

SOUTHSIDE BANCSHARES INC  
Form 10-Q  
August 06, 2007

**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 June 30, 2007**

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, Tyler, Texas

75701

903-531-7111

(Registrant's telephone number, including area code)

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

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

Edgar Filing: SOUTHSIDE BANCSHARES INC - Form 10-Q

Large accelerated filer       Accelerated filer       Non-accelerated filer

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

The number of shares of the issuer's common stock, par value \$1.25, outstanding as of July 26, 2007 was 13,081,616 shares.

---

**TABLE OF CONTENTS**

**PART I. FINANCIAL INFORMATION**

**ITEM 1. FINANCIAL STATEMENTS**

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

**ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

**ITEM 4. CONTROLS AND PROCEDURES**

**PART II. OTHER INFORMATION**

**ITEM 1. LEGAL PROCEEDINGS**

**ITEM 1A. RISK FACTORS**

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

**ITEM 3. DEFAULTS UPON SENIOR SECURITIES**

**ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS**

**ITEM 5. OTHER INFORMATION**

**ITEM 6. EXHIBITS**

**SIGNATURES**

**Exhibit Index**

Certification Pursuant to Section 302

Certification Pursuant to Section 302

Certification Pursuant to Section 906

**PART I. FINANCIAL INFORMATION****ITEM 1. FINANCIAL STATEMENTS****SOUTHSIDE BANCSHARES, INC. AND SUBSIDIARIES****CONSOLIDATED BALANCE SHEETS**

(UNAUDITED)

(in thousands, except share amounts)

	June 30, 2007	December 31, 2006
<b>ASSETS</b>		
Cash and due from banks	\$ 43,762	\$ 52,537
Interest earning deposits	544	550
Federal funds sold	11,850	1,925
Total cash and cash equivalents	56,156	55,012
Investment securities:		
Available for sale, at estimated fair value	88,566	98,952
Held to maturity, at cost	1,353	1,351
Mortgage-backed and related securities:		
Available for sale, at estimated fair value	599,326	643,164
Held to maturity, at cost	207,262	226,162
Federal Home Loan Bank stock, at cost	15,540	25,614
Other investments, at cost	881	882
Loans held for sale	5,042	3,909
Loans:		
Loans	768,739	759,147
Less: allowance for loan losses	(7,367)	(7,193)
Net Loans	761,372	751,954
Premises and equipment, net	35,268	32,641
Interest receivable	9,921	10,110
Deferred tax asset	10,456	8,678
Other assets	30,633	32,547
<b>TOTAL ASSETS</b>	<b>\$ 1,821,776</b>	<b>\$ 1,890,976</b>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Deposits:		
Noninterest bearing	\$ 328,361	\$ 325,771
Interest bearing	1,007,989	956,704
Total Deposits	1,336,350	1,282,475
Short-term obligations:		
Federal funds purchased	-	5,675
FHLB Dallas advances	239,826	322,241
Other obligations	1,511	1,605
Total Short-term obligations	241,337	329,521
Long-term obligations:		
FHLB Dallas advances	89,393	129,379
Long-term debt	20,619	20,619
Total Long-term obligations	110,012	149,998
Other liabilities	18,583	18,378
<b>TOTAL LIABILITIES</b>	<b>1,706,282</b>	<b>1,780,372</b>

Off-Balance-Sheet Arrangements, Commitments and Contingencies (Note 9)

## Shareholders' equity:

Common stock: (\$1.25 par, 20,000,000 shares authorized, 14,805,225 and 14,075,653 shares issued)	18,507	17,594
Paid-in capital	114,462	100,736
Retained earnings	21,392	29,648
Treasury stock (1,724,857 and 1,718,737 shares at cost)	(22,983)	(22,850)
Accumulated other comprehensive loss	(15,884)	(14,524)
<b>TOTAL SHAREHOLDERS' EQUITY</b>	<b>115,494</b>	<b>110,604</b>
<b>TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY</b>	<b>\$ 1,821,776</b>	<b>\$ 1,890,976</b>

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		Six Months	
	Ended June 30,		Ended June 30,	
	2007	2006	2007	2006
Interest income				
Loans	\$ 12,733	\$ 11,328	\$ 25,247	\$ 21,956
Investment securities – taxable	616	594	1,452	1,337
Investment securities – tax-exempt	505	490	1,012	1,089
Mortgage-backed and related securities	10,163	11,149	21,097	21,386
Federal Home Loan Bank stock and other investments	330	350	700	694
Other interest earning assets	33	14	69	32
Total interest income	24,380	23,925	49,577	46,494
Interest expense				
Deposits	10,025	7,404	19,590	13,658
Short-term obligations	2,776	4,037	6,722	7,587
Long-term obligations	1,518	1,947	3,178	4,143
Total interest expense	14,319	13,388	29,490	25,388
Net interest income	10,061	10,537	20,087	21,106
Provision for loan losses	217	448	334	729
Net interest income after provision for loan losses	9,844	10,089	19,753	20,377
Non interest income				
Deposit services	4,270	3,947	8,198	7,416
Gain on sale of securities available for sale	6	101	435	224
Gain on sale of loans	724	469	1,069	842
Trust income	576	403	1,040	807
Bank owned life insurance income	268	265	532	509
Other	818	782	1,526	1,267
Total non interest income	6,662	5,967	12,800	11,065
Non interest expense				
Salaries and employee benefits	7,298	7,310	14,402	14,730
Occupancy expense	1,190	1,201	2,358	2,374
Equipment expense	242	225	470	428
Advertising, travel & entertainment	449	472	870	924
ATM and debit card expense	242	275	496	445
Director fees	141	167	268	312
Supplies	188	168	336	352
Professional fees	240	318	551	633
Postage	155	155	303	305
Telephone and communications	193	191	384	354
Other	1,118	1,081	2,254	2,140
Total non interest expense	11,456	11,563	22,692	22,997
Income before income tax expense	5,050	4,493	9,861	8,445
Provision for income tax expense	463	950	1,511	1,674
Net Income	\$ 4,587	\$ 3,543	\$ 8,350	\$ 6,771
Earnings per common share –basic	\$ 0.35	\$ 0.28	\$ 0.64	\$ 0.53
Earnings per common share –diluted	\$ 0.34	\$ 0.27	\$ 0.62	\$ 0.51

Dividends declared per common share	\$	0.12	\$	0.11	\$	0.23	\$	0.22
-------------------------------------	----	------	----	------	----	------	----	------

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

2

---

SOUTHSIDE BANCSHARES, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY  
(UNAUDITED)  
(in thousands, except share amounts)

	Compre-hensive Income	Common Stock	Paid-in Capital	Retained Earnings	Treasury Stock	Accumulated Other Compre- hensive Income (Loss)	Total Share-holders Equity
Balance at December 31, 2005		\$ 16,633	\$ 87,962	\$ 32,054	\$ (22,850)	\$ (4,509)	\$ 109,290
Net Income	\$ 6,771			6,771			6,771
Other comprehensive loss, net of tax							
Unrealized losses on securities, net of reclassification adjustment (see Note 3)	(9,167)					(9,167)	(9,167)
Comprehensive loss	\$ (2,396)						
Common stock issued (94,803 shares)		119	714				833
Stock compensation expense				14			14
Tax benefit of incentive stock options				41			41
Dividends paid on common stock				(2,626)			(2,626)
Stock dividend		728	10,978	(11,706)			—
Balance at June 30, 2006		\$ 17,480	\$ 99,709	\$ 24,493	\$ (22,850)	\$ (13,676)	\$ 105,156
Balance at December 31, 2006		\$ 17,594	\$ 100,736	\$ 29,648	\$ (22,850)	\$ (14,524)	\$ 110,604
Net Income	\$ 8,350			8,350			8,350
Other comprehensive income, net of tax							
Unrealized losses on securities, net of reclassification adjustment	(1,533)					(1,533)	(1,533)



(see Note 3)

Adjustment to net periodic benefit cost (see Note 3)	173			173	173
Comprehensive Income	\$ 6,990				
Common stock issued (108,634 shares)		137	788		925
Stock compensation expense			14		14
Tax benefit of incentive stock options			21		21
Dividends paid on common stock				(2,927)	(2,927)
Purchase of 6,120 shares of common stock				(133)	(133)
Stock dividend		776	12,903	(13,679)	—
Balance at June 30, 2007	\$ 18,507	\$ 114,462	\$ 21,392	\$ (22,983)	\$ (15,884) \$ 115,494

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

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

	Six Months Ended June 30,	
	2007	2006
<b>OPERATING ACTIVITIES:</b>		
Net income	\$ 8,350	\$ 6,771
Adjustments to reconcile net income to net cash provided by operations:		
Depreciation	1,085	1,132
Amortization of premium	2,445	3,066
Accretion of discount and loan fees	(1,314)	(929)
Provision for loan losses	334	729
Stock compensation expense	14	14
Decrease (increase) in interest receivable	189	(659)
Decrease in other assets	1,585	208
Net change in deferred taxes	(1,077)	(176)
(Decrease) increase in interest payable	(134)	338
Decrease in other liabilities	(434)	(4,378)
Increase in loans held for sale	(1,133)	(2,839)
Gain on sale of available for sale securities	(435)	(224)
Gain on sale of assets	–	(1)
Loss on sale of other real estate owned	1	–
Net cash provided by operating activities	9,476	3,052
<b>INVESTING ACTIVITIES:</b>		
Proceeds from sales of investment securities available for sale	4,953	39,197
Proceeds from sales of mortgage-backed securities available for sale	51,430	30,651
Proceeds from maturities of investment securities available for sale	57,891	14,175
Proceeds from maturities of mortgage-backed securities available for sale	50,874	53,060
Proceeds from maturities of mortgage-backed securities held to maturity	20,596	16,683
Proceeds from redemption of Federal Home Loan Bank stock	10,729	2,019
Purchases of investment securities available for sale	(51,789)	(23,027)
Purchases of investment securities held to maturity	–	(1,348)
Purchases of mortgage-backed securities available for sale	(60,474)	(157,067)
Purchases of mortgage-backed securities held to maturity	(2,180)	(33,749)
Purchases of Federal Home Loan Bank stock and other investments	(654)	(657)
Net increase in loans	(10,048)	(45,119)
Purchases of premises and equipment	(3,712)	(933)
Proceeds from sales of premises and equipment	–	1
Proceeds from sales of other real estate owned	334	45
Proceeds from sales of repossessed assets	191	185
Net cash provided by (used in) investing activities	68,141	(105,884)

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



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

	Six Months Ended June 30,	
	2007	2006
<b>FINANCING ACTIVITIES:</b>		
Net increase in demand and savings accounts	21,773	5,388
Net increase in certificates of deposit	31,944	78,801
Net (decrease) increase in federal funds purchased	(5,675)	10,600
Proceeds from FHLB Advances	2,786,999	3,608,804
Repayment of FHLB Advances	(2,909,400)	(3,603,261)
Tax benefit of incentive stock options	21	41
Purchases of common stock	(133)	—
Proceeds from the issuance of common stock	925	833
Dividends paid	(2,927)	(2,626)
Net cash (used in) provided by financing activities	(76,473)	98,580
Net increase (decrease) in cash and cash equivalents	1,144	(4,252)
Cash and cash equivalents at beginning of period	55,012	51,829
Cash and cash equivalents at end of period	\$ 56,156	\$ 47,577
<b>SUPPLEMENTAL DISCLOSURES FOR CASH FLOW INFORMATION:</b>		
Interest paid	\$ 29,624	\$ 25,050
Income taxes paid	2,000	1,150
<b>SUPPLEMENTAL DISCLOSURES OF NONCASH INVESTING AND FINANCING ACTIVITIES:</b>		
Acquisition of other repossessed assets and real estate through foreclosure	\$ 197	\$ 957
Payment of 5% stock dividend	13,679	11,706
Adjustment to pension liability	(262)	—
Unsettled trades to purchase securities	941	—

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

SOUTHSIDE BANCSHARES, INC. AND SUBSIDIARIES  
NOTES TO FINANCIAL STATEMENTS

1. Basis of Presentation

The term “Company” is used throughout this report to refer to Southside Bancshares, Inc. and its subsidiaries. The term “Bank” is used to refer to Southside Bank wherever a distinction between Southside Bancshares, Inc. and Southside Bank aids in the understanding of this report.

