

PROSPERITY BANCSHARES INC

Form 10-Q

November 09, 2012

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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-Q**

(Mark One)

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

**FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2012**

**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: 001-35388**

**PROSPERITY BANCSHARES, INC.<sup>®</sup>**

(Exact name of registrant as specified in its charter)

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**TEXAS**  
(State or other jurisdiction of  
incorporation or organization)

**74-2331986**  
(I.R.S. Employer  
Identification No.)

**Prosperity Bank Plaza**

**4295 San Felipe**

**Houston, Texas 77027**

(Address of principal executive offices, including zip code)

**(713) 693-9300**

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

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

Large Accelerated Filer ☒

Accelerated Filer ☐

Non-accelerated Filer ☐ (Do not check if a smaller reporting company)

Smaller Reporting Company ☐

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

As of November 5, 2012, there were 56,430,192 outstanding shares of the registrant's Common Stock, par value \$1.00 per share.

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**PROSPERITY BANCSHARES, INC. ® AND SUBSIDIARIES**

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**Table of Contents****PART I FINANCIAL INFORMATION****ITEM 1. FINANCIAL STATEMENTS****PROSPERITY BANCSHARES, INC®. AND SUBSIDIARIES****CONSOLIDATED BALANCE SHEETS****(UNAUDITED)**

|                                                                                                        | September 30,<br>2012<br>(In thousands, except share data) | December 31,<br>2011 |
|--------------------------------------------------------------------------------------------------------|------------------------------------------------------------|----------------------|
| ASSETS                                                                                                 |                                                            |                      |
| Cash and due from banks                                                                                | \$ 207,401                                                 | \$ 212,800           |
| Federal funds sold                                                                                     | 302                                                        | 642                  |
| Total cash and cash equivalents                                                                        | 207,703                                                    | 213,442              |
| Interest-bearing time deposits in other financial institutions                                         | 249                                                        |                      |
| Securities available for sale, at fair value (amortized cost of \$233,396 and \$301,589, respectively) | 250,387                                                    | 322,316              |
| Securities held to maturity, at cost (fair value of \$6,772,151 and \$4,492,988, respectively)         | 6,549,126                                                  | 4,336,620            |
| Loans held for investment                                                                              | 5,074,771                                                  | 3,765,906            |
| Loans held for sale                                                                                    | 4,332                                                      |                      |
| Allowance for credit losses                                                                            | (50,927)                                                   | (51,594)             |
| Loans, net                                                                                             | 5,028,176                                                  | 3,714,312            |
| Accrued interest receivable                                                                            | 39,661                                                     | 29,405               |
| Goodwill                                                                                               | 1,200,098                                                  | 924,537              |
| Core deposit intangibles, net of accumulated amortization of \$63,455 and \$58,158, respectively       | 28,092                                                     | 20,996               |
| Bank premises and equipment, net                                                                       | 201,445                                                    | 159,656              |
| Other real estate owned                                                                                | 8,846                                                      | 8,328                |
| Bank Owned Life Insurance (BOLI)                                                                       | 107,859                                                    | 50,029               |
| Federal Home Loan Bank stock                                                                           | 42,417                                                     | 11,601               |
| Other assets                                                                                           | 48,060                                                     | 31,429               |
| TOTAL ASSETS                                                                                           | \$ 13,712,119                                              | \$ 9,822,671         |
| LIABILITIES AND SHAREHOLDERS' EQUITY                                                                   |                                                            |                      |
| LIABILITIES:                                                                                           |                                                            |                      |
| Deposits:                                                                                              |                                                            |                      |
| Noninterest-bearing                                                                                    | \$ 2,827,748                                               | \$ 1,972,226         |
| Interest-bearing                                                                                       | 8,126,849                                                  | 6,088,028            |
| Total deposits                                                                                         | 10,954,597                                                 | 8,060,254            |
| Other borrowings                                                                                       | 112,017                                                    | 12,790               |
| Securities sold under repurchase agreements                                                            | 443,856                                                    | 54,883               |
| Accrued interest payable                                                                               | 2,089                                                      | 2,803                |
| Other liabilities                                                                                      | 76,329                                                     | 39,621               |
| Junior subordinated debentures                                                                         | 85,055                                                     | 85,055               |

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|                                                                                                                                                                                                                                                                       |                      |                     |
|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|----------------------|---------------------|
| Total liabilities                                                                                                                                                                                                                                                     | 11,673,943           | 8,255,406           |
| <b>COMMITMENTS AND CONTINGENCIES</b>                                                                                                                                                                                                                                  |                      |                     |
| <b>SHAREHOLDERS' EQUITY:</b>                                                                                                                                                                                                                                          |                      |                     |
| Preferred stock, \$1 par value; 20,000,000 shares authorized; none issued or outstanding                                                                                                                                                                              |                      |                     |
| Common stock, \$1 par value; 200,000,000 shares authorized; 56,095,248 and 46,947,415 shares issued at September 30, 2012 and December 31, 2011, respectively; 56,058,160 and 46,910,327 shares outstanding at September 30, 2012 and December 31, 2011, respectively |                      |                     |
|                                                                                                                                                                                                                                                                       | 56,095               | 46,947              |
| Capital surplus                                                                                                                                                                                                                                                       | 1,257,541            | 883,575             |
| Retained earnings                                                                                                                                                                                                                                                     | 714,103              | 623,878             |
| Accumulated other comprehensive income net unrealized gain on available for sale securities, net of tax of \$5,947 and \$7,254, respectively                                                                                                                          |                      |                     |
|                                                                                                                                                                                                                                                                       | 11,044               | 13,472              |
| Less treasury stock, at cost, 37,088 shares                                                                                                                                                                                                                           | (607)                | (607)               |
| Total shareholders' equity                                                                                                                                                                                                                                            | 2,038,176            | 1,567,265           |
| <b>TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY</b>                                                                                                                                                                                                                     | <b>\$ 13,712,119</b> | <b>\$ 9,822,671</b> |

See notes to interim consolidated financial statements.

**Table of Contents****PROSPERITY BANCSHARES, INC. ® AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF INCOME****(UNAUDITED)**

|                                                       | Three Months Ended<br>September 30,<br>20122011 |           | Nine Months Ended<br>September 30,<br>20122011 |            |
|-------------------------------------------------------|-------------------------------------------------|-----------|------------------------------------------------|------------|
|                                                       | (Dollars in thousands, except per share data)   |           |                                                |            |
| INTEREST INCOME:                                      |                                                 |           |                                                |            |
| Loans, including fees                                 | \$ 80,587                                       | \$ 54,471 | \$ 188,597                                     | \$ 160,374 |
| Securities                                            | 37,025                                          | 38,714    | 113,418                                        | 121,861    |
| Federal funds sold                                    | 21                                              | 4         | 108                                            | 15         |
| Total interest income                                 | 117,633                                         | 93,189    | 302,123                                        | 282,250    |
| INTEREST EXPENSE:                                     |                                                 |           |                                                |            |
| Deposits                                              | 9,395                                           | 9,717     | 26,269                                         | 32,293     |
| Junior subordinated debentures                        | 651                                             | 607       | 1,962                                          | 2,352      |
| Federal funds purchased and other borrowings          | 379                                             | 200       | 1,076                                          | 718        |
| Securities sold under repurchase agreements           | 315                                             | 127       | 411                                            | 306        |
| Total interest expense                                | 10,740                                          | 10,651    | 29,718                                         | 35,669     |
| NET INTEREST INCOME                                   | 106,893                                         | 82,538    | 272,405                                        | 246,581    |
| PROVISION FOR CREDIT LOSSES                           | 1,800                                           | 950       | 2,550                                          | 4,050      |
| NET INTEREST INCOME AFTER PROVISION FOR CREDIT LOSSES | 105,093                                         | 81,588    | 269,855                                        | 242,531    |
| NONINTEREST INCOME:                                   |                                                 |           |                                                |            |
| Customer service fees                                 | 18,873                                          | 12,662    | 42,430                                         | 37,250     |
| Other                                                 | 4,955                                           | 1,919     | 8,999                                          | 4,728      |
| Total noninterest income                              | 23,828                                          | 14,581    | 51,429                                         | 41,978     |
| NONINTEREST EXPENSE:                                  |                                                 |           |                                                |            |
| Salaries and employee benefits                        | 36,701                                          | 23,601    | 83,525                                         | 70,799     |
| Net occupancy                                         | 4,614                                           | 3,784     | 11,663                                         | 10,979     |
| Debit card, data processing and software amortization | 2,901                                           | 1,954     | 6,339                                          | 5,406      |
| Core deposit intangible amortization                  | 2,007                                           | 1,924     | 5,297                                          | 5,901      |
| Depreciation                                          | 2,369                                           | 2,041     | 6,432                                          | 6,099      |
| Other                                                 | 11,650                                          | 7,847     | 28,233                                         | 26,176     |
| Total noninterest expense                             | 60,242                                          | 41,151    | 141,489                                        | 125,360    |
| INCOME BEFORE INCOME TAXES                            | 68,679                                          | 55,018    | 179,795                                        | 159,149    |
| PROVISION FOR INCOME TAXES                            | 22,503                                          | 18,645    | 60,160                                         | 53,806     |
| NET INCOME AVAILABLE TO COMMON SHAREHOLDERS           | \$ 46,176                                       | \$ 36,373 | \$ 119,635                                     | \$ 105,343 |
| EARNINGS PER SHARE                                    |                                                 |           |                                                |            |
| Basic                                                 | \$ 0.83                                         | \$ 0.78   | \$ 2.38                                        | \$ 2.25    |

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|                          |    |       |    |       |    |       |    |       |
|--------------------------|----|-------|----|-------|----|-------|----|-------|
| Diluted                  | \$ | 0.82  | \$ | 0.77  | \$ | 2.37  | \$ | 2.24  |
| DIVIDENDS PAID PER SHARE | \$ | 0.195 | \$ | 0.175 | \$ | 0.585 | \$ | 0.525 |

See notes to interim consolidated financial statements.

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**PROSPERITY BANCSHARES, INC. ® AND SUBSIDIARIES**

**CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**

**(UNAUDITED)**

|                                                                      | Three Months Ended<br>September 30,<br>2012 |           | Nine Months Ended<br>September 30,<br>2011 |            |
|----------------------------------------------------------------------|---------------------------------------------|-----------|--------------------------------------------|------------|
|                                                                      | 2012                                        | 2011      | 2012                                       | 2011       |
|                                                                      | (In thousands)                              |           |                                            |            |
| Net income                                                           | \$ 46,176                                   | \$ 36,373 | \$ 119,635                                 | \$ 105,343 |
| Other comprehensive (loss) income, before tax:                       |                                             |           |                                            |            |
| Securities available for sale:                                       |                                             |           |                                            |            |
| Change in unrealized (loss) gain during period                       | (718)                                       | 632       | (3,736)                                    | 2,272      |
| Total other comprehensive (loss) income                              | (718)                                       | 632       | (3,736)                                    | 2,272      |
| Deferred tax benefit (expense) related to other comprehensive income | 251                                         | (222)     | 1,308                                      | (795)      |
| Other comprehensive (loss) income, net of tax                        | (467)                                       | 410       | (2,428)                                    | 1,477      |
| Comprehensive income                                                 | \$ 45,709                                   | \$ 36,783 | \$ 117,207                                 | \$ 106,820 |

See notes to interim consolidated financial statements.

**Table of Contents****PROSPERITY BANCSHARES, INC. ® AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY****(UNAUDITED)**

|                                                                                                  | Accumulated  |           |              |            |                     |          |                      |
|--------------------------------------------------------------------------------------------------|--------------|-----------|--------------|------------|---------------------|----------|----------------------|
|                                                                                                  | Common Stock |           | Capital      | Retained   | Other Comprehensive | Treasury | Total                |
|                                                                                                  | Shares       | Amount    | Surplus      | Earnings   | Income (Loss)       | Stock    | Shareholders' Equity |
| (Amounts in thousands, except share and per share data)                                          |              |           |              |            |                     |          |                      |
| BALANCE AT JANUARY 1, 2012                                                                       | 46,947,415   | \$ 46,947 | \$ 883,575   | \$ 623,878 | \$ 13,472           | \$ (607) | \$ 1,567,265         |
| Net income                                                                                       |              |           |              | 119,635    |                     |          | 119,635              |
| Other comprehensive loss                                                                         |              |           |              |            | (2,428)             |          | (2,428)              |
| Common stock issued in connection with the exercise of stock options and restricted stock awards | 172,698      | 173       | 2,518        |            |                     |          | 2,691                |
| Common stock issued in connection with the acquisition of Texas Bankers, Inc.                    | 314,953      | 315       | 12,393       |            |                     |          | 12,708               |
| Common stock issued in connection with the acquisition of The Bank Arlington                     | 135,347      | 135       | 6,063        |            |                     |          | 6,198                |
| Common stock issued in connection with the acquisition of American State Financial Corporation   | 8,524,835    | 8,525     | 349,774      |            |                     |          | 358,299              |
| Stock based compensation expense                                                                 |              |           | 3,218        |            |                     |          | 3,218                |
| Cash dividends declared, \$0.585 per share                                                       |              |           |              | (29,410)   |                     |          | (29,410)             |
| BALANCE AT SEPTEMBER 30, 2012                                                                    | 56,095,248   | \$ 56,095 | \$ 1,257,541 | \$ 714,103 | \$ 11,044           | \$ (607) | \$ 2,038,176         |
| BALANCE AT JANUARY 1, 2011                                                                       | 46,721,114   | \$ 46,721 | \$ 876,050   | \$ 515,871 | \$ 14,304           | \$ (607) | \$ 1,452,339         |
| Net income                                                                                       |              |           |              | 105,343    |                     |          | 105,343              |
| Other comprehensive income                                                                       |              |           |              |            | 1,477               |          | 1,477                |
| Common stock issued in connection with the exercise of stock options and restricted stock awards | 208,918      | 209       | 3,966        |            |                     |          | 4,175                |
| Stock based compensation expense                                                                 |              |           | 2,604        |            |                     |          | 2,604                |
| Cash dividends declared, \$0.525 per share                                                       |              |           |              | (24,599)   |                     |          | (24,599)             |
| BALANCE AT SEPTEMBER 30, 2011                                                                    | 46,930,032   | \$ 46,930 | \$ 882,620   | \$ 596,615 | \$ 15,781           | \$ (607) | \$ 1,541,339         |

See notes to interim consolidated financial statements.

