest. When a loan is categorized as nonaccrual, the accrual of interest is discontinued and any accrued balance is reversed for financial statement purposes. Payments received on nonaccrual loans are

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applied to the outstanding principal balance. Payments of contractual interest are recognized as income only to the extent that full recovery of the principal balance of the loan is reasonably certain. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured. Other factors, such as the value of collateral securing the loan and the financial condition of the borrower, are considered in judgments as to potential loan loss.

Nonaccrual loans and accruing loans past due more than 90 days include both smaller balance homogeneous loans that are collectively evaluated for impairment and individually classified impaired loans.

The following table sets forth the recorded investment in nonaccrual and accruing loans past due more than 90 days by class of loans for the periods presented (in thousands):

| | September 30, 2014 | | December 31, 2013 | |
|------------------------|--------------------|---|-------------------|---|
| | Nonaccrual | Accruing Loans Past Due More Than 90 Days | Nonaccrual | Accruing Loans Past Due More Than 90 Days |
| Real Estate Loans: | | | | |
| Construction | \$794 | \$— | \$1,472 | \$— |
| 1-4 Family Residential | 2,539 | — | 1,435 | — |
| Other | 510 | — | 599 | — |
| Commercial Loans | 581 | — | 1,062 | — |
| Loans to Individuals | 261 | 1 | 3,520 | 3 |
| Total | \$4,685 | \$1 | \$8,088 | \$3 |

The following tables present the aging of the recorded investment in past due loans by class of loans (in thousands):

| | September 30, 2014 | | | Total Past Due | Current | Total |
|------------------------|------------------------|------------------------|-------------------------------------|-------------------|-------------|-------------|
| | 30-59 Days Past Due | 60-89 Days Past Due | Greater than 90 Days Past Due | | | |
| Real Estate Loans: | | | | | | |
| Construction | \$292 | \$16 | \$794 | \$1,102 | \$177,025 | \$178,127 |
| 1-4 Family Residential | 160 | 411 | 2,539 | 3,110 | 391,779 | 394,889 |
| Other | 103 | 1,919 | 510 | 2,532 | 329,987 | 332,519 |
| Commercial Loans | 338 | 37 | 581 | 956 | 161,400 | 162,356 |
| Municipal Loans | 250 | — | — | 250 | 256,069 | 256,319 |
| Loans to Individuals | 432 | 78 | 262 | 772 | 73,692 | 74,464 |
| Total | \$1,575 | \$2,461 | \$4,686 | \$8,722 | \$1,389,952 | \$1,398,674 |

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| | December 31, 2013 | | | Total Past Due | Current | Total |
|------------------------|---------------------|---------------------|-------------------------------|----------------|-------------|-------------|
| | 30-59 Days Past Due | 60-89 Days Past Due | Greater than 90 Days Past Due | | | |
| Real Estate Loans: | | | | | | |
| Construction | \$311 | \$— | \$1,472 | \$1,783 | \$123,436 | \$125,219 |
| 1-4 Family Residential | 4,340 | 781 | 1,435 | 6,556 | 383,943 | 390,499 |
| Other | 2,652 | — | 599 | 3,251 | 259,285 | 262,536 |
| Commercial Loans | 411 | 22 | 1,062 | 1,495 | 156,160 | 157,655 |
| Municipal Loans | — | — | — | — | 245,550 | 245,550 |
| Loans to Individuals | 7,241 | 2,590 | 3,523 | 13,354 | 156,460 | 169,814 |
| Total | \$14,955 | \$3,393 | \$8,091 | \$26,439 | \$1,324,834 | \$1,351,273 |

The following tables set forth interest income recognized on impaired loans by class of loans for the periods presented. Average recorded investment of impaired loans is reported on a year-to-date basis (in thousands):

| | Nine Months Ended | | | |
|------------------------|-----------------------------|----------------------------|-----------------------------|----------------------------|
| | September 30, 2014 | | September 30, 2013 | |
| | Average Recorded Investment | Interest Income Recognized | Average Recorded Investment | Interest Income Recognized |
| Real Estate Loans: | | | | |
| Construction | \$1,354 | \$— | \$1,801 | \$2 |
| 1-4 Family Residential | 3,371 | 49 | 3,015 | 31 |
| Other | 2,339 | 47 | 2,031 | 50 |
| Commercial Loans | 1,353 | 19 | 2,090 | 12 |
| Municipal Loans | 741 | 31 | 152 | 16 |
| Loans to Individuals | 2,402 | 2 | 3,016 | 313 |
| Total | \$11,560 | \$148 | \$12,105 | \$424 |

| | Three Months Ended | | | |
|------------------------|-----------------------------|----------------------------|-----------------------------|----------------------------|
| | September 30, 2014 | | September 30, 2013 | |
| | Average Recorded Investment | Interest Income Recognized | Average Recorded Investment | Interest Income Recognized |
| Real Estate Loans: | | | | |
| Construction | \$1,141 | \$— | \$1,539 | \$— |
| 1-4 Family residential | 4,206 | 18 | 2,840 | 11 |
| Other | 2,604 | 16 | 1,781 | 17 |
| Commercial loans | 1,072 | 7 | 2,218 | 4 |
| Municipal loans | 714 | 10 | 379 | 5 |
| Loans to individuals | 1,854 | — | 2,950 | 64 |
| Total | \$11,591 | \$51 | \$11,707 | \$101 |

Loans are considered impaired if, based on current information and events, it is probable that we will be unable to collect the scheduled payments of principal and interest when due according to the contractual terms of the loan agreement. The measurement of loss on impaired loans is generally based on the fair value of the collateral if repayment is expected solely from the collateral or the present value of the expected future cash flows discounted at the historical effective interest rate stipulated in the loan agreement. In measuring the fair value of the collateral, in addition to

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relying on third party appraisals, we use assumptions, such as discount rates, and methodologies, such as comparison to the recent selling price of similar assets, consistent with those that would be utilized by unrelated third parties performing a valuation. Loans that are evaluated and determined not to meet the definition of an impaired loan are reserved for at the general reserve rate for its appropriate class.

The following tables set forth impaired loans by class of loans for the periods presented (in thousands):

| | September 30, 2014 | | | | |
|------------------------|--------------------------------------|---------------------------------------|------------------------------------|---------------------------|-----------------------------------|
| | Unpaid Contractual Principal Balance | Recorded Investment With No Allowance | Recorded Investment With Allowance | Total Recorded Investment | Related Allowance for Loan Losses |
| Real Estate Loans: | | | | | |
| Construction | \$1,494 | \$— | \$794 | \$794 | \$20 |
| 1-4 Family Residential | 4,538 | — | 4,394 | 4,394 | 100 |
| Other | 1,654 | — | 1,643 | 1,643 | 24 |
| Commercial Loans | 1,358 | — | 1,209 | 1,209 | 368 |
| Municipal Loans | 699 | — | 699 | 699 | 14 |
| Loans to Individuals | 316 | — | 304 | 304 | 92 |
| Total | \$10,059 | \$— | \$9,043 | \$9,043 | \$618 |
| | December 31, 2013 | | | | |
| | Unpaid Contractual Principal Balance | Recorded Investment With No Allowance | Recorded Investment With Allowance | Total Recorded Investment | Related Allowance for Loan Losses |
| Real Estate Loans: | | | | | |
| Construction | \$2,629 | \$— | \$1,472 | \$1,472 | \$103 |
| 1-4 Family Residential | 2,748 | — | 2,624 | 2,624 | 161 |
| Other | 1,800 | — | 1,778 | 1,778 | 73 |
| Commercial Loans | 1,606 | — | 1,369 | 1,369 | 240 |
| Municipal Loans | 759 | — | 759 | 759 | 15 |
| Loans to Individuals | 4,280 | — | 3,943 | 3,943 | 1,950 |
| Total | \$13,822 | \$— | \$11,945 | \$11,945 | \$2,542 |

At the time a loss is probable in the collection of contractual amounts, specific reserves are allocated. Loans are charged off when deemed uncollectible or as soon as collection by liquidation is evident to the liquidation value of the collateral net of liquidation costs, if any, and placed in nonaccrual status.

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Troubled Debt Restructurings

The restructuring of a loan is considered a TDR if both (i) the borrower is experiencing financial difficulties and (ii) the creditor has granted a concession. Concessions may include interest rate reductions or below market interest rates, restructuring amortization schedules and other actions intended to minimize potential losses.

The following tables set forth the recorded balance at September 30, 2014 and 2013 of loans considered to be TDRs that were restructured during the periods presented (dollars in thousands):

| | Nine Months Ended September 30, 2014 | | | | |
|------------------------|---------------------------------------|-----------------------------|----------------------------|------------------------|--------------------|
| | Extend Amortization Period | Interest Rate Reductions | Combination ⁽¹⁾ | Total Modifications | Number of Loans |
| Real Estate Loans: | | | | | |
| 1-4 Family Residential | \$— | \$282 | \$193 | \$475 | 2 |
| Other | — | — | 401 | 401 | 2 |
| Commercial Loans | 302 | — | 173 | 475 | 6 |
| Loans to Individuals | — | 12 | 73 | 85 | 7 |
| Total | \$302 | \$294 | \$840 | \$1,436 | 17 |
| | Three Months Ended September 30, 2014 | | | | |
| | Extend Amortization Period | Interest Rate Reductions | Combination ⁽¹⁾ | Total Modifications | Number of Loans |
| Real Estate Loans: | | | | | |
| 1-4 Family Residential | \$— | \$— | \$193 | \$193 | 1 |
| Commercial Loans | — | — | 117 | 117 | 1 |
| Loans to Individuals | — | — | 27 | 27 | 3 |
| Total | \$— | \$— | \$337 | \$337 | 5 |
| | Nine Months Ended September 30, 2013 | | | | |
| | Extend Amortization Period | Interest Rate Reductions | Combination ⁽¹⁾ | Total Modifications | Number of Loans |
| Real Estate Loans: | | | | | |
| Construction | \$40 | \$— | \$— | \$40 | 1 |
| 1-4 Family Residential | 282 | — | 120 | 402 | 5 |
| Other | 162 | — | 15 | 177 | 2 |
| Commercial Loans | 266 | — | 91 | 357 | 5 |
| Municipal Loans | 759 | — | — | 759 | 1 |
| Loans to Individuals | 14 | 278 | 55 | 347 | 42 |
| Total | \$1,523 | \$278 | \$281 | \$2,082 | 56 |

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| | Three Months Ended September 30, 2013 | | | Total Modifications | Number of Loans |
|----------------------|---------------------------------------|-----------------------------|----------------------------|------------------------|--------------------|
| | Extend Amortization Period | Interest Rate Reductions | Combination ⁽¹⁾ | | |
| Real Estate Loans: | | | | | |
| Other | \$ 162 | \$— | \$— | \$ 162 | 1 |
| Commercial Loans | — | — | 73 | 73 | 1 |
| Municipal Loans | 759 | — | — | 759 | 1 |
| Loans to Individuals | — | 120 | 8 | 128 | 16 |
| Total | \$921 | \$ 120 | \$81 | \$ 1,122 | 19 |

(1) These modifications include an extension of the amortization period and interest rate reduction.

The majority of loans restructured as TDRs during the three and nine months ended September 30, 2014 were modified with a combination of interest rate reductions and maturity extensions. Interest continues to be charged on principal balances outstanding during the term extended. Therefore, the financial effects of the recorded investment of loans restructured as TDRs during the three and nine months ended September 30, 2014 and September 30, 2013 were insignificant. Generally, the loans identified as TDRs were previously reported as impaired loans prior to restructuring and therefore the modification did not impact our determination of the allowance for loan losses.

On an ongoing basis, the performance of the TDRs is monitored for subsequent payment default. Payment default for TDRs is recognized when the borrower is 90 days or more past due. For the three and nine months ended September 30, 2014, there were \$117,000 TDRs in payment default. There were no material defaults for the three and nine months ended September 30, 2013. Payment defaults for TDRs did not significantly impact the determination of the allowance for loan loss.

At September 30, 2014 and December 31, 2013, there were no commitments to lend additional funds to borrowers whose terms had been modified in TDRs.

7. Long-term Obligations

Long-term obligations are summarized as follows (in thousands):

| | September 30, 2014 | December 31, 2013 |
|---|-----------------------|----------------------|
| FHLB Advances ⁽¹⁾ | \$476,004 | \$499,349 |
| Long-term Debt ⁽²⁾ | | |
| Southside Statutory Trust III Due 2033 ⁽³⁾ | 20,619 | 20,619 |
| Southside Statutory Trust IV Due 2037 ⁽⁴⁾ | 23,196 | 23,196 |
| Southside Statutory Trust V Due 2037 ⁽⁵⁾ | 12,887 | 12,887 |
| Magnolia Trust Company I Due 2035 ⁽⁶⁾ | 3,609 | 3,609 |
| Total Long-term Debt | 60,311 | 60,311 |
| Total Long-term Obligations | \$536,315 | \$559,660 |

(1) At September 30, 2014, the weighted average cost of these advances was 1.37%. Long-term FHLB Advances have maturities ranging from October 2015 through July 2028.

(2) This long-term debt consists of trust preferred securities that qualify under the risk-based capital guidelines as Tier 1 capital, subject to certain limitations.

(3) This debt carries an adjustable rate of 3.1731% through December 30, 2014 and adjusts quarterly at a rate equal to three-month LIBOR plus 294 basis points.

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- (4) This debt carries an adjustable rate of 1.5361% through October 29, 2014 and adjusts quarterly at a rate equal to three-month LIBOR plus 130 basis points.
- (5) This debt carries an adjustable rate of 2.4841% through December 14, 2014 and adjusts quarterly at a rate equal to three-month LIBOR plus 225 basis points.
- (6) This debt carries an adjustable rate of 2.0349% through November 23, 2014 and adjusts quarterly at a rate equal to three-month LIBOR plus 180 basis points.

8. Employee Benefit Plans

The components of net periodic benefit cost are as follows (in thousands):

| | Nine Months Ended September 30, | | | |
|--|----------------------------------|----------|------------------|---------|
| | Defined Benefit Pension Plan | | Restoration Plan | |
| | 2014 | 2013 | 2014 | 2013 |
| Service cost | \$1,273 | \$1,588 | \$206 | \$224 |
| Interest cost | 2,623 | 2,366 | 422 | 351 |
| Expected return on assets | (4,236) | (3,596) | — | — |
| Net actuarial loss recognition | 407 | 1,648 | 374 | 443 |
| Prior service (credit) cost amortization | (14) | (31) | 4 | (1) |
| Net periodic benefit cost | \$53 | \$1,975 | \$1,006 | \$1,017 |
| | Three Months Ended September 30, | | | |
| | Defined Benefit Pension Plan | | Restoration Plan | |
| | 2014 | 2013 | 2014 | 2013 |
| Service cost | \$424 | \$529 | \$69 | \$75 |
| Interest cost | 875 | 789 | 141 | 117 |
| Expected return on assets | (1,412) | (1,199) | — | — |
| Net loss recognition | 135 | 549 | 125 | 148 |
| Prior service (credit) cost amortization | (4) | (10) | 1 | — |
| Net periodic benefit cost | \$18 | \$658 | \$336 | \$340 |

Employer Contributions. As of September 30, 2014, contributions of \$180,000 have been made to our Restoration Plan. We do not anticipate contributing to our Defined Benefit Pension Plan in 2014.