The consolidated balance sheet as of June 30, 2007, and the related consolidated statements of income, shareholders' equity and cash flows and notes to the financial statements for the three and six month periods ended June 30, 2007 and 2006 are unaudited; in the opinion of management, all adjustments necessary for a fair presentation 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, 2006. All share data has been adjusted to give retroactive recognition to stock splits and stock dividends. For a description of our significant accounting and reporting policies, refer to Note 1 of the Notes to Financial Statements in our Annual Report on Form 10-K for the year ended December 31, 2006.

2. Earnings Per Share

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

	Three Months		Six Months	
	Ended June 30,		Ended June 30,	
	2007	2006	2007	2006
<b>Basic Earnings and Shares:</b>				
Net Income	\$ 4,587	\$ 3,543	\$ 8,350	\$ 6,771
Weighted-average basic shares outstanding	13,035	12,853	13,008	12,830
<b>Basic Earnings Per Share:</b>				
Net Income	\$ 0.35	\$ 0.28	\$ 0.64	\$ 0.53
<b>Diluted Earnings and Shares:</b>				
Net Income	\$ 4,587	\$ 3,543	\$ 8,350	\$ 6,771
Weighted-average basic shares outstanding	13,035	12,853	13,008	12,830
Add: Stock options	401	484	421	496

Weighted-average diluted shares outstanding	13,436	13,337	13,429	13,326
<b>Diluted Earnings Per Share:</b>				
Net Income	\$ 0.34	\$ 0.27	\$ 0.62	\$ 0.51

For the three and six month periods ended June 30, 2007 and 2006, there were no antidilutive options.

3. Comprehensive Income (Loss)

The components of other comprehensive income (loss) are as follows (in thousands):

	Six Months Ended June 30, 2007		
	Before-Tax Amount	Tax	Net-of-Tax Amount
		(Expense) Benefit	
Unrealized losses on securities:			
Unrealized holding losses arising during period	\$ (1,888)	\$ 642	\$ (1,246)
Less: reclassification adjustment for gains included in net income	435	(148)	287
Net unrealized losses on securities	(2,323)	790	(1,533)
Adjustment to net periodic benefit cost	262	(89)	173
Other comprehensive loss	\$ (2,061)	\$ 701	\$ (1,360)

	Three Months Ended June 30, 2007		
	Before-Tax Amount	Tax	Net-of-Tax Amount
		(Expense) Benefit	
Unrealized losses on securities:			
Unrealized holding losses arising during period	\$ (5,556)	\$ 1,889	\$ (3,667)
Less: reclassification adjustment for gains included in net income	6	(2)	4
Net unrealized losses on securities	(5,562)	1,891	(3,671)
Adjustment to net periodic benefit cost	104	(35)	69
Other comprehensive loss	\$ (5,458)	\$ 1,856	\$ (3,602)

	Six Months Ended June 30, 2006		
	Before-Tax Amount	Tax	Net-of-Tax Amount
		(Expense) Benefit	
Unrealized losses on securities:			
Unrealized holding losses arising during period	\$ (13,665)	\$ 4,646	\$ (9,019)
Less: reclassification adjustment for gains included in net income	224	(76)	148
Net unrealized losses on securities	(13,889)	4,722	(9,167)
Other comprehensive loss	\$ (13,889)	\$ 4,722	\$ (9,167)

	Three Months Ended June 30, 2006		
	Before-Tax Amount	Tax	Net-of-Tax Amount
		(Expense) Benefit	
Unrealized losses on securities:			
Unrealized holding losses arising during period	\$ (5,982)	\$ 2,034	\$ (3,948)

Less: reclassification adjustment for gains included in net income	101	(34)	67
Net unrealized losses on securities	(6,083)	2,068	(4,015)
Other comprehensive loss	\$ (6,083)	\$ 2,068	\$ (4,015)

7

---



4. Securities

The amortized cost and estimated market value of investment and mortgage-backed securities as of June 30, 2007 and December 31, 2006, are reflected in the tables below (in thousands):

	June 30, 2007			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Market Value
<b>AVAILABLE FOR SALE:</b>				
<b>Investment Securities:</b>				
U.S. Treasury	\$ 18,157	\$ –	\$ 1,051	\$ 17,106
Government Sponsored Enterprise Debentures	8,999	–	2	8,997
State and Political Subdivisions	54,361	1,077	480	54,958
Other Stocks and Bonds	7,591	9	95	7,505
<b>Mortgage-backed Securities:</b>				
U.S. Government Agencies	73,596	274	1,669	72,201
Government Sponsored Enterprises	527,797	896	8,196	520,497
Other Private Issues	6,711	39	122	6,628
<b>Total</b>	<b>\$ 697,212</b>	<b>\$ 2,295</b>	<b>\$ 11,615</b>	<b>\$ 687,892</b>

**HELD TO MATURITY:****Investment Securities:**

Other Stocks and Bonds	\$ 1,353	\$ 14	\$ –	\$ 1,367
------------------------	----------	-------	------	----------

**Mortgage-backed Securities:**

U.S. Government Agencies	28,228	–	621	27,607
Government Sponsored Enterprises	179,034	44	3,485	175,593
<b>Total</b>	<b>\$ 208,615</b>	<b>\$ 58</b>	<b>\$ 4,106</b>	<b>\$ 204,567</b>

	December 31, 2006			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Market Value
<b>AVAILABLE FOR SALE:</b>				
<b>Investment Securities:</b>				
U.S. Treasury	\$ 27,104	\$ –	\$ 721	\$ 26,383
Government Sponsored Enterprise Debentures	9,923	–	–	9,923
State and Political Subdivisions	54,037	1,488	390	55,135
Other Stocks and Bonds	7,611	12	112	7,511
<b>Mortgage-backed Securities:</b>				
U.S. Government Agencies	72,183	425	1,209	71,399
Government Sponsored Enterprises	570,777	1,250	7,377	564,650
Other Private Issues	7,190	20	95	7,115
<b>Total</b>	<b>\$ 748,825</b>	<b>\$ 3,195</b>	<b>\$ 9,904</b>	<b>\$ 742,116</b>

**HELD TO MATURITY:****Investment Securities:**

Other Stocks and Bonds	\$ 1,351	\$ 7	\$ 16	\$ 1,342
------------------------	----------	------	-------	----------

**Mortgage-backed Securities:**

U.S. Government Agencies	30,788	–	407	30,381
--------------------------	--------	---	-----	--------

Edgar Filing: SOUTHSIDE BANCSHARES INC - Form 10-Q

Government Sponsored Enterprises	195,374	97	3,104	192,367
<b>Total</b>	<b>\$ 227,513</b>	<b>\$ 104</b>	<b>\$ 3,527</b>	<b>\$ 224,090</b>

The Bank concluded that, based on the creditworthiness of the issuer, the unrealized loss on each security in the above table represents a temporary impairment and does not require adjustment to the carrying amount of any of the individual securities. Additionally, the Bank has the ability and the intent to hold such securities through recovery of the unrealized losses.

Investment and mortgage-backed securities with book values of \$322.9 million at June 30, 2007 and \$454.6 million at December 31, 2006 were pledged to collateralize FHLB advances, public funds, trust deposits, repurchase agreements and for other purposes, as required or permitted by law.

8

---

## 5. Loans and Allowance for Probable Loan Losses

The following table sets forth loan totals by category for the periods presented (in thousands):

	At June 30, 2007	At December 31, 2006
<b>Real Estate Loans:</b>		
Construction	\$ 46,876	\$ 39,588
1-4 Family Residential	223,996	227,354
Other	177,918	181,047
Commercial Loans	125,609	118,962
Municipal Loans	110,416	106,155
Loans to Individuals	83,924	86,041
Total Loans	\$ 768,739	\$ 759,147

The summaries of the Allowance for Loan Losses are as follows (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
Balance at beginning of period	\$ 7,261	\$ 7,193	\$ 7,193	\$ 7,090
Provision for loan losses	217	448	334	729
Loans charged off	(616)	(744)	(1,209)	(1,447)
Recoveries of loans charged off	505	449	1,049	974
Balance at end of period	\$ 7,367	\$ 7,346	\$ 7,367	\$ 7,346

6. Employee Benefit Plans

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

	Six Months Ended June 30,			
	Defined Benefit			
	Pension Plan		Restoration Plan	
	2007	2006	2007	2006
Service cost	\$ 665	\$ 669	\$ 31	\$ 34
Interest cost	1,156	1,095	84	92
Expected return on assets	(1,264)	(1,162)	–	–
Transition obligation recognition	–	–	1	1
Net loss recognition	241	392	42	90
Prior service credit amortization	(21)	(21)	(1)	(1)
Net periodic benefit cost	\$ 777	\$ 973	\$ 157	\$ 216

	Three Months Ended June 30,			
	Defined Benefit			
	Pension Plan		Restoration Plan	
	2007	2006	2007	2006
Service cost	\$ 356	\$ 347	\$ 16	\$ 16
Interest cost	566	548	39	43
Expected return on assets	(631)	(581)	–	–
Transition obligation recognition	–	–	–	–
Net loss recognition	105	203	10	40
Prior service credit amortization	(11)	(21)	–	(1)
Net periodic benefit cost	\$ 385	\$ 496	\$ 65	\$ 98

## Employer Contributions

We previously disclosed in our financial statements for the year ended December 31, 2006, that we expected to contribute \$3.0 million to our defined benefit pension plan and \$88,000 to our post retirement benefit plan in 2007. As of June 30, 2007, we had contributed \$3.0 million to the defined benefit pension plan, and \$40,000 of contributions had been made to the post retirement benefit plan.

## 7. Incentive Stock Options

In April 1993, we adopted the Southside Bancshares, Inc. 1993 Incentive Stock Option Plan ("the ISO Plan"), a stock-based incentive compensation plan. The ISO Plan expired March 31, 2003. Prior to January 1, 2006, we applied APB Opinion 25 and related Interpretations in accounting for the ISO Plan and disclosed the pro forma information required by SFAS 123 and SFAS 148. There was no compensation expense recognized for the stock options prior to January 1, 2006.

A summary of the status of our nonvested shares as of June 30, 2007 is as follows:

	<b>Six Months Ended June 30, 2007</b>	
	<b>Number of Options</b>	<b>Weighted Average Grant-Date Fair Value</b>
Nonvested at beginning of the period	12,257	\$ 4.91
Vested	(6,127)	\$ 4.91
Cancelled	(383)	\$ 4.91
Nonvested at end of period	5,747	\$ 4.91

For the three and six months ended June 30, 2007 and 2006, we recorded approximately \$7,000 and \$14,000, respectively, of stock-based compensation expense. As of June 30, 2007 and 2006, there was \$20,000 and \$47,000, respectively, of total unrecognized compensation cost related to the ISO Plan for nonvested options granted in March 2003. The cost is expected to be recognized over a weighted-average period of 9 months.

The fair value of each stock option granted is estimated on the date of grant using the Black-Scholes method of option pricing with the following weighted-average assumptions for grants in 2003: dividend yield of 1.93%; risk-free interest rate of 4.93%; expected life of 6 years; and expected volatility of 28.90%.