**Table of Contents****PROSPERITY BANCSHARES, INC.® AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF CASH FLOWS****(UNAUDITED)**

|                                                                                                | <div> <div>Nine Months Ended</div> <div>September 30,</div> <div>2012</div> <div>2011</div> </div> |             |
|------------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------|-------------|
|                                                                                                | (In thousands)                                                                                     |             |
| CASH FLOWS FROM OPERATING ACTIVITIES:                                                          |                                                                                                    |             |
| Net income                                                                                     | \$ 119,635                                                                                         | \$ 105,343  |
| Adjustments to reconcile net income to net cash provided by operating activities:              |                                                                                                    |             |
| Depreciation and amortization                                                                  | 11,729                                                                                             | 12,000      |
| Stock based compensation expense                                                               | 3,218                                                                                              | 2,604       |
| Net proceeds from the sale of held for sale loans                                              | 9,438                                                                                              |             |
| Net accretion of discount on loans and deposits                                                | (11,988)                                                                                           | (27)        |
| Provision for credit losses                                                                    | 2,550                                                                                              | 4,050       |
| Net amortization of premium on investments                                                     | 42,897                                                                                             | 19,686      |
| Net loss on sale of other real estate                                                          | 344                                                                                                | 431         |
| Net gain on sale of premises and equipment                                                     | (13)                                                                                               | (377)       |
| Net (increase) decrease in accrued interest receivable and other assets                        | (19,623)                                                                                           | 19,352      |
| Net increase in accrued interest payable and other liabilities                                 | 42,510                                                                                             | 19,314      |
| Net cash provided by operating activities                                                      | 200,697                                                                                            | 182,376     |
| CASH FLOWS FROM INVESTING ACTIVITIES:                                                          |                                                                                                    |             |
| Proceeds from maturities and principal paydowns of securities held to maturity                 | 1,238,538                                                                                          | 875,900     |
| Purchase of securities held to maturity                                                        | (2,499,561)                                                                                        | (781,977)   |
| Proceeds from maturities, sales and principal paydowns of securities available for sale        | 1,703,676                                                                                          | 1,075,249   |
| Purchase of securities available for sale                                                      | (1,109,999)                                                                                        | (1,000,000) |
| Net increase in loans held for investment                                                      | (128,225)                                                                                          | (263,587)   |
| Purchase of bank premises and equipment                                                        | (7,924)                                                                                            | (7,621)     |
| Net proceeds from sale of bank premises, equipment and other real estate                       | 12,004                                                                                             | 10,699      |
| Net cash and cash equivalents acquired in the purchase of Texas Bankers, Inc.                  | 44,550                                                                                             |             |
| Net cash and cash equivalents acquired in the purchase of The Bank Arlington                   | 12,037                                                                                             |             |
| Net cash and cash equivalents acquired in the purchase of American State Financial Corporation | 123,022                                                                                            |             |
| Net cash used in investing activities                                                          | (611,882)                                                                                          | (91,337)    |

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|                                                                                      | <div> <div>Nine Months Ended</div> <div>September 30,</div> <div>2012</div> <div>2011</div> </div> (In thousands) |              |
|--------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------|--------------|
| CASH FLOWS FROM FINANCING ACTIVITIES:                                                |                                                                                                                   |              |
| Net increase in noninterest-bearing deposits                                         | 193,360                                                                                                           | \$ 188,717   |
| Net increase in interest-bearing deposits                                            | 101,866                                                                                                           | 155,408      |
| Net proceeds from (repayments of) short-term debt                                    | 100,000                                                                                                           | (360,000)    |
| Net repayments of long-term debt                                                     | (772)                                                                                                             | (850)        |
| Redemption of junior subordinated debentures                                         |                                                                                                                   | (7,210)      |
| Net increase in securities sold under repurchase agreements                          | 37,711                                                                                                            | 5,507        |
| Proceeds from exercise of stock options                                              | 2,691                                                                                                             | 4,175        |
| Payments of cash dividends                                                           | (29,410)                                                                                                          | (24,599)     |
| Net cash provided by (used in) financing activities                                  | 405,446                                                                                                           | (38,852)     |
| NET DECREASE IN CASH AND CASH EQUIVALENTS                                            | \$ (5,739)                                                                                                        | \$ 52,187    |
| CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD                                       | 213,442                                                                                                           | 159,368      |
| CASH AND CASH EQUIVALENTS, END OF PERIOD                                             | \$ 207,703                                                                                                        | \$ 211,555   |
| NONCASH ACTIVITIES:                                                                  |                                                                                                                   |              |
| Stock issued in connection with the Texas Bankers, Inc. acquisition                  | \$ 12,708                                                                                                         |              |
| Stock issued in connection with The Bank Arlington acquisition                       | 6,198                                                                                                             |              |
| Stock issued in connection with the American State Financial Corporation acquisition | 358,299                                                                                                           |              |
| SUPPLEMENTAL DISCLOSURES:                                                            |                                                                                                                   |              |
| Cash paid for income taxes                                                           | \$ 53,737                                                                                                         | \$ 51,438    |
| Cash paid for interest                                                               | 30,434                                                                                                            | 36,616       |
| Noncash investing and financing activities                                           | acquisition of real estate through foreclosure of collateral                                                      | 11,354 9,414 |
| See notes to interim consolidated financial statements.                              |                                                                                                                   |              |

**Table of Contents****PROSPERITY BANCSHARES, INC.® AND SUBSIDIARIES****NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS****SEPTEMBER 30, 2012****(UNAUDITED)****1. BASIS OF PRESENTATION**

The interim consolidated financial statements include the accounts of Prosperity Bancshares, Inc.® (the Company) and its wholly-owned subsidiaries, Prosperity Bank® (the Bank) and Prosperity Holdings of Delaware, L.L.C. All intercompany transactions and balances have been eliminated.

The accompanying unaudited interim consolidated financial statements have been prepared in accordance with generally accepted accounting principles for interim financial information and with the rules and regulations of the Securities and Exchange Commission. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of management, the statements reflect all adjustments necessary for a fair presentation of the financial position, results of operations and cash flows of the Company on a consolidated basis, and all such adjustments are of a normal recurring nature. These financial statements and the notes thereto should be read in conjunction with the Company's Annual Report on Form 10-K for the year ended December 31, 2011. Operating results for the nine month period ended September 30, 2012 are not necessarily indicative of the results that may be expected for the year ending December 31, 2012 or any other period.

**2. EARNINGS PER SHARE**

The following table illustrates the computation of basic and diluted earnings per share:

|                                                            | <b>Three Months Ended<br/>September 30,</b>     |             | <b>Nine Months Ended<br/>September 30,</b> |             |
|------------------------------------------------------------|-------------------------------------------------|-------------|--------------------------------------------|-------------|
|                                                            | <b>2012</b>                                     | <b>2011</b> | <b>2012</b>                                | <b>2011</b> |
|                                                            | <b>(In thousands, except per share amounts)</b> |             |                                            |             |
| Net income available to common shareholders                | \$ 46,176                                       | \$ 36,373   | \$ 119,635                                 | \$ 105,343  |
| Weighted average common shares outstanding                 | 55,958                                          | 46,890      | 50,239                                     | 46,830      |
| Potential dilutive common shares                           | 135                                             | 143         | 154                                        | 183         |
| Weighted average common shares and equivalents outstanding | 56,093                                          | 47,033      | 50,393                                     | 47,013      |
| Basic earnings per common share                            | \$ 0.83                                         | \$ 0.78     | \$ 2.38                                    | \$ 2.25     |
| Diluted earnings per common share                          | \$ 0.82                                         | \$ 0.77     | \$ 2.37                                    | \$ 2.24     |

Basic earnings per share is computed by dividing net income by the weighted average number of shares outstanding during the applicable period using the two-class method. Diluted earnings per share is computed using the weighted-average number of shares determined for the basic computation plus the dilutive effect of stock options and non-vested restricted stock granted using the treasury stock method. There were no stock options exercisable at September 30, 2012 and 2011 that would have had an anti-dilutive effect on the above computation.

**3. NEW ACCOUNTING STANDARDS*****Accounting Standards Updates***

ASU 2011-03, *Transfers and Servicing (Topic 860) Reconsideration of Effective Control for Repurchase Agreements*. ASU 2011-03 is intended to improve financial reporting of repurchase agreements and other agreements that both entitle and obligate a transferor to repurchase or redeem financial assets before their maturity. ASU 2011-03 removes from the assessment of effective control (i) the criterion requiring the

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transferor to have the ability to repurchase or redeem the financial assets on substantially the agreed terms, even in the event of default by the transferee, and (ii) the collateral maintenance guidance related to that criterion. ASU 2011-03 became effective for the Company on January 1, 2012 and did not have a significant impact on the Company's financial statements.

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**PROSPERITY BANCSHARES, INC.® AND SUBSIDIARIES**

**NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS**

**SEPTEMBER 30, 2012**

**(UNAUDITED)**

*ASU 2011-04, Fair Value Measurement (Topic 820) Amendments to Achieve Common Fair Value Measurements and Disclosure Requirements in U.S. GAAP and IFRSs.* ASU 2011-04 amends Topic 820, Fair Value Measurements and Disclosures, to converge the fair value measurement guidance in U.S. generally accepted accounting principles and International Financial Reporting Standards. ASU 2011-04 clarifies the application of existing fair value measurement requirements, changes certain principles in Topic 820 and requires additional fair value disclosures. ASU 2011-04 became effective for the Company on January 1, 2012 and did not have a significant impact on the Company's financial statements (see Note 5-Fair Value).

*ASU 2011-05, Comprehensive Income (Topic 220) Presentation of Comprehensive Income.* ASU 2011-05 amends Topic 220, Comprehensive Income, to require that all non-owner changes in stockholders' equity be presented in either a single continuous statement of comprehensive income or in two separate but consecutive statements. Additionally, ASU 2011-05 requires entities to present, on the face of the financial statements, reclassification adjustments for items that are reclassified from other comprehensive income to net income in the statement or statements where the components of net income and the components of other comprehensive income are presented. The option to present components of other comprehensive income as part of the statement of changes in stockholders' equity was eliminated. ASU 2011-05 became effective for the Company on January 1, 2012; however, certain provisions related to the presentation of reclassification adjustments have been deferred by ASU 2011-12 Comprehensive Income (Topic 220) Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in Accounting Standards Update No. 2011-05, as further discussed below. In connection with the application of ASU 2011-05, the Company's financial statements now include a separate statement of comprehensive income.

*ASU 2011-08, Intangibles Goodwill and Other (Topic 350) Testing Goodwill for Impairment.* ASU 2011-08 amends Topic 350, Intangibles Goodwill and Other, to give entities the option to first assess qualitative factors to determine whether the existence of events or circumstances leads to a determination that it is more likely than not that the fair value of a reporting unit is less than its carrying amount. If, after assessing the totality of events or circumstances, an entity determines it is not more likely than not that the fair value of a reporting unit is less than its carrying amount, then performing the two-step impairment test is unnecessary. However, if an entity concludes otherwise, then it is required to perform the first step of the two-step impairment test by calculating the fair value of the reporting unit and comparing the fair value with the carrying amount of the reporting unit. ASU 2011-08 became effective for the Company on January 1, 2012 and its adoption did not have a significant impact on its financial statements.

*ASU 2011-11, Balance Sheet (Topic 210) Disclosures about Offsetting Assets and Liabilities.* ASU 2011-11 amends Topic 210, Balance Sheet, to require an entity to disclose both gross and net information about financial instruments, such as sales and repurchase agreements and reverse sale and repurchase agreements and securities borrowing/lending arrangements, and derivative instruments that are eligible for offset in the statement of financial position and/or subject to a master netting arrangement or similar agreement. ASU 2011-11 is effective for annual and interim periods beginning on January 1, 2013, and is not expected to have a significant impact on the Company's financial statements.

*ASU 2011-12 Comprehensive Income (Topic 220) Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in Accounting Standards Update No. 2011-05.* ASU 2011-12 defers changes in ASU 2011-05 that relate to the presentation of reclassification adjustments to allow the FASB time to redeliberate whether to require presentation of such adjustments on the face of the financial statements to show the effects of reclassifications out of accumulated other comprehensive income on the components of net income and other comprehensive income. ASU 2011-12 allows entities to continue to report reclassifications out of accumulated other comprehensive income consistent with the presentation requirements in effect before ASU 2011-05. All other requirements in ASU 2011-05 are not affected by ASU 2011-12. ASU 2011-12 became effective for the Company on January 1, 2012. In connection with the application of ASU 2011-05, the Company's financial statements now include a separate statement of comprehensive income.