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9. Share-based Incentive Plans

2009 Incentive Plan

On April 16, 2009, our shareholders approved the Southside Bancshares, Inc. 2009 Incentive Plan (the “2009 Incentive Plan”), which is a stock-based incentive compensation plan. A total of 1,340,098 shares of our common stock were reserved and available for issuance pursuant to awards granted under the 2009 Incentive Plan. Under the 2009 Incentive Plan, we were authorized to grant nonqualified stock options (“NQSOs”), restricted stock units (“RSUs”), or any combination thereof to certain officers. During the nine months ended September 30, 2014 and 2013, there were no grants of RSUs or NQSOs pursuant to the 2009 Incentive Plan.

As of September 30, 2014, there were 298,925 unvested awards outstanding. For the three and nine months ended September 30, 2014, there was share-based compensation expense of \$266,000 and \$843,000, respectively, with an associated income tax benefit for the three and nine months of \$90,000 and \$286,000, respectively. As of September 30, 2013, there were 241,603 unvested awards outstanding. Share-based compensation expense for the three and nine months ended September 30, 2013 was \$198,000 and \$571,000, respectively, with an associated income tax benefit for the three and nine months of \$69,000 and \$200,000, respectively.

As of September 30, 2014 and 2013, there was \$2.2 million and \$1.5 million of unrecognized compensation cost, respectively, related to the unvested awards outstanding. The remaining cost at September 30, 2014 is expected to be recognized over a weighted-average period of 2.54 years.

The NQSOs have contractual terms of 10 years and vest in equal annual installments over three- and four-year periods.

The fair value of each RSU is the closing stock price on the date of grant. The RSUs vest in equal annual installments over three- and four-year periods.

Each award is evidenced by an award agreement that specifies the exercise price, if applicable, the duration of the award, the number of shares to which the award pertains, and such other provisions as the Board determines.

Shares issued in connection with stock compensation awards are issued from authorized shares and not from treasury shares. During the nine months ended September 30, 2014 and 2013, there were 72,482 and 20,315 shares, respectively, issued in connection with stock compensation awards from available authorized shares.

The following table presents activity related to our RSUs and NQSOs as of September 30, 2014.

| | | Restricted Stock Units Outstanding | | Stock Options Outstanding | | |
|--------------------------|----------------------------------|---------------------------------------|--|------------------------------|---|--|
| | Shares Available for Grant | Number of Shares | Weighted- Average Grant-Date Fair Value | Number of Shares | Weighted- Average Exercise Price | Weighted- Average Grant-Date Fair Value |
| Balance, January 1, 2014 | 738,764 | 56,823 | \$22.00 | 501,846 | \$20.56 | \$6.18 |
| Granted | — | — | — | — | — | — |
| Stock options exercised | — | — | — | (59,292) | 17.69 | 5.18 |

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| | | | | | | |
|-----------------------------|---------|---------|---------|---------|---------|--------|
| Stock awards vested | — | (13,246 |) 17.80 | — | — | — |
| Forfeited | 22,751 | (2,901 |) 22.11 | (19,850 |) 22.55 | 6.81 |
| Canceled/expired | 1,898 | — | — | (1,898 |) 18.99 | 5.27 |
| Balance, September 30, 2014 | 763,413 | 40,676 | \$23.36 | 420,806 | \$20.88 | \$6.30 |

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Other information regarding options outstanding and exercisable as of September 30, 2014 is as follows:

| Range of Exercise Prices | Options Outstanding | | | Options Exercisable | |
|--------------------------|---------------------|---------------------------------|--|---------------------|---------------------------------|
| | Number of Shares | Weighted-Average Exercise Price | Weighted-Average Remaining Contractual Life in Years | Number of Shares | Weighted-Average Exercise Price |
| \$16.58 - \$25.85 | 420,806 | \$20.88 | 8.03 | 162,557 | \$17.70 |
| Total | 420,806 | \$20.88 | 8.03 | 162,557 | \$17.70 |

The total intrinsic value (i.e., the amount by which the fair value of the underlying common stock exceeds the exercise price of a stock option) of outstanding stock options and exercisable stock options was \$5.2 million and \$2.5 million at September 30, 2014, respectively.

Cash received from stock options exercised for the nine months ended September 30, 2014 and 2013 was \$1.0 million and \$79,000, respectively. The total intrinsic value related to stock options exercised during the nine months ended September 30, 2014 and 2013, was approximately \$885,000 and \$31,000, respectively.

10. Fair Value Measurement

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. A fair value measurement assumes that the transaction to sell the asset or transfer the liability occurs in the principal market for the asset or liability or, in the absence of a principal market, the most advantageous market for the asset or liability. The price in the principal (or most advantageous) market used to measure the fair value of the asset or liability shall not be adjusted for transaction costs. An orderly transaction is a transaction that assumes exposure to the market for a period prior to the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets and liabilities; it is not a forced transaction. Market participants are buyers and sellers in the principal market that are (i) independent, (ii) knowledgeable, (iii) able to transact and (iv) willing to transact.

Valuation techniques including the market approach, the income approach and/or the cost approach are utilized to determine fair value. Inputs to valuation techniques refer to the assumptions that market participants would use in pricing the asset or liability. Valuation policies and procedures are determined by our investment department and reported to our Asset/Liability Committee (“ALCO”) for review. An entity must consider all aspects of nonperforming risk, including the entity’s own credit standing when measuring fair value of a liability. Inputs may be observable, meaning those that reflect the assumptions market participants would use in pricing the asset or liability developed based on market data obtained from independent sources, or unobservable, meaning those that reflect the reporting entity’s own assumptions about the assumptions market participants would use in pricing the asset or liability developed based on the best information available in the circumstances. A fair value hierarchy for valuation inputs gives the highest priority to quoted prices in active markets for identical assets or liabilities and the lowest priority to unobservable inputs. The fair value hierarchy is as follows:

Level 1 Inputs - Unadjusted quoted prices in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date.

Level 2 Inputs - Inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly or indirectly. These might include quoted prices for similar assets or liabilities in active markets, quoted prices for identical or similar assets or liabilities in markets that are not active, inputs other than quoted prices that are

observable for the asset or liability (such as interest rates, volatilities, prepayment speeds, credit risks, etc.) or inputs that are derived principally from or corroborated by market data by correlation or other means.

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Level 3 Inputs - Unobservable inputs for determining the fair values of assets or liabilities that reflect an entity's own assumptions about the assumptions that market participants would use in pricing the assets or liabilities.

A description of the valuation methodologies used for assets and liabilities measured at fair value, as well as the general classification of such instruments pursuant to the valuation hierarchy, is set forth below.

Securities Available for Sale – U.S. Treasury securities are reported at fair value utilizing Level 1 inputs. Other securities classified as available for sale are reported at fair value utilizing Level 2 inputs. For these securities, we obtain fair value measurements from an independent pricing service. The fair value measurements consider observable data that may include dealer quotes, market spreads, cash flows, the U.S. Treasury yield curve, live trading levels, trade execution data, market consensus prepayment speeds, credit information and the bond's terms and conditions, among other things.

Quarterly, we review the prices supplied by the independent pricing service for reasonableness and to ensure such prices are aligned with traditional pricing matrices. In addition, we obtain an understanding of their underlying pricing methodologies and their Statement on Standards for Attestation Engagements-Reporting on Controls of a Service Organization (“SSAE 16”). We validate prices supplied by the independent pricing service by comparison to prices obtained from, in most cases, three additional third party sources, with the exception of municipal securities in which case two additional third party source prices are obtained. For securities where prices are outside a reasonable range, we further review those securities to determine what a reasonable price estimate is for that security, given available data.

Certain financial assets are measured at fair value in accordance with GAAP. Adjustments to the fair value of these assets usually result from the application of fair value accounting or write-downs of individual assets. Transfers between levels of the fair value hierarchy are recognized on the actual date of the event or circumstances that caused the transfer, which generally coincides with our monthly and/or quarterly valuation process. There were no transfers between Level 1 and Level 2 during the nine months ended September 30, 2014.

Loans Held for Sale – These loans are reported at the lower of cost or fair value. Fair value is determined based on expected proceeds, which are based on sales contracts and commitments and are considered Level 2 inputs. At September 30, 2014, loans held for sale included \$684,000 of 1-4 family residential loans and \$74.8 million of subprime automobile loans. At September 30, 2014, the subprime automobile loans were transferred to held for sale. Based on our estimates of fair value, no valuation allowance was recognized as of September 30, 2014 or December 31, 2013.

Foreclosed Assets – Foreclosed assets are initially recorded at fair value less costs to sell. The fair value of foreclosed assets can include Level 2 measurement inputs such as real estate appraisals and comparable real estate sales information, in conjunction with Level 3 measurement inputs such as cash flow projections, qualitative adjustments, sales cost estimates, etc. As a result, the categorization of foreclosed assets is Level 3 of the fair value hierarchy. In connection with initial recognition of foreclosed assets, we recognize charge-offs through the allowance for loan losses to the extent the fair value of the foreclosed asset, less costs to sell, is less than the loan amount.

Impaired Loans – Certain impaired loans may be reported at the fair value of the underlying collateral if repayment is expected solely from the collateral. Collateral values are estimated using Level 3 inputs based on customized discounting criteria or appraisals. At September 30, 2014 and December 31, 2013, the impact of loans with specific reserves based on the fair value of the collateral was reflected in our allowance for loan losses.

Certain nonfinancial assets and nonfinancial liabilities measured at fair value on a recurring basis include reporting units measured at fair value and tested for goodwill impairment.

Level 3 assets recorded at fair value on a nonrecurring basis at September 30, 2014, included loans for which a specific allowance was established based on the fair value of collateral and other real estate for which fair value of the properties was less than the cost basis. For both asset classes, the unobservable inputs were the additional adjustments applied by management to the appraised values to reflect such factors as non-current appraisals and revisions to estimated time to

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sell. These adjustments are determined based on qualitative judgments made by management on a case-by-case basis and are not quantifiable inputs, although they are used in the determination of fair value.

The following tables summarize assets measured at fair value on a recurring and nonrecurring basis segregated by the level of the valuation inputs within the fair value hierarchy utilized to measure fair value (in thousands):

| | At or For the Nine Months Ended September 30, 2014 | | | |
|--|--|--|---|---|
| | | Fair Value Measurements at the End of the Reporting Period Using | | |
| | Carrying Amount | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| Recurring fair value measurements | | | | |
| Investment Securities: | | | | |
| U.S. Treasuries | \$34,771 | \$34,771 | \$— | \$— |
| State and Political Subdivisions | 273,191 | — | 273,191 | — |
| Other Stocks and Bonds | 13,259 | — | 13,259 | — |
| Mortgage-backed Securities: ⁽¹⁾ | | | | |
| Residential | 580,891 | — | 580,891 | — |
| Commercial | 93,638 | — | 93,638 | — |
| Total recurring fair value measurements | \$995,750 | \$34,771 | \$960,979 | \$— |
| Nonrecurring fair value measurements | | | | |
| Foreclosed assets | \$790 | \$— | \$— | \$790 |
| Impaired loans ⁽²⁾ | 8,425 | — | — | 8,425 |
| Loans held for sale | 75,436 | — | 75,436 | — |
| Total nonrecurring fair value measurements | \$84,651 | \$— | \$75,436 | \$9,215 |

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| | At or For the Year Ended December 31, 2013 | | | |
|--|--|--|---|---|
| | Fair Value Measurements at the End of the Reporting Period Using | | | |
| | Carrying Amount | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| Recurring fair value measurements | | | | |
| Investment Securities: | | | | |
| U.S. Government Agency Debentures | \$10,129 | \$— | \$10,129 | \$— |
| State and Political Subdivisions | 314,074 | — | 314,074 | — |
| Other Stocks and Bonds | 13,226 | — | 13,226 | — |
| Mortgage-backed Securities: ⁽¹⁾ | | | | |
| Residential | 772,085 | — | 772,085 | — |
| Commercial | 68,173 | — | 68,173 | — |
| Total recurring fair value measurements | \$1,177,687 | \$— | \$1,177,687 | \$— |
| Nonrecurring fair value measurements | | | | |
| Foreclosed assets | \$1,627 | \$— | \$— | \$1,627 |
| Impaired loans ⁽²⁾ | 9,403 | — | — | 9,403 |
| Loans held for sale | 151 | — | 151 | — |
| Total nonrecurring fair value measurements | \$11,181 | \$— | \$151 | \$11,030 |

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

(2) Loans represent collateral dependent impaired loans with a specific valuation allowance.

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For the periods prior to the TRUPs sale in December 2013, the following table presents additional information about the TRUPs measured at fair value on a recurring basis and for which we utilized Level 3 inputs to determine fair value (in thousands):

| | Three Months Ended September 30, 2013 | Nine Months Ended September 30, 2013 |
|---|--|---|
| TRUPs | | |
| Balance at Beginning of Period | \$1,144 | \$990 |
| Total gains or losses (realized/unrealized): | | |
| Included in earnings | — | (42) |
| Included in other comprehensive income (loss) | 23 | 219 |
| Purchases | — | — |
| Issuances | — | — |
| Settlements | — | — |
| Transfers in and/or out of Level 3 | — | — |
| Balance at End of Period | \$1,167 | \$1,167 |

The amount of total gains or losses for the periods included in earnings attributable to the change in unrealized gains or losses relating to assets still held at reporting date

| | | |
|--|-----|---------|
| | \$— | \$(42) |
|--|-----|---------|

The significant unobservable inputs used in the fair value measurement of our TRUPs included the credit rating downgrades, the severity and duration of the mark-to-market loss, and the structural nuances of each TRUP. Our analysis of the underlying cash flows contemplated various default, deferral and recovery scenarios to arrive at our best estimate of cash flows. Significant increases (decreases) in any of those inputs would result in a significant lower (higher) fair value.

Disclosure of fair value information about financial instruments, whether or not recognized in the balance sheet, is required for which it is practicable to estimate that value. In cases where quoted market prices are not available, fair values are based on estimates using present value or other estimation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. Such techniques and assumptions, as they apply to individual categories of our financial instruments, are as follows:

Cash and cash equivalents - The carrying amount for cash and cash equivalents is a reasonable estimate of those assets' fair value.

Investment and mortgage-backed securities - Fair values for these securities are based on quoted market prices, where available. If quoted market prices are not available, fair values are based on quoted market prices for similar securities or estimates from independent pricing services.

FHLB stock and other investments - The carrying amount of FHLB stock is a reasonable estimate of those assets' fair value.