Under the ISO Plan, we were authorized to issue shares of common stock pursuant to "Awards" granted in the form of incentive stock options (intended to qualify under Section 422 of the Internal Revenue Code of 1986, as amended). Before the ISO Plan expired, awards were granted to selected employees and directors. No stock options have been available for grant under the ISO Plan since its expiration in March 2003. Currently, we do not offer share-based payment programs to our employees.

The ISO Plan provided that the exercise price of any stock option not be less than the fair market value of the common stock on the date of grant. The outstanding stock options have contractual terms of 10 years. All options vest on a graded schedule, 20% per year for 5 years, beginning on the first anniversary date of the grant date.

A summary of the status of our stock options as of June 30, 2007 and the changes during the six months ended on those dates is presented below:

	<b>Number of Options</b>	<b>Weighted Average Exercise Prices</b>	<b>Weighted Average Remaining Contract Life (Years)</b>	<b>Aggregate Intrinsic Value (in thousands)</b>

Edgar Filing: SOUTHSIDE BANCSHARES INC - Form 10-Q

Outstanding at December 31, 2006	604,281	\$	5.76		
Exercised	(90,601)	\$	5.43		
Cancelled	(383)	\$	12.61		
Outstanding at June 30, 2007	513,297	\$	5.82	2.60	\$ 8,278
Exercisable at June 30, 2007	507,550	\$	5.74	2.56	\$ 8,226

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 on exercise date) of stock options exercised during the six months ended June 30, 2007 and 2006 were \$1.5 million and \$1.1 million, respectively.

Cash received from stock option exercises for the six months ended June 30, 2007 and 2006 was \$360,000 and \$396,000, respectively. The tax benefit realized for the deductions related to the stock option exercises were \$21,000 and \$41,000 for the six months ended June 30, 2007 and 2006, respectively.

## 8. Accounting Pronouncements

### Statements of Financial Accounting Standards

SFAS No. 159, “The Fair Value Option for Financial Assets and Financial Liabilities, including an amendment of FASB Statement No. 115.” SFAS 159, issued by the Financial Accounting Standards Board (“FASB”) in February 2007, allows entities to irrevocably elect fair value as the initial and subsequent measurement attribute for certain financial assets and financial liabilities that are not otherwise required to be measured at fair value, with changes in fair value recognized in earnings as they occur. SFAS 159 also requires entities to report those financial assets and financial liabilities measured at fair value in a manner that separates those reported fair values from the carrying amounts of similar assets and liabilities measured using another measurement attribute on the face of the statement of financial position. Lastly, SFAS 159 establishes presentation and disclosure requirements designed to improve comparability between entities that elect different measurement attributes for similar assets and liabilities. SFAS 159 is effective for fiscal years beginning after November 15, 2007, with early adoption permitted if an entity also early adopts the provisions of SFAS 157. We intend to adopt SFAS 159 on January 1, 2008. We have not yet determined if, or to what extent, we will elect to use the fair value option to value our financial assets and liabilities or the impact that the implementation of SFAS 159 will have on our consolidated financial statements.

SFAS No. 157, “Fair Value Measurements.” SFAS 157 defines fair value, establishes a framework for measuring fair value in GAAP, and expands disclosures about fair value measurements. SFAS 157 is effective for us on January 1, 2008 and is not expected to have a material impact on our consolidated financial statements.

SFAS No. 155, “Accounting for Certain Hybrid Financial Instruments — an amendment of FASB Statements No. 133 and 140.” SFAS 155 amends SFAS 133, “Accounting for Derivative Instruments and Hedging Activities” and SFAS 140, “Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities.” SFAS 155 permits, but does not require, fair value accounting for hybrid financial instruments that contain an embedded derivative that would otherwise require bifurcation in accordance with SFAS 133. SFAS 155 also eliminated the temporary exemption for interests in securitized financial assets provided for by SFAS 133, Derivatives Implementation Group (“DIG”) Issue D1, “Application of Statement 133 to Beneficial Interests in Securitized Financial Assets.” However, in January 2007, the FASB issued interpretive guidance in SFAS 133, DIG Issue B40, “Application of Paragraph 13(b) to Securitized Interests in Prepayable Financial Assets.” In DIG Issue B40, the FASB concluded that a securitized interest in prepayable financial assets was not subject to the bifurcation requirements of SFAS 155 provided that the interest met both the following criteria: (1) the right to accelerate the settlement of the securitized interest cannot be controlled by the investor; and (2) the securitized interest itself does not contain an embedded derivative for which bifurcation would be required other than an embedded derivative that results solely from the embedded call options in the underlying financial assets. The guidance in DIG Issue B40 is effective upon the adoption of SFAS 155. SFAS 155 was effective for all financial instruments acquired or issued after December 31, 2006 as well as to those hybrid financial instruments that had been previously bifurcated under SFAS 133. The adoption of SFAS 155 did not have a material impact on our consolidated financial statements.

### Emerging Issues Task Force Consensuses

In September 2006, the Emerging Issues Task Force (“EITF”) reached a final consensus on Issue 06-4, “Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements.” EITF 06-4 requires that for a split-dollar life insurance arrangement, an employer should recognize a liability for future benefits in accordance with SFAS 106, “Employers' Accounting for Postretirement Benefits Other Than Pensions.” Under the guidance, the purchase of an endorsement type policy does not constitute a settlement since the policy does not qualify as nonparticipating because the policyholders are subject to the favorable and unfavorable experience of the insurance company. EITF 06-4 is effective for fiscal years beginning after December 15, 2007. We are currently assessing the impact of the adoption of EITF 06-4 on our consolidated financial statements.

In September 2006, the EITF reached a final consensus on Issue 06-5, "Accounting for Purchases of Life Insurance." EITF 06-5 provides guidance on FASB Technical Bulletin No. 85-4, "Accounting for Purchases of Life Insurance." Under the guidance, the policyholder should consider any additional amounts included in the contractual terms of the policy in determining the amount that could be realized under the insurance contract. In addition, the policyholder should also determine the amount that could be realized under the life insurance contract assuming the surrender of an individual-life by individual-life policy. EITF 06-5 was effective for fiscal years beginning after December 15, 2006. The adoption of EITF 06-5 did not have a material impact on our consolidated financial statements.



## Financial Accounting Standards Board Staff Positions and Interpretations

FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement 109." FASB Interpretation No. 48 ("FIN 48") prescribes a recognition threshold and a measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. Benefits from tax positions should be recognized in the financial statements only when it is more likely than not that the tax position will be sustained upon examination by the appropriate taxing authority that would have full knowledge of all relevant information. A tax position that meets the more-likely-than-not recognition threshold is measured at the largest amount of benefit that is greater than fifty percent likely of being realized upon ultimate settlement. Tax positions that previously failed to meet the more-likely-than-not recognition threshold should be recognized in the first subsequent financial reporting period in which that threshold is met. Previously recognized tax positions that no longer meet the more-likely-than-not recognition threshold should be derecognized in the first subsequent financial reporting period in which that threshold is no longer met. Interpretation 48 also provides guidance on the accounting for and disclosure of unrecognized tax benefits, interest and penalties.

We adopted the provisions of FIN 48 on January 1, 2007. As of the date of adoption, we had no unrecognized tax benefits and thus had accrued no interest or penalties on such benefits. At adoption, we did not anticipate a significant increase in unrecognized tax benefits during the subsequent 12 months. As of January 1, 2007, our 2003 through 2006 tax years were open to examination by the Internal Revenue Service and state taxing jurisdictions. There were no material changes in these items during the current quarter. While we typically do not incur significant interest or penalties on income tax liabilities, it is our policy to classify such amounts as interest expense and miscellaneous expense, respectively. We did not change our policy on classification of interest and penalties upon adoption of FIN 48.

## 9. 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 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 \$118.0 million and \$99.5 million at June 30, 2007 and 2006, 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 June 30, 2007 and 2006 were \$9.3 million and \$7.9 million, respectively, and are reflected in the due after one year category. We had outstanding standby letters of credit of \$3.9 million and \$3.6 million at June 30, 2007 and 2006, respectively.

The scheduled maturities of unused commitments as of June 30, 2007 and 2006 were as follows (in thousands):

	June 30,	
	2007	2006
<b>Unused commitments:</b>		
Due in one year or less	\$ 87,271	\$ 57,812
Due after one year	30,691	41,697
Total	\$ 117,962	\$ 99,509

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 credit worthiness 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 and 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 \$941,000 of unsettled trades to purchase and no unsettled trades to sell securities at June 30, 2007. At December 31, 2006, there were no unsettled trades to purchase or sell securities.

*Litigation.* We are subject to 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 and results of operations or our liquidity.

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 presentation and in our Annual Report on Form 10-K for the year ended December 31, 2006.

We reported an increase in net income for the three months and six months ended June 30, 2007 compared to the same periods in 2006. Net income for the three and six months ended June 30, 2007 was \$4.6 million and \$8.4 million, respectively, compared to \$3.5 million and \$6.8 million, respectively, for the same periods in 2006.

All share data has been adjusted to give retroactive recognition to stock splits and stock dividends.

Forward Looking Statements

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

- general economic conditions, either globally, nationally, in the State of Texas, or in the specific markets in which we operate;
- legislation, regulatory changes or changes in monetary or fiscal policy that adversely affect the businesses in which we are engaged;
- 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;
  - economic or other disruptions caused by acts of terrorism in the United States, Europe or other areas;
- changes in the interest rate yield curve such as flat, inverted or steep yield curves, or changes in the interest rate environment that impact interest margins and may impact prepayments on the mortgage-backed securities portfolio;
  - unexpected outcomes of existing or new litigation involving us;
  - changes impacting the leverage strategy;
  - significant increases in competition in the banking and financial services industry;
  - changes in consumer spending, borrowing and saving habits;
  - technological changes;
  - our ability to increase market share and control expenses;
  - the effect of changes in federal or state tax laws;

- the effect of compliance with legislation or regulatory changes;
- the effect of changes in accounting policies and practices;
- the costs and effects of unanticipated litigation;
- risks of mergers and acquisitions including the related time and cost of implementing transactions and the potential failure to achieve expected gains, revenue growth or expense savings; and
- failure of assumptions underlying allowance for loan losses and other estimates.

Additional information concerning us and our business, including additional factors that could materially affect our financial results, is included in our filings with the Securities and Exchange Commission. 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.

Critical Accounting Estimates

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

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

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

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

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

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

As of June 30, 2007, our review of the loan portfolio indicated that a loan loss allowance of \$7.4 million was adequate 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 1 - Summary of Significant Accounting and Reporting Policies" of the Notes to Consolidated Financial Statements in our Annual Report on Form 10-K for the year ended December 31, 2006 for a detailed description of our estimation process and methodology related to the allowance for loan losses.

*Estimation of Fair Value.* The estimation of fair value is significant to a number of our assets and liabilities. GAAP requires disclosure of the fair value of financial instruments as a part of the notes to the consolidated financial statements. Fair values are volatile and may be influenced by a number of factors, including market interest rates, prepayment speeds, discount rates and the shape of yield curves.

Fair values for most investment and mortgage-backed securities are based on quoted market prices, where available. If quoted market prices are not available, fair values are based on the quoted prices of similar instruments. The fair value of fixed rate loans is estimated by discounting the future cash flows using the current rates at which similar loans would be made to borrowers with similar credit ratings and for the same remaining

16

---

maturities. Nonperforming loans are estimated using discounted cash flow analyses or underlying value of the collateral where applicable. Fair values for fixed rate certificates of deposits are estimated using a discounted cash flow calculation that applies interest rates currently being offered for deposits of similar remaining maturities. The fair value of Federal Home Loan Bank (“FHLB”) advances is estimated by discounting the future cash flows using rates at which advances would be made to borrowers with similar credit ratings and for the same remaining maturities. The fair values of other real estate owned (“OREO”) are typically determined based on appraisals by third parties, less estimated costs to sell, and recorded at the lower of cost or fair value.