*ASU 2012-02 Intangibles Goodwill and Other (Topic 350) Testing Indefinite-Lived Intangible Assets for Impairment.* ASU 2012-02 give entities the option to first assess qualitative factors to determine whether the existence of events or circumstances leads to a determination that it is more likely than not that an indefinite-lived intangible asset is impaired. If, after assessing the totality of events or circumstances, an entity

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determines it is more likely than not that an indefinite-lived intangible asset is impaired, then the entity must perform the quantitative impairment test. If, under the quantitative impairment test, the carrying amount of the intangible asset exceeds its fair value, an entity should recognize an impairment loss in the amount of that excess. Permitting an entity to assess qualitative factors when testing indefinite-lived intangible assets for impairment results in guidance that is similar to the goodwill impairment testing guidance in ASU 2011-08. ASU 2012-02 is effective for the Company beginning January 1, 2013 (early adoption permitted) and is not expected to have a significant impact on the Company's financial statements.

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*ASU 2012-03 Technical Amendments and Corrections to SEC Sections Amendments to SEC Paragraphs Pursuant to SEC Staff Bulletin No. 114, Technical Amendments Pursuant to SEC Release No. 33-9250, and Corrections Related to FASB Accounting Standards Update 2010-22.* ASU 2012-03 amends a number of SEC sections in the ASC as a result of (1) the issuance of SAB 114, (2) the issuance of SEC Final Rule 33-9250, and (3) necessary corrections related to ASU 2010-22. ASU 2012-03 is effective for the Company beginning January 1, 2013 and is not expected to have a significant impact on the Company's financial statements.

*ASU 2012-04 Technical Corrections and Improvements.* ASU 2012-04 makes certain technical corrections and conforming fair value amendments to the FASB Accounting Standards Codification (the Codification). The amendments cover a wide range of Topics in the Codification, related to technical corrections and improvements and conforming amendments related to fair value measurements. The amendments represent changes to clarify the Codification, correct unintended application of guidance, or make minor improvements to the Codification that are not expected to have a significant effect on current accounting practice. The amendments apply to all reporting entities within the scope of those topics. ASU 2012-04 is effective for the Company beginning January 1, 2013 and is not expected to have a significant impact on the Company's financial statements.

**4. LOANS AND ALLOWANCE FOR CREDIT LOSSES**

Total loans were \$5.08 billion at September 30, 2012, an increase of \$1.31 billion or 34.9% compared with \$3.77 billion at December 31, 2011. Loan growth was impacted by the acquisition of Texas Bankers, Inc., The Bank Arlington and American State Financial Corporation (ASB). The fair value of loans attributed to these acquisitions totaled \$24.2 million, \$21.8 million and \$1.13 billion at September 30, 2012, respectively. The Company recorded a preliminary discount on loans of \$104.9 million, of which \$27.1 million related to purchased credit impaired loans accounted for under ASC Topic 310-30 (formerly SOP 03-03) and \$77.8 million related to loans accounted for under ASC Topic 310-20 (formerly SFAS No. 91). Acquired loans included in the tables below are reported at fair value. See Note 11-Acquisitions for more information on acquired loans and purchased credit impaired loans.

The loan portfolio consists of various types of loans made principally to borrowers located in Bryan/College Station, Central Texas, Dallas/Fort Worth, East Texas, Houston, South Texas and West Texas and is classified by major type as follows:

|                                       | September 30,<br>2012  | December 31,<br>2011 |
|---------------------------------------|------------------------|----------------------|
|                                       | (Dollars in thousands) |                      |
| Commercial and industrial             | \$ 756,342             | \$ 406,433           |
| Real estate:                          |                        |                      |
| Construction and land development     | 496,417                | 482,140              |
| 1-4 family residential <sup>(1)</sup> | 1,213,873              | 1,007,266            |
| Home equity                           | 183,844                | 146,999              |
| Commercial mortgage                   | 1,837,224              | 1,351,986            |
| Agriculture real estate               | 205,333                | 136,008              |
| Multi-family residential              | 138,888                | 89,240               |
| Agriculture                           | 98,801                 | 34,226               |
| Consumer (net of unearned discount)   | 112,476                | 78,187               |
| Other                                 | 35,905                 | 33,421               |
| Total                                 | \$ 5,079,103           | \$ 3,765,906         |

(1) Includes \$4.3 million in loans held for sale carried at the lower of cost or market.

*(i) Commercial and Industrial Loans.* In nearly all cases, the Company's commercial loans are made in the Company's market areas and are underwritten on the basis of the borrower's ability to service the debt from income. As a general practice, the Company takes as collateral a lien on any available real estate, equipment or other assets owned by the borrower and obtains a personal guaranty of the borrower or principal. Working capital loans are primarily collateralized by short-term assets whereas term loans are primarily collateralized by long-term assets. In general, commercial loans involve more credit risk than residential mortgage loans and commercial mortgage loans and, therefore, usually yield a higher return. The increased risk in commercial loans is due to the type of collateral securing these loans. The increased risk also derives from the expectation that commercial loans generally will be serviced principally from the operations of the business, and those operations may not be

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successful. Historical trends have shown these types of loans to have higher delinquencies than mortgage loans. As a result of these additional complexities, variables and risks, commercial loans require more thorough underwriting and servicing than other types of loans.

(ii) **Commercial Mortgages.** The Company makes commercial mortgage loans collateralized by owner-occupied and non-owner-occupied real estate to finance the purchase of real estate. The Company's commercial mortgage loans are collateralized by first liens on real estate, typically have variable interest rates (or five year or less fixed rates) and amortize over a 15 to 20 year period. Payments on loans secured by such properties are often dependent on the successful operation or management of the properties.

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Accordingly, repayment of these loans may be subject to adverse conditions in the real estate market or the economy to a greater extent than other types of loans. The Company seeks to minimize these risks in a variety of ways, including giving careful consideration to the property's operating history, future operating projections, current and projected occupancy, location and physical condition in connection with underwriting these loans. The underwriting analysis also includes credit verification, analysis of global cash flow, appraisals and a review of the financial condition of the borrower. At September 30, 2012, approximately 43.3% of the outstanding principal balance of the Company's commercial real estate loans was secured by owner-occupied properties. At September 30, 2012, the Company had commercial real estate loans totaling \$2.47 billion which include the categories of construction and land development loans, commercial mortgage loans and multi-family residential loans.

**(iii) 1-4 Family Residential Loans.** The Company originates 1-4 family residential mortgage loans collateralized by owner-occupied residential properties located in the Company's market areas. The Company offers a variety of mortgage loan products which generally are amortized over five to 25 years. Loans collateralized by 1-4 family residential real estate generally have been originated in amounts of no more than 89% of appraised value or have mortgage insurance. The Company requires mortgage title insurance and hazard insurance. The Company has elected to keep all 1-4 family residential loans for its own account rather than selling such loans into the secondary market. By doing so, the Company is able to realize a higher yield on these loans; however, the Company also incurs interest rate risk as well as the risks associated with nonpayments on such loans.

**(iv) Construction and Land Development Loans.** The Company makes loans to finance the construction of residential and, to a lesser extent, nonresidential properties. Construction loans generally are collateralized by first liens on real estate and have floating interest rates. The Company conducts periodic inspections, either directly or through an agent, prior to approval of periodic draws on these loans. Underwriting guidelines similar to those described above are also used in the Company's construction lending activities. Construction loans involve additional risks attributable to the fact that loan funds are advanced upon the security of a project under construction, and the project is of uncertain value prior to its completion. Because of uncertainties inherent in estimating construction costs, the market value of the completed project and the effects of governmental regulation on real property, it can be difficult to accurately evaluate the total funds required to complete a project and the related loan to value ratio. As a result of these uncertainties, construction lending often involves the disbursement of substantial funds with repayment dependent, in part, on the success of the ultimate project rather than the ability of a borrower or guarantor to repay the loan. If the Company is forced to foreclose on a project prior to completion, there is no assurance that the Company will be able to recover all of the unpaid portion of the loan. In addition, the Company may be required to fund additional amounts to complete a project and may have to hold the property for an indeterminate period of time. While the Company has underwriting procedures designed to identify what it believes to be acceptable levels of risks in construction lending, no assurance can be given that these procedures will prevent losses from the risks described above.

**(v) Agriculture Loans and Farmland.** The Company provides agriculture loans for short-term crop production, including rice, cotton, milo and corn, farm equipment financing and agriculture real estate financing. The Company evaluates agriculture borrowers primarily based on their historical profitability, level of experience in their particular agriculture industry, overall financial capacity and the availability of secondary collateral to withstand economic and natural variations common to the industry. Because agriculture loans present a higher level of risk associated with events caused by nature, the Company routinely makes on-site visits and inspections in order to identify and monitor such risks. The Company's farmland loans are collateralized by first liens on real estate and typically have five to 15 year fixed rates.

**(vi) Consumer Loans.** Consumer loans made by the Company include direct credit automobile loans, recreational vehicle loans, boat loans, home improvement loans, home equity loans, personal loans (collateralized and uncollateralized) and deposit account collateralized loans. The terms of these loans typically range from 12 to 120 months and vary based upon the nature of collateral and size of loan. Generally, consumer loans present greater risk than do real estate secured loans, particularly in the case of consumer loans that are unsecured or collateralized by rapidly depreciating assets such as automobiles. In such cases, any repossessed collateral for a defaulted consumer loan may not provide an adequate source of repayment for the outstanding loan balance. The remaining deficiency often does not warrant further substantial collection efforts against the borrower beyond obtaining a deficiency judgment. In addition, consumer loan collections are dependent on the borrower's continuing financial stability, and thus are more likely to be adversely affected by job loss, divorce, illness or personal bankruptcy. Furthermore, the application of various federal and state laws may limit the amount which can be recovered on such loans.

The Company maintains an independent loan review department that reviews and validates the credit risk program on a periodic basis. Results of these reviews are presented to management. The loan review process complements and reinforces the risk identification and assessment decisions made by lenders and credit personnel, as well as the Company's policies and procedures.

**Concentrations of Credit.** Most of the Company's lending activity occurs within the State of Texas, including the four largest metropolitan areas of Austin, Dallas/Ft. Worth, Houston and San Antonio. The majority of the Company's loan portfolio consists of commercial real estate loans, 1-4 family residential loans and commercial and industrial loans. As of September 30, 2012 and December 31, 2011, there were no concentrations of loans related to any single industry in excess of 10% of total loans.



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*Foreign Loans.* The Company has U.S. dollar denominated loans and commitments to borrowers in Mexico. The outstanding balance of these loans and the unfunded amounts available under these commitments were not significant at September 30, 2012 or December 31, 2011.

*Related Party Loans.* As of September 30, 2012 and December 31, 2011, loans outstanding to directors, officers and their affiliates totaled \$6.7 million and \$9.8 million, respectively. All transactions entered into between the Company and such related parties are done in the ordinary course of business, made on the same terms and conditions as similar transactions with unaffiliated persons.

An analysis of activity with respect to these related-party loans is as follows:

|                                          | <b>For the<br/>Nine<br/>Months Ended<br/>September<br/>30,<br/>2012</b> | <b>For the Year<br/>Ended<br/>December 31,<br/>2011</b> |
|------------------------------------------|-------------------------------------------------------------------------|---------------------------------------------------------|
|                                          | <b>(Dollars in thousands)</b>                                           |                                                         |
| Beginning balance                        | \$ 9,809                                                                | \$ 12,783                                               |
| New loans and reclassified related loans | 736                                                                     | 4,168                                                   |
| Repayments                               | (3,851)                                                                 | (7,142)                                                 |
| Ending balance                           | \$ 6,694                                                                | \$ 9,809                                                |

*Nonaccrual and Past Due Loans.* The Company has several procedures in place to assist it in maintaining the overall quality of its loan portfolio. The Company has established underwriting guidelines to be followed by its officers and the Company also monitors its delinquency levels for any negative or adverse trends. There can be no assurance, however, that the Company's loan portfolio will not become subject to increasing pressures from deteriorating borrower credit due to general economic conditions.

The Company generally places a loan on nonaccrual status and ceases accruing interest when the payment of principal or interest is delinquent for 90 days, or earlier in some cases, unless the loan is in the process of collection and the underlying collateral fully supports the carrying value of the loan.

The Company requires appraisals on loans collateralized by real estate. With respect to potential problem loans, an evaluation of the borrower's overall financial condition is made to determine the need, if any, for possible writedowns or appropriate additions to the allowance for credit losses.