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Loans receivable - For adjustable rate loans that reprice frequently and with no significant change in credit risk, the carrying amounts are a reasonable estimate of those assets' fair value. The fair value of fixed rate loans is estimated by discounting the future cash flows using the current rates at which similar loans would be made to borrowers with similar credit ratings and for the same remaining maturities. Nonperforming loans are estimated using discounted cash flow analyses or the underlying value of the collateral where applicable.

Deposit liabilities - The fair value of demand deposits, savings accounts, and certain money market deposits is the amount on demand at the reporting date, that is, the carrying value. Fair values for fixed rate CDs are estimated using a discounted cash flow calculation that applies interest rates currently being offered for deposits of similar remaining maturities.

Federal funds purchased and repurchase agreements - Federal funds purchased generally have original terms to maturity of one day and repurchase agreements, generally less than one year, and therefore both are considered short-term borrowings. Consequently, their carrying value is a reasonable estimate of fair value.

FHLB advances - The fair value of these advances is estimated by discounting the future cash flows using rates at which advances would be made to borrowers with similar credit ratings and for the same remaining maturities.

Long-term debt - The carrying amount for the long-term debt is estimated by discounting future cash flows using estimated rates at which long-term debt would be made to borrowers with similar credit ratings and for the remaining maturities.

The following tables present our financial assets, financial liabilities, and unrecognized financial instruments measured on a nonrecurring basis at both their respective carrying amounts and fair value (in thousands):

| September 30, 2014 | Carrying Amount | Estimated Fair Value | | | |
|---|-----------------|----------------------|----------|-------------|-----------|
| | | Total | Level 1 | Level 2 | Level 3 |
| Financial Assets: | | | | | |
| Cash and cash equivalents | \$69,221 | \$69,221 | \$69,221 | \$— | \$— |
| Investment securities: | | | | | |
| Held to maturity, at carrying value | 389,529 | 398,386 | — | 398,386 | — |
| Mortgage-backed securities: | | | | | |
| Held to maturity, at carrying value | 256,528 | 260,695 | — | 260,695 | — |
| FHLB stock and other investments, at cost | 26,534 | 26,534 | — | 26,534 | — |
| Loans, net of allowance for loan losses | 1,385,259 | 1,355,989 | — | — | 1,355,989 |
| Loans held for sale | 75,436 | 75,436 | — | 75,436 | — |
| Financial Liabilities: | | | | | |
| Retail deposits | \$2,443,564 | \$2,441,462 | \$— | \$2,441,462 | \$— |
| Federal funds purchased and repurchase agreements | 2,116 | 2,116 | — | 2,116 | — |
| FHLB advances | 527,812 | 517,180 | — | 517,180 | — |
| Long-term debt | 60,311 | 43,755 | — | 43,755 | — |

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| December 31, 2013 | Carrying Amount | Estimated Fair Value | | | |
|---|-----------------|----------------------|----------|-------------|-----------|
| | | Total | Level 1 | Level 2 | Level 3 |
| Financial Assets: | | | | | |
| Cash and cash equivalents | \$54,431 | \$54,431 | \$54,431 | \$— | \$— |
| Investment securities: | | | | | |
| Held to maturity, at carrying value | 391,552 | 377,383 | — | 377,383 | — |
| Mortgage-backed securities: | | | | | |
| Held to maturity, at carrying value | 275,569 | 271,836 | — | 271,836 | — |
| FHLB stock and other investments, at cost | 36,130 | 36,130 | — | 36,130 | — |
| Loans, net of allowance for loan losses | 1,332,396 | 1,306,524 | — | — | 1,306,524 |
| Loans held for sale | 151 | 151 | — | 151 | — |
| Financial Liabilities: | | | | | |
| Retail deposits | \$2,527,808 | \$2,526,143 | \$— | \$2,526,143 | \$— |
| Federal funds purchased and repurchase agreements | 859 | 859 | — | 859 | — |
| FHLB advances | 572,794 | 559,648 | — | 559,648 | — |
| Long-term debt | 60,311 | 43,476 | — | 43,476 | — |

As discussed earlier, the fair value estimate of financial instruments for which quoted market prices are unavailable is dependent upon the assumptions used. Consequently, those estimates cannot be substantiated by comparison to independent markets and, in many cases, could not be realized in immediate settlement of the instruments. Accordingly, the aggregate fair value amounts presented in the above fair value table do not necessarily represent their underlying value.

11. Income Taxes

The income tax expense (benefit) included in the accompanying statements of income consist of the following (in thousands):

| | Three Months Ended | | Nine Months Ended | |
|---------------------------------------|--------------------|--------------------|--------------------|--------------------|
| | September 30, 2014 | September 30, 2013 | September 30, 2014 | September 30, 2013 |
| Current income tax expense | \$718 | \$1,526 | \$4,076 | \$4,237 |
| Deferred income tax (benefit) expense | (961) | (1,269) | (2,322) | (421) |
| Income tax (benefit) expense | \$(243) | \$257 | \$1,754 | \$3,816 |

Net deferred tax assets totaled \$12.8 million at September 30, 2014 and \$18.4 million at December 31, 2013. The decrease in net deferred tax assets resulted primarily from an increase in unrealized gains on securities available for sale, partially offset by an increase in the alternative minimum tax. No valuation allowance for deferred tax assets was recorded at September 30, 2014 or December 31, 2013, as management believes it is more likely than not that all of the deferred tax assets will be realized in future years. There was approximately \$50,000 in unrecognized tax benefits at September 30, 2014.

We recognized income tax benefit of \$243,000 and income tax expense of \$1.8 million, for an effective benefit rate of 4.2% and an effective tax rate of 6.6% for the three and nine months ended September 30, 2014, respectively, compared to income tax expense of \$257,000 and \$3.8 million, for an effective tax rate of 2.8% and 11.6% for the three and nine months ended September 30, 2013, respectively. The lower effective tax rate for the three and nine months ended September 30, 2014 was due to an increase in tax-exempt income as a percentage of taxable income as compared to the same periods in 2013.

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We file income tax returns in the U.S. federal jurisdiction and in certain states. We are no longer subject to U.S. federal income tax examinations by tax authorities for years before 2010.

12. Off-Balance-Sheet Arrangements, Commitments and Contingencies

Financial Instruments with Off-Balance-Sheet Risk. In the normal course of business, we are a party to certain financial instruments, with off-balance-sheet risk, to meet the financing needs of our customers. These off-balance-sheet instruments include commitments to extend credit and standby letters of credit. These instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount reflected in the financial statements. The contract or notional amounts of these instruments reflect the extent of involvement and exposure to credit loss that we have in these particular classes of financial instruments.

Commitments to extend credit are agreements to lend to a customer provided that the terms established in the contract are met. Commitments generally have fixed expiration dates and may require payment of fees. Since some commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. Standby letters of credit are conditional commitments issued to guarantee the performance of a customer to a third party. These guarantees are primarily issued to support public and private borrowing arrangements. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan commitments to customers.

We had outstanding unused commitments to extend credit of \$226.8 million and \$156.2 million at September 30, 2014 and December 31, 2013, respectively. Each commitment has a maturity date and the commitment expires on that date with the exception of credit card and ready reserve commitments, which have no stated maturity date. Unused commitments for credit card and ready reserve at September 30, 2014 and December 31, 2013 were \$14.0 million and \$13.8 million, respectively, and are reflected in the due after one year category. We had outstanding standby letters of credit of \$5.9 million at both September 30, 2014 and December 31, 2013.

The scheduled maturities of unused commitments were as follows (in thousands):

| | At September 30, 2014 | At December 31, 2013 |
|-------------------------|-----------------------------|----------------------------|
| Unused commitments: | | |
| Due in one year or less | \$ 167,145 | \$ 110,210 |
| Due after one year | 59,625 | 46,032 |
| Total | \$ 226,770 | \$ 156,242 |

We apply the same credit policies in making commitments and standby letters of credit as we do for on-balance-sheet instruments. We evaluate each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary, upon extension of credit is based on management's credit evaluation of the borrower. Collateral held varies but may include cash or cash equivalents, negotiable instruments, real estate, accounts receivable, inventory, oil, gas and mineral interests, property, plant, and equipment.

Lease Commitments. We lease certain branch facilities and office equipment under operating leases. It is expected that certain leases will be renewed, or equipment replaced with new leased equipment, as these leases expire.

Securities. In the normal course of business we buy and sell securities. There were \$15.2 million and \$973,000 of unsettled trades to purchase securities at September 30, 2014 and December 31, 2013, respectively. There were \$5.1 million and \$3.9 million unsettled trades to sell securities as of September 30, 2014 and December 31, 2013, respectively.

Deposits. There were no unsettled issuances of brokered CDs at September 30, 2014 or December 31, 2013.

Litigation. We are involved with various litigation in the normal course of business. Management, after consulting with our legal counsel, believes that any liability resulting from litigation will not have a material effect on our financial position, results of operations or liquidity.

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Litigation Relating to the Merger. On June 25, 2014, a purported stockholder of OmniAmerican filed a lawsuit in the Circuit Court for Baltimore City, Maryland (the “Court”) captioned McDougal v. OmniAmerican Bancorp, Inc., et al., Case No. 24-C-14-003920 (the “Litigation”), naming OmniAmerican, members of OmniAmerican's board of directors, Southside and Omega Merger Sub, Inc., a wholly owned subsidiary of Southside (“Merger Sub”), as defendants. The lawsuit is purportedly brought on behalf of a putative class of OmniAmerican's public stockholders and seeks a declaration that it is properly maintainable as a class action and a certification of the plaintiff and her counsel as class representative and class counsel. The lawsuit asserts direct and derivative claims against OmniAmerican's directors and alleges that they breached their fiduciary duties and that OmniAmerican, Southside and Merger Sub aided and abetted those alleged breaches by, among other things, (a) failing to take steps to maximize shareholder value for OmniAmerican public stockholders; (b) failing to properly value OmniAmerican; (c) failing to protect against conflicts of interest; (d) failing to disclose material information necessary for OmniAmerican stockholders to make an informed vote on the merger; and (e) agreeing to deal protection devices that preclude a fair sales process. Among other relief, the plaintiff seeks to enjoin the merger.

After filing the Litigation and engaging in certain limited discovery, plaintiff’s counsel indicated to defendants’ counsel that they believed additional disclosures should be made available to the stockholders of OmniAmerican.

On September 12, 2014, the defendants and the plaintiff in the Litigation entered into a memorandum of understanding (the “MOU”) agreeing in principle to settle the Litigation in exchange for defendants’ agreement to make certain supplemental disclosures. The MOU contemplates that the parties will prepare a definitive stipulation of settlement, which will be subject to Court approval. If approved by the Court, it is anticipated that the settlement will result in a release of the defendants from any and all claims that were or could have been asserted challenging any aspect of or otherwise relating to the merger, the Merger Agreement or the disclosures made in connection therewith, and that the Litigation will be dismissed with prejudice.

Pursuant to the terms of the MOU, OmniAmerican and Southside agreed to make certain supplemental disclosures regarding the merger. The supplemental disclosures were contained in a Form 8-K filed by Southside with the U.S. Securities and Exchange Commission on September 16, 2014. In return, the plaintiff has agreed to the dismissal of the Litigation with prejudice and to withdraw and/or refrain from filing any and all motions seeking to enjoin the merger. In addition, the MOU contemplates that the parties will negotiate in good faith to attempt to agree upon an amount of attorneys’ fees and expenses and that plaintiff’s counsel may petition the Court for an award of attorneys’ fees and expenses, which if granted by the Court, would be paid by OmniAmerican or its insurers or successors. Should the parties fail to reach an agreement on attorneys’ fees and expenses, the defendants may oppose the petition for an award of attorneys’ fees and expenses. There can be no assurance that the parties will ultimately reach agreement on a definitive stipulation of settlement or that the Court will approve the proposed settlement, even if the parties were to enter into such stipulation of settlement. In such event, the proposed settlement as contemplated by the MOU may be terminated.

The settlement will not affect the consideration to be paid to stockholders of OmniAmerican in connection with the proposed merger.

The defendants have vigorously denied, and continue to vigorously deny, any wrongdoing or liability with respect to the facts and claims asserted, or which could have been asserted, in the Litigation, including that they have committed any violations of law or breach of fiduciary duty, aided and abetted any violations of law or breaches of fiduciary duty, acted improperly in any way or have any liability or owe any damages of any kind to the plaintiff or to the purported class, and specifically deny that any further supplemental disclosure is required under any applicable rule, statute, regulation or law or that the OmniAmerican directors failed to maximize stockholder value by entering into the merger agreement with Southside and Merger Sub. The settlement contemplated by the MOU is not, and should not be construed as, an admission of wrongdoing or liability by any defendant. However, to avoid the risk of delaying the merger, and to provide additional information to the stockholders of OmniAmerican and shareholders of Southside at a time and in a manner that would not cause any delay of the merger, the defendants agreed to the settlement described above.

The parties considered it desirable that the Litigation be settled to avoid the substantial burden, expense, risk, inconvenience and distraction of continued litigation and to fully and finally resolve the Litigation.

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ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following is a discussion of the consolidated financial condition, changes in financial condition, and results of our operations, and should be read and reviewed in conjunction with the financial statements, and the notes thereto, in this Quarterly Report on Form 10-Q and in our Annual Report on Form 10-K for the year ended December 31, 2013. We reported a decrease in net income for the three and nine months ended September 30, 2014 compared to the same period in 2013. Net income for the three and nine months ended September 30, 2014 was \$6.1 million and \$24.8 million, respectively, compared to \$8.9 million and \$29.0 million, respectively, for the same period in 2013.