*Impairment of Investment Securities and Mortgage-backed Securities.* Investment and mortgage-backed securities classified as available for sale (“AFS”) are carried at fair value and the impact of changes in fair value are recorded on our consolidated balance sheet as an unrealized gain or loss in “Accumulated other comprehensive income (loss),” a separate component of shareholders’ equity. Securities classified as AFS or held to maturity (“HTM”) are subject to our review to identify when a decline in value is other than temporary. Factors considered in determining whether a decline in value is other than temporary include: whether the decline is substantial; the duration of the decline; the reasons for the decline in value; whether the decline is related to a credit event or to a change in interest rate; our ability and intent to hold the investment for a period of time that will allow for a recovery of value; and the financial condition and near-term prospects of the issuer. When it is determined that a decline in value is other than temporary, the carrying value of the security is reduced to its estimated fair value, with a corresponding charge to earnings.

*Defined Benefit Pension Plan.* The plan obligations and related assets of the defined benefit pension plan (the “Plan”) are presented in “Note 12 – Employee Benefits” of the Notes to Consolidated Financial Statements in our Annual Report on Form 10-K for the year ended December 31, 2006. Plan assets, which consist primarily of marketable equity and debt instruments, are valued using market quotations. Plan obligations and the annual pension expense are determined by independent actuaries and through the use of a number of assumptions. Key assumptions in measuring the plan obligations include the discount rate, the rate of salary increases and the estimated future return on plan assets. In determining the discount rate, we utilized a cash flow matching analysis to determine a range of appropriate discount rates for our defined benefit pension and restoration plans. In developing the cash flow matching analysis, we constructed a portfolio of high quality non-callable bonds (rated AA- or better) to match as close as possible the timing of future benefit payments of the plans at December 31, 2006. Based on this cash flow matching analysis, we were able to determine an appropriate discount rate.

Salary increase assumptions are based upon historical experience and our anticipated future actions. The expected long-term rate of return assumption reflects the average return expected based on the investment strategies and asset allocation on the assets invested to provide for the Plan’s liabilities. We considered broad equity and bond indices, long-term return projections, and actual long-term historical Plan performance when evaluating the expected long-term rate of return assumption. At June 30, 2007, the weighted-average actuarial assumptions of the Plan were: a discount rate of 6.05%; a long-term rate of return on plan assets of 7.50%; 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 June 30, 2007 and 2006, are included in “Note 9 – Off-Balance-Sheet Arrangements, Commitments and Contingencies” in the accompanying Notes to Financial Statements included in this report.

#### Leverage Strategy



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

Risks associated with the asset structure we maintain include a lower net interest rate spread and margin when compared to our peers, changes in the slope of the yield curve, which can reduce our net interest rate spread and margin, increased interest rate risk, the length of interest rate cycles, and the unpredictable nature of mortgage-backed securities prepayments. See “Item 1A. Risk Factors – Risks Related to our Business” in our Annual Report on Form 10-K for the year ended December 31, 2006. During 2006, the interest rate yield curve inverted. An inverted yield curve is defined as shorter term interest rates at a higher level than longer term interest rates. During the quarter ended June 30, 2007, longer term interest rates increased faster than shorter term interest rates and at June 30, 2007, the U. S. Treasury yield curve was no longer inverted. Should the yield curve invert again, our net interest margin and spread could decrease. Our asset structure, net interest spread and net interest margin require an increase in the need to monitor our interest rate risk. An additional risk is the change in market value of the AFS securities portfolio as a result of changes in interest rates. Significant increases in interest rates, especially long-term interest rates, could adversely impact the market value of the AFS securities portfolio which could also significantly impact our equity capital. Due to the unpredictable nature of mortgage-backed securities prepayments, the length of interest rate cycles, and the slope of the interest rate yield curve, net interest income could fluctuate more than simulated under the scenarios modeled by our Asset/Liability Committee (“ALCO”) and described under “Item 3. Quantitative and Qualitative Disclosures about Market Risk” in this report.

The management of the securities portfolio as a percent of earning assets is guided by changes in our overall loan and deposit levels combined with changes in our wholesale funding levels. If adequate quality loan growth is not available to achieve our goal of enhancing profitability by maximizing the use of capital, as described above, then we could purchase additional securities, if appropriate, which could cause securities as a percentage of earning assets to increase. Should we determine that increasing the securities portfolio or replacing the current securities maturities and principal payments is not an efficient use of capital, we could adjust the level of securities through proceeds from maturities, principal payments on mortgage-backed securities or sales. During the quarter ended June 30, 2007, our loan growth was less than desired but due to the yield curve, we determined a slight decrease in the securities portfolio as a percentage of total assets was appropriate. At June 30, 2007, the securities portfolio as a percentage of total assets decreased to 50.1% from 50.7% at March 31, 2007 and 52.7% at December 31, 2006. The current interest rate environment is more investment friendly and changes to the securities portfolio as a percent of earning assets will be guided by changes in our loan and deposit levels during the third quarter of 2007. During the first six months of 2007, we reduced our investment and mortgage-backed securities approximately \$70.5 million as investment and mortgage-backed securities excluding the net unrealized loss on available for sale securities decreased from \$976.3 million at December 31, 2006 to \$905.8 million at June 30, 2007. Our strategy will be reevaluated as market conditions warrant. The leverage strategy is dynamic and requires ongoing management. As interest rates, yield curves, mortgage-backed securities prepayments, funding costs and security spreads change, our determination of the proper types and maturities of securities to own, proper amount of securities to own and funding needs and funding sources will continue to be reevaluated.

With respect to liabilities, we will continue to utilize a combination of FHLB advances and deposits to achieve our strategy of minimizing cost while achieving overall interest rate risk objectives as well as the liability management objectives of the ALCO. The FHLB funding and the brokered CDs represent wholesale funding sources. Our FHLB borrowings at June 30, 2007 decreased 27.1%, or \$122.4 million, to \$329.2 million from \$451.6 million at December 31, 2006 as a result of the decrease in the securities portfolio and an increase in deposits in excess of loan growth. During the second quarter ended June 30, 2007, FHLB borrowings decreased \$24.5 million due to an increase in deposits in excess of loan growth. During the quarter and six months ended June 30, 2007, we did not issue any additional callable brokered CDs. At June 30, 2007, our callable brokered CDs totaled \$123.4 million. These brokered CDs have maturities from approximately 1 to 4.5 years and have calls that we control, all of which are currently six months or less. During the last twelve months we utilized long-term brokered CDs to a greater extent than long-term FHLB funding because the brokered CDs better matched overall ALCO objectives by protecting Southside Bank with fixed rates should interest rates increase, while providing Southside Bank options to call the funding should interest rates decrease. Our wholesale funding policy currently allows maximum brokered CDs of \$150 million; however, this amount could be increased to match changes in ALCO objectives. The potential

higher interest expense and lack of customer loyalty are risks associated with the use of brokered CDs. Due to the non-brokered deposit growth and the decrease in FHLB borrowings during the quarter and six months ended June 30, 2007, our total wholesale funding as a percentage of deposits, not including brokered CDs, decreased to 37.3% at June 30, 2007, from 40.2% at March 31, 2007, and 49.6% at December 31, 2006, reflective of our strategy to deleverage during these periods.

### Net Interest Income

Net interest income is the difference between interest income earned on assets (loans and investments) and interest expense due on our funding sources (deposits and borrowings) during a particular period.

Net interest income for the six months ended June 30, 2007 was \$20.1 million, a decrease of \$1.0 million, or 4.8%, when compared to the same period in 2006. Average interest earning assets increased \$9.9 million, or 0.6%, to \$1.73 billion, while the net interest spread decreased from 1.99% for the six months ended June 30, 2006 to 1.68% for the same period in 2007 and the net interest margin decreased from 2.67% for the six months ended June 30, 2006 to 2.52% for the same period in 2007. Net interest income decreased as a result of decreases in our net interest spread and net interest margin during the six months of 2007 when compared to the same period in 2006, which more than offset the increase in our average interest earning assets.

For the three months ended June 30, 2007, when compared to the same period in 2006, net interest income decreased \$476,000, or 4.5%, to \$10.1 million, primarily as a result of a decrease in our net interest margin and spread and a decrease in our average earning assets. For the three months ended June 30, 2007, when compared to the same period in 2006, average interest earning assets decreased \$51.3 million, or 2.9%, to \$1.69 billion, and the net interest margin and net interest spread decreased to 2.57% and 1.71%, respectively, from 2.61% and 1.90%, respectively. The decrease in our net interest margin and net interest spread was due primarily to the increase in short-term funding costs during the three months ended June 30, 2007 when compared to the same period in 2006. Future changes in interest rates or the yield curve could influence our net interest margin and net interest spread during future quarters. Future changes in interest rates could also impact prepayment speeds on our mortgage-backed securities, which could influence our net interest margin and net interest spread during future quarters.

During the six months ended June 30, 2007, average loans, funded by the growth in average deposits, increased \$62.3 million, or 8.8%, to \$767.2 million, compared to \$704.8 million for the same period in 2006. The average yield on loans increased from 6.57% for the six months ended June 30, 2006 to 6.90% for the six months ended June 30, 2007. For the three months ended June 30, 2007, average loans increased \$53.3 million, or 7.5%, to \$768.7 million, compared to \$715.4 million for the same period in 2006. The average yield on loans increased from 6.62% for the three months ended June 30, 2006 to 6.91% for the three months ended June 30, 2007. The increase in interest income on loans of \$3.3 million, or 15.0%, to \$25.2 million for the six months ended June 30, 2007, when compared to \$22.0 million for the same period in 2006, and the increase in interest income on loans of \$1.4 million, or 12.4%, to \$12.7 million for the three months ended June 30, 2007, when compared to \$11.3 million for the same period in 2006 was the result of an increase in average loans and the average yield. The rate at which loan yields are increasing has been partially impacted by repricing characteristics of the loans, interest rates at the time the loans repriced, and the competitive loan pricing environment. Due to the competitive loan pricing environment, we anticipate that we may be required to continue to offer lower interest rate loans that compete with those offered by other financial institutions in order to retain quality loan relationships. Offering lower interest rate loans could impact the overall loan yield and, therefore profitability.

Average investment and mortgage-backed securities decreased \$45.5 million, or 4.6%, to \$933.4 million, for the six months ended June 30, 2007, when compared to \$978.9 million for the same period in 2006. This decrease was the result of implementing a strategy designed to reduce our overall leverage. The overall yield on average investment and mortgage-backed securities increased to 5.18% during the six months ended June 30, 2007, from 5.01% during the same period in 2006. Interest income on investment and mortgage-backed securities for the six months ended June 30, 2007 decreased \$251,000, or 1.1%, to \$23.6 million compared to \$23.8 million for the same period in 2006. For the three months ended June 30, 2007, average investment and mortgage-backed securities decreased \$94.7 million, or 9.6%, to \$895.4 million, when compared to \$990.0 million for the same period in 2006, which is also reflective of the strategy to reduce our balance sheet leverage during that time. The overall yield on average

investment and mortgage-backed securities increased to 5.15% during the three months ended June 30, 2007, from 5.05% during the same period in 2006. Interest income from investment and mortgage-backed securities decreased \$949,000, or 7.8%, to \$11.3 million for the three months ended June 30, 2007, compared to \$12.2 million for the same period in 2006. The decrease in interest income for the three and six month periods ending June 30, 2007 was due to the decrease in the average balance which more than offset the increase in the average yield. The increase in the average yield primarily reflects decreased prepayment rates on mortgage-backed securities, which led to decreased amortization expense, combined with reinvestment of proceeds from lower-yielding matured securities into higher yielding securities due to the overall higher interest rate environment. The overall higher interest rate environment during 2007 when compared to 2006 contributed to a decrease in residential mortgage refinancing nationwide and in our market area. The decrease in prepayments on mortgage loans combined with a previous restructuring of the securities portfolio reduced overall amortization expense which contributed to the increase in interest income. A return to lower long-term interest rate levels similar to that experienced in May and June of 2003 could impact our net interest margin in the future due to increased prepayments and repricing.