As of the dates indicated, nonaccrual loans, segregated by class of loans, were as follows:

|                                                                           | <b>September 30,<br/>2012</b> | <b>December 31,<br/>2011</b> |
|---------------------------------------------------------------------------|-------------------------------|------------------------------|
|                                                                           | <b>(Dollars in thousands)</b> |                              |
| Construction and land development                                         | \$ 86                         | \$ 1,175                     |
| Agriculture and agriculture real estate                                   | 410                           | 49                           |
| 1-4 family (includes home equity)                                         | 1,694                         | 923                          |
| Commercial real estate (commercial mortgage and multi-family residential) | 1,292                         | 790                          |
| Commercial and industrial                                                 | 1,557                         | 633                          |
| Consumer and other                                                        | 24                            | 8                            |
| Total                                                                     | \$ 5,063                      | \$ 3,578                     |



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An age analysis of past due loans, segregated by class of loans, as of the dates indicated, was as follows:

| As of September 30, 2012                                                  |                                    |                                            |                            |                  | Accruing                                   |
|---------------------------------------------------------------------------|------------------------------------|--------------------------------------------|----------------------------|------------------|--------------------------------------------|
|                                                                           | Loans<br>30-89<br>Days<br>Past Due | Loans<br>90 or<br>More<br>Days<br>Past Due | Total Past<br>Due<br>Loans | Current<br>Loans | Loans 90<br>or<br>More<br>Days<br>Past Due |
| (Dollars in thousands)                                                    |                                    |                                            |                            |                  |                                            |
| Construction and land development                                         | \$ 5,157                           | \$ 86                                      | \$ 5,243                   | \$ 491,174       | \$                                         |
| Agriculture and agriculture real estate                                   | 1,772                              | 362                                        | 2,134                      | 302,000          |                                            |
| 1-4 family (includes home equity)                                         | 1,756                              | 1,413                                      | 3,169                      | 1,394,548        |                                            |
| Commercial real estate (commercial mortgage and multi-family residential) | 9,965                              |                                            | 9,965                      | 1,966,147        |                                            |
| Commercial and industrial                                                 | 4,211                              | 426                                        | 4,637                      | 751,705          | 132                                        |
| Consumer and other                                                        | 1,104                              | 20                                         | 1,124                      | 147,257          |                                            |
| Total                                                                     | \$ 23,965                          | \$ 2,307                                   | \$ 26,272                  | \$ 5,052,831     | \$ 132                                     |

| As of December 31, 2011                                                   |                                    |                                            |                            |                  | Accruing                                   |
|---------------------------------------------------------------------------|------------------------------------|--------------------------------------------|----------------------------|------------------|--------------------------------------------|
|                                                                           | Loans<br>30-89<br>Days<br>Past Due | Loans<br>90 or<br>More<br>Days<br>Past Due | Total Past<br>Due<br>Loans | Current<br>Loans | Loans 90<br>or<br>More<br>Days<br>Past Due |
| (Dollars in thousands)                                                    |                                    |                                            |                            |                  |                                            |
| Construction and land development                                         | \$ 1,281                           | \$ 111                                     | \$ 1,392                   | \$ 480,748       | \$                                         |
| Agriculture and agriculture real estate                                   | 365                                | 9                                          | 374                        | 169,860          |                                            |
| 1-4 family (includes home equity)                                         | 1,527                              | 314                                        | 1,841                      | 1,152,424        |                                            |
| Commercial real estate (commercial mortgage and multi-family residential) | 5,630                              | 390                                        | 6,020                      | 1,435,206        |                                            |
| Commercial and industrial                                                 | 1,544                              | 394                                        | 1,938                      | 404,495          |                                            |
| Consumer and other                                                        | 89                                 |                                            | 89                         | 111,519          |                                            |
| Total                                                                     | \$ 10,436                          | \$ 1,218                                   | \$ 11,654                  | \$ 3,754,252     | \$                                         |

The following table presents information regarding past due loans and nonperforming assets at the dates indicated:

|                                         | September 30,<br>2012 | December 31,<br>2011 |
|-----------------------------------------|-----------------------|----------------------|
| (Dollars in thousands)                  |                       |                      |
| Nonaccrual loans                        | \$ 5,063              | \$ 3,578             |
| Accruing loans 90 or more days past due | 132                   |                      |
| Total nonperforming loans               | 5,195                 | 3,578                |

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|                                                           |           |           |
|-----------------------------------------------------------|-----------|-----------|
| Reposessed assets                                         | 10        | 146       |
| Other real estate                                         | 8,846     | 8,328     |
|                                                           |           |           |
| Total nonperforming assets                                | \$ 14,051 | \$ 12,052 |
|                                                           |           |           |
| Nonperforming assets to total loans and other real estate | 0.28%     | 0.32%     |

The Company had \$14.1 million in nonperforming assets at September 30, 2012 compared with \$12.1 million at December 31, 2011. If interest on nonaccrual loans had been accrued under the original loan terms, approximately \$252,000 and \$156,000 would have been recorded as income for the nine months ended September 30, 2012 and 2011, respectively.

*Impaired Loans.* Loans are considered impaired when, based on current information and events, it is probable the Company will be unable to collect all amounts due in accordance with the original contractual terms of the loan agreement, including scheduled principal and interest payments. Impairment is evaluated in total for smaller-balance loans of a similar nature and on an individual loan basis for other loans. If a loan is impaired, a specific valuation allowance is allocated, if necessary, so that the loan is reported net, at the present value of estimated future cash flows using the loan's existing rate or at the fair value of collateral if repayment is expected solely from the collateral. Interest payments on impaired loans are typically applied to principal unless collectability of the principal amount is reasonably assured, in which case interest is recognized on a cash basis. Impaired loans, or portions thereof, are charged off when deemed uncollectible.

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Impaired loans as of September 30, 2012 are set forth in the following table. No interest income was recognized on impaired loans subsequent to their classification as impaired.

|                                                                              | September 30, 2012     |                                |                                                |                                                      |                                                   |
|------------------------------------------------------------------------------|------------------------|--------------------------------|------------------------------------------------|------------------------------------------------------|---------------------------------------------------|
|                                                                              | Recorded<br>Investment | Unpaid<br>Principal<br>Balance | Related<br>Allowance<br>(Dollars in thousands) | Average Recorded<br>Investment<br>Quarter<br>to Date | Average Recorded<br>Investment<br>Year to<br>Date |
| <b>With no related allowance recorded:</b>                                   |                        |                                |                                                |                                                      |                                                   |
| Construction and land development                                            | \$ 60                  | \$ 61                          | \$                                             | \$ 143                                               | \$ 168                                            |
| Agriculture and agriculture real estate                                      | 77                     | 77                             |                                                | 41                                                   | 23                                                |
| 1-4 family (includes home equity)                                            | 362                    | 407                            |                                                | 379                                                  | 353                                               |
| Commercial real estate (commercial mortgage<br>and multi-family residential) | 396                    | 421                            |                                                | 379                                                  | 733                                               |
| Commercial and industrial                                                    | 157                    | 158                            |                                                | 80                                                   | 69                                                |
| Consumer and other                                                           |                        |                                |                                                |                                                      |                                                   |
| <b>With an allowance recorded:</b>                                           |                        |                                |                                                |                                                      |                                                   |
| Construction and land development                                            | 26                     | 26                             | 26                                             | 64                                                   | 564                                               |
| Agriculture and agriculture real estate                                      | 66                     | 72                             | 61                                             | 52                                                   | 47                                                |
| 1-4 family (includes home equity)                                            | 1,086                  | 1,103                          | 336                                            | 660                                                  | 650                                               |
| Commercial real estate (commercial mortgage<br>and multi-family residential) | 2,774                  | 2,786                          | 567                                            | 2,766                                                | 2,794                                             |
| Commercial and industrial                                                    | 1,238                  | 1,547                          | 1,180                                          | 869                                                  | 717                                               |
| Consumer and other                                                           | 20                     | 34                             | 20                                             | 13                                                   | 10                                                |
| <b>Total:</b>                                                                |                        |                                |                                                |                                                      |                                                   |
| Construction and land development                                            | 86                     | 87                             | 26                                             | 207                                                  | 732                                               |
| Agriculture and agriculture real estate                                      | 143                    | 149                            | 61                                             | 93                                                   | 70                                                |
| 1-4 family (includes home equity)                                            | 1,448                  | 1,510                          | 336                                            | 1,039                                                | 1,003                                             |
| Commercial real estate (commercial mortgage<br>and multi-family residential) | 3,170                  | 3,207                          | 567                                            | 3,145                                                | 3,527                                             |
| Commercial and industrial                                                    | 1,395                  | 1,705                          | 1,180                                          | 949                                                  | 786                                               |
| Consumer and other                                                           | 20                     | 34                             | 20                                             | 13                                                   | 10                                                |

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Impaired loans as of December 31, 2011 are set forth in the following table. No interest income was recognized on impaired loans subsequent to their classification as impaired. The average recorded investment is reported on a year-to-date basis.

|                                                                           | December 31, 2011      |           |           |            |
|---------------------------------------------------------------------------|------------------------|-----------|-----------|------------|
|                                                                           |                        | Unpaid    |           | Average    |
|                                                                           | Recorded Investment    | Principal | Related   | Recorded   |
|                                                                           |                        | Balance   | Allowance | Investment |
|                                                                           | (Dollars in thousands) |           |           |            |
| <b>With no related allowance recorded:</b>                                |                        |           |           |            |
| Construction and land development                                         | \$ 111                 | \$ 111    | \$        | \$ 58      |
| Agriculture and agriculture real estate                                   | 6                      | 6         |           | 5          |
| 1-4 family (includes home equity)                                         | 313                    | 344       |           | 291        |
| Commercial real estate (commercial mortgage and multi-family residential) | 668                    | 705       |           | 637        |
| Commercial and industrial                                                 | 112                    | 1,513     |           | 253        |
| Consumer and other                                                        |                        |           |           | 3          |
| <b>With an allowance recorded:</b>                                        |                        |           |           |            |
| Construction and land development                                         | 1,064                  | 1,064     | 312       | 584        |
| Agriculture and agriculture real estate                                   | 43                     | 46        | 39        | 21         |
| 1-4 family (includes home equity)                                         | 677                    | 731       | 362       | 663        |
| Commercial real estate (commercial mortgage and multi-family residential) | 483                    | 485       | 165       | 309        |
| Commercial and industrial                                                 | 521                    | 535       | 300       | 642        |
| Consumer and other                                                        | 8                      | 20        | 8         | 18         |
| <b>Total:</b>                                                             |                        |           |           |            |
| Construction and land development                                         | 1,175                  | 1,175     | 312       | 642        |
| Agriculture and agriculture real estate                                   | 49                     | 52        | 39        | 26         |
| 1-4 family (includes home equity)                                         | 990                    | 1,075     | 362       | 954        |
| Commercial real estate (commercial mortgage and multi-family residential) | 1,151                  | 1,190     | 165       | 946        |
| Commercial and industrial                                                 | 633                    | 2,048     | 300       | 895        |
| Consumer and other                                                        | 8                      | 20        | 8         | 21         |

**Credit Quality Indicators.** As part of the ongoing monitoring of the credit quality of the Company's loan portfolio and methodology for calculating the allowance for credit losses, management assigns and tracks loan risk grades to be used as credit quality indicators. The following is a general description of the loan risk grades used (1-7):

**Grade 1** Credits in this category are of the highest standards of credit quality with virtually no risk of loss. These borrowers would represent top rated companies and individuals with unquestionable financial standing with excellent global cash flow coverage, net worth, liquidity and collateral coverage and/or secured by CD/savings accounts.

**Grade 2** Credits in this category are not immune from risk but are well-protected by the collateral and paying capacity of the borrower. These loans may exhibit a minor unfavorable credit factor, but the overall credit is sufficiently strong to minimize the possibility of loss.

**Grade 3** Credits graded 3 constitute an undue and unwarranted credit risk, however the factors do not rise to a level of substandard. These credits have potential weaknesses and/or declining trends that, if not corrected, could expose the Bank to risk at a future date. Credits graded 3 are monitored on the Bank's internally generated watch list and evaluated on a quarterly basis.

**Grade 4** Credits in this category are deemed substandard loans in accordance with regulatory guidelines. Loans in this category have well-defined weakness that, if not corrected, could make default of principal and interest possible, but it is not yet certain. Loans in this category are still accruing interest and may be dependent upon secondary sources of repayment and/or collateral liquidation.

**Grade 5** Credits in this category are deemed substandard and impaired pursuant to regulatory guidelines. As such, the Bank has determined that it is probable that less than 100% of the principal and interest will be collected. Loans graded 5 are individually evaluated for a specific reserve valuation and will typically have the accrual of interest stopped.



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**Grade 6** Credits in this category include doubtful loans in accordance with regulatory guidance. Such loans are on nonaccrual and factors have indicated a loss is imminent. These loans are also deemed impaired. While a specific reserve may be in place while the loan and collateral is being evaluated these loans are typically charged down to an amount the Bank deems can be collected.

**Grade 7** Credits in this category are deemed a loss in accordance with regulatory guidelines and charged off or charged down. The Bank may continue collection efforts and may have partial recovery in the future.