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," "would," "seek," "intend," "probability," "risk," "goal," "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. By their nature, certain of the market risk disclosures are only estimates and could be materially different from what actually occurs in the future. As a result, actual income gains and losses could materially differ from those that have been estimated. Other factors that could cause actual results to differ materially from forward-looking statements include, but are not limited to, the following:

- general economic conditions, either globally, nationally, in the State of Texas, or in the specific markets in which we operate, including, without limitation, the deterioration of the commercial real estate, residential real estate, construction and development, credit and liquidity markets, which could cause an adverse change in our net interest margin, or a decline in the value of our assets, which could result in realized losses;
- legislation, regulatory changes or changes in monetary or fiscal policy that adversely affect the businesses in which we are engaged, including the impact of the Dodd-Frank Act, the Federal Reserve's actions with respect to interest rates and other regulatory responses to current economic conditions;
- adverse changes in the status or financial condition of the Government-Sponsored Enterprises (the "GSEs") impacting the GSEs' guarantees or ability to pay or issue debt;
- adverse changes in the credit portfolio of other U.S. financial institutions relative to the performance of certain of our investment securities;
- economic or other disruptions caused by acts of terrorism in the United States, Europe or other areas;
- changes in the interest rate yield curve such as flat, inverted or steep yield curves, or changes in the interest rate environment that impact interest margins and may impact prepayments on the mortgage-backed securities ("MBS") portfolio;
- increases in our nonperforming assets;
- our ability to maintain adequate liquidity to fund operations and growth;
- the failure of our assumptions underlying allowance for loan losses and other estimates;

- unexpected outcomes of, and the costs associated with, existing or new litigation involving us;
- changes impacting our balance sheet and leverage strategy;

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risks related to actual U.S. Agency MBS prepayments exceeding projected prepayment levels;
risks related to U.S. Agency MBS prepayments increasing due to U.S. Government programs designed to assist homeowners to refinance their mortgage that might not otherwise have qualified;
our ability to monitor interest rate risk;
significant increases in competition in the banking and financial services industry;
changes in consumer spending, borrowing and saving habits;
technological changes;
our ability to increase market share and control expenses;
the effect of changes in federal or state tax laws;
the effect of compliance with legislation or regulatory changes;
the effect of changes in accounting policies and practices;
risks of mergers and acquisitions including the potential occurrence of an event, change or other circumstance that could give rise to the termination of a transaction, the outcome of legal proceedings relating to a transaction, the inability to complete transactions due to the failure to satisfy the conditions to closing, including the receipt of regulatory and shareholder approvals, the time and cost of implementing transactions and the potential failure to achieve expected gains, revenue growth or expense savings;
credit risks of borrowers, including any increase in those risks due to changing economic conditions;
risks related to loans secured by real estate, including the risk that the value and marketability of collateral could decline; and
other risks and uncertainties discussed in Part I - "Item 1A. Risk Factors" in our Annual Report on Form 10-K for the year ended December 31, 2013.

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

Impact of Dodd-Frank Act

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

A permanent increase in deposit insurance coverage to \$250,000 per account, and an increase in the minimum Deposit Insurance Fund reserve requirement from 1.15% to 1.35%, with assessments to be based on assets as opposed to deposits;
New disclosure and other requirements relating to executive compensation and corporate governance;
New prohibitions and restrictions on the ability of a banking entity and nonbank financial company to engage in proprietary trading and have certain interests in, or relationships with, a hedge fund or private equity fund;
Amendments to the Truth in Lending Act aimed at improving consumer protections with respect to mortgage originations, including originator compensation, minimum repayment standards, and prepayment considerations;
The establishment of the Financial Stability Oversight Council, which will be responsible for identifying and monitoring systemic risks posed by financial firms, activities, and practices;
The development of regulations to limit debit card interchange fees;
The elimination of newly issued trust preferred securities as a permitted element of Tier 1 capital;

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- The creation of a special regime to allow for the orderly liquidation of systemically important financial companies, including the establishment of an orderly liquidation fund;
- The development of regulations to address derivatives markets, including clearing and exchange trading requirements and a framework for regulating derivatives-market participants;
- Enhanced supervision of credit rating agencies through the Office of Credit Ratings within the SEC;
- Increased regulation of asset-backed securities, including a requirement that issuers of asset-backed securities retain at least 5% of the risk of the asset-backed securities; and
- The establishment of a Bureau of Consumer Financial Protection with centralized authority, including examination and enforcement authority, for consumer protection in the banking industry.

We are continuing to evaluate the potential impact of the Dodd-Frank Act on our business, financial condition and results of operations and expect that some provisions may have adverse effects on us, such as the cost of complying with the numerous new regulations and reporting requirements mandated by the Dodd-Frank Act.

Critical Accounting Estimates

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

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

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

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

Loans are considered impaired if, based on current information and events, it is probable that we will be unable to collect the scheduled payments of principal and interest when due according to the contractual terms of the loan agreement. The measurement of loss on impaired loans is generally based on the fair value of the collateral if repayment is expected solely from the collateral or the present value of the expected future cash flows discounted at the historical effective interest rate stipulated in the loan agreement. In measuring the fair value of the collateral, in

addition to relying on third party appraisals, we use assumptions, such as discount rates, and methodologies, such as comparison

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to the recent selling price of similar assets, consistent with those that would be utilized by unrelated third parties performing a valuation.

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

As of September 30, 2014, our review of the loan portfolio indicated that a loan loss allowance of \$13.4 million was appropriate to cover probable losses in the portfolio.

Refer to “Part II - Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations - Loan Loss Experience and Allowance for Loan Losses” and “Note 5– Loans and Allowance for Probable Loan Losses” of the Notes to Consolidated Financial Statements in our Annual Report on Form 10-K for the year ended December 31, 2013 for a detailed description of our estimation process and methodology related to the allowance for loan losses.

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

Impairment of Investment Securities and Mortgage-backed Securities. Investment and MBS classified as available for sale (“AFS”) are carried at fair value and the impact of changes in fair value are recorded on our consolidated balance sheet as an unrealized gain or loss in “Accumulated other comprehensive (loss) income,” a separate component of shareholders’ equity. Securities classified as AFS or held to maturity (“HTM”) are subject to our review to identify when a decline in value is other-than-temporary. When it is determined that a decline in value is other-than-temporary, the carrying value of the security is reduced to its estimated fair value, with a corresponding charge to earnings for the credit portion and to other comprehensive income for the noncredit portion. Factors considered in determining whether a decline in value is other-than-temporary include: (1) whether the decline is substantial; the duration of the decline; and the reasons for the decline in value; (2) whether the decline is related to a credit event, a change in interest rate or a change in the market discount rate; (3) the financial condition and near-term prospects of the issuer; and (4) whether we have a current intent to sell the security and whether it is not more likely than not that we will be required to sell the security before the anticipated recovery of its amortized cost basis. For certain assets we consider expected cash flows of the investment in determining if impairment exists.

Defined Benefit Pension Plan. The plan obligations and related assets of our defined benefit pension plan (the “Plan”) are presented in “Note 11 – Employee Benefits” of the Notes to Consolidated Financial Statements in our Annual Report on Form 10-K for the year ended December 31, 2013. Entry into the Plan by new employees was frozen effective December 31, 2005. Plan assets, which consist primarily of marketable equity and debt instruments, are valued using observable market quotations. Plan obligations and the annual pension expense are determined by independent actuaries and through the use of a number of assumptions that are reviewed by management. Key assumptions in measuring the plan obligations include the discount rate, the rate of salary increases and the estimated future return on plan assets. In determining the discount rate, we utilized a cash flow matching analysis to determine a range of appropriate discount rates for our defined benefit pension and restoration plans. In developing the cash flow matching analysis, we constructed a portfolio of high quality noncallable bonds (rated AA- or better) to match as close as possible the timing of future benefit payments of the plans at December 31, 2013. Based on this cash flow matching analysis, we were able to determine an appropriate discount rate.

Salary increase assumptions are based upon historical experience and our anticipated future actions. The expected long-term rate of return assumption reflects the average return expected based on the investment strategies and asset allocation on the assets invested to provide for the Plan’s liabilities. We considered broad equity and bond indices,

long-term return projections, and actual long-term historical Plan performance when evaluating the expected long-term rate of return assumption. At September 30, 2014, the weighted-average actuarial assumptions of the Plan were:

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a discount rate of 5.06%; a long-term rate of return on Plan assets of 7.25%; and assumed salary increases of 4.50%. Material changes in pension benefit costs may occur in the future due to changes in these assumptions. Future annual amounts could be impacted by changes in the number of Plan participants, changes in the level of benefits provided, changes in the discount rates, changes in the expected long-term rate of return, changes in the level of contributions to the Plan and other factors.

Off-Balance-Sheet Arrangements, Commitments and Contingencies

Details of our off-balance-sheet arrangements, commitments and contingencies as of September 30, 2014 and December 31, 2013 are included in “Note 12 – Off-Balance-Sheet Arrangements, Commitments and Contingencies” in the accompanying Notes to Consolidated Financial Statements included in this report.

Balance Sheet Strategy

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

Risks associated with the asset structure we maintain include a lower net interest rate spread and margin when compared to our peers, changes in the slope of the yield curve, which can reduce our net interest rate spread and margin, increased interest rate risk, the length of interest rate cycles, changes in volatility spreads associated with the MBS and municipal securities, the unpredictable nature of MBS prepayments and credit risks associated with the municipal securities. See “Part I - Item 1A. Risk Factors – Risks Related to Our Business” in our Annual Report on Form 10-K for the year ended December 31, 2013, for a discussion of risks related to interest rates. Our asset structure, net interest spread and net interest margin require us to closely monitor our interest rate risk. An additional risk is the change in fair value of the AFS securities portfolio as a result of changes in interest rates. Significant increases in interest rates, especially long-term interest rates, could adversely impact the fair value of the AFS securities portfolio, which could also significantly impact our equity capital. Due to the unpredictable nature of MBS prepayments, the length of interest rate cycles, and the slope of the interest rate yield curve, net interest income could fluctuate more than simulated under the scenarios modeled by our ALCO and described under “Item 3. Quantitative and Qualitative Disclosures about Market Risk” in this report.

Determining the appropriate size of the balance sheet is one of the critical decisions any bank makes. Our balance sheet is not merely the result of a series of micro-decisions, but rather the size is controlled based on the economics of assets compared to the economics of funding. The current low interest rate environment and investment and economic landscape make it unlikely that we will experience asset growth driven by an increase in the securities portfolio until one or more of these conditions change.

The management of our securities portfolio as a percentage of earning assets is guided by the current economics associated with increasing the securities portfolio, changes in our overall loan and deposit levels, and changes in our wholesale funding levels. If adequate quality loan growth is not available to achieve our goal of enhancing

profitability by maximizing the use of capital, as described above, then we could purchase additional securities, if appropriate, which could cause securities as a percentage of earning assets to increase. Should we determine that increasing the securities portfolio or replacing the current securities maturities and principal payments is not an efficient use of capital, we could decrease the level of securities through proceeds from maturities, principal payments on MBS or sales. Our

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balance sheet strategy is designed such that our securities portfolio should help mitigate financial performance associated with slower loan growth and higher credit costs.

During the quarter ended September 30, 2014, we primarily sold municipal securities, commercial mortgage-backed securities (“CMBS”) and U.S. Treasury notes that resulted in an overall gain on the sale of AFS securities of \$1.2 million. Due to a continued steep yield curve, we sold CMBS and two collateralized mortgage obligations (“CMO”) with durations of three to six years and replaced a portion of them with longer duration CMBS, more than replacing the income while making available nearly \$20 million to fund loan growth during the quarter. In addition, we sold low yielding long duration nonbank qualified municipal securities and partially replaced them with other municipal securities with better expected returns in relation to risk, including several that were bank qualified. These sales made available over \$50 million to fund loan growth during the quarter. Our total investment securities and U.S. Agency MBS decreased from \$1.84 billion at December 31, 2013 to \$1.64 billion at September 30, 2014. At September 30, 2014, total unamortized premium for our MBS decreased to \$20.1 million from \$26.8 million at December 31, 2013, primarily as a result of a net decrease in the MBS portfolio of approximately \$185 million during the nine months ended September 30, 2014. Total unamortized premium for our MBS was approximately \$31.2 million at September 30, 2013.

The average coupon of the MBS portfolio decreased to 4.20% at September 30, 2014 from 4.31% at December 31, 2013. The average coupon of the municipal securities portfolio decreased to 4.87% at September 30, 2014 when compared to 4.91% at December 31, 2013. At September 30, 2014, securities as a percentage of assets decreased to 48.7% as compared to 53.5% at December 31, 2013. Our balance sheet management strategy is dynamic and will be continually reevaluated as market conditions warrant. As interest rates, yield curves, MBS prepayments, funding costs, security spreads and loan and deposit portfolios change, our determination of the proper types, amount and maturities of securities to own and funding needs and funding sources will continue to be reevaluated. Should the economics of purchasing securities remain the same or decrease, we will likely allow this part of the balance sheet to shrink through run-off or security sales. However, should the economics become more attractive, we might strategically increase the securities portfolio and the balance sheet.

With respect to liabilities, we continue to utilize a combination of FHLB advances and deposits to achieve our strategy of minimizing cost while achieving overall interest rate risk objectives as well as the liability management objectives of the ALCO. FHLB funding is the primary wholesale funding source we are currently utilizing. Our FHLB borrowings decreased 7.9%, or \$45.0 million, to \$527.8 million at September 30, 2014 from \$572.8 million at December 31, 2013, due to the decrease in the securities portfolio. During the nine months ended September 30, 2014, our long-term FHLB advances decreased \$23.3 million, to \$476.0 million, from \$499.3 million at December 31, 2013. We will continue to purchase long-term FHLB advances as a hedge against future potential high interest rates. Our brokered CDs decreased from \$54.4 million at December 31, 2013 to \$23.4 million at September 30, 2014. All of the brokered CDs, except for one \$5.0 million CD, are long-term with short-term calls that we control. We utilized long-term callable brokered CDs because the brokered CDs at the time of issuance better matched overall ALCO objectives by protecting us with fixed rates should interest rates increase, while providing us options to call the funding should interest rates decrease. We are actively evaluating the callable brokered CDs and may exercise the call option if there is an economic benefit. Our wholesale funding policy currently allows maximum brokered CDs of \$180 million; however, this amount could be increased to match changes in ALCO objectives. The potential higher interest expense and lack of customer loyalty are risks associated with the use of brokered CDs. When looking at deposits without brokered CDs, the overall decrease in brokered CDs and FHLB advances resulted in a decrease in our total wholesale funding as a percentage of deposits, to 22.8% at September 30, 2014 from 31.7% at September 30, 2013 and 25.4% at December 31, 2013.

Net Interest Income

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

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Net interest income for the nine months ended September 30, 2014 was \$81.5 million, an increase of \$8.5 million, or 11.6%, compared to the same period in 2013 as a result of an increase in interest income, along with a decrease in interest expense.

During the nine months ended September 30, 2014, total interest income increased \$7.6 million, or 8.8%, to \$94.2 million compared to \$86.6 million for the same period in 2013. The increase in total interest income was the result of an increase in the average yield on earning assets from 4.16% for the nine months ended September 30, 2013 to 4.42% for the nine months ended September 30, 2014, and the increase in average interest earning assets of \$89.1 million, or 2.8%, from \$3.13 billion for the nine months ended September 30, 2013 to \$3.22 billion for the same period in 2014. Total interest expense decreased \$918,000, or 6.7%, to \$12.7 million, during the nine months ended September 30, 2014, as compared to \$13.6 million during the same period in 2013. The decrease was attributable to a decrease in the average yield on interest bearing liabilities for the nine months ended September 30, 2014, to 0.67% from 0.74% for the same period in 2013, which more than offset the increase in average interest bearing liabilities of \$77.6 million, or 3.1%, from \$2.47 billion for the nine months ended September 30, 2013, to \$2.55 billion for the same period in 2014.