Average FHLB stock and other investments decreased \$7.5 million, or 25.9%, to \$21.5 million, for the six months ended June 30, 2007 when compared to \$29.1 million for the same period in 2006 due to the decrease in FHLB Dallas advances. The average yield of FHLB stock and other investments increased to 6.56% for the six months ended June 30, 2007, when compared to 4.82% for the same period in 2006 due to the higher average short-term interest rates. Interest income from our FHLB stock and other investments increased \$6,000, or 0.9%, to \$700,000 for the six months ended June 30, 2007, when compared to \$694,000 for the same period in 2006 due to increases in the average yield which more than offset the decrease in average balance. For the three months ended June 30, 2007, average FHLB stock and other investments decreased \$10.7 million, or 37.6%, to \$17.8 million, when compared to \$28.5 million for the same period in 2006. For the three months ended June 30, 2007, interest income from FHLB stock and other investments decreased \$20,000, or 5.7%, to \$330,000, when compared to \$350,000 for the same period in 2006 as a result of the decrease in the average balance which more than offset the increase in the average yield from 4.92% in 2006 to 7.45% in 2007.

Average federal funds sold and other interest earning assets increased \$1.3 million, or 94.4%, to \$2.7 million, for the six months ended June 30, 2007, when compared to \$1.4 million for the same period in 2006. Interest income from federal funds sold and other interest earning assets increased \$37,000, or 115.6%, for the six months ended June 30, 2007, when compared to the same period in 2006, as a result of the increase in the average balance and yield from 4.66% in 2006 to 5.17% in 2007, which was due to the higher average short-term interest rates. Average federal funds sold and other interest earning assets increased \$1.1 million, or 82.4%, to \$2.5 million, for the three months ended June 30, 2007, when compared to \$1.4 million for the same period in 2006. Interest income from federal funds sold and other interest earning assets increased \$19,000, or 135.7%, for the three months ended June 30, 2007, when compared to the same period in 2006, as a result of the increase in the average balance and the average yield from 4.10% in 2006 to 5.31% in 2007.

Total interest expense increased \$4.1 million, or 16.2%, to \$29.5 million during the six months ended June 30, 2007 as compared to \$25.4 million during the same period in 2006. The increase was primarily attributable to an increase in the average yield on interest bearing liabilities from 3.65% for the six months ended June 30, 2006 to 4.28% for the six months ended June 30, 2007. Average interest bearing liabilities decreased \$11.3 million, or 0.8%, for the six months ended June 30, 2007 as compared to the same period in 2006. For the three months ended June 30, 2007, total interest expense increased \$931,000, or 7.0%, to \$14.3 million, compared to \$13.4 million for the same period in 2006 primarily as a result of an increase in the average yield on interest bearing liabilities. Average interest bearing liabilities decreased \$73.4 million, or 5.2%, while the average yield on interest bearing liabilities increased from 3.79% for the three month period ended June 30, 2006 to 4.27% for the three month period ended June 30, 2007.

Average interest bearing deposits increased \$143.3 million, or 17.0%, to \$985.1 million during the six months ended June 30, 2007, when compared to \$841.9 million for the same period in 2006, and the average rate paid increased from 3.27% for the six month period ended June 30, 2006 to 4.01% for the same period in 2007. For the three months ended June 30, 2007, average interest bearing deposits increased \$131.0 million, or 15.1%, when compared to the same period in 2006 and the average rate paid increased from 3.43% for the three month period ended June 30, 2006 to 4.03% for the three month period ended June 30, 2007. The largest increase in average interest bearing deposits resulted from the issuance of callable brokered CDs. The remaining increase in our average total deposits is the result of overall bank growth and branch expansion. Interest expense for interest bearing deposits for the three and six months ended June 30, 2007 increased \$2.6 million, or 35.4%, and \$5.9 million, or 43.4%, when compared to the same periods in 2006 due to the increase in the average balance and yield.

Average short-term interest bearing liabilities, consisting primarily of FHLB advances and federal funds purchased, decreased \$88.3 million, or 23.9%, to \$280.7 million for the six months ended June 30, 2007, when compared to \$369.0 million for the same period in 2006. Interest expense associated with short-term interest bearing liabilities decreased \$865,000, or 11.4%, and the average rate paid increased 68 basis points to 4.83% for the six month period

ended June 30, 2007 when compared to 4.15% for the same period in 2006. For the three months ended June 30, 2007, average short-term interest bearing liabilities decreased \$146.7 million, or 38.8%, when compared to the same period in 2006. Interest expense associated with short-term interest bearing liabilities decreased \$1.3 million, or 31.2%, while the average rate paid increased 52 basis points to 4.80% for the three month period ended June 30, 2007 when compared to 4.28% for the same period in 2006. The decrease in the interest expense for the three and six month periods ended June 30, 2007 when compared to 2006 was due to the decrease in the average balance for short-term interest bearing liabilities which more than offset the increase in the average yield.

Average long-term interest bearing liabilities consisting of FHLB advances decreased \$66.2 million, or 39.0%, during the six months ended June 30, 2007 to \$103.5 million as compared to \$169.7 million for the six month period ending June 30, 2006. The decrease in the average long-term FHLB advances occurred primarily as a result of long-term FHLB advances moving into the short-term FHLB advances category combined with the increase in the use of brokered CDs to better match ALCO objectives. Interest expense associated with long-term FHLB advances decreased \$1.0 million, or 30.7%, while the average rate paid increased 55 basis points to 4.52% for the six months ended June 30, 2007 when compared to 3.97% for the same period in 2006. For the three months ended June 30, 2007, long-term interest bearing liabilities decreased \$57.7 million, or 38.0%, when compared to the same period in 2006. Interest expense associated with long-term FHLB advances decreased \$448,000, or 29.2%, and the average rate paid increased 58 basis points to 4.63% for the three month period ended June 30, 2007 when compared to 4.05% for the same period in 2006. The decrease in interest expense was due to the decrease in the average balance of long-term interest bearing liabilities more than offsetting the increase in the average rate paid. FHLB advances are collateralized by FHLB stock, securities and nonspecific real estate loans.

Average long-term debt, consisting entirely of our junior subordinated debentures issued in 2003 in connection with the issuance of trust preferred securities by our subsidiary Southside Statutory Trust III, was \$20.6 million for the three and six months ended June 30, 2007 and 2006. Interest expense increased \$62,000, or 7.8%, to \$860,000 for the six months ended June 30, 2007 when compared to \$798,000 for the same period in 2006 as a result of the increase in three-month LIBOR due to higher short-term interest rates during 2007 when compared to 2006. Interest expense increased \$19,000, or 4.6%, to \$432,000 for the three months ended June 30, 2007 when compared to \$413,000 for the same period in 2006. The long-term debt adjusts quarterly at a rate equal to three-month LIBOR plus 294 basis points.



## 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)						
Six Months Ended						
	June 30, 2007			June 30, 2006		
	AVG BALANCE	INTEREST	AVG YIELD	AVG BALANCE	INTEREST	AVG YIELD
<b>ASSETS</b>						
<b>INTEREST EARNING ASSETS:</b>						
Loans(1) (2)	\$ 767,168	\$ 26,259	6.90%	\$ 704,827	\$ 22,952	6.57%
Loans Held For Sale	3,884	96	4.98%	4,645	117	5.08%
<b>Securities:</b>						
Investment Securities (Taxable)(4)	59,374	1,452	4.93%	59,593	1,337	4.52%
Investment Securities (Tax-Exempt)(3)(4)	40,893	1,449	7.15%	44,994	1,591	7.13%
Mortgage-backed and Related Securities (4)	833,161	21,097	5.11%	874,318	21,386	4.93%
<b>Total Securities</b>	<b>933,428</b>	<b>23,998</b>	<b>5.18%</b>	<b>978,905</b>	<b>24,314</b>	<b>5.01%</b>
Federal Home Loan Bank stock and other investments, at cost	21,517	700	6.56%	29,056	694	4.82%
Interest Earning Deposits	551	17	6.22%	691	17	4.96%
Federal Funds Sold	2,140	52	4.90%	693	15	4.36%
<b>Total Interest Earning Assets</b>	<b>1,728,688</b>	<b>51,122</b>	<b>5.96%</b>	<b>1,718,817</b>	<b>48,109</b>	<b>5.64%</b>
<b>NONINTEREST EARNING ASSETS:</b>						
Cash and Due From Banks	42,669			45,926		
Bank Premises and Equipment	33,952			33,534		
Other Assets	43,359			41,854		
Less: Allowance for Loan Loss	(7,298)			(7,139)		
<b>Total Assets</b>	<b>\$ 1,841,370</b>			<b>\$ 1,832,992</b>		
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>						
<b>INTEREST BEARING LIABILITIES:</b>						
Savings Deposits	\$ 51,815	334	1.30%	\$ 50,663	312	1.24%
Time Deposits	540,684	13,072	4.88%	433,362	8,827	4.11%
Interest Bearing Demand Deposits	392,614	6,184	3.18%	357,837	4,519	2.55%
<b>Total Interest Bearing Deposits</b>	<b>985,113</b>	<b>19,590</b>	<b>4.01%</b>	<b>841,862</b>	<b>13,658</b>	<b>3.27%</b>
Short-term Interest Bearing Liabilities	280,657	6,722	4.83%	368,963	7,587	4.15%
Long-term Interest Bearing Liabilities – FHLB Dallas	103,515	2,318	4.52%	169,749	3,345	3.97%

Edgar Filing: SOUTHSIDE BANCSHARES INC - Form 10-Q

Long-term Debt (5)	20,619	860	8.30%	20,619	798	7.70%
<b>Total Interest Bearing Liabilities</b>	<b>1,389,904</b>	<b>29,490</b>	<b>4.28%</b>	<b>1,401,193</b>	<b>25,388</b>	<b>3.65%</b>
<b>NONINTEREST BEARING LIABILITIES:</b>						
Demand Deposits	318,189			311,844		
Other Liabilities	18,692			11,014		
<b>Total Liabilities</b>	<b>1,726,785</b>			<b>1,724,051</b>		
<b>SHAREHOLDERS' EQUITY</b>	<b>114,585</b>			<b>108,941</b>		
<b>Total Liabilities and Shareholders' Equity</b>	<b>\$ 1,841,370</b>			<b>\$ 1,832,992</b>		
<b>NET INTEREST INCOME</b>		<b>\$ 21,632</b>			<b>\$ 22,721</b>	
<b>NET YIELD ON AVERAGE EARNING ASSETS</b>			<b>2.52%</b>			<b>2.67%</b>
<b>NET INTEREST SPREAD</b>			<b>1.68%</b>			<b>1.99%</b>

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

(2) Interest income includes taxable-equivalent adjustments of \$1,108 and \$1,113 for the six months ended June 30, 2007 and 2006, respectively.

(3) Interest income includes taxable-equivalent adjustments of \$437 and \$502 for the six months ended June 30, 2007 and 2006, respectively.

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

(5) Represents junior subordinated debentures issued by Southside Bancshares, Inc. to Southside Statutory Trust III in connection with the issuance by Southside Statutory Trust III of \$20 million of trust preferred securities.