The following table presents loan risk grades and classified loans by class of loan at September 30, 2012. Classified loans include loans in risk grades 5, 6 and 7.

|         | Construction and Land Development | Agriculture and Agriculture Real Estate | 1-4 Family (Includes Home Equity) | Commercial Real Estate (Commercial Mortgage and Multi-Family) | Commercial and Industrial | Consumer and Other | Total        |
|---------|-----------------------------------|-----------------------------------------|-----------------------------------|---------------------------------------------------------------|---------------------------|--------------------|--------------|
|         | (Dollars in thousands)            |                                         |                                   |                                                               |                           |                    |              |
| Grade 1 | \$                                | \$ 2,601                                | \$                                | \$                                                            | \$ 45,371                 | \$ 28,269          | \$ 76,241    |
| Grade 2 | 482,385                           | 297,231                                 | 1,384,513                         | 1,930,565                                                     | 695,762                   | 119,392            | 4,909,848    |
| Grade 3 | 8,351                             | 2,128                                   | 6,617                             | 9,163                                                         | 8,206                     |                    | 34,465       |
| Grade 4 | 5,595                             | 2,031                                   | 5,139                             | 33,214                                                        | 5,608                     | 700                | 52,287       |
| Grade 5 | 86                                | 143                                     | 1,435                             | 3,170                                                         | 1,393                     | 20                 | 6,247        |
| Grade 6 |                                   |                                         | 13                                |                                                               | 2                         |                    | 15           |
| Grade 7 |                                   |                                         |                                   |                                                               |                           |                    |              |
| Total   | \$ 496,417                        | \$ 304,134                              | \$ 1,397,717                      | \$ 1,976,112                                                  | \$ 756,342                | \$ 148,381         | \$ 5,079,103 |

The following table presents risk grades and classified loans by class of loan at December 31, 2011. Classified loans include loans in risk grades 5, 6 and 7.

|         | Construction and Land Development | Agriculture and Agriculture Real Estate | 1-4 Family (Includes Home Equity) | Commercial Real Estate (Commercial Mortgage and Multi-Family) | Commercial and Industrial | Consumer and Other | Total        |
|---------|-----------------------------------|-----------------------------------------|-----------------------------------|---------------------------------------------------------------|---------------------------|--------------------|--------------|
|         | (Dollars in thousands)            |                                         |                                   |                                                               |                           |                    |              |
| Grade 1 | \$                                | \$ 3,319                                | \$                                | \$                                                            | \$ 45,218                 | \$ 31,602          | \$ 80,139    |
| Grade 2 | 465,572                           | 166,656                                 | 1,140,210                         | 1,399,915                                                     | 355,862                   | 79,996             | 3,608,211    |
| Grade 3 | 1,757                             | 210                                     | 9,131                             | 14,335                                                        | 4,189                     |                    | 29,622       |
| Grade 4 | 13,636                            |                                         | 3,934                             | 25,825                                                        | 531                       | 2                  | 43,928       |
| Grade 5 | 1,175                             | 49                                      | 970                               | 1,151                                                         | 532                       | 8                  | 3,885        |
| Grade 6 |                                   |                                         | 20                                |                                                               | 101                       |                    | 121          |
| Grade 7 |                                   |                                         |                                   |                                                               |                           |                    |              |
| Total   | \$ 482,140                        | \$ 170,234                              | \$ 1,154,265                      | \$ 1,441,226                                                  | \$ 406,433                | \$ 111,608         | \$ 3,765,906 |

Net charge-offs/recoveries, segregated by class of loans, for the three and nine months ended September 30, 2012 and 2011 were as follows:

|                                   | Three Months Ended September 30, |        | Nine Months Ended September 30, |          |
|-----------------------------------|----------------------------------|--------|---------------------------------|----------|
|                                   | 2012                             | 2011   | 2012                            | 2011     |
| Construction and land development | \$ (155)                         | \$ 197 | \$ (1,356)                      | \$ (955) |

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|                                                                |                |              |                |                |
|----------------------------------------------------------------|----------------|--------------|----------------|----------------|
| 1-4 family (includes home equity)                              | (251)          | (134)        | (392)          | (517)          |
| Commercial real estate and agriculture (includes multi-family) | (770)          | (271)        | (1,080)        | (768)          |
| Commercial and industrial                                      | 511            | (7)          | 345            | (492)          |
| Consumer and other                                             | (590)          | (153)        | (734)          | (389)          |
| <br>Total                                                      | <br>\$ (1,255) | <br>\$ (368) | <br>\$ (3,217) | <br>\$ (3,121) |

*Allowance for Credit Losses.* The allowance for credit losses is a valuation established through charges to earnings in the form of a provision for credit losses. Management has established an allowance for credit losses which it believes is adequate for estimated losses in the Company's loan portfolio. The amount of the allowance for credit losses is affected by the following: (i) charge-offs of loans that occur when loans are deemed uncollectible and decrease the allowance, (ii) recoveries on loans previously charged off that

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increase the allowance and (iii) provisions for credit losses charged to earnings that increase the allowance. Based on an evaluation of the loan portfolio and consideration of the factors listed below, management presents a quarterly review of the allowance for credit losses to the Bank's Board of Directors, indicating any change in the allowance since the last review and any recommendations as to adjustments in the allowance.

The Company's allowance for credit losses consists of two components: a specific valuation allowance based on probable losses on specifically identified loans and a general valuation allowance based on historical loan loss experience, general economic conditions and other qualitative risk factors both internal and external to the Company.

In setting the specific valuation allowance, the Company follows a loan review program to evaluate the credit risk in the loan portfolio. Through this loan review process, the Company maintains an internal list of impaired loans which, along with the delinquency list of loans, helps management assess the overall quality of the loan portfolio and the adequacy of the allowance for credit losses. All loans that have been identified as impaired are reviewed on a quarterly basis in order to determine whether a specific reserve is required. For each impaired loan, the Company allocates a specific loan loss reserve primarily based on the value of the collateral securing the impaired loan in accordance with ASC Topic 310, *Receivables*. The specific reserves are determined on an individual loan basis. Loans for which specific reserves are provided are excluded from the general valuation allowance described below.

In determining the amount of the general valuation allowance, management considers factors such as historical loan loss experience, industry diversification of the Company's commercial loan portfolio, concentration risk of specific loan types, the volume, growth and composition of the Company's loan portfolio, current economic conditions that may affect the borrower's ability to pay and the value of collateral, the evaluation of the Company's loan portfolio through its internal loan review process, general economic conditions and other qualitative risk factors both internal and external to the Company and other relevant factors in accordance with ASC Topic 450, *Contingencies*. Based on a review of these factors for each loan type, the Company applies an estimated percentage to the outstanding balance of each loan type, excluding any loan that has a specific reserve allocated to it. The Company uses this information to establish the amount of the general valuation allowance.

In connection with its review of the loan portfolio, the Company considers risk elements attributable to particular loan types or categories in assessing the quality of individual loans. Some of the risk elements include:

for 1-4 family residential mortgage loans, the borrower's ability to repay the loan, including a consideration of the debt to income ratio and employment and income stability, the loan to value ratio, and the age, condition and marketability of collateral;

for commercial mortgage loans and multifamily residential loans, the debt service coverage ratio (income from the property in excess of operating expenses compared to loan payment requirements), operating results of the owner in the case of owner-occupied properties, the loan to value ratio, the age and condition of the collateral and the volatility of income, property value and future operating results typical of properties of that type;

for construction and land development loans, the perceived feasibility of the project including the ability to sell developed lots or improvements constructed for resale or the ability to lease property constructed for lease, the quality and nature of contracts for presale or prelease, if any, experience and ability of the developer and loan to value ratio;

for commercial and industrial loans, the operating results of the commercial, industrial or professional enterprise, the borrower's business, professional and financial ability and expertise, the specific risks and volatility of income and operating results typical for businesses in that category and the value, nature and marketability of collateral;

for agricultural real estate loans, the experience and financial capability of the borrower, projected debt service coverage of the operations of the borrower and loan to value ratio; and

for non-real estate agricultural loans, the operating results, experience and financial capability of the borrower, historical and expected market conditions and the value, nature and marketability of collateral.

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In addition, for each category, the Company considers secondary sources of income and the financial strength and credit history of the borrower and any guarantors.

At September 30, 2012, the allowance for credit losses totaled \$50.9 million or 1.00% of total loans. At December 31, 2011, the allowance aggregated \$51.6 million or 1.37% of total loans.

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The following table details the recorded investment in loans and activity in the allowance for credit losses by portfolio segment for the nine months ended September 30, 2012. Allocation of a portion of the allowance to one category of loans does not preclude its availability to absorb losses in other categories.

|                                                          | Construction<br>and Land<br>Development | Agriculture<br>and<br>Agriculture<br>Real Estate | 1-4 Family<br>(includes<br>Home<br>Equity) | Commercial Real<br>Estate (Commercial<br>Mortgage and<br>Multi-Family) | Commercial<br>and<br>Industrial | Consumer<br>and Other | Total        |
|----------------------------------------------------------|-----------------------------------------|--------------------------------------------------|--------------------------------------------|------------------------------------------------------------------------|---------------------------------|-----------------------|--------------|
| (Dollars in thousands)                                   |                                         |                                                  |                                            |                                                                        |                                 |                       |              |
| <b>Allowance for credit losses:</b>                      |                                         |                                                  |                                            |                                                                        |                                 |                       |              |
| Beginning balance                                        | \$ 12,094                               | \$ 511                                           | \$ 12,645                                  | \$ 21,460                                                              | \$ 3,826                        | \$ 1,058              | \$ 51,594    |
| Provision for credit losses                              | (469)                                   | 226                                              | 1,121                                      | (250)                                                                  | 1,237                           | 685                   | 2,550        |
| Charge-offs                                              | (1,368)                                 |                                                  | (478)                                      | (1,278)                                                                | (376)                           | (2,101)               | (5,601)      |
| Recoveries                                               | 12                                      | 33                                               | 86                                         | 165                                                                    | 721                             | 1,367                 | 2,384        |
| Net charge-offs                                          | (1,356)                                 | 33                                               | (392)                                      | (1,113)                                                                | 345                             | (734)                 | (3,217)      |
| Ending balance                                           | 10,269                                  | 770                                              | 13,374                                     | 20,097                                                                 | 5,408                           | 1,009                 | 50,927       |
| Ending balance: individually<br>evaluated for impairment | 26                                      | 61                                               | 336                                        | 567                                                                    | 1,180                           | 20                    | 2,190        |
| Ending balance: collectively<br>evaluated for impairment | \$ 10,243                               | \$ 709                                           | \$ 13,038                                  | \$ 19,530                                                              | \$ 4,228                        | \$ 989                | \$ 48,737    |
| <b>Loans:</b>                                            |                                         |                                                  |                                            |                                                                        |                                 |                       |              |
| Ending balance: individually<br>evaluated for impairment | 86                                      | 143                                              | 1,448                                      | 3,170                                                                  | 1,395                           | 20                    | 6,262        |
| Ending balance: collectively<br>evaluated for impairment | 496,331                                 | 303,991                                          | 1,396,269                                  | 1,972,942                                                              | 754,947                         | 148,361               | 5,072,841    |
| Ending balance                                           | \$ 496,417                              | \$ 304,134                                       | \$ 1,397,717                               | \$ 1,976,112                                                           | \$ 756,342                      | \$ 148,381            | \$ 5,079,103 |

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The following table details the recorded investment in loans and activity in the allowance for credit losses by portfolio segment for the year ended December 31, 2011. Allocation of a portion of the allowance to one category of loans does not preclude its availability to absorb losses in other categories.

|                                                          | Construction<br>and Land<br>Development | Agriculture<br>and<br>Agriculture<br>Real Estate | 1-4 Family<br>(includes<br>Home<br>Equity) | Commercial Real<br>Estate (Commercial<br>Mortgage and<br>Multi-Family) | Commercial<br>and<br>Industrial | Consumer<br>and Other | Total        |
|----------------------------------------------------------|-----------------------------------------|--------------------------------------------------|--------------------------------------------|------------------------------------------------------------------------|---------------------------------|-----------------------|--------------|
| (Dollars in thousands)                                   |                                         |                                                  |                                            |                                                                        |                                 |                       |              |
| <b>Allowance for credit losses:</b>                      |                                         |                                                  |                                            |                                                                        |                                 |                       |              |
| Beginning balance                                        | \$ 12,994                               | \$ 271                                           | \$ 12,837                                  | \$ 20,436                                                              | \$ 3,891                        | \$ 1,155              | \$ 51,584    |
| Provision for credit losses                              | 209                                     | 239                                              | 1,168                                      | 2,011                                                                  | 1,103                           | 470                   | 5,200        |
| Charge-offs                                              | (1,509)                                 |                                                  | (1,392)                                    | (1,027)                                                                | (1,694)                         | (1,228)               | (6,850)      |
| Recoveries                                               | 400                                     | 1                                                | 32                                         | 40                                                                     | 526                             | 661                   | 1,660        |
| Net charge-offs                                          | (1,109)                                 | 1                                                | (1,360)                                    | (987)                                                                  | (1,168)                         | (567)                 | (5,190)      |
| Ending balance                                           | 12,094                                  | 511                                              | 12,645                                     | 21,460                                                                 | 3,826                           | 1,058                 | 51,594       |
| Ending balance: individually<br>evaluated for impairment | 312                                     | 39                                               | 362                                        | 165                                                                    | 300                             | 8                     | 1,186        |
| Ending balance: collectively<br>evaluated for impairment | \$ 11,782                               | \$ 472                                           | \$ 12,283                                  | \$ 21,295                                                              | \$ 3,526                        | \$ 1,050              | \$ 50,408    |
| <b>Loans:</b>                                            |                                         |                                                  |                                            |                                                                        |                                 |                       |              |
| Ending balance: individually<br>evaluated for impairment | 1,175                                   | 49                                               | 990                                        | 1,151                                                                  | 633                             | 8                     | 4,006        |
| Ending balance: collectively<br>evaluated for impairment | 480,965                                 | 170,185                                          | 1,153,275                                  | 1,440,075                                                              | 405,800                         | 111,600               | 3,761,900    |
| Ending balance                                           | \$ 482,140                              | \$ 170,234                                       | \$ 1,154,265                               | \$ 1,441,226                                                           | \$ 406,433                      | \$ 111,608            | \$ 3,765,906 |

**Troubled Debt Restructurings.** The restructuring of a loan is considered a troubled debt restructuring if both (i) the borrower is experiencing financial difficulties and (ii) the creditor has granted a concession. Concessions may include interest rate reductions or below market interest rates, principal forgiveness, restructuring amortization schedules and other actions intended to minimize potential losses. Effective July 1, 2011, the Company adopted the provisions of ASU No. 2011-02, *Receivables (Topic 310) A Creditor's Determination of Whether a Restructuring Is a Troubled Debt Restructuring*. As such, the Company reassessed all loan modifications occurring since January 1, 2011 for identification as troubled debt restructurings.