Net interest income decreased during the three months ended September 30, 2014, when compared to the same period in 2013 primarily as a result of a decrease in interest income on loans and tax-exempt securities. Our average interest earning assets decreased \$119.0 million, or 3.7%, during the three months ended September 30, 2014, when compared to the same period in 2013. For the three months ended September 30, 2014, our net interest spread and net interest margin increased to 3.65% and 3.80%, respectively, from 3.59% and 3.72%, respectively, for the same period in 2013. During the nine months ended September 30, 2014, average loans increased \$98.7 million, or 7.7%, to \$1.38 billion, when compared to \$1.29 billion for the same period in 2013. Construction real estate loans represent a large part of this increase. The average yield on loans decreased from 5.98% for the nine months ended September 30, 2013, to 5.49% for the nine months ended September 30, 2014, due to overall lower interest rates. Interest income on loans decreased \$844,000, or 1.5%, to \$53.8 million for the nine months ended September 30, 2014, when compared to \$54.7 million for the same period in 2013 as a result of a decrease in the average yield which more than offset the increase in the average balance. For the three months ended September 30, 2014, average loans increased \$115.5 million, or 8.9%, to \$1.42 billion, when compared to \$1.30 billion for the same period in 2013. The average yield on loans decreased from 5.97% for the three months ended September 30, 2013 to 5.09% for the three months ended September 30, 2014. Due to the competitive loan pricing environment, we anticipate that we may be required to continue to offer lower interest rate loans that compete with those offered by other financial institutions in order to retain quality loan relationships. Offering lower interest rate loans could impact the overall yield on loans and, therefore, profitability.

Average investment and mortgage-backed securities decreased \$11.8 million, or 0.7%, from \$1.77 billion to \$1.76 billion, for the nine months ended September 30, 2014 when compared to the same period in 2013. At September 30, 2014, substantially all of our mortgage-backed securities were fixed rate securities. The overall yield on average investment and mortgage-backed securities increased to 3.75% during the nine months ended September 30, 2014, from 2.99% during the same period in 2013. Interest income on investment and mortgage-backed securities increased \$8.4 million during the nine months ended September 30, 2014, or 26.5%, compared to the same period in 2013 due to an increase in the average yield which more than offset the decrease in the average balance. For the three months ended September 30, 2014, average investment and mortgage-backed securities decreased \$248.9 million, or 13.1%, to \$1.64 billion, when compared to \$1.89 billion for the same period in 2013. The overall yield on average investment and mortgage-backed securities increased to 3.83% during the three months ended September 30, 2014, from 3.15% during the same period in 2013. Interest income from investment and mortgage-backed securities increased \$470,000, or 3.9%, to \$12.6 million for the three months ended September 30, 2014, compared to \$12.1 million for the same period in 2013. The increase in the overall yield on average investment and mortgage-backed securities for the three and nine months ended September 30, 2014 primarily reflects an overall higher interest rate environment during 2014, a decrease in prepayments on the mortgage-backed securities and the purchase of higher yielding securities when compared to those securities paying off, maturing or sold. The increase in interest income from investment and

mortgage-backed securities for the three and nine months ended September 30, 2014 as compared to the same periods in 2013 was due to an increase in the average yield which more than offset the decrease in the average balance.

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Average interest earning deposits increased \$4.2 million, or 9.3%, to \$49.9 million for the nine months ended September 30, 2014, when compared to \$45.6 million for the same period in 2013. Interest income from interest earning deposits was \$96,000 and \$93,000 for the nine months ended September 30, 2014 and 2013, respectively. The increase in interest income from interest earning deposits was the result of the increase in the average balance which more than offset the decrease in the average yield from 0.27% for the nine months ended September 30, 2013 to 0.26% for the same period in 2014. Average interest earning deposits increased \$21.3 million, or 86.9%, to \$45.7 million for the three months ended September 30, 2014, when compared to \$24.5 million for the same period in 2013. Interest income from interest earning deposits increased \$16,000, or 106.7%, for the three months ended September 30, 2014, when compared to the same period in 2013, as a result of an increase in the average balance and average yield from 0.24% in 2013 to 0.27% in 2014.

During the nine months ended September 30, 2014, our average loans increased and our average securities decreased when compared to the same period in 2013. Average total securities as a percentage of total average interest earning assets was 55.5% and 57.5% for the nine months ended September 30, 2014, and 2013, respectively. Average loans increased to 43.0% of average total interest earning assets for the nine months ended September 30, 2014 as compared to 41.1% for the same period in 2013. The other interest earning asset categories averaged 1.5% and 1.4% for the nine months ended September 30, 2014 and 2013, respectively.

Total interest expense decreased \$918,000, or 6.7%, to \$12.7 million during the nine months ended September 30, 2014, as compared to \$13.6 million during the same period in 2013. The decrease was primarily attributable to decreased funding costs as the average yield on interest bearing liabilities decreased from 0.74% for the nine months ended September 30, 2013, to 0.67% for the nine months ended September 30, 2014, which more than offset the increase in average interest bearing liabilities of \$77.6 million, or 3.1%, for the nine months ended September 30, 2014 compared to the same period in 2013. This increase in average interest bearing liabilities included an increase in interest bearing deposits of \$131.5 million, or 7.3%, and an increase in long-term FHLB advances of \$79.0 million, or 18.9%, which was partially offset by a decrease in short-term interest bearing liabilities of \$132.9 million, or 71.3%. For the three months ended September 30, 2014, total interest expense decreased \$50,000, or 1.2%, to \$4.1 million, compared to \$4.2 million for the same period in 2013, as a result of a decrease in the average balance on interest bearing liabilities which was partially offset by a slight increase in the average yield. Average interest bearing liabilities decreased \$150.9 million, or 5.8%, for the three months ended September 30, 2014 when compared to the same period in 2013, while the average yield increased from 0.64% for the three months ended September 30, 2013 to 0.67% for the three months ended September 30, 2014.

Our average total deposits increased \$139.8 million, or 5.9%, from \$2.37 billion for the nine months ended September 30, 2013 to \$2.51 billion for the nine months ended September 30, 2014. The increase in our average total deposits was primarily the result of an increase in public fund deposits and deposit growth due to market penetration. Average interest bearing deposits increased \$131.5 million, or 7.3%, from \$1.80 billion for the nine months ended September 30, 2013 to \$1.94 billion for the same period in 2014, while the average rate paid decreased from 0.45% for the nine months ended September 30, 2013, to 0.41% for the nine months ended September 30, 2014. Average time deposits decreased \$27.6 million, or 4.4%, from \$632.5 million for the nine months ended September 30, 2013 to \$604.9 million for the same period in 2014, while the average rate paid decreased slightly to 0.72% for the nine months ended September 30, 2014, as compared to 0.74% for the same period in 2013. Average interest bearing demand deposits increased \$151.1 million, or 14.2%, for the nine months ended September 30, 2014 when compared to the same period in 2013, while the average rate paid decreased to 0.29% for the nine months ended September 30, 2014, as compared to 0.31% for the same period in 2013. Average savings deposits increased \$8.1 million, or 7.5%, for the nine months ended September 30, 2014 when compared to the same period in 2013, while the average rate paid decreased slightly to 0.12% for the nine months ended September 30, 2014, as compared to 0.13% for the same period in 2013. Interest expense for interest bearing demand deposits for the nine months ended September 30, 2014, increased \$134,000, or 5.4%, when compared to the same period in 2013, due to an increase in the average balance which more than offset the decrease in the average yield. Average noninterest bearing demand deposits increased \$8.3 million, or 1.5%, during the nine months ended September 30, 2014 compared to the same period in 2013. The latter three categories,

interest bearing demand deposits, savings deposits and noninterest bearing demand deposits, are considered the lowest cost deposits and comprised 75.9% of total average deposits during the nine months ended September 30, 2014 compared to 73.3% during the same period in 2013.

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At September 30, 2014, we had \$23.4 million in brokered CDs which represented 0.8% of deposits, all with maturities of less than six years. At December 31, 2013, we had \$54.4 million in brokered CDs which represented 2.2% of deposits, all with maturities of less than seven years.

For the three and nine months ended September 30, 2014, average short-term interest bearing liabilities, consisting primarily of FHLB advances, federal funds purchased and repurchase agreements, were \$39.1 million and \$53.6 million, respectively, and reflected decreases of \$215.1 million, or 84.6%, and \$132.9 million, or 71.3%, respectively, when compared to the same periods in 2013. Average short-term interest bearing liabilities decreased due to the increase in average deposits and the increase in the use of long-term funding. Interest expense associated with short-term interest bearing liabilities decreased \$1.4 million, or 79.9%, for the nine months ended September 30, 2014 compared to the same period in 2013 and the average rate paid decreased to 0.88% for the nine months ended September 30, 2014, compared to 1.26% for the same period in 2013. Interest expense associated with short-term interest bearing liabilities increased \$110,000, or 94.8%, for the three months ended September 30, 2014, when compared to the same period in 2013, and the average rate paid increased to 2.29% for the three months ended September 30, 2014, when compared to 0.18% for the same period in 2013 primarily due to higher rate long term advances transferring into the short term category.

Average long-term interest bearing liabilities consisting of FHLB advances increased \$79.0 million, or 18.9%, during the nine months ended September 30, 2014 to \$497.1 million, as compared to \$418.1 million for the nine months ended September 30, 2013. Interest expense associated with long-term FHLB advances increased \$613,000, or 13.1%, while the average rate paid decreased seven basis points for the nine months ended September 30, 2014, when compared to the same period in 2013. For the three months ended September 30, 2014, average long-term interest bearing liabilities increased \$25.8 million, or 5.7%, when compared to the same period in 2013. Interest expense associated with long-term FHLB advances decreased \$20,000, or 1.2%, for the three months ended September 30, 2014, when compared to the same period in 2013, and the average rate paid decreased to 1.36% for the three months ended September 30, 2014, when compared to 1.46% for the same period in 2013. The increase in the average long-term FHLB advances during the three and nine months ended September 30, 2014, when compared to the same periods in 2013 was due to the continued use of long-term advances as a hedge against future potential high interest rates.

Average long-term debt, consisting of our junior subordinated debentures, was \$60.3 million for the three and nine months ended September 30, 2014 and 2013, respectively. Interest expense associated with long-term debt decreased slightly for the three and nine months ended September 30, 2014 compared to the same periods in 2013, respectively, as a result of a slight decrease in the average yield during the three and nine months ended September 30, 2014. The interest rate on the \$20.6 million of long-term debentures issued to Southside Statutory Trust III adjusts quarterly at a rate equal to three-month LIBOR plus 294 basis points. The interest rate on the \$23.2 million of long-term debentures issued to Southside Statutory Trust IV adjusts quarterly at a rate equal to three-month LIBOR plus 130 basis points. The interest rate on the \$12.9 million of long-term debentures issued to Southside Statutory Trust V adjusts quarterly at a rate equal to three-month LIBOR plus 225 basis points. The interest rate on the \$3.6 million of long-term debentures issued to Magnolia Trust Company I, adjusts quarterly at a rate equal to three-month LIBOR plus 180 basis points.

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RESULTS OF OPERATIONS

The analysis below shows average interest earning assets and interest bearing liabilities together with the average yield on the interest earning assets and the average cost of the interest bearing liabilities.

AVERAGE BALANCES AND YIELDS

| | (dollars in thousands) | | | | | | |
|--|------------------------|-----------|--------|--------------------|-----------|--------|--|
| | (unaudited) | | | | | | |
| | Nine Months Ended | | | | | | |
| | September 30, 2014 | | | September 30, 2013 | | | |
| | AVG | | AVG | AVG | | AVG | |
| | BALANCE | INTEREST | YIELD | BALANCE | INTEREST | YIELD | |
| ASSETS | | | | | | | |
| INTEREST EARNING ASSETS: | | | | | | | |
| Loans ^{(1) (2)} | \$ 1,384,269 | \$ 56,849 | 5.49 % | \$ 1,285,612 | \$ 57,531 | 5.98 % | |
| Loans Held For Sale | 682 | 12 | 2.35 % | 1,421 | 35 | 3.29 % | |
| Securities: | | | | | | | |
| Investment Securities (Taxable) ⁽⁴⁾ | 33,943 | 476 | 1.87 % | 54,150 | 672 | 1.66 % | |
| Investment Securities (Tax-Exempt) ⁽³⁾⁽⁴⁾ | 666,084 | 27,488 | 5.52 % | 660,537 | 25,211 | 5.10 % | |
| Mortgage-backed Securities ⁽⁴⁾ | 1,057,683 | 21,309 | 2.69 % | 1,054,822 | 13,685 | 1.73 % | |
| Total Securities | 1,757,710 | 49,273 | 3.75 % | 1,769,509 | 39,568 | 2.99 % | |
| FHLB stock and other investments, at cost | 28,597 | 144 | 0.67 % | 29,843 | 135 | 0.60 % | |
| Interest Earning Deposits | 49,850 | 96 | 0.26 % | 45,620 | 93 | 0.27 % | |
| Total Interest Earning Assets | 3,221,108 | 106,374 | 4.42 % | 3,132,005 | 97,362 | 4.16 % | |
| NONINTEREST EARNING ASSETS: | | | | | | | |
| Cash and Due From Banks | 42,780 | | | 44,416 | | | |
| Bank Premises and Equipment | 53,012 | | | 50,409 | | | |
| Other Assets | 126,457 | | | 121,650 | | | |
| Less: Allowance for Loan Loss | (18,435) | | | (18,917) | | | |
| Total Assets | \$ 3,424,922 | | | \$ 3,329,563 | | | |
| LIABILITIES AND SHAREHOLDERS' EQUITY | | | | | | | |
| INTEREST BEARING LIABILITIES: | | | | | | | |
| Savings Deposits | \$ 115,633 | 101 | 0.12 % | \$ 107,571 | 106 | 0.13 % | |
| Time Deposits | 604,881 | 3,244 | 0.72 % | 632,518 | 3,479 | 0.74 % | |
| Interest Bearing Demand Deposits | 1,215,800 | 2,631 | 0.29 % | 1,064,743 | 2,497 | 0.31 % | |
| Total Interest Bearing Deposits | 1,936,314 | 5,976 | 0.41 % | 1,804,832 | 6,082 | 0.45 % | |
| Short-term Interest Bearing Liabilities | 53,604 | 353 | 0.88 % | 186,520 | 1,755 | 1.26 % | |
| Long-term Interest Bearing Liabilities – FHLB Dallas | 497,076 | 5,303 | 1.43 % | 418,074 | 4,690 | 1.50 % | |
| Long-term Debt ⁽⁵⁾ | 60,311 | 1,065 | 2.36 % | 60,311 | 1,088 | 2.41 % | |
| Total Interest Bearing Liabilities | 2,547,305 | 12,697 | 0.67 % | 2,469,737 | 13,615 | 0.74 % | |
| NONINTEREST BEARING LIABILITIES: | | | | | | | |
| Demand Deposits | 570,854 | | | 562,545 | | | |
| Other Liabilities | 28,765 | | | 46,693 | | | |
| Total Liabilities | 3,146,924 | | | 3,078,975 | | | |
| SHAREHOLDERS' EQUITY | | | | | | | |
| Total Liabilities and Shareholders' Equity | \$ 3,424,922 | | | \$ 3,329,563 | | | |
| NET INTEREST INCOME | | \$ 93,677 | | | \$ 83,747 | | |

| | | |
|---|--------|--------|
| NET INTEREST MARGIN ON AVERAGE EARNING ASSETS | 3.89 % | 3.58 % |
| NET INTEREST SPREAD | 3.75 % | 3.42 % |

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

(2) Interest income includes taxable-equivalent adjustments of \$3,025 and \$2,886 for the nine months ended September 30, 2014 and 2013, respectively.