Note: As of June 30, 2007 and 2006, loans totaling \$1,637 and \$1,424, respectively, were on nonaccrual status. The policy is to reverse previously accrued but unpaid interest on nonaccrual loans; thereafter, interest income is recorded to the extent received when appropriate.

AVERAGE BALANCES AND YIELDS						
(dollars in thousands)						
(unaudited)						
Three Months Ended						
	June 30, 2007			June 30, 2006		
	AVG BALANCE	INTEREST	AVG YIELD	AVG BALANCE	INTEREST	AVG YIELD
<b>ASSETS</b>						
<b>INTEREST EARNING ASSETS:</b>						
Loans(1) (2)	\$ 768,744	\$ 13,238	6.91%	\$ 715,423	\$ 11,816	6.62%
Loans Held For Sale	4,458	55	4.95%	4,826	64	5.32%
<b>Securities:</b>						
Investment Securities (Taxable)(4)	50,584	616	4.88%	51,840	594	4.60%
Investment Securities (Tax-Exempt)(3)(4)	40,747	726	7.15%	40,557	720	7.12%
Mortgage-backed and Related Securities (4)	804,026	10,163	5.07%	897,645	11,149	4.98%
Total Securities	895,357	11,505	5.15%	990,042	12,463	5.05%
Federal Home Loan Bank stock and other investments, at cost	17,778	330	7.45%	28,507	350	4.92%
Interest Earning Deposits	550	10	7.29%	825	8	3.89%
Federal Funds Sold	1,945	23	4.74%	543	6	4.43%
Total Interest Earning Assets	1,688,832	25,161	5.98%	1,740,166	24,707	5.69%
<b>NONINTEREST EARNING ASSETS:</b>						
Cash and Due From Banks	40,259			43,345		
Bank Premises and Equipment	35,342			33,549		
Other Assets	42,910			39,442		
Less: Allowance for Loan Loss	(7,360)			(7,200)		
Total Assets	\$ 1,799,983			\$ 1,849,302		
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>						
<b>INTEREST BEARING LIABILITIES:</b>						
Savings Deposits	\$ 52,454	170	1.30%	\$ 51,402	165	1.29%
Time Deposits	548,969	6,711	4.90%	460,139	4,897	4.27%
Interest Bearing Demand Deposits	395,653	3,144	3.19%	354,549	2,342	2.65%
Total Interest Bearing Deposits	997,076	10,025	4.03%	866,090	7,404	3.43%
Short-term Interest Bearing Liabilities	231,818	2,776	4.80%	378,536	4,037	4.28%

Edgar Filing: SOUTHSIDE BANCSHARES INC - Form 10-Q

Long-term Interest Bearing Liabilities – FHLB						
Dallas	94,082	1,086	4.63%	151,794	1,534	4.05%
Long-term Debt (5)	20,619	432	8.29%	20,619	413	7.92%
Total Interest Bearing Liabilities						
	1,343,595	14,319	4.27%	1,417,039	13,388	3.79%
NONINTEREST BEARING LIABILITIES:						
Demand Deposits	320,966			313,422		
Other Liabilities	18,927			11,958		
Total Liabilities	1,683,488			1,742,419		
SHAREHOLDERS' EQUITY						
	116,495			106,883		
Total Liabilities and Shareholders' Equity	\$ 1,799,983			\$ 1,849,302		
NET INTEREST INCOME						
		\$ 10,842			\$ 11,319	
NET YIELD ON AVERAGE EARNING ASSETS						
			2.57%			2.61%
NET INTEREST SPREAD						
			1.71%			1.90%

- (1) Interest on loans includes fees on loans that are not material in amount.
- (2) Interest income includes taxable-equivalent adjustments of \$560 and \$552 for the three months ended June 30, 2007 and 2006, respectively.
- (3) Interest income includes taxable-equivalent adjustments of \$221 and \$230 for the three months ended June 30, 2007 and 2006, respectively.
- (4) For the purpose of calculating the average yield, the average balance of securities is presented at historical cost.
- (5) Represents junior subordinated debentures issued by Southside Bancshares, Inc. to Southside Statutory Trust III in connection with the issuance by Southside Statutory Trust III of \$20 million of trust preferred securities.

Note: As of June 30, 2007 and 2006, loans totaling \$1,637 and \$1,424, respectively, were on nonaccrual status. The policy is to reverse previously accrued but unpaid interest on nonaccrual loans; thereafter, interest income is recorded to the extent received when appropriate.

Noninterest  
Income

We earn noninterest income from a variety of sources which include deposit related fees 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 participate in.

Noninterest income was \$12.8 million for the six months ended June 30, 2007 compared to \$11.1 million for the same period in 2006, an increase of \$1.7 million, or 15.7%. For the three months ended June 30, 2007, noninterest income was \$6.7 million, compared to \$6.0 million for the same period in 2006, an increase of \$695,000, or 11.6%. During the six months ended June 30, 2007, we had gains on the sale of AFS securities of \$435,000 compared to gains of \$224,000 for the same period in 2006. Gains on the sale of AFS securities for the three months ended June 30, 2007 were \$6,000 compared to \$101,000 for the same period in 2006. The market value of the AFS securities portfolio at June 30, 2007 was \$687.9 million with a net unrealized loss on that date of \$9.3 million. The net unrealized loss is comprised of \$11.6 million in unrealized losses and \$2.3 million in unrealized gains. The market value of the HTM securities portfolio at June 30, 2007 was \$204.6 million with a net unrealized loss on that date of \$4.0 million. The net unrealized loss is comprised of \$4.1 million in unrealized losses and \$58,000 in unrealized gains. During the six months ended June 30, 2007 we sold securities out of our AFS portfolio as a result of the inverted yield curve, low volatility and tight credit spreads with the primary objective of decreasing the overall securities portfolio.

Deposit services income increased \$323,000, or 8.2%, and \$782,000, or 10.5%, for the three and six months ended June 30, 2007, respectively, when compared to the same periods in 2006, primarily as a result of increases in overdraft income, increased numbers of deposit accounts and an increase in debit card income.

Trust income increased \$173,000, or 42.9%, and \$233,000, or 28.9%, for the three and six months ended June 30, 2007, respectively, when compared to the same periods in 2006 due to growth experienced in our trust department.

Gain on sale of loans increased \$255,000, or 54.4%, and \$227,000, or 27.0%, for the three and six months ended June 30, 2007, respectively, when compared to the same periods in 2006. The increase was due to an increase in premiums on student loans sold when compared to the same period in 2006.

Other noninterest income increased \$36,000, or 4.6%, and \$259,000, or 20.4%, for the three and six months ended June 30, 2007, respectively, when compared to the same periods in 2006. The increases for the three and six month periods ended June 30, 2007 were primarily a result of increases in brokerage services income, credit card fee income, and Mastercard income which was offset by decreases in other recoveries, including a recovery of a loss from 2005 on a check of \$150,000 received during the second quarter of 2006.

Noninterest Expense

We incur numerous types of noninterest expenses associated with the operation of our various business activities, the largest of which are salaries and employee benefits. In addition, we incur numerous other expenses, the largest of which are detailed in the consolidated statements of income.

Noninterest expense was \$11.5 million and \$22.7 million for the three and six months ended June 30, 2007, respectively, compared to \$11.6 million and \$23.0 million for the same periods in 2006, respectively, representing decreases of \$107,000, or 0.9%, and \$305,000, or 1.3%, respectively.

Salaries and employee benefits expense decreased \$12,000, or 0.2%, and \$328,000, or 2.2%, during the three and six months ended June 30, 2007, respectively, when compared to the same periods in 2006. Direct salary expense and

payroll taxes decreased \$83,000, or 1.4%, and \$198,000, or 1.6%, for the three and six months ended June 30, 2007, respectively, when compared to the same periods in 2006. These decreases were the result of department managers completing an evaluation of work flow in their respective departments during the third quarter of 2006, with the primary objective of identifying any opportunities to increase productivity primarily through the use of technology investments with less personnel expense. In certain departments the evaluations identified the ability to utilize part-time employees to better staff for peak customer transaction times in lieu of full-time employees. In addition, management is utilizing productivity gains to not fill certain vacancies created by normal attrition. The combination of these initiatives resulted in salary and employee benefit expense savings and improved productivity gains.

Retirement expense, included in salary and benefits, decreased \$166,000, or 26.5%, and \$303,000, or 24.2%, for the three and six months ended June 30, 2007, respectively, when compared to the same periods in 2006, primarily as a result of the amendments to the Plan and the changes in the actuarial assumptions used to determine net periodic pension costs for 2007 when compared to 2006. Specifically, the assumed long-term rate of return was reduced to 7.50% and the assumed discount rate was increased to 6.05%. We will continue to evaluate the assumed long-term rate of return and the discount rate to determine if either should be changed in the future. If either of these assumptions were decreased, the cost and funding required for the retirement plan could increase.

Health and life insurance expense, included in salary and benefits, increased \$238,000, or 38.2%, and \$174,000, or 13.8%, for the three and six months ended June 30, 2007, respectively, when compared to the same periods in 2006 due to increased health claims expense. We have a self-insured health plan that is supplemented with stop loss insurance policies. Health insurance costs are rising nationwide and these costs may continue to increase during the remainder of 2007.

ATM and debit card expense decreased \$33,000, or 12.0%, for the three months ended June 30, 2007, and increased \$51,000, or 11.5%, for the six months ended June 30, 2007, respectively, compared to the same periods in 2006. The decrease for the three months ended June 30, 2007 as compared to the same period in 2006 was the result of the implementation of the new billing system from our service provider during the second quarter of 2006. The increase for the six months ended June 30, 2007 as compared to the same period in 2006, was primarily due to an increase in combined use of ATM and debit cards and point of sale activity.

Director fees decreased \$26,000, or 15.6%, and \$44,000, or 14.1%, for the three and six months ended June 30, 2007, respectively, compared to the same periods in 2006 due to a decrease in the number of directors.

Professional fees decreased \$78,000, or 24.5%, and \$82,000, or 13.0%, for the three and six months ended June 30, 2007, respectively, compared to the same periods in 2006. The decrease occurred primarily due to a decrease in legal fees associated with legal matters and litigation resulting from the normal course of business.

Other expense increased \$37,000, or 3.4%, and \$114,000, or 5.3%, for the three and six months ended June 30, 2007, respectively, compared to the same periods in 2006. The increase occurred primarily due to increases in bank exam fees, bank analysis fees, brokerage services expense and student loan origination and lender fee expense.

#### Income Taxes

Pre-tax income for the three and six months ended June 30, 2007 was \$5.1 million and \$9.9 million, respectively, compared to \$4.5 million and \$8.4 million, respectively, for the same periods in 2006.

Income tax expense was \$463,000 and \$1.5 million for the three and six months ended June 30, 2007, respectively, compared to \$950,000 and \$1.7 million for the three and six months ended June 30, 2006, respectively. The effective tax rate as a percentage of pre-tax income was 9.2% and 15.3% for the three and six months ended June 30, 2007, respectively, compared to 21.1% and 19.8% for the three and six months ended June 30, 2006, respectively.

The decrease in the effective tax rate and income tax expense for 2007 was due to a one-time state tax credit resulting from a change in Texas tax law during the quarter ended June 30, 2007, related to the new margin tax. The state tax credit was \$770,000, which was partially offset by an increase in our estimated margin tax of \$109,000, net of tax. Excluding the effect of the state tax credit and estimated margin tax, the effective tax rate for the three and six months ended June 30, 2007, would have been 22.3% and 22.0%, respectively.