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The Company had the following troubled debt restructurings outstanding as of the dates indicated:

|                                                               | As of September 30, 2012 |                                                               |                                                                                          | As of December 31, 2011 |                                                               |                                                                |
|---------------------------------------------------------------|--------------------------|---------------------------------------------------------------|------------------------------------------------------------------------------------------|-------------------------|---------------------------------------------------------------|----------------------------------------------------------------|
|                                                               | Number of                | Pre-<br>Modification<br>Outstanding<br>Recorded<br>Investment | Post-<br>Modification<br>Outstanding<br>Recorded<br>Investment<br>(Dollars in thousands) | Number of               | Pre-<br>Modification<br>Outstanding<br>Recorded<br>Investment | Post-<br>Modification<br>Outstanding<br>Recorded<br>Investment |
| <b>Troubled Debt Restructurings</b>                           |                          |                                                               |                                                                                          |                         |                                                               |                                                                |
| Construction and land development                             |                          | \$                                                            | \$                                                                                       |                         | \$                                                            | \$                                                             |
| Agriculture and agriculture real estate                       |                          |                                                               |                                                                                          |                         |                                                               |                                                                |
| 1-4 family (includes home equity)                             | 4                        | 109                                                           | 66                                                                                       | 4                       | 109                                                           | 84                                                             |
| Commercial real estate (commercial mortgage and multi-family) | 1                        | 2,560                                                         | 2,469                                                                                    | 2                       | 5,264                                                         | 5,171                                                          |
| Commercial and industrial                                     | 7                        | 1,086                                                         | 1,061                                                                                    | 3                       | 114                                                           | 93                                                             |
| Consumer and other                                            |                          |                                                               |                                                                                          |                         |                                                               |                                                                |
| Total                                                         | 12                       | \$ 3,755                                                      | \$ 3,596                                                                                 | 9                       | \$ 5,487                                                      | \$ 5,348                                                       |

As of September 30, 2012, there have been no defaults on any loans that were modified as troubled debt restructurings during the preceding twelve months. Default is determined at 90 or more days past due. The modifications primarily related to extending the amortization periods of the loans, which may include loans modified during bankruptcy. The Company did not grant principal reductions on any restructured loan. Loans restructured during the nine months ended September 30, 2012 on non-accrual status as of September 30, 2012 totaled \$972,000. The remaining restructured loans are performing and accruing loans. These modifications did not have a material impact on the Company's determination of the allowance for credit losses.

**5. FAIR VALUE DISCLOSURES**

Effective January 1, 2008, the Company adopted FASB ASC Topic 820, *Fair Value Measurement and Disclosures*. ASC Topic 820, which defines fair value, addresses aspects of the expanding application of fair value accounting and establishes a consistent framework for measuring fair value. Fair value represents the estimated price that would be received from selling an asset or paid to transfer a liability, otherwise known as an exit price.

***Fair Value Hierarchy***

ASC Topic 820 specifies a hierarchy of valuation techniques based on whether the inputs to those valuation techniques are observable or unobservable. In accordance with ASC Topic 820, these inputs are summarized in the three broad levels listed below:

Level 1 Quoted prices in active markets for identical assets or liabilities. Level 1 assets include U.S. Treasury securities that are highly liquid and are actively traded in over-the-counter markets and CRA funds.

Level 2 Other significant observable inputs (including quoted prices in active markets for similar assets or liabilities) or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities. The Company's Level 2 assets include U.S. government and agency mortgage-backed debt securities, corporate securities and municipal bonds.

Level 3 Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities. Level 3 assets and liabilities include financial instruments whose value is determined using pricing models, discounted cash flow methodologies, or similar techniques, as well as instruments for which the determination of fair values requires significant

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management judgment or estimation.

In determining the appropriate levels, the Company performs a detailed analysis of the assets and liabilities that are subject to ASC Topic 820.

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The following table summarizes financial assets and financial liabilities measured at fair value on a recurring basis as of September 30, 2012 and December 31, 2011, segregated by the level of the valuation inputs within the fair value hierarchy utilized to measure fair value:

|                                                | Level 1  | September 30, 2012<br>Level 2      Level 3<br>(Dollars in thousands) |    | Total      |
|------------------------------------------------|----------|----------------------------------------------------------------------|----|------------|
| Available for sale securities (at fair value): |          |                                                                      |    |            |
| States and political subdivisions              | \$       | \$ 37,188                                                            | \$ | \$ 37,188  |
| Corporate debt securities and other            | 7,747    | 1,553                                                                |    | 9,300      |
| Collateralized mortgage obligations            |          | 638                                                                  |    | 638        |
| Mortgage-backed securities                     |          | 203,261                                                              |    | 203,261    |
| Total                                          | \$ 7,747 | \$ 242,640                                                           | \$ | \$ 250,387 |

  

|                                                | Level 1  | December 31, 2011<br>Level 2      Level 3<br>(Dollars in thousands) |    | Total      |
|------------------------------------------------|----------|---------------------------------------------------------------------|----|------------|
| Available for sale securities (at fair value): |          |                                                                     |    |            |
| States and political subdivisions              | \$       | \$ 39,076                                                           | \$ | \$ 39,076  |
| Corporate debt securities and other            | 7,656    | 1,613                                                               |    | 9,269      |
| Collateralized mortgage obligations            |          | 765                                                                 |    | 765        |
| Mortgage-backed securities                     |          | 273,206                                                             |    | 273,206    |
| Total                                          | \$ 7,656 | \$ 314,660                                                          | \$ | \$ 322,316 |

Certain assets and liabilities are measured at fair value on a non-recurring basis; that is, the instruments are not measured at fair value on an ongoing basis but are subject to fair value adjustments in certain circumstances (for example, when there is evidence of impairment). Financial assets measured at fair value on a non-recurring basis during the reported periods include certain impaired loans reported at the fair value of the underlying collateral if repayment is expected solely from the collateral. Collateral values are estimated using Level 2 inputs based on observable market data, typically in the case of real estate collateral. For the nine months ended September 30, 2012, the Company had additions to impaired loans of \$8.2 million, of which \$4.3 million were outstanding at September 30, 2012.

Assets measured at fair value on a non-recurring basis during the reported periods also include other real estate owned and repossessed assets. For the nine months ended September 30, 2012, the Company had additions to other real estate owned of \$10.9 million, of which \$5.2 million were outstanding at September 30, 2012. The remaining assets and liabilities measured at fair value on a non-recurring basis that were recorded in 2012 and remained outstanding at September 30, 2012 were not significant. During the reported periods, all fair value measurements for assets and liabilities measured at fair value on a non-recurring basis utilized Level 2 inputs based on observable market data. There were no transfers between Level 1 and Level 2 assets during the nine months ended September 30, 2012.

These fair value disclosures represent the Company's estimates based on relevant market information and information about the financial instruments. Fair value estimates are based on judgments regarding future expected loss experience, current economic conditions, risk characteristics of the various instruments and other factors. These estimates are subjective in nature and involve uncertainties and matters of significant judgment and therefore cannot be determined with precision. Changes in the above methodologies and assumptions could significantly affect the estimates.

The following methods and assumptions were used to estimate the fair value of each class of financial instruments for which it is practicable to estimate that value:

**Cash and Cash Equivalents** For these short-term instruments, the carrying amount is a reasonable estimate of fair value.

**Federal Funds Sold** For these short-term instruments, the carrying amount is a reasonable estimate of fair value.

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**Securities** For securities held as investments, fair value equals quoted market price, if available. If a quoted market price is not available, fair value is estimated using quoted market prices for similar securities.

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**Loans Held for Investment** For fixed rate loans and certain homogeneous categories of loans (such as some residential mortgages and other consumer loans), fair value is estimated by discounting the future cash flows using the risk-free Treasury rate for the applicable maturity, adjusted for servicing and credit risk. An overall valuation adjustment is made for specific credit risks as well as general portfolio credit risk. The carrying value of variable rate loans approximates fair value because the loans reprice frequently to current market rates.

**Loans Held for Sale** Loans held for sale are recorded at the lower of cost or fair value. Loans held for sale may be carried at fair value on a nonrecurring basis when fair value is less than cost. The fair value is based on what secondary markets are currently offering for portfolios with similar characteristics. As such, the Company classifies both loans held for sale subjected to nonrecurring fair value adjustments and the estimated fair value of loans held for sale as Level 2.

**Deposits** The fair value of demand deposits, savings accounts and certain money market deposits is the amount payable on demand at the reporting date. The fair value of fixed-maturity certificates of deposit is estimated using the rates currently offered for deposits of similar remaining maturities.

**Junior Subordinated Debentures** The fair value of the junior subordinated debentures is calculated using the quoted market prices, if available. If quoted market prices are not available, fair value is estimated using quoted market prices for similar subordinated debentures.

**Other Borrowings** Rates currently available to the Company for debt with similar terms and remaining maturities are used to estimate the fair value of existing debt using a discounted cash flows methodology.

**Securities Sold Under Repurchase Agreements** The fair value of securities sold under repurchase agreements is the amount payable on demand at the reporting date.

**Off-Balance Sheet Financial Instruments** The fair value of commitments to extend credit and standby letters of credit is estimated using the fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreement and the present creditworthiness of the counterparties. The Company's off-balance sheet commitments are funded at current market rates at the date they are drawn upon. It is management's opinion that the fair value of these commitments would approximate their carrying value, if drawn upon.

FASB ASC Topic 825, *Financial Instruments*, requires disclosure of the fair value of financial assets and financial liabilities, including those financial assets and financial liabilities that are not measured and reported at fair value on a recurring basis or non-recurring basis. The Company provides fair value estimates for loans not recorded at fair value. During the reported periods, fair value measurements for loans utilized Level 3 inputs. The estimated fair value is determined based on characteristics such as loan category, repricing features and remaining maturity, and includes prepayment and credit loss estimates. The model used to estimate fair value of loans employs a discount rate that reflects the Company's current pricing for loans with similar characteristics and remaining maturity, adjusted by an amount for estimated credit losses inherent in the portfolio and liquidity risk, at the balance sheet date. The adjustment approximates 25 basis points for the reported periods. The rates take into account the expected yield curve, as well as an adjustment for prepayment risk, when applicable. The Company utilizes a third party to assist with its fair value measurements. Inputs used in the pricing model are validated by management.

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All fair value measurements for remaining financial assets and financial liabilities utilized Level 2 inputs based on observable market data. The carrying amount and estimated fair value of the Company's financial instruments, as of the dates indicated, are as follows:

|                                                                | September 30, 2012   |                      | December 31, 2011   |                      |
|----------------------------------------------------------------|----------------------|----------------------|---------------------|----------------------|
|                                                                | Carrying Amount      | Estimated Fair Value | Carrying Amount     | Estimated Fair Value |
| (Dollars in thousands)                                         |                      |                      |                     |                      |
| <b>Financial Assets:</b>                                       |                      |                      |                     |                      |
| Cash and due from banks                                        | \$ 207,401           | \$ 207,401           | \$ 212,800          | \$ 212,800           |
| Federal funds sold                                             | 302                  | 302                  | 642                 | 642                  |
| Interest-bearing time deposits in other financial institutions | 249                  | 249                  |                     |                      |
| Held to maturity securities                                    | 6,549,126            | 6,772,151            | 4,336,620           | 4,492,988            |
| Available for sale securities                                  | 250,387              | 250,387              | 322,316             | 322,316              |
| Loans held for sale                                            | 4,332                | 4,332                |                     |                      |
| Loans held for investment, net of allowance for credit losses  | 5,023,844            | 5,098,007            | 3,714,312           | 3,814,858            |
| <b>Total</b>                                                   | <b>\$ 12,035,641</b> | <b>\$ 12,332,829</b> | <b>\$ 8,586,690</b> | <b>\$ 8,843,604</b>  |
| <b>Financial liabilities:</b>                                  |                      |                      |                     |                      |
| Deposits                                                       | \$ 10,954,597        | \$ 10,971,925        | \$ 8,060,254        | \$ 8,074,093         |
| Junior subordinated debentures                                 | 85,055               | 72,242               | 85,055              | 71,001               |
| Other borrowings                                               | 112,017              | 114,170              | 12,790              | 14,974               |
| Securities sold under repurchase agreements                    | 443,856              | 443,976              | 54,883              | 54,883               |
| <b>Total</b>                                                   | <b>\$ 11,595,525</b> | <b>\$ 11,602,313</b> | <b>\$ 8,212,982</b> | <b>\$ 8,214,951</b>  |

The Company's off-balance sheet commitments, which total \$911.5 million at September 30, 2012, are funded at current market rates at the date they are drawn upon. It is management's opinion that the fair value of these commitments would approximate their carrying value, if drawn upon.

The fair value estimates presented herein are based on pertinent information available to management at September 30, 2012. Although management is not aware of any factors that would significantly affect the estimated fair value amounts, such amounts have not been comprehensively revalued for purposes of these financial statements since those dates and, therefore, current estimates of fair value may differ significantly from the amounts presented herein.

Under ASC Topic 825, entities may choose to measure eligible financial instruments at fair value at specified election dates. The fair value measurement option (i) may be applied instrument by instrument, with certain exceptions, (ii) is generally irrevocable and (iii) is applied only to entire instruments and not to portions of instruments. Unrealized gains and losses on items for which the fair value measurement option has been elected must be reported in earnings at each subsequent reporting date. During the reported periods, the Company had no financial instruments measured at fair value under the fair value measurement option.

## 6. GOODWILL AND CORE DEPOSIT INTANGIBLES

Changes in the carrying amount of the Company's goodwill and core deposit intangibles (CDI) for nine months ended September 30, 2012 were as follows:

|                                    | Goodwill               | Core Deposit Intangibles |
|------------------------------------|------------------------|--------------------------|
|                                    | (Dollars in thousands) |                          |
| Balance as of December 31, 2011    | \$ 924,537             | \$ 20,996                |
| Amortization                       |                        | (5,297)                  |
| Acquisition of Texas Bankers, Inc. | 5,869                  |                          |
| Acquisition of The Bank Arlington  | 3,013                  |                          |

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|                                               |              |           |
|-----------------------------------------------|--------------|-----------|
| Acquisition of American State Financial Corp. | 266,679      | 12,393    |
| Balance as of September 30, 2012              | \$ 1,200,098 | \$ 28,092 |

Goodwill is recorded on the acquisition date of each entity. The Company may record subsequent adjustments to goodwill for amounts undeterminable at acquisition date, such as deferred taxes and real estate valuations, and therefore the goodwill amounts reflected in the table above may change accordingly. The Company initially records the total premium paid on acquisitions as goodwill. After finalizing the valuation, core deposit intangibles are identified and reclassified from goodwill to core deposit intangibles on the balance sheet. This reclassification has no effect on total assets or liabilities. Management performs an evaluation annually, and more frequently if a triggering event occurs, of whether any impairment of the goodwill and other intangibles has occurred. If any such impairment is determined, a write down is recorded. As of September 30, 2012, there were no impairments recorded on goodwill or other intangibles.