(3) Interest income includes taxable-equivalent adjustments of \$9,184 and \$7,889 for the nine months ended September 30, 2014 and 2013, respectively.

(4) For the purpose of calculating the average yield, the average balance of securities is presented at historical cost.

(5) Represents issuance of junior subordinated debentures.

Note: As of September 30, 2014 and 2013, loans totaling \$4,685 and \$8,370, respectively, were on nonaccrual status.

Our policy is to reverse previously accrued but unpaid interest on nonaccrual loans; thereafter, interest income is recorded to the extent received when appropriate.

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AVERAGE BALANCES AND YIELDS

(dollars in thousands)

(unaudited)

Three Months Ended

| | September 30, 2014 | | September 30, 2013 | |
|--|--------------------|----------------|--------------------|----------------|
| | AVG | AVG | AVG | AVG |
| | BALANCE | INTEREST YIELD | BALANCE | INTEREST YIELD |

ASSETS

INTEREST EARNING ASSETS:

| | | | | | | |
|--|--------------|-----------|--------|--------------|-----------|--------|
| Loans ^{(1) (2)} | \$ 1,416,061 | \$ 18,172 | 5.09 % | \$ 1,300,606 | \$ 19,581 | 5.97 % |
| Loans Held For Sale | 1,277 | 4 | 1.24 % | 702 | 7 | 3.96 % |
| Securities: | | | | | | |
| Investment Securities (Taxable) ⁽⁴⁾ | 43,951 | 210 | 1.90 % | 33,128 | 139 | 1.66 % |
| Investment Securities (Tax-Exempt) ⁽³⁾⁽⁴⁾ | 698,438 | 9,614 | 5.46 % | 773,187 | 9,819 | 5.04 % |
| Mortgage-backed Securities ⁽⁴⁾ | 902,406 | 6,070 | 2.67 % | 1,087,403 | 5,069 | 1.85 % |
| Total Securities | 1,644,795 | 15,894 | 3.83 % | 1,893,718 | 15,027 | 3.15 % |
| FHLB stock and other investments, at cost | 26,123 | 36 | 0.55 % | 33,472 | 36 | 0.43 % |
| Interest Earning Deposits | 45,726 | 31 | 0.27 % | 24,472 | 15 | 0.24 % |
| Total Interest Earning Assets | 3,133,982 | 34,137 | 4.32 % | 3,252,970 | 34,666 | 4.23 % |

NONINTEREST EARNING ASSETS:

| | | | | | | |
|-------------------------------|--------------|--|--|--------------|--|--|
| Cash and Due From Banks | 39,533 | | | 40,344 | | |
| Bank Premises and Equipment | 53,626 | | | 50,879 | | |
| Other Assets | 132,724 | | | 109,716 | | |
| Less: Allowance for Loan Loss | (18,029) | | | (18,667) | | |
| Total Assets | \$ 3,341,836 | | | \$ 3,435,242 | | |

LIABILITIES AND SHAREHOLDERS'

EQUITY

INTEREST BEARING LIABILITIES:

| | | | | | | |
|--|------------|-------|--------|------------|-------|--------|
| Savings Deposits | \$ 118,745 | 32 | 0.11 % | \$ 109,789 | 35 | 0.13 % |
| Time Deposits | 573,893 | 1,011 | 0.70 % | 660,771 | 1,199 | 0.72 % |
| Interest Bearing Demand Deposits | 1,168,888 | 833 | 0.28 % | 1,052,529 | 777 | 0.29 % |
| Total Interest Bearing Deposits | 1,861,526 | 1,876 | 0.40 % | 1,823,089 | 2,011 | 0.44 % |
| Short-term Interest Bearing Liabilities | 39,146 | 226 | 2.29 % | 254,256 | 116 | 0.18 % |
| Long-term Interest Bearing Liabilities – FHLB Dallas | 482,241 | 1,659 | 1.36 % | 456,448 | 1,679 | 1.46 % |
| Long-term Debt ⁽⁵⁾ | 60,311 | 359 | 2.36 % | 60,311 | 364 | 2.39 % |
| Total Interest Bearing Liabilities | 2,443,224 | 4,120 | 0.67 % | 2,594,104 | 4,170 | 0.64 % |

NONINTEREST BEARING LIABILITIES:

| | | | | | | |
|-------------------|-----------|--|--|-----------|--|--|
| Demand Deposits | 578,866 | | | 568,023 | | |
| Other Liabilities | 32,058 | | | 38,048 | | |
| Total Liabilities | 3,054,148 | | | 3,200,175 | | |

SHAREHOLDERS' EQUITY

| | | | | | | |
|--|--------------|--|--|--------------|--|--|
| Total Liabilities and Shareholders' Equity | \$ 3,341,836 | | | \$ 3,435,242 | | |
|--|--------------|--|--|--------------|--|--|

| | | | | | | |
|---------------------|--|-----------|--|--|-----------|--|
| NET INTEREST INCOME | | \$ 30,017 | | | \$ 30,496 | |
|---------------------|--|-----------|--|--|-----------|--|

| | | | | | | |
|---|--|--|--------|--|--|--------|
| NET INTEREST MARGIN ON AVERAGE EARNING ASSETS | | | 3.80 % | | | 3.72 % |
|---|--|--|--------|--|--|--------|

| | | | | | | |
|---------------------|--|--|--------|--|--|--------|
| NET INTEREST SPREAD | | | 3.65 % | | | 3.59 % |
|---------------------|--|--|--------|--|--|--------|

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

- (2) Interest income includes taxable-equivalent adjustments of \$1,008 and \$963 for the three months ended September 30, 2014 and 2013, respectively.
 - (3) Interest income includes taxable-equivalent adjustments of \$3,289 and \$2,892 for the three months ended September 30, 2014 and 2013, respectively.
 - (4) For the purpose of calculating the average yield, the average balance of securities is presented at historical cost.
 - (5) Represents issuance of junior subordinated debentures.
- Note: As of September 30, 2014 and 2013, loans totaling \$4,685 and \$8,370, respectively, were on nonaccrual status. Our policy is to reverse previously accrued but unpaid interest on nonaccrual loans; thereafter, interest income is recorded to the extent received when appropriate.

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Liquidity and Interest Rate Sensitivity

Liquidity management involves our ability to convert assets to cash with a minimum risk of loss to enable us to meet our obligations to our customers at any time. This means addressing (1) the immediate cash withdrawal requirements of depositors and other funds providers; (2) the funding requirements of all lines and letters of credit; and (3) the short-term credit needs of customers. Liquidity is provided by short-term investments that can be readily liquidated with a minimum risk of loss. Cash, interest earning deposits, federal funds sold and short-term investments with maturities or repricing characteristics of one year or less continue to be a substantial percentage of total assets. At September 30, 2014, these investments were 12.9% of total assets as compared with 14.1% for December 31, 2013 and 14.0% for September 30, 2013. The decrease to 12.9% at September 30, 2014 is primarily reflective of changes in the investment portfolio. Liquidity is further provided through the matching, by time period, of rate sensitive interest earning assets with rate sensitive interest bearing liabilities. Southside Bank has three lines of credit for the purchase of overnight federal funds at prevailing rates. One \$30.0 million and two \$15.0 million unsecured lines of credit have been established with Frost Bank, Comerica Bank and TIB - The Independent Bankers Bank, respectively. There were no federal funds purchased at September 30, 2014. Southside Bank has a \$5.0 million line of credit with Frost Bank to be used to issue letters of credit. At September 30, 2014, the amount of additional funding Southside Bank could obtain from FHLB using unpledged securities at FHLB was approximately \$451.1 million, net of FHLB stock purchases required. Southside Bank obtained no letters of credit from FHLB as collateral for a portion of its public fund deposits.

Interest rate sensitivity management seeks to avoid fluctuating net interest margins and to enhance consistent growth of new interest income through periods of changing interest rates. The ALCO closely monitors various liquidity ratios, interest rate spreads and margins. The ALCO performs interest rate simulation tests that apply various interest rate scenarios including immediate shocks and market value of portfolio equity ("MVPE") with interest rates immediately shocked plus and minus 200 basis points to assist in determining our overall interest rate risk and adequacy of the liquidity position. In addition, the ALCO utilizes a simulation model to determine the impact on net interest income of several different interest rate scenarios. By utilizing this technology, we can determine changes that need to be made to the asset and liability mixes to minimize the change in net interest income under these various interest rate scenarios. See Part I - "Item 3. Quantitative and Qualitative Disclosures about Market Risk" in this Quarterly Report on Form 10-Q.

Noninterest Income

Noninterest income consists of revenue generated from a broad range of financial services and activities including deposit related fee based services such as ATM, overdraft, and check processing fees. In addition, we earn income from the sale of loans and securities, trust services, bank owned life insurance ("BOLI"), brokerage services, and other fee generating programs that we either provide or in which we participate.

Noninterest income was \$5.0 million and \$17.3 million for the three and nine months ended September 30, 2014, respectively, compared to \$6.4 million and \$27.7 million for the same period in 2013, a decrease of \$1.4 million, or 21.7%, and \$10.4 million, or 37.5%, respectively. The decrease in noninterest income for the nine months ended September 30, 2014 when compared to the same period in 2013 was due primarily to the decrease in the net gain on sale of AFS securities and the impairment charge related to our investment in SFG Finance, LLC. During the three months ended September 30, 2014, noninterest income decreased when compared to the same period in 2013, due to the impairment of our investment in SFG Finance, LLC., which more than offset the increase in net gain on sale of AFS securities.

During the nine months ended September 30, 2014, we had a net gain on sale of AFS securities of \$1.7 million compared to \$9.2 million for the same period in 2013. Net gain on sale of AFS securities for the three months ended September 30, 2014 was \$1.2 million compared to a net loss of \$142,000 for the same period in 2013. The fair value of the AFS securities portfolio at September 30, 2014 was \$1.0 billion with a net unrealized gain on that date of \$18.3

million. The net unrealized gain was comprised of \$21.1 million in unrealized gains and \$2.7 million in unrealized losses. The fair value of the HTM securities portfolio at September 30, 2014 was \$659.1 million with a net unrealized gain on that date of \$1.6 million. The net unrealized gain was comprised of \$21.5 million in unrealized gains and approximately

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\$19.8 million in unrealized losses. During the nine months ended September 30, 2014, we pro-actively managed the investment portfolio which included recalibrating the blend of our investment portfolio.

For the three and nine months ended September 30, 2014, we recorded an impairment charge of \$2.2 million on our investment in SFG Finance, LLC. The impairment occurred as a result of our decision to sell the SFG purchased automobile loans and the associated write down to fair market value and transfer to loans held for sale of \$74.8 million.

Gain on sale of loans decreased \$22,000, or 16.9%, and \$421,000, or 61.0%, for the three and nine months ended September 30, 2014, respectively, when compared to the same periods in 2013. The decrease for the three and nine months ended September 30, 2014 was due primarily to a decrease in the dollar amount of loans sold and the related servicing release and secondary market fees.

Other income decreased \$313,000, or 23.5%, and \$101,000, or 3.2%, for the three and nine months ended September 30, 2014, respectively, when compared to the same periods in 2013, primarily due to decreases in other fee income.

Noninterest Expense

We incur certain types of noninterest expenses associated with the operation of our various business activities, the largest of which are salaries and employee benefits.

Noninterest expense was \$20.0 million and \$60.6 million for the three and nine months ended September 30, 2014, respectively, compared to \$20.3 million and \$61.7 million for the same periods in 2013, respectively, representing a decrease of \$247,000, or 1.2%, and \$1.1 million, or 1.8%, for the three and nine months ended September 30, 2014, respectively.

Salaries and employee benefits expense decreased \$369,000, or 2.8%, and \$785,000, or 2.0%, during the three and nine months ended September 30, 2014, respectively, when compared to the same periods in 2013. The decrease for the three and nine months ended September 30, 2014, was primarily the result of the decrease in retirement expense which was partially offset by an increase in direct salary expense and increased health insurance expense.

Direct salary expense and payroll taxes increased \$175,000, or 1.6%, and \$1.1 million, or 3.4%, during the three and nine months ended September 30, 2014, respectively, when compared to the same periods in 2013. This increase was due to normal salary increases effective in the first quarter of 2014.

Retirement expense, included in salary and benefits, decreased \$765,000, or 58.1%, and \$2.3 million, or 58.2%, for the three and nine months ended September 30, 2014, respectively, when compared to the same periods in 2013. The decrease was primarily related to the decrease in the defined benefit plan expense due to the funded status of the plan and the increase in the discount rate to 5.06% from 4.08% for the same period in 2013.

Health and life insurance expense, included in salary and benefits, increased \$222,000, or 20.3%, and \$385,000, or 12.6%, for the three and nine months ended September 30, 2014, respectively, when compared to the same periods in 2013. The increase for the three and nine months ended September 30, 2014 was due to increased health claims expense and plan administrative cost for the comparable period of time. We have a self-insured health plan which is supplemented with stop loss insurance policies. Health insurance costs are rising nationwide and these costs may increase during the remainder of 2014.

Professional fees increased \$402,000, or 55.1%, and \$1.4 million, or 74.1%, for the three and nine months ended September 30, 2014, respectively, when compared to the same periods in 2013, due to approximately \$465,000 and \$1.1 million of increased legal and accounting fees associated with the pending OmniAmerican merger during the respective periods.

Telephone and communications decreased \$91,000, or 23.8%, and \$328,000, or 26.9%, for the three and nine months ended September 30, 2014, respectively, as compared to the same periods in 2013 due primarily to contract negotiations with our service providers.

FHLB prepayment fees decreased \$1.0 million, or 100%, during the nine months ended September 30, 2014 as a result of the prepayment of \$90.2 million of FHLB advances during the second quarter of 2013.