Our current estimated alternative minimum tax position has been reduced to less than \$100,000. We believe the remaining alternative minimum tax position is reversible in the future and no valuation allowance against the related deferred tax asset is deemed necessary at this time. We continue to review the appropriate level of tax-free income so as to minimize any alternative minimum tax position in the future.



### Capital Resources

Our total shareholders' equity at June 30, 2007, was \$115.5 million, representing an increase of \$4.9 million from December 31, 2006, and represented 6.3% of total assets at June 30, 2007 compared to 5.8% of total assets at December 31, 2006.

Increases to shareholders' equity consisted of net income of \$8.4 million and the issuance of \$925,000 in common stock (108,634 shares) through our incentive stock option and dividend reinvestment plans, which more than offset an increase in accumulated other comprehensive loss of \$1.4 million, and \$2.9 million in dividends paid.

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 \$20 million of trust preferred securities issued by our subsidiary, Southside Statutory Trust III, is 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 regulations can initiate certain mandatory and possibly additional discretionary actions by regulators, which could have a material adverse effect on our financial condition and results of operations. Management believes that, as of June 30, 2007, 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 material effect on our financial condition and results of operation.

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 Southside Bank not exceed earnings for that year. Shareholders should not anticipate a continuation of the cash dividend simply because of the existence of a dividend reinvestment program. The payment of dividends is at the discretion of our board of directors and will depend upon future earnings, our financial condition, and other related factors.

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 June 30, 2007:						
(dollars in thousands)						
<b>Total Capital (to Risk Weighted Assets)</b>						
Consolidated	\$ 158,503	18.54%	\$ 68,387	8.00%	N/A	N/A
Bank Only	\$ 151,064	17.67%	\$ 68,385	8.00%	\$ 85,481	10.00%
<b>Tier 1 Capital (to Risk Weighted Assets)</b>						
Consolidated	\$ 151,136	17.68%	\$ 34,193	4.00%	N/A	N/A
Bank Only	\$ 143,697	16.81%	\$ 34,193	4.00%	\$ 51,289	6.00%
<b>Tier 1 Capital (to Average Assets) (1)</b>						
Consolidated	\$ 151,136	8.41%	\$ 71,924	4.00%	N/A	N/A
Bank Only	\$ 143,697	7.99%	\$ 71,896	4.00%	\$ 89,870	5.00%
As of June 30, 2006:						
<b>Total Capital (to Risk Weighted Assets)</b>						
Consolidated	\$ 145,506	17.60%	\$ 66,141	8.00%	N/A	N/A
Bank Only	\$ 140,251	16.98%	\$ 66,090	8.00%	\$ 82,612	10.00%
<b>Tier 1 Capital (to Risk Weighted Assets)</b>						
Consolidated	\$ 138,160	16.71%	\$ 33,070	4.00%	N/A	N/A
Bank Only	\$ 132,905	16.09%	\$ 33,045	4.00%	\$ 49,567	6.00%
<b>Tier 1 Capital (to Average Assets) (1)</b>						
Consolidated	\$ 138,160	7.44%	\$ 74,290	4.00%	N/A	N/A
Bank Only	\$ 132,905	7.16%	\$ 74,262	4.00%	\$ 92,827	5.00%

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

### Liquidity and Interest Rate Sensitivity

Liquidity management involves our ability to convert assets to cash with a minimum 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 June 30, 2007, these investments were 14.7% of total assets compared to 15.2% at June 30, 2006. Liquidity is further provided through the matching, by time period, of rate sensitive interest earning assets with rate sensitive interest bearing liabilities. We have three lines of credit for the purchase of overnight federal funds at prevailing rates. Two \$15.0 million and one \$10.0 million unsecured lines of credit have been established with Bank of America, Frost Bank and TIB - The Independent BankersBank, respectively. At June 30, 2007, the amount of additional funding we could obtain from FHLB using our unpledged securities at FHLB was approximately \$440.0 million, net of FHLB stock purchases required. We have obtained a \$12.0 million letter of credit from FHLB as collateral for a portion of our 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, interest rate simulation tests utilizing 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 of 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.

### Composition of Loans

One of our main objectives is to seek attractive lending opportunities in Texas, primarily in the counties in which we operate. Substantially all of our loans are made to borrowers who live in and conduct business in the counties in Texas in which we operate, with the exception of municipal loans. Municipal loans are made to municipalities, school districts and colleges primarily throughout the state of Texas. We look forward to the possibility that our loan growth will continue to accelerate in the future as we work to identify and develop additional markets and strategies to expand our lending territory.

The following table sets forth loan totals by category for the periods presented (in thousands):

	At June 30, 2007	At December 31, 2006	At June 30, 2006
<b>Real Estate Loans:</b>			
Construction	\$ 46,876	\$ 39,588	\$ 33,084
1-4 Family Residential	223,996	227,354	222,332
Other	177,918	181,047	173,776
<b>Commercial Loans</b>	<b>125,609</b>	<b>118,962</b>	<b>104,623</b>
Municipal Loans	110,416	106,155	105,316
Loans to Individuals	83,924	86,041	84,793
<b>Total Loans</b>	<b>\$ 768,739</b>	<b>\$ 759,147</b>	<b>\$ 723,924</b>

Construction loans increased \$7.3 million, or 18.4%, to \$46.9 million for the six month period ended June 30, 2007 from \$39.6 million at December 31, 2006, and \$13.8 million, or 41.7%, from \$33.1 million at June 30, 2006. Commercial loans increased \$6.6 million, or 5.6%, to \$125.6 million for the six month period ended June 30, 2007 from \$119.0 million at December 31, 2006, and \$21.0 million, or 20.1%, from \$104.6 million at June 30, 2006. Municipal loans increased \$4.3 million, or 4.0%, to \$110.4 million for the six month period ended June 30, 2007 from \$106.2 million at December 31, 2006, and \$5.1 million, or 4.8%, from \$105.3 million at June 30, 2006.

Our 1-4 family residential mortgage loans decreased \$3.4 million, or 1.5%, to \$224.0 million for the six month period ended June 30, 2007 from \$227.4 million at December 31, 2006, and increased \$1.7 million, or 0.7%, from \$222.3 million at June 30, 2006. Commercial real estate loans decreased \$3.1 million, or 1.7% to \$177.9 million for the six month period ended June 30, 2007 from \$181.0 million at December 31, 2006, and increased \$4.1 million, or 2.4%, from \$173.8 million at June 30, 2006. Loans to individuals decreased \$2.1 million, or 2.5% to \$83.9 million for the six month period ended June 30, 2007 from \$86.0 million at December 31, 2006, and \$869,000, or 1.0%, from \$84.8 million at June 30, 2006.



### Loan Loss Experience and Allowance for Loan Losses

The loan loss allowance is based on the most current review of the loan portfolio. Several methods are used to maintain the review in the most current manner. First, the servicing officer has the primary responsibility for updating significant changes in a customer's financial position. Accordingly, each officer prepares status updates on any credit deemed to be experiencing repayment difficulties that, in the officer's opinion, would place the collection of principal or interest in doubt. Second, our internal loan review department is responsible for an ongoing review of our loan portfolio with specific goals set for the loans to be reviewed on an annual basis.

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

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

As of June 30, 2007, our review of the loan portfolio indicated that a loan loss allowance of \$7.4 million was adequate to cover probable losses in the portfolio.

For the three and six months ended June 30, 2007, loan charge-offs were \$616,000 and \$1.2 million and recoveries were \$505,000 and \$1.0 million, resulting in net charge-offs of \$111,000 and \$160,000, respectively. For the three and six months ended June 30, 2006, loan charge-offs were \$744,000 and \$1.4 million and recoveries were \$449,000 and \$974,000, resulting in net charge-offs of \$295,000 and \$473,000, respectively. The necessary provision expense was estimated at \$217,000 and \$334,000 for the three and six months ended June 30, 2007, respectively.

### Nonperforming Assets

Nonperforming assets consist of delinquent loans 90 days or more past due, nonaccrual loans, OREO, repossessed assets and restructured loans. Nonaccrual loans are those loans which are 90 days or more delinquent and collection in full of both the principal and interest is in doubt. Additionally, some loans that are not delinquent may be placed on nonaccrual status due to doubts about full collection of principal or interest. When a loan is categorized as nonaccrual, the accrual of interest is discontinued and the accrued balance is reversed for financial statement purposes. Restructured loans represent loans that have been renegotiated to provide a reduction or deferral of interest or principal because of deterioration in the financial position of the borrowers. 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 valuation 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 table sets forth nonperforming assets for the periods presented (in thousands):

	At June 30, 2007	At December 31, 2006	At June 30, 2006
Nonaccrual loans	\$ 1,637	\$ 1,333	\$ 1,424
Loans 90 days past due	408	128	692
Restructured loans	179	220	239
Other real estate owned	23	351	841
Reposessed assets	77	78	41
Total Nonperforming Assets	\$ 2,324	\$ 2,110	\$ 3,237

Total nonperforming assets at June 30, 2007 were \$2.3 million, an increase of \$214,000, or 10.1%, from \$2.1 million at December 31, 2006 and a decrease of \$913,000, or 28.2%, from \$3.2 million at June 30, 2006. From December 31, 2006 to June 30, 2007, nonaccrual loans increased \$304,000, or 22.8%, to \$1.6 million and from June 30, 2006, increased \$213,000, or 15.0%. Of the total at June 30, 2007, 18.0% are residential real estate loans, 46.3% are commercial real estate loans, 11.1% are commercial loans, 23.8% are loans to individuals and 0.8% are construction loans. OREO decreased \$328,000, or 93.4%, to \$23,000 at June 30, 2007 from \$351,000 at December 31, 2006 and decreased \$818,000, or 97.3%, from \$841,000 at June 30, 2006. The primary decrease in OREO resulted from the sale of one residential dwelling during the first quarter of 2007, which comprised approximately 90% of OREO at December 31, 2006. Total OREO at June 30, 2007 consist of one residential dwelling. We actively market all properties and none are held for investment purposes. Loans 90 days or more past due increased \$280,000, or 218.8%, to \$408,000 at June 30, 2007 from \$128,000 at December 31, 2006 and decreased \$284,000, or 41.0%, from \$692,000 at June 30, 2006. Reposessed assets decreased \$1,000, or 1.3%, to \$77,000 at June 30, 2007 from \$78,000 at December 31, 2006 and increased \$36,000, or 87.8%, from \$41,000 at June 30, 2006. Approximately \$51,000 of the reposessed assets at June 30, 2007 represented two loans with an SBA guarantee of 85.0%. Restructured loans decreased \$41,000, or 18.6%, to \$179,000 at June 30, 2007 from \$220,000 at December 31, 2006 and decreased \$60,000, or 25.1%, from \$239,000 at June 30, 2006.

### Expansion

We opened our sixth full service grocery store branch in our largest market area, the city of Tyler, in Smith County in July 2007.

On May 17, 2007, we announced that we had entered into a definitive agreement with Fort Worth Bancshares, Inc., the bank holding company of Fort Worth National Bank, that provides for the merger of Fort Worth Bancshares, Inc. into a wholly-owned subsidiary of Southside Bancshares, Inc. The merger has been approved by the Federal Reserve Board, but consummation of the merger is still subject to the approval of the shareholders of Fort Worth Bancshares, Inc. and other customary closing conditions. The merger is expected to be consummated in the third quarter of 2007.

This merger expands our presence in Texas into the Fort Worth, Arlington and Austin markets in Tarrant and Travis Counties. The expansion will make the Tarrant County market our second largest lending market and third largest deposit market. We will retain the Fort Worth National Bank charter and continue to operate Fort Worth National Bank under that name. The bank has two branches in Fort Worth, one branch in adjoining Arlington and a loan production office in Austin. Under the terms of the definitive agreement, the all cash transaction is valued at \$36.5 million, based on a purchase price of \$52.00 per share of Fort Worth Bancshares, Inc. common stock, subject to



customary closing adjustments.