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Although the Company completed the Texas Bankers, Inc. acquisition in January 2012, The Bank Arlington acquisition in April 2012 and the American State Financial Corporation acquisition in July 2012, the Company has not yet completed the allocation of the purchase price and therefore fair values for certain acquired assets and assumed liabilities are still being finalized (see Note 11-Acquisitions).

Core deposit intangibles are amortized on an accelerated basis over their estimated lives, which the Company believes is between 8 and 10 years. Gross core deposit intangibles outstanding were \$91.5 million at September 30, 2012 and \$79.2 million at December 31, 2011. Net core deposit intangibles outstanding were \$28.1 million and \$21.0 million at the same dates, respectively. Amortization expense related to intangible assets totaled \$2.0 million and \$1.9 million for the three months ended September 30, 2012 and 2011, respectively, and \$5.3 million and \$5.9 million for the nine months ended September 30, 2012 and 2011, respectively.

The estimated aggregate future amortization expense for intangible assets remaining as of September 30, 2012 is as follows (dollars in thousands):

|                |                  |
|----------------|------------------|
| Remaining 2012 | \$ 1,933         |
| 2013           | 6,186            |
| 2014           | 4,866            |
| 2015           | 4,219            |
| 2016           | 3,781            |
| Thereafter     | 7,107            |
| <b>Total</b>   | <b>\$ 28,092</b> |

## 7. STOCK BASED COMPENSATION

At September 30, 2012, the Company had four stock-based employee compensation plans and one stock option plan assumed in connection with an acquisition under which no additional options will be granted. Two of the four plans adopted by the Company have expired and therefore no additional awards may be issued under those plans. The Company accounts for stock-based employee compensation plans using the fair value-based method of accounting in accordance with ASC Topic 718. ASC Topic 718 was effective for companies in 2006; however, the Company has been recognizing compensation expense since January 1, 2003. The Company recognized \$1.1 million and \$961,000 in stock-based compensation expense for the three months ended September 30, 2012 and 2011, respectively, and \$3.2 million and \$2.6 million in stock-based compensation expense for the nine months ended September 30, 2012 and 2011, respectively. There was approximately \$364,000 and \$322,000 of income tax benefit recorded for the stock-based compensation expense for the three months ended September 30, 2012 and 2011, respectively, and \$1.1 million and \$870,000 of income tax benefit recorded for the stock-based compensation expense for the nine months ended September 30, 2012 and 2011, respectively.

On February 22, 2012, the Company's Board of Directors adopted the Prosperity Bancshares, Inc. 2012 Stock Incentive Plan (the 2012 Plan), subject to approval by the Company's shareholders. The Company's shareholders approved the 2012 Plan at the annual meeting of shareholders on April 17, 2012. The 2012 Plan authorizes the issuance of up to 1,250,000 shares of common stock upon the exercise of options granted under the 2012 Plan or pursuant to the grant or exercise, as the case may be, of other awards granted under the 2012 Plan, including restricted stock, stock appreciation rights, phantom stock awards and performance awards. As of September 30, 2012, no options or other awards have been granted under the 2012 Plan.

During 2004, the Company's Board of Directors adopted the Prosperity Bancshares, Inc. 2004 Stock Incentive Plan (the 2004 Plan) which authorizes the issuance of up to 1,250,000 shares of common stock pursuant to the exercise or grant, as the case may be, of awards under such plan and the shareholders approved the 2004 Plan in 2005. The Company has granted shares with forfeiture restrictions (restricted stock) to certain directors, officers and associates under the 2004 Plan. The awardee is not entitled to the shares until they vest, which is generally over a one to five year period, but the awardee is entitled to receive dividends on and vote the shares prior to vesting. The shares granted do not have a cost to the awardee and the only requirement of vesting is continued service to the Company. Compensation cost related to restricted stock is calculated based on the fair value of the shares at the date of grant. If the awardee leaves the Company before the shares vest, the unvested shares are forfeited. Options to purchase a total of 162,250 shares of common stock of the Company granted under the 2004 Plan were outstanding at September 30, 2012, of which 98,375 were exercisable. As of September 30, 2012, there were 446,146 shares of restricted stock outstanding with a weighted average grant date fair value of \$38.06 per share. Remaining shares available for grant under the 2004 Plan totaled 477,625 at September 30, 2012.



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Stock options are issued at the current market price on the date of the grant, subject to a pre-determined vesting period with a contractual term of 10 years. Options assumed in connection with acquisitions have contractual terms as established in the original option grant agreements entered into prior to acquisition. The fair value of stock options granted is estimated at the date of grant using the Black-Scholes option-pricing model. Stock-based compensation expense is recognized ratably over the requisite service period for all awards.

The fair value of options was estimated using an option-pricing model with the following weighted average assumptions:

|                         | September 30, |        |
|-------------------------|---------------|--------|
|                         | 2012          | 2011   |
| Expected life in years  | 5.26          | 5.30   |
| Risk free interest rate | 3.67%         | 3.67%  |
| Volatility              | 20.84%        | 20.98% |
| Dividend yield          | 1.26%         | 1.25%  |

A summary of changes in outstanding vested and unvested options during the nine months ended September 30, 2012 is set forth below:

|                                          | Number<br>of<br>Options<br>(In thousands) | Weighted Average<br>Exercise<br>Price | Weighted Average<br>Remaining Contractual<br>Term<br>(In years) | Aggregate Intrinsic<br>Value<br>(In thousands) |
|------------------------------------------|-------------------------------------------|---------------------------------------|-----------------------------------------------------------------|------------------------------------------------|
| Options outstanding, beginning of period | 525                                       | \$ 28.18                              |                                                                 |                                                |
| Options granted                          |                                           |                                       |                                                                 |                                                |
| Options forfeited                        | (6)                                       | 31.63                                 |                                                                 |                                                |
| Options exercised                        | (99)                                      | 27.03                                 |                                                                 |                                                |
| Options outstanding, end of period       | 420                                       | \$ 28.36                              | 3.36                                                            | \$ 5,982                                       |
| Options vested or expected to vest       | 407                                       | \$ 27.98                              | 3.32                                                            | \$ 5,956                                       |
| Options exercisable, end of period       | 280                                       | \$ 27.62                              | 2.83                                                            | \$ 4,198                                       |

No options were granted during the nine months ended September 30, 2012 and 2011. The total intrinsic value of the options exercised during the nine month periods ended September 30, 2012 and 2011 was \$1.8 million and \$1.4 million, respectively. The total fair value of options vested during the nine month periods ended September 30, 2012 and 2011 was \$234,000 and \$368,000, respectively.

A summary of changes in unvested options is set forth below:

|                                                   | Nine Months Ended September 30,           |                                           |                                           |                                           |
|---------------------------------------------------|-------------------------------------------|-------------------------------------------|-------------------------------------------|-------------------------------------------|
|                                                   | 2012                                      |                                           | 2011                                      |                                           |
|                                                   | Number<br>of<br>Options<br>(In thousands) | Weighted Average<br>Grant Date Fair Value | Number<br>of<br>Options<br>(In thousands) | Weighted Average<br>Grant Date Fair Value |
| Unvested options outstanding, beginning of period | 177                                       | \$ 6.96                                   | 313                                       | \$ 6.89                                   |
| Options granted                                   |                                           |                                           |                                           |                                           |
| Unvested options forfeited                        | (4)                                       | 6.76                                      |                                           |                                           |
| Options vested                                    | (33)                                      | 7.07                                      | (59)                                      | 6.31                                      |
|                                                   | 140                                       | \$ 6.92                                   | 254                                       | \$ 6.96                                   |

Unvested options outstanding, end of  
period

The Company received \$2.7 million and \$4.2 million in cash from the exercise of stock options during the nine month periods ended September 30, 2012 and 2011, respectively. There was no tax benefit realized from option exercises of the stock-based compensation arrangements during the nine month periods ended September 30, 2012 and 2011.

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As of September 30, 2012, there was \$8.9 million of total unrecognized compensation expense related to unvested stock-based compensation arrangements. That cost is expected to be recognized over a weighted average period of 2.6 years.

**8. SECURITIES**

The carrying cost of securities totaled \$6.80 billion at September 30, 2012 compared with \$4.66 billion at December 31, 2011, an increase of \$2.14 billion or 45.9%. The increase is due to securities acquired from ASB. At September 30, 2012, securities represented 49.6% of total assets compared with 47.4% of total assets at December 31, 2011.

The amortized cost and fair value of investment securities as of September 30, 2012 are as follows:

|                                                                      | Amortized<br>Cost | September 30, 2012<br>Gross<br>Unrealized<br>Gains<br>(Dollars in thousands) | Gross<br>Unrealized<br>Losses | Fair<br>Value |
|----------------------------------------------------------------------|-------------------|------------------------------------------------------------------------------|-------------------------------|---------------|
| <b>Available for Sale</b>                                            |                   |                                                                              |                               |               |
| States and political subdivisions                                    | \$ 35,262         | \$ 1,937                                                                     | \$ (11)                       | \$ 37,188     |
| Collateralized mortgage obligations                                  | 651               |                                                                              | (13)                          | 638           |
| Mortgage-backed securities                                           | 188,699           | 14,618                                                                       | (56)                          | 203,261       |
| Corporate debt securities and other                                  | 8,784             | 516                                                                          |                               | 9,300         |
| Total                                                                | \$ 233,396        | \$ 17,071                                                                    | \$ (80)                       | \$ 250,387    |
| <b>Held to Maturity</b>                                              |                   |                                                                              |                               |               |
| U.S. Treasury securities and obligations of U.S. government agencies | \$ 10,597         | \$ 213                                                                       | \$                            | \$ 10,810     |
| States and political subdivisions (including QSCB)                   | 387,246           | 9,355                                                                        | (151)                         | 396,450       |
| Corporate debt securities                                            | 1,500             | 53                                                                           |                               | 1,553         |
| Collateralized mortgage obligations                                  | 160,478           | 2,994                                                                        | (215)                         | 163,257       |
| Mortgage-backed securities                                           | 5,989,305         | 211,153                                                                      | (377)                         | 6,200,081     |
| Total                                                                | \$ 6,549,126      | \$ 223,768                                                                   | \$ (743)                      | \$ 6,772,151  |

The amortized cost and fair value of investment securities as of December 31, 2011 are as follows:

|                                                                      | Amortized<br>Cost | December 31, 2011<br>Gross<br>Unrealized<br>Gains<br>(Dollars in thousands) | Gross<br>Unrealized<br>Losses | Fair<br>Value |
|----------------------------------------------------------------------|-------------------|-----------------------------------------------------------------------------|-------------------------------|---------------|
| <b>Available for Sale</b>                                            |                   |                                                                             |                               |               |
| States and political subdivisions                                    | \$ 37,060         | \$ 2,022                                                                    | \$ (6)                        | \$ 39,076     |
| Collateralized mortgage obligations                                  | 786               |                                                                             | (21)                          | 765           |
| Mortgage-backed securities                                           | 254,965           | 18,307                                                                      | (66)                          | 273,206       |
| Corporate debt securities and other                                  | 8,778             | 491                                                                         |                               | 9,269         |
| Total                                                                | \$ 301,589        | \$ 20,820                                                                   | \$ (93)                       | \$ 322,316    |
| <b>Held to Maturity</b>                                              |                   |                                                                             |                               |               |
| U.S. Treasury securities and obligations of U.S. government agencies | \$ 8,696          | \$ 455                                                                      | \$                            | \$ 9,151      |

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|                                                    |                     |                   |                 |                     |
|----------------------------------------------------|---------------------|-------------------|-----------------|---------------------|
| States and political subdivisions (including QSCB) | 50,814              | 3,324             | (284)           | 53,854              |
| Corporate debt securities                          | 1,500               | 114               |                 | 1,614               |
| Collateralized mortgage obligations                | 281,778             | 5,009             | (150)           | 286,637             |
| Mortgage-backed securities                         | 3,993,832           | 147,991           | (91)            | 4,141,732           |
| <b>Total</b>                                       | <b>\$ 4,336,620</b> | <b>\$ 156,893</b> | <b>\$ (525)</b> | <b>\$ 4,492,988</b> |

Management evaluates securities for other-than-temporary impairment at least on a quarterly basis, and more frequently when economic or market conditions warrant such an evaluation. The investment securities portfolio is evaluated for OTTI by segregating the portfolio into two general segments and applying the appropriate OTTI model. Investment securities classified as available for sale or held-to-maturity are evaluated for OTTI under FASB ASC Topic 320, *Investments Debt and Equity Securities*. Certain purchased beneficial interests, including non-agency mortgage-backed securities, asset-backed securities, and collateralized debt obligations, that had credit ratings at the time of purchase of below AA are evaluated using the model outlined in ASC Topic 325, *Investments Other*. The Company currently does not own any securities that are accounted for under ASC Topic 325.