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Income Taxes

Pre-tax income for the three and nine months ended September 30, 2014 was \$5.9 million and \$26.5 million, respectively, compared to \$9.2 million and \$32.8 million for the same periods in 2013, respectively. We recorded an income tax benefit of \$243,000 for the three months ended September 30, 2014, compared to an income tax expense of \$257,000 for the same period in 2013. For the nine months ended September 30, 2014, income tax expense was \$1.8 million compared to \$3.8 million for the same period in 2013. The effective benefit rate as a percentage of pre-tax income was 4.2% for the three months ended September 30, 2014 while the effective tax rate as a percentage of pre-tax income was 6.6% for the nine months ended September 30, 2014, compared to an effective tax rate as a percentage of pre-tax income of 2.8% and 11.6%, respectively, for the same periods in 2013. The decrease in the effective tax rate for the three and nine months ended September 30, 2014 was due to an increase in tax-exempt income as a percentage of taxable income, as compared to the same periods in 2013. The increase in tax-exempt income as a percentage of taxable income was primarily due to the significant increase in our average tax-exempt securities portfolio for the nine months ended September 30, 2014 compared to the same period in 2013. Net deferred tax assets totaled \$12.8 million at September 30, 2014, as compared to \$18.4 million at December 31, 2013. The decrease in net deferred tax assets resulted primarily from increases in unrealized gains on securities available for sale, partially offset by an increase in the alternative minimum tax.

Capital Resources

Our total shareholders' equity at September 30, 2014, was \$291.1 million, representing an increase of 12.2%, or \$31.6 million, from December 31, 2013, and represented 8.6% of total assets at September 30, 2014, compared to 7.5% of total assets at December 31, 2013.

Increases to our shareholders' equity consisted primarily of net income of \$24.8 million, a decrease in accumulated other comprehensive loss of \$13.5 million, increases in additional paid in capital due to issuance of stock under employee stock plans of \$1.0 million, stock compensation expense of \$842,000, and the issuance of \$797,000 in common stock (26,894 shares) through our dividend reinvestment plan. These increases were slightly offset by \$11.9 million in cash dividends paid.

On March 20, 2014, our board of directors declared a 5% stock dividend to common stock shareholders of record as of April 10, 2014, which was paid on May 1, 2014.

Under the Federal Reserve Board's risk-based capital guidelines for bank holding companies, the minimum ratio of total capital to risk-adjusted assets (including certain off-balance sheet items, such as standby letters of credit) is currently 8%. The minimum Tier 1 capital to risk-adjusted assets is 4%. Our trust preferred securities issued by our subsidiaries, Southside Statutory Trust III, IV, V and Magnolia Trust Company I, respectively, are considered Tier 1 capital by the Federal Reserve Board. The Federal Reserve Board also requires bank holding companies to comply with the minimum leverage ratio guidelines. The leverage ratio is the ratio of bank holding company's Tier 1 capital to its total consolidated quarterly average assets, less goodwill and certain other intangible assets. The guidelines require a minimum leverage ratio of 4% for bank holding companies that meet certain specified criteria. Failure to meet minimum capital requirements could result in certain mandatory and possibly additional discretionary actions by our regulators that, if undertaken, could have a direct material effect on our financial statements. Management believes that, as of September 30, 2014, we met all capital adequacy requirements to which we were subject.

The Federal Deposit Insurance Act requires bank regulatory agencies to take "prompt corrective action" with respect to FDIC-insured depository institutions that do not meet minimum capital requirements. A depository institution's treatment for purposes of the prompt corrective action provisions will depend on how its capital levels compare to various capital measures and certain other factors, as established by regulation. Prompt corrective action and other discretionary actions could have a direct material effect on our financial statements.

It is management's intention to maintain our capital at a level acceptable to all regulatory authorities and future dividend payments will be determined accordingly. Regulatory authorities require that any dividend payments made by either us or the Bank, not exceed earnings for that year. Shareholders should not anticipate a continuation of the cash dividend

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simply because of the existence of a dividend reinvestment program. The payment of dividends will depend upon future earnings, our financial condition, and other related factors including the discretion of the board of directors. To be categorized as well capitalized we must maintain minimum Total risk-based, Tier 1 risk-based, and Tier 1 leverage ratios as set forth in the following table:

| | Actual | | For Capital Adequacy Purposes | | To Be Well Capitalized Under Prompt Corrective Actions Provisions | | |
|---|-----------|-------|-------------------------------|-------|---|-------|---|
| | Amount | Ratio | Amount | Ratio | Amount | Ratio | |
| As of September 30, 2014: | | | | | | | |
| Total Capital (to Risk Weighted Assets) | | | | | | | |
| Consolidated | \$348,696 | 21.73 | % \$128,374 | 8.00 | % N/A | N/A | |
| Bank Only | \$344,627 | 21.50 | % \$128,239 | 8.00 | % \$160,299 | 10.00 | % |
| Tier 1 Capital (to Risk Weighted Assets) | | | | | | | |
| Consolidated | \$334,878 | 20.87 | % \$64,187 | 4.00 | % N/A | N/A | |
| Bank Only | \$330,809 | 20.64 | % \$64,119 | 4.00 | % \$96,179 | 6.00 | % |
| Tier 1 Capital (to Average Assets) (1) | | | | | | | |
| Consolidated | \$334,878 | 10.15 | % \$131,910 | 4.00 | % N/A | N/A | |
| Bank Only | \$330,809 | 10.04 | % \$131,790 | 4.00 | % \$164,738 | 5.00 | % |
| As of December 31, 2013: | | | | | | | |
| Total Capital (to Risk Weighted Assets) | | | | | | | |
| Consolidated | \$335,944 | 21.71 | % \$123,776 | 8.00 | % N/A | N/A | |
| Bank Only | \$332,069 | 21.46 | % \$123,775 | 8.00 | % \$154,719 | 10.00 | % |
| Tier 1 Capital (to Risk Weighted Assets) | | | | | | | |
| Consolidated | \$316,754 | 20.47 | % \$61,888 | 4.00 | % N/A | N/A | |
| Bank Only | \$312,879 | 20.22 | % \$61,888 | 4.00 | % \$92,831 | 6.00 | % |
| Tier 1 Capital (to Average Assets) (1) | | | | | | | |
| Consolidated | \$316,754 | 9.07 | % \$139,665 | 4.00 | % N/A | N/A | |
| Bank Only | \$312,879 | 8.97 | % \$139,559 | 4.00 | % \$174,449 | 5.00 | % |

(1) Refers to quarterly average assets as calculated by bank regulatory agencies.

The capital requirements applicable to the Company and Southside Bank are subject to change because, over the coming years, the regulatory capital framework will change as a result of the Dodd-Frank Act and as a result of a separate international regulatory capital initiative known as "Basel III." See the section captioned "Supervision and Regulation" in Part I - Item 1. Business of our Annual Report on Form 10-K for the year ended December 31, 2013 for more information on these topics.

Management believes that, as of September 30, 2014, Southside Bancshares and Southside Bank would meet all capital adequacy requirements under the Basel III Capital Rules on a fully phased-in basis as if such requirements were currently in effect.

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The table below summarizes our key equity ratios for the three and nine months ended September 30, 2014 and 2013:

| | Nine Months Ended September 30, | | |
|--|-------------------------------------|--------|---|
| | 2014 | 2013 | |
| Return on Average Assets | 0.97 | % 1.16 | % |
| Return on Average Shareholders' Equity | 11.92 | 15.47 | |
| Dividend Payout Ratio – Basic | 48.48 | 38.96 | |
| Dividend Payout Ratio – Diluted | 48.85 | 38.96 | |
| Average Shareholders' Equity to Average Total Assets | 8.12 | 7.53 | |
| | Three Months Ended September 30, | | |
| | 2014 | 2013 | |
| Return on Average Assets | 0.72 | % 1.03 | % |
| Return on Average Shareholders' Equity | 8.41 | 15.01 | |
| Dividend Payout Ratio – Basic | 68.75 | 42.55 | |
| Dividend Payout Ratio – Diluted | 68.75 | 42.55 | |
| Average Shareholders' Equity to Average Total Assets | 8.61 | 6.84 | |

Composition of Loans

One of our main objectives is to seek attractive lending opportunities in Texas, primarily in the counties in which we operate. Refer to “Part I - Item 1. Business - Market Area” in our Annual Report on Form 10-K for the year ended December 31, 2013 for a discussion of our primary market area and the geographic concentration of our loan portfolio as of December 31, 2013. There were no substantial changes in these concentrations during the nine months ended September 30, 2014. Substantially all of our loan originations are made to borrowers who live in and conduct business in our primary market area, with the exception of municipal loans, which are made almost entirely in Texas, and purchases of automobile loan portfolios throughout the United States. Municipal loans are made to municipalities, counties, school districts and colleges primarily throughout the state of Texas. Through SFG, we purchased portfolios of automobile loans from a variety of lenders throughout the United States. These high yield loans represented existing subprime automobile loans with payment histories that were collateralized by new and used automobiles. At September 30, 2014, we decided to sell all remaining subprime automobile loans purchased by SFG and the repossessed assets SFG holds. We are endeavoring to complete such a sale in the fourth quarter of 2014. As a result of this decision, we transferred all SFG purchased loans, approximately \$74.8 million, to loans held for sale. Our loan growth may accelerate in the future when the economy in the markets we serve improves and as we work to identify and develop additional markets and strategies that will allow us to expand our lending territory. Total loans increased \$47.4 million, or 3.5%, to \$1.40 billion for the nine months ended September 30, 2014 from \$1.35 billion at December 31, 2013, and increased \$81.1 million, or 6.2%, from \$1.32 billion at September 30, 2013. Average loans increased \$98.7 million, or 7.7%, during the nine months ended September 30, 2014 when compared to the same period in 2013.

Our market areas to date have not experienced the level of downturn in the economy and real estate prices that some of the harder hit areas of the country have experienced. However, we did experience a slight slowdown as a result of the real estate led downturn across the country during 2008 and continuing into 2011. During 2012 and 2013, our markets stabilized and in some cases strengthened. A more severe decline in credit markets generally could adversely affect our financial condition and results of operation if we are unable to extend credit or sell loans into the secondary market. Our real estate loan portfolio does not have Alt-A or subprime mortgage exposure.

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The following table sets forth loan totals for the periods presented:

| | At September 30, 2014 (in thousands) | At December 31, 2013 | At September 30, 2013 |
|------------------------|---|----------------------------|-----------------------------|
| Real Estate Loans: | | | |
| Construction | \$178,127 | \$125,219 | \$126,922 |
| 1-4 Family Residential | 394,889 | 390,499 | 387,964 |
| Other | 332,519 | 262,536 | 252,827 |
| Commercial Loans | 162,356 | 157,655 | 153,019 |
| Municipal Loans | 256,319 | 245,550 | 223,063 |
| Loans to Individuals | 74,464 | 169,814 | 173,773 |
| Total Loans | \$1,398,674 | \$1,351,273 | \$1,317,568 |

Construction loans increased \$52.9 million, or 42.3%, to \$178.1 million at September 30, 2014, from \$125.2 million at December 31, 2013, and \$51.2 million, or 40.3%, from \$126.9 million at September 30, 2013, due to increased activity in the Austin and Dallas-Fort Worth markets.

Our 1-4 family residential mortgage loans increased \$4.4 million, or 1.1%, to \$394.9 million at September 30, 2014, from \$390.5 million at December 31, 2013, and \$6.9 million, or 1.8%, from \$388.0 million at September 30, 2013, due primarily to the low interest rate environment and increased activity in the Dallas-Fort Worth market.

Other real estate loans, which are comprised primarily of commercial real estate loans, increased \$70.0 million, or 26.7%, to \$332.5 million at September 30, 2014, from \$262.5 million at December 31, 2013, and increased \$79.7 million, or 31.5%, from \$252.8 million at September 30, 2013. This increase was a result of growth in our Austin and Dallas-Fort Worth markets.

Commercial loans increased \$4.7 million, or 3.0%, to \$162.4 million at September 30, 2014, from \$157.7 million at December 31, 2013, and increased \$9.3 million, or 6.1%, from \$153.0 million at September 30, 2013.

Municipal loans increased \$10.8 million, or 4.4%, to \$256.3 million at September 30, 2014, from \$245.6 million at December 31, 2013, and increased \$33.3 million, or 14.9%, from \$223.1 million at September 30, 2013. The increase in municipal loans is due to continued demand which provided additional opportunities for us to lend to municipalities during 2014.

Loans to individuals decreased \$95.4 million, or 56.1%, to \$74.5 million at September 30, 2014, from \$169.8 million at December 31, 2013, and decreased \$99.3 million, or 57.1%, from \$173.8 million at September 30, 2013. The decrease for the nine months ended September 30, 2014 was due to the transfer of all subprime automobile loans purchased by SFG, to loans held for sale as of September 30, 2014.

Loan Loss Experience and Allowance for Loan Losses

The allowance for loan losses is based on the most current review of the loan portfolio and is a result of multiple processes. First, the bank utilizes historical data to establish general reserve amounts for each class of loans. The historical charge-off figure is further adjusted through qualitative factors that include general trends in past dues, nonaccruals and classified loans to more effectively and promptly react to both positive and negative movements. Second, our lenders have the primary responsibility for identifying problem loans and estimating necessary reserves based on customer financial stress and underlying collateral. These recommendations are reviewed by senior loan administration, the Special Assets department, and the Loan Review department. Third, the Loan Review department independently reviews the portfolio on an annual basis. The Loan Review department follows a board-approved annual loan review scope. The loan review scope encompasses a number of considerations including the size of the loan, the type of credit extended, the seasoning of the loan and the performance of the loan. The Loan Review scope, as it

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relates to size, focuses more on larger dollar loan relationships, typically, for example, aggregate debt of \$500,000 or greater. The Loan Review officer also reviews specific reserves compared to general reserves to determine trends in comparative reserves as well as losses not reserved for prior to charge-off to determine the effectiveness of the specific reserve process.

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

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

Industry and our own experience indicate that a portion of our loans will become delinquent and a portion of the loans will require partial or full charge-off. Regardless of the underwriting criteria utilized, losses may be experienced as a result of various factors beyond our control, including, among other things, changes in market conditions affecting the value of properties used as collateral for loans and problems affecting the credit of the borrower and the ability of the borrower to make payments on the loan. Our determination of the appropriateness of the allowance for loan losses is based on various considerations, including an analysis of the risk characteristics of various classifications of loans, previous loan loss experience, specific loans which would have loan loss potential, delinquency trends, estimated fair value of the underlying collateral, current economic conditions, and geographic and industry loan concentration. Prior to September 30, 2014, SFG loans included in loans to individuals that experienced past due status or extension of maturity characteristics were reserved for at higher levels based on the circumstances associated with each specific loan. In general the reserves for SFG were calculated based on the past due status of the loan. For reserve purposes, the portfolio was segregated by past due status and by the remaining term variance from the original contract. During repayment, loans that paid late took longer to repay than the original contract. Additionally, some loans may have been granted extensions for extenuating payment circumstances and evaluated for troubled debt classification. The remaining term extensions increased the risk of collateral deterioration and, accordingly, reserves were increased to recognize this risk.

After all of the data in the loan portfolio is accumulated the reserve allocations are separated into various loan classes. As of September 30, 2014, our review of the loan portfolio indicated that a loan loss allowance of \$13.4 million was appropriate to cover probable losses in the portfolio. Changes in economic and other conditions may require future adjustments to the allowance for loan losses.