Accounting Pronouncements

See “Note 8 - Accounting Pronouncements” in our financial statements included in this report.

30

---

**ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

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 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. Through these simulations we attempt to estimate the impact on net interest income of a 200 basis point parallel shift in the yield curve. Our policy guidelines seek to limit the estimated change in net interest income to 10 percent of forecasted net interest income over the succeeding 12 months and 200 basis point parallel rate shock. Our policy guidelines limit the change in market value of equity in a 200 basis point parallel rate shock to 20 percent of the base case. The results of the valuation analysis as of June 30, 2007 were within policy guidelines for all scenarios except for the immediate down 200 basis point shock scenario, which reflected net interest income would increase approximately 11%. Due to the level of our interest bearing demand and savings deposit rates at June 30, 2007, some of these rates cannot move down 200 basis points. 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 repricings 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 following table provides information about our financial instruments that are sensitive to changes in interest rates. Except for the effects of prepayments and scheduled principal amortization on fixed rate loans and mortgage-backed securities, the table presents principal cash flows and related weighted average interest rates by the contractual term to maturity. Adjustable rate student loans totaling \$3.2 million are classified in the one year category. Callable FHLB Advances are presented based on contractual maturity. Callable brokered CDs are presented based on contractual maturity. Loans held for sale totaling \$5.0 million are classified in the one-year category. Nonaccrual loans totaling \$1.6 million are not included in total loans. All instruments are classified as other than trading.

EXPECTED MATURITY DATE								
(dollars in thousands)								
Twelve Months Ending June 30, 2007								
	2008	2009	2010	2011	2012	Thereafter	Total	Fair Value
<b>Loans:</b>								
Fixed Rate	\$ 199,669	\$ 92,291	\$ 51,125	\$ 32,158	\$ 20,107	\$ 108,030	\$ 503,380	\$ 497,547
	6.88%	6.78%	6.70%	6.63%	6.48%	5.72%	6.56%	
Adjustable Rate	58,066	18,173	8,828	7,817	3,995	171,885	268,764	268,764
	8.36%	7.94%	8.26%	8.16%	8.29%	6.65%	7.23%	
<b>Mortgage-backed Securities:</b>								
Fixed Rate	183,801	186,089	154,461	109,180	69,297	103,760	806,588	802,526
	5.27%	5.05%	5.01%	5.06%	5.00%	4.75%	5.05%	
<b>Investments and Other Interest Earning Assets:</b>								
Fixed Rate	40,898	1,690	3,250	3,470	3,330	60,189	112,827	112,841
	5.19%	6.08%	6.64%	6.66%	6.10%	6.04%	5.77%	
Adjustable Rate	–	–	–	–	–	5,907	5,907	5,907
	–	–	–	–	–	7.06%	7.06%	
<b>Total Interest</b>								
Earning Assets	\$ 482,434	\$ 298,243	\$ 217,664	\$ 152,625	\$ 96,729	\$ 449,771	\$ 1,697,466	\$ 1,687,585
	6.30%	5.77%	5.56%	5.59%	5.48%	5.91%	5.90%	
Savings Deposits	\$ 5,264	\$ 2,632	\$ 2,632	\$ 2,632	\$ 2,632	\$ 36,846	\$ 52,638	\$ 52,638
	1.31%	1.31%	1.31%	1.31%	1.31%	1.31%	1.31%	
NOW Deposits	95,473	5,229	5,229	5,229	5,229	73,210	189,599	189,599
	4.63%	0.85%	0.85%	0.85%	0.85%	0.85%	2.75%	
<b>Money Market Deposits</b>								
	24,873	8,290	8,290	8,290	8,290	24,872	82,905	82,905
	3.12%	3.12%	3.12%	3.12%	3.12%	3.12%	3.12%	
<b>Platinum Money Market</b>								
	70,984	10,775	10,775	10,775	10,775	12,676	126,760	126,760
	3.95%	3.95%	3.95%	3.95%	3.95%	3.95%	3.95%	
<b>Certificates of Deposit</b>								
	385,901	40,764	41,016	31,435	56,824	147	556,087	553,991
	4.87%	4.71%	5.00%	5.24%	5.44%	4.34%	4.95%	
FHLB Advances	225,432	43,649	36,811	18,171	1,099	4,057	329,219	327,061
	4.81%	4.69%	4.65%	5.20%	4.99%	5.14%	4.80%	
	1,511	–	–	–	–	20,619	22,130	22,130

Edgar Filing: SOUTHSIDE BANCSHARES INC - Form 10-Q

Other Borrowings	5.10%	–	–	–	–	8.30%	8.08%	
Total Interest Bearing Liabilities	\$ 809,438	\$ 111,339	\$ 104,753	\$ 76,532	\$ 84,849	\$ 172,427	\$ 1,359,338	\$ 1,355,084
	4.67%	4.25%	4.32%	4.38%	4.61%	2.50%	4.31%	

Residential fixed rate loans are assumed to have annual prepayment rates between 7% and 35% of the portfolio. Residential adjustable rate loans are assumed to have annual prepayment rates between 12% and 50%. Commercial and multi-family real estate loans are assumed to prepay at an annualized rate between 8% and 40%. Consumer loans are assumed to prepay at an annualized rate between 8% and 30%. Commercial loans are assumed to prepay at an annual rate between 8% and 45%. Municipal loans are assumed to prepay at an annual rate between 6% and 18%. Fixed rate mortgage-backed securities, including Collateralized Mortgage Obligations ("CMOs") and Real Estate Mortgage Investment Conduits ("REMICs"), have annual payment assumptions ranging from 6% to 50%. At June 30, 2007, the contractual maturity of substantially all of our mortgage-backed or related securities was in excess of ten years. The actual maturity of a mortgage-backed or related security is less than its stated maturity due to regular principal payments and prepayments of the underlying mortgages. Prepayments that are faster than anticipated may shorten the life of the security and affect its yield to maturity. The yield to maturity is based upon the interest income and the amortization of any premium or accretion of any discount related to the security. In accordance with GAAP, premiums and discounts are amortized or accreted over the estimated lives of the loans, which decrease and increase interest income, respectively. The prepayment assumptions used to determine the amortization period for premiums and discounts can significantly affect the yield of the mortgage-backed or related security, and these assumptions are reviewed periodically to reflect actual prepayments. Although prepayments of underlying mortgages depend on many factors, including the type of mortgages, the coupon rate, the age of mortgages, the geographical location of the underlying real estate collateralizing the mortgages and general levels of market interest rates, the difference between the interest rates on the underlying mortgages and the prevailing mortgage interest rates generally is the most significant determinant of the rate of prepayments. During periods of falling mortgage interest rates, if the coupon rate of the underlying mortgages exceeds the prevailing market interest rates offered for mortgage loans, refinancing may increase and accelerate the prepayment of the underlying mortgages and the related security. At June 30, 2007, 100% of the mortgage-backed and related securities we held were secured by fixed-rate mortgage loans.

We assume 70% of savings accounts and non public fund transaction accounts at June 30, 2007, are core deposits and are, therefore, expected to mature after five years. All public fund transaction accounts are assumed to mature within one year. We assume 30% of money market accounts at June 30, 2007 are core deposits and are, therefore, expected to mature after five years. We assume 10% of our platinum money market accounts are core deposits and are, therefore, expected to mature after five years. Fixed maturity deposits reprice at maturity.

In evaluating our exposure to interest rate risk, certain limitations inherent in the method of analysis presented in the foregoing table must be considered. For example, although certain assets and liabilities may have similar maturities or periods to repricing, they may react in different degrees to changes in market interest rates. Also, the interest rates on certain types of assets and liabilities may fluctuate in advance of changes in market interest rates, while interest rates on other types may lag behind changes in market rates. Certain assets, such as adjustable rate mortgages, have features which restrict changes in interest rates. Prepayment and early withdrawal levels associated with mortgage-backed securities may deviate significantly from those assumed in calculating the table. Finally, the ability of many borrowers to service their debt may decrease in the event of an interest rate increase. We consider all of these factors in monitoring our exposure to interest rate risk.

#### ITEM 4. CONTROLS AND PROCEDURES

Our Chief Executive Officer and our Chief Financial Officer 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 of the end of the period covered by this report and concluded that our disclosure controls and procedures were effective as of the end of the period covered by this report. No changes were made to our internal control over financial reporting (as defined in Rule 13a-15(f) under the Securities Exchange Act of 1934) during our last fiscal quarter that materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.



**PART II. OTHER INFORMATION****ITEM 1. LEGAL PROCEEDINGS**

We are a party to legal proceedings arising in the normal course of business. Management believes that at June 30, 2007 such litigation is not material to our financial position or results of operations.

**ITEM 1A. RISK FACTORS**

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, 2006. There have been no material changes from the risk factors previously disclosed in our Annual Report on Form 10-K.

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

The following table provides information with respect to purchases made by or on our behalf or any “affiliated purchaser” (as defined in Rule 10b-18(a)(3) under the Securities Exchange Act of 1934), of our common stock during the three months ended June 30, 2007.

	Total Number of Shares Purchased	Average Price Paid Per Share	Total Number of Shares Purchased as Part of Publicly Announced Plan	Maximum Number of Shares That May Yet Be Purchased Under the Plan at the End of the Period
April 1, 2007 to April 30, 2007	–	\$ –	–	–
May 1, 2007 to May 31, 2007	6,120	(1)\$ 21.56	–	–
June 1, 2007 to June 30, 2007	–	\$ –	–	–
Total	6,120	\$ 21.56	–	–

(1) Repurchase of shares made in connection with the exercise of certain employee stock options.

**ITEM 3. DEFAULTS UPON SENIOR SECURITIES**

Not Applicable

**ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS**

(a) An annual meeting of shareholders was held on April 19, 2007.

(b) The election of three directors (terms expiring at the 2010 Annual Meeting) were as follows:

	<u>FOR</u>	<u>WITHHELD</u>
Alton Cade	9,091,763	306,918
B. G. Hartley	9,090,750	307,931





ITEM 6. EXHIBITS

Exhibit

- | <u>No.</u> |  |
|------------|--|
| 3          | Articles of Incorporation as amended and in effect on December 31, 1992, of SoBank, Inc. (now  |
| (a)(i) -   | named Southside Bancshares, Inc.)(filed as Exhibit 3 to the Registrant's Form 10-K for the year ended December 31, 1992, (commission file number 000-12247) and incorporated herein by reference).         |
| 3          | Articles of Amendment effective May 9, 1994 to Articles of Incorporation of SoBank, Inc. (now  |
| (a)(ii) -  | named Southside Bancshares, Inc.) (filed as Exhibit 3(a)(ii) to the Registrant's Form 10-K for the year ended December 31, 1994, (commission file number 000-12247) and incorporated herein by reference). |
| 3          | Amended and Restated Bylaws of Southside Bancshares,   |
| (b)        |  |
| -          | Inc. (filed as Exhibit 3(b) to the Registrant's Form 8-K, filed June 28, 2006, 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  |

\* Filed herewith.

\*\*The certifications attached as Exhibit 32 accompany this quarterly Report on Form 10-Q and are "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.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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.

BY:/s/ B. G. HARTLEY

B. G. Hartley, Chairman of the Board  
and Chief Executive Officer  
(Principal Executive Officer)

DATE: August 6, 2007

/s/ LEE R. GIBSON

Lee R. Gibson, Executive Vice President  
and Chief Financial Officer (Principal Financial  
and Accounting Officer)

DATE: August 6, 2007

Exhibit Index

<u>Exhibit Number</u>	<u>Description</u>
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