During the nine months ended September 30, 2014, the allowance for loan losses decreased \$5.5 million, or 28.9%, to \$13.4 million, or 0.96% of total loans, when compared to \$18.9 million, or 1.40% of total loans, at December 31, 2013. The decrease was due primarily to the subprime automobile loans transferred to held for sale and was partially offset by an increase of approximately \$1.4 million in the allowance for loan losses on the existing loan portfolio, excluding the subprime automobile loans transferred to held for sale. The decrease in the allowance as a percentage of total loans was due to the shift in the risk characteristics of the loan portfolio during the nine months ended September 30, 2014.

For the three and nine months ended September 30, 2014, loan charge-offs were \$10.4 million and \$18.7 million, and recoveries were \$556,000 and \$1.6 million, resulting in net charge-offs of \$9.9 million and \$17.1 million, respectively. For the three and nine months ended September 30, 2013, loan charge-offs were \$3.5 million and \$9.4 million, and recoveries were \$860,000 and \$2.0 million, resulting in net charge-offs of \$2.7 million and \$7.4 million, respectively. The increase in net charge-offs for the three and nine months ended September 30, 2014, was primarily

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related to an increase in charge-offs recorded on SFG loans. The necessary provision expense was estimated at \$4.9 million and \$11.7 million for the three and nine months ended September 30, 2014, respectively, compared to \$3.6 million and \$6.2 million for the comparable periods in 2013, respectively. The increase in provision expense for the three and nine months ended September 30, 2014, compared to the same periods in 2013 was primarily related to charge-offs in the SFG loan portfolio during the nine months ended September 30, 2014, and to a lesser extent, the write down and transfer of SFG loans to loans held for sale.

Nonperforming Assets

Nonperforming assets consist of delinquent loans 90 days or more past due, nonaccrual loans, OREO, repossessed assets and restructured loans. Nonaccrual loans are loans 90 days or more delinquent and collection in full of both the principal and interest is not expected. Additionally, some loans that are not delinquent may be placed on nonaccrual status due to doubts about full collection of principal or interest. When a loan is categorized as nonaccrual, the accrual of interest is discontinued and any accrued balance is reversed for financial statement purposes. Restructured loans represent loans that have been renegotiated to provide a reduction or deferral of interest or principal because of deterioration in the financial position of the borrowers. The restructuring of a loan is considered a “troubled debt restructuring” if both (i) the borrower is experiencing financial difficulties and (ii) the creditor has granted a concession. Concessions may include interest rate reductions or below market interest rates, principal forgiveness, restructuring amortization schedules and other actions intended to minimize potential losses. Categorization of a loan as nonperforming is not in itself a reliable indicator of potential loan loss. Other factors, such as the value of collateral securing the loan and the financial condition of the borrower must be considered in judgments as to potential loan loss. OREO represents real estate taken in full or partial satisfaction of debts previously contracted. The dollar amount of OREO is based on a current evaluation of the OREO at the time it is recorded on our books, net of estimated selling costs. Updated valuations are obtained as needed and any additional impairments are recognized. The following tables set forth nonperforming assets for the periods presented (in thousands)⁽¹⁾:

| | At September 30, 2014 | At December 31, 2013 | At September 30, 2013 |
|---|-----------------------------|----------------------------|-----------------------------|
| Nonaccrual loans | \$4,685 | \$8,088 | \$8,370 |
| Accruing loans past due more than 90 days | 1 | 3 | 2 |
| Restructured loans | 4,388 | 3,888 | 3,802 |
| Other real estate owned | 383 | 726 | 740 |
| Repossessed assets | 407 | 901 | 739 |
| Total Nonperforming Assets | \$9,864 | \$13,606 | \$13,653 |
| | At September 30, 2014 | At December 31, 2013 | At September 30, 2013 |
| Asset Quality Ratios: | | | |
| Nonaccruing loans to total loans | 0.33 | % 0.60 | % 0.64 |
| Allowance for loan losses to nonaccruing loans | 286.34 | 233.40 | 231.25 |
| Allowance for loan losses to nonperforming assets | 136.00 | 138.74 | 141.77 |
| Allowance for loan losses to total loans | 0.96 | 1.40 | 1.47 |
| Nonperforming assets to total assets | 0.29 | 0.39 | 0.39 |
| Net charge-offs to average loans | 1.65 | 0.82 | 0.77 |

(1) At September 30, 2014, there were \$2.0 million in SFG nonaccrual loans and \$40,000 in SFG restructured loans that were transferred to held for sale and not included in the nonperforming assets or the asset quality ratios presented above. At September 30, 2014, total nonperforming assets, including loans held for sale, were \$11.9 million.

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Total nonperforming assets at September 30, 2014 were \$9.9 million, a decrease of \$3.7 million, or 27.5%, from \$13.6 million at December 31, 2013 and a decrease of \$3.8 million, or 27.8%, from \$13.7 million at September 30, 2013. The decrease in nonperforming assets for the nine months ended September 30, 2014 as compared to the same period in 2013 was primarily a result of the transfer of SFG loans to held for sale.

From December 31, 2013 to September 30, 2014, nonaccrual loans decreased \$3.4 million, or 42.1%, to \$4.7 million, and from September 30, 2013, decreased \$3.7 million, or 44.0%. Of the total nonaccrual loans at September 30, 2014, 54.2% are residential real estate loans, 10.9% are commercial real estate loans, 12.4% are commercial loans, 5.6% are loans to individuals, and 16.9% are construction loans. Restructured loans increased \$500,000, or 12.9%, to \$4.4 million at September 30, 2014, from \$3.9 million at December 31, 2013 and \$586,000, or 15.4%, from \$3.8 million at September 30, 2013. OREO decreased \$343,000, or 47.2%, to \$383,000 at September 30, 2014 from \$726,000 at December 31, 2013 and \$357,000, or 48.2%, from \$740,000 at September 30, 2013. The OREO at September 30, 2014, consisted primarily of commercial real estate property. We are actively marketing all properties and none are being held for investment purposes. Repossessed assets decreased \$494,000, or 54.8%, to \$407,000 at September 30, 2014, from \$901,000 at December 31, 2013 and decreased \$332,000, or 44.9%, from \$739,000 at September 30, 2013.

Pending Acquisition

See “Note 2 – Pending Acquisition” in our consolidated financial statements included in this report.

Recent Accounting Pronouncements

See “Note 1 – Basis of Presentation” in our consolidated financial statements included in this report.

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ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The disclosures set forth in this item are qualified by the section captioned “Forward-Looking Statements” included in “Item 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations” of this report and other cautionary statements set forth elsewhere in this report.

Refer to the discussion of market risks included in “Item 7A. Quantitative and Qualitative Disclosures About Market Risks” in our Annual Report on Form 10-K for the year ended December 31, 2013. There have been no significant changes in the types of market risks we face since December 31, 2013.

In the banking industry, a major risk exposure is changing interest rates. The primary objective of monitoring our interest rate sensitivity, or risk, is to provide management the tools necessary to manage the balance sheet to minimize adverse changes in net interest income as a result of changes in the direction and level of interest rates. Federal Reserve Board monetary control efforts, the effects of deregulation, the current economic downturn and legislative changes have been significant factors affecting the task of managing interest rate sensitivity positions in recent years.

In an attempt to manage our exposure to changes in interest rates, management closely monitors our exposure to interest rate risk through our ALCO. Our ALCO meets regularly and reviews our interest rate risk position and makes recommendations to our board for adjusting this position. In addition, our board reviews our asset/liability position on a monthly basis. We primarily use two methods for measuring and analyzing interest rate risk: net income simulation analysis and MVPE modeling. We utilize the net income simulation model as the primary quantitative tool in measuring the amount of interest rate risk associated with changing market rates. This model quantifies the effects of various interest rate scenarios on projected net interest income and net income over the next 12 months. The model was used to measure the impact on net interest income relative to a base case scenario of rates immediately increasing 100 and 200 basis points or decreasing 100 and 200 basis points over the next 12 months. These simulations incorporate assumptions regarding balance sheet growth and mix, pricing and the repricing and maturity characteristics of the existing and projected balance sheet. The impact of interest rate-related risks such as prepayment, basis and option risk are also considered. As of September 30, 2014, the model simulations projected that 100 and 200 basis point immediate increases in interest rates would result in negative variances on net interest income of 1.66% and 2.71%, respectively, relative to the base case over the next 12 months, while an immediate decrease in interest rates of 100 and 200 basis points would result in negative variances in net interest income of 3.89% and 4.02%, respectively, relative to the base case over the next 12 months. As of December 31, 2013, the model simulations projected that 100 and 200 basis point immediate increases in interest rates would result in negative variances on net interest income of 5.86% and 8.42%, respectively, relative to the base case over the next 12 months, while an immediate decrease in interest rates of 100 and 200 basis points would result in negative variances in net interest income of 2.69% and 4.15%, respectively, relative to the base case over the next 12 months. As of September 30, 2013, the model simulations projected that 100 and 200 basis point immediate increases in interest rates would result in negative variances on net interest income of 6.75% and 8.26%, respectively, relative to the base case over the next 12 months, while an immediate decrease in interest rates of 100 and 200 basis points would result in negative variances in net interest income of 3.16% and 3.09%, respectively, relative to the base case over the next 12 months. As part of the overall assumptions, certain assets and liabilities have been given reasonable floors. This type of simulation analysis requires numerous assumptions including but not limited to changes in balance sheet mix, prepayment rates on mortgage-related assets and fixed rate loans, cash flows and repricing of all financial instruments, changes in volumes and pricing, future shapes of the yield curve, relationship of market interest rates to each other (basis risk), credit spread and deposit sensitivity. Assumptions are based on management’s best estimates but may not accurately reflect actual results under certain changes in interest rates.

The ALCO monitors various liquidity ratios to ensure a satisfactory liquidity position for us. Management continually evaluates the condition of the economy, the pattern of market interest rates and other economic data to determine the types of investments that should be made and at what maturities. Using this analysis, management from time to time assumes calculated interest sensitivity gap positions to maximize net interest income based upon anticipated movements in the general level of interest rates. Regulatory authorities also monitor our gap position along with other liquidity

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ratios. In addition, as described above, we utilize a simulation model to determine the impact of net interest income under several different interest rate scenarios. By utilizing this technology, we can determine changes that need to be made to the asset and liability mixes to mitigate the change in net interest income under these various interest rate scenarios.

ITEM 4. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

Management, including our Chief Executive Officer (“CEO”) and our Chief Financial Officer (“CFO”), undertook an evaluation of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) of the Securities Exchange Act of 1934, as amended (the “Exchange Act”)) as of the end of the period covered by this report, and, based on that evaluation, our CEO and CFO concluded that our disclosure controls and procedures were effective as of the end of the period covered by this report in recording, processing, summarizing and reporting in a timely manner the information that the Company is required to disclose in its reports under the Exchange Act and in accumulating and communicating to the Company's management, including the Company's CEO and CFO, such information as appropriate to allow timely decisions regarding required disclosure.

As disclosed in Part II, Item 9A of our Annual Report on Form 10-K for the year ended December 31, 2013, management identified a control deficiency that was determined to be a material weakness related to our interest income recognition on callable municipal securities purchased at a premium. As a result of the control deficiency, we did not properly amortize the premium to the maturity of the security, but instead we amortized the premium to the earliest call date. The control deficiency resulted in an interest income recognition error for individual callable municipal securities purchased at a premium that required specific accounting in accordance with generally accepted accounting principles.

Subsequent to December 31, 2013, we enhanced our interest income recognition controls for callable municipal securities purchased at a premium. As a result, we are amortizing all municipal securities purchased at a premium to the maturity date of the security.

As of September 30, 2014, management believes it has placed in operation controls to address the material weakness mentioned above and believes that the material weakness identified has been remediated.

Our Audit Committee has directed management to monitor and test the controls implemented and develop additional controls should any of the new controls require additional enhancement. In addition, under the direction of our Audit Committee, management will continue to review and make necessary changes to the overall design of our internal control environment, as well as policies and procedures to improve the overall effectiveness of internal control over financial reporting.

Changes in Internal Control Over Financial Reporting

Except as described above, there have been no changes in our internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) that occurred during the quarter ended September 30, 2014 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

See “Note 12 - Off-Balance-Sheet Arrangements, Commitments and Contingencies” in our consolidated financial statements included in this report.

ITEM 1A. RISK FACTORS

Additional information regarding risk factors appears in “Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations - Forward-Looking Statements” of this Form 10-Q and in Part I - “Item 1A. Risk Factors” in our Annual Report on Form 10-K for the year ended December 31, 2013. There have been no material changes from the risk factors previously disclosed in our Annual Report on Form 10-K for the year ended December 31, 2013. The risks and uncertainties described in our Annual Report on Form 10-K for the year ended December 31, 2013 are not the only ones we face. 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.

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

Not Applicable.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

Not Applicable.

ITEM 4. MINE SAFETY DISCLOSURES

Not Applicable.

ITEM 5. OTHER INFORMATION

Not Applicable.

ITEM 6. EXHIBITS

A list of exhibits to this Form 10-Q is set forth on the Exhibit Index and is incorporated herein by reference.

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

SOUTHSIDE BANCSHARES, INC.

DATE: November 6, 2014

BY: /s/ SAM DAWSON
Sam Dawson
President and Chief Executive Officer
(Principal Executive Officer)

DATE: November 6, 2014

BY: /s/ LEE R. GIBSON
Lee R. Gibson, CPA
Senior Executive Vice President and Chief Financial Officer
(Principal Financial Officer)

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Exhibit Index

| Exhibit Number | Description |
|----------------|--|
| 3 (a) | Restated Certificate of Formation of Southside Bancshares, Inc. effective May 2, 2014 (filed as Exhibit 3 (a) to the Registrant's Form 10-Q, filed May 9, 2014, and incorporated herein by reference). |
| 3 (b) | Amended and Restated Bylaws of Southside Bancshares, Inc. effective August 9, 2012 (filed as Exhibit 3(b) to the Registrant's Form 8-K, filed August 10, 2012, and incorporated herein by reference). |
| *31.1 | Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| *31.2 | Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| †*32 | Certification Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |
| *101.INS | XBRL Instance Document. |
| *101.SCH | XBRL Taxonomy Extension Schema Document. |
| *101.CAL | XBRL Taxonomy Extension Calculation Linkbase Document. |
| *101.LAB | XBRL Taxonomy Extension Label Linkbase Document. |
| *101.PRE | XBRL Taxonomy Extension Presentation Linkbase Document. |
| *101.DEF | XBRL Taxonomy Extension Definition Linkbase Document. |

*Filed herewith.

† The certification attached as Exhibit 32 accompanies this Quarterly Report on Form 10-Q and is “furnished” to the Commission pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 and shall not be deemed “filed” by us for purposes of Section 18 of the Securities Exchange Act of 1934, as amended.