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In determining OTTI under ASC Topic 320, management considers many factors, including: (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, (3) whether the market decline was affected by macroeconomic conditions, and (4) whether the entity has the intent to sell the debt security or more likely than not will be required to sell the debt security before its anticipated recovery. The assessment of whether an other-than-temporary decline exists involves a high degree of subjectivity and judgment and is based on the information available to management at a point in time. If applicable, the second segment of the portfolio uses the OTTI guidance provided by ASC Topic 325 that is specific to purchased beneficial interests that, on the purchase date, were rated below AA. Under the ASC Topic 325 model, an impairment is considered other than temporary if, based on the Company's best estimate of cash flows that a market participant would use in determining the current fair value of the beneficial interest, there has been an adverse change in those estimated cash flows.

When OTTI occurs under either model, the amount of the other-than-temporary impairment recognized in earnings depends on whether an entity intends to sell the security or more likely than not will be required to sell the security before recovery of its amortized cost basis less any current-period credit loss. If an entity intends to sell or more likely than not will be required to sell the security before recovery of its amortized cost basis less any current-period credit loss, the OTTI shall be recognized in earnings equal to the entire difference between the investment's amortized cost basis and its fair value at the balance sheet date. If an entity does not intend to sell the security and it is not more likely than not that the entity will be required to sell the security before recovery of its amortized cost basis less any current-period loss, the OTTI shall be separated into the amount representing the credit-related portion of the impairment loss (credit loss) and the noncredit portion of the impairment loss (noncredit portion). The amount of the total OTTI related to the credit loss is determined based on the difference between the present value of cash flows expected to be collected and the amortized cost basis and such difference is recognized in earnings. The amount of the total OTTI related to the noncredit portion is recognized in other comprehensive income, net of applicable taxes. The previous amortized cost basis less the OTTI recognized in earnings shall become the new amortized cost basis of the investment.

As of September 30, 2012, the Company does not intend to sell any debt securities and management believes that the Company more likely than not will not be required to sell any debt securities before their anticipated recovery, at which time the Company will receive full value for the securities. Furthermore, as of September 30, 2012, management does not have the intent to sell any of its securities and believes that it is more likely than not that the Company will not have to sell any such securities before a recovery of cost. The unrealized losses are largely due to increases in market interest rates over the yields available at the time the underlying securities were purchased. The fair value is expected to recover as the securities approach their maturity date or repricing date or if market yields for such investments decline. Management does not believe any of the securities are impaired due to reasons of credit quality. Accordingly, as of September 30, 2012, management believes any impairment in the Company's securities are temporary and no impairment loss has been realized in the Company's consolidated statements of income.

Securities with unrealized losses segregated by length of time such securities have been in a continuous loss position at September 30, 2012 were as follows:

|                                     | Less than 12 Months     |                      | More than 12 Months     |                      | Total                   |                      |
|-------------------------------------|-------------------------|----------------------|-------------------------|----------------------|-------------------------|----------------------|
|                                     | Estimated<br>Fair Value | Unrealized<br>Losses | Estimated<br>Fair Value | Unrealized<br>Losses | Estimated<br>Fair Value | Unrealized<br>Losses |
| (Dollars in thousands)              |                         |                      |                         |                      |                         |                      |
| <b>Available for Sale</b>           |                         |                      |                         |                      |                         |                      |
| States and political subdivisions   | \$                      | \$                   | \$ 503                  | \$ (11)              | \$ 503                  | \$ (11)              |
| Collateralized mortgage obligations |                         |                      | 638                     | (13)                 | 638                     | (13)                 |
| Mortgage-backed securities          | 162                     |                      | 6,779                   | (56)                 | 6,941                   | (56)                 |
| Total                               | \$ 162                  | \$                   | \$ 7,920                | \$ (80)              | \$ 8,082                | \$ (80)              |
| <b>Held to Maturity</b>             |                         |                      |                         |                      |                         |                      |
| States and political subdivisions   | \$ 14,301               | \$ (131)             | \$ 1,140                | \$ (19)              | \$ 15,441               | \$ (150)             |
| Collateralized mortgage obligations | 2,384                   | (215)                |                         |                      | 2,384                   | (215)                |
| Mortgage-backed securities          | 16,551                  | (375)                | 320                     | (3)                  | 16,871                  | (378)                |
| Total                               | \$ 33,236               | \$ (721)             | \$ 1,460                | \$ (22)              | \$ 34,696               | \$ (743)             |



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The amortized cost and fair value of investment securities at September 30, 2012, by contractual maturity, are shown below. Actual maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations at any time with or without call or prepayment penalties.

|                                                                    | September 30, 2012 |              |                    |            |
|--------------------------------------------------------------------|--------------------|--------------|--------------------|------------|
|                                                                    | Held to Maturity   |              | Available for Sale |            |
|                                                                    | Amortized Cost     | Fair Value   | Amortized Cost     | Fair Value |
| (Dollars in thousands)                                             |                    |              |                    |            |
| Due in one year or less                                            | \$ 30,938          | \$ 31,294    | \$ 8,874           | \$ 9,392   |
| Due after one year through five years                              | 118,902            | 120,003      | 2,942              | 3,116      |
| Due after five years through ten years                             | 148,003            | 150,818      | 23,562             | 24,862     |
| Due after ten years                                                | 101,500            | 106,698      | 8,668              | 9,118      |
| Subtotal                                                           | 399,343            | 408,813      | 44,046             | 46,488     |
| Mortgage-backed securities and collateralized mortgage obligations | 6,149,783          | 6,363,338    | 189,350            | 203,899    |
| Total                                                              | \$ 6,549,126       | \$ 6,772,151 | \$ 233,396         | \$ 250,387 |

The Company had no gain or loss on sale of securities for the three months ended September 30, 2012 or 2011 and had no gain or loss on sale of securities for the nine months ended September 30, 2012 compared with a net loss of \$581,000 for the nine months ended September 30, 2011. The Company sold two non-agency CMOs with a total book value of \$3.2 million due to a downgrade of the CMOs to less than investment grade in the second quarter of 2011. As of September 30, 2012, the Company had eight non-agency CMOs remaining with a total book value of \$2.7 million and total market value of \$2.5 million.

At September 30, 2012 and December 31, 2011, the Company did not own securities of any one issuer (other than the U.S. government and its agencies) for which aggregate adjusted cost exceeded 10% of the consolidated shareholders' equity at such respective dates.

Securities with an amortized cost of \$4.22 billion and \$2.48 billion and a fair value of \$4.37 billion and \$2.57 billion at September 30, 2012 and December 31, 2011, respectively, were pledged to collateralize public deposits and for other purposes required or permitted by law.

**9. CONTRACTUAL OBLIGATIONS AND OFF-BALANCE SHEET ITEMS*****Contractual Obligations***

The following table summarizes the Company's contractual obligations and other commitments to make future payments as of September 30, 2012 (other than deposit obligations). The payments do not include pre-payment options that may be available to the Company. The Company's future cash payments associated with its contractual obligations pursuant to its junior subordinated debentures, FHLB borrowings and operating leases as of September 30, 2012 are summarized below. Payments for junior subordinated debentures include interest of \$52.0 million that will be paid over the future periods. The future interest payments were calculated using the current rate in effect at September 30, 2012. The current principal balance of the junior subordinated debentures at September 30, 2012 was \$85.1 million. Payments for FHLB borrowings include interest of \$3.0 million that will be paid over the future periods. Payments related to leases are based on actual payments specified in underlying contracts.

|                                   | Remaining<br>Fiscal 2012 | Fiscal<br>2013-2014 | Fiscal<br>2015-2016 | Payments due in:<br>Thereafter | Total      |
|-----------------------------------|--------------------------|---------------------|---------------------|--------------------------------|------------|
|                                   | (Dollars in thousands)   |                     |                     |                                |            |
| Junior subordinated debentures    | \$ 1,222                 | \$ 4,888            | \$ 4,888            | \$ 126,017                     | \$ 137,015 |
| Federal Home Loan Bank borrowings | 100,282                  | 3,258               | 3,456               | 8,001                          | 114,997    |
| Operating leases                  | 1,324                    | 8,547               | 4,013               | 759                            | 14,643     |

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|       |            |           |           |            |            |
|-------|------------|-----------|-----------|------------|------------|
| Total | \$ 102,828 | \$ 16,693 | \$ 12,357 | \$ 134,777 | \$ 266,655 |
|-------|------------|-----------|-----------|------------|------------|

**Table of Contents****Off-Balance Sheet Items**

In the normal course of business, the Company enters into various transactions, which, in accordance with accounting principles generally accepted in the United States, are not included in its consolidated balance sheets. The Company enters into these transactions to meet the financing needs of its customers. These transactions include commitments to extend credit and standby letters of credit, which involve, to varying degrees, elements of credit risk and interest rate risk in excess of the amounts recognized in the consolidated balance sheets.

The Company's commitments associated with outstanding standby letters of credit and commitments to extend credit as of September 30, 2012 are summarized below. Since commitments associated with letters of credit and commitments to extend credit may expire unused, the amounts shown do not necessarily reflect the actual future cash funding requirements.

|                              | Remaining<br>Fiscal 2012 | Fiscal<br>2013-2014 | Fiscal<br>2015-2016<br>(Dollars in thousands) | Thereafter | Total      |
|------------------------------|--------------------------|---------------------|-----------------------------------------------|------------|------------|
| Standby letters of credit    | \$ 4,472                 | \$ 20,399           | \$ 564                                        | \$         | \$ 25,435  |
| Commitments to extend credit | 114,567                  | 445,549             | 50,391                                        | 275,538    | 886,045    |
| Total                        | \$ 119,039               | \$ 465,948          | \$ 50,955                                     | \$ 275,538 | \$ 911,480 |

**10. OTHER COMPREHENSIVE (LOSS) INCOME**

The tax effects allocated to each component of other comprehensive (loss) income were as follows (dollars in thousands):

|                                                        | Three Months Ended<br>September 30, 2012 |                           |                      | Three Months Ended<br>September 30, 2011 |                           |                      |
|--------------------------------------------------------|------------------------------------------|---------------------------|----------------------|------------------------------------------|---------------------------|----------------------|
|                                                        | Before Tax<br>Amount                     | Tax Expense,<br>(Benefit) | Net of Tax<br>Amount | Before Tax<br>Amount                     | Tax Expense,<br>(Benefit) | Net of Tax<br>Amount |
| Securities available for sale:                         |                                          |                           |                      |                                          |                           |                      |
| Change in net unrealized (loss) gain during the period | \$ (718)                                 | \$ (251)                  | \$ (467)             | \$ 632                                   | \$ 222                    | \$ 410               |
| Total other comprehensive (loss) income                | \$ (718)                                 | \$ (251)                  | \$ (467)             | \$ 632                                   | \$ 222                    | \$ 410               |

|                                                        | Nine Months Ended<br>September 30, 2012 |                           |                      | Nine Months Ended<br>September 30, 2011 |                           |                      |
|--------------------------------------------------------|-----------------------------------------|---------------------------|----------------------|-----------------------------------------|---------------------------|----------------------|
|                                                        | Before Tax<br>Amount                    | Tax Expense,<br>(Benefit) | Net of Tax<br>Amount | Before Tax<br>Amount                    | Tax Expense,<br>(Benefit) | Net of Tax<br>Amount |
| Securities available for sale:                         |                                         |                           |                      |                                         |                           |                      |
| Change in net unrealized (loss) gain during the period | \$ (3,736)                              | \$ (1,308)                | \$ (2,428)           | \$ 2,272                                | \$ 795                    | \$ 1,477             |
| Total other comprehensive (loss) income                | \$ (3,736)                              | \$ (1,308)                | \$ (2,428)           | \$ 2,272                                | \$ 795                    | \$ 1,477             |

Activity in accumulated other comprehensive income, net of tax, was as follows:

| Securities<br>Available For<br>Sale | Accumulated<br>Other<br>Comprehensive<br>Income |
|-------------------------------------|-------------------------------------------------|
| (Dollars in thousands)              |                                                 |

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|                                   |           |    |         |
|-----------------------------------|-----------|----|---------|
| Balance January 1, 2012           | \$ 13,472 | \$ | 13,472  |
| Other comprehensive (loss) income | (2,428)   |    | (2,428) |
| Balance September 30, 2012        | \$ 11,044 | \$ | 11,044  |
| Balance as of January 1, 2011     | \$ 14,304 | \$ | 14,304  |
| Other comprehensive (loss) income | 1,477     |    | 1,477   |
| Balance September 30, 2011        | \$ 15,781 | \$ | 15,781  |

**Table of Contents****11. ACQUISITIONS**

*Acquisition of American State Financial Corporation* On July 1, 2012, the Company completed the previously announced acquisition of American State Financial Corporation and its wholly owned subsidiary American State Bank (collectively referred to as ASB). ASB operated thirty-seven (37) full service banking offices in eighteen (18) counties across West Texas.

As of June 30, 2012, ASB, on a consolidated basis, reported total assets of \$3.16 billion, total loans of \$1.24 billion and total deposits of \$2.51 billion. Under the terms of the merger agreement, the Company issued 8,524,835 shares of Company common stock plus \$178.5 million in cash for all outstanding shares of American State Financial Corporation capital stock, for total merger consideration of \$536.8 million and an initial premium of \$240.4 million.

The acquisition was accounted for under the acquisition method of accounting. Under this method of accounting, the identifiable assets acquired and assumed liabilities were recorded at their estimated fair value as of the date of the acquisition. Accordingly, the results of operations of the acquired company have been included in the Company's results of operations since the date of acquisition.

**FAIR VALUE:** The measurement period for the Company to determine the fair values of acquired identifiable assets and assumed liabilities will end at the earlier of (i) twelve months from the date of the acquisition or (ii) as soon as the Company receives the information it was seeking about facts and circumstances that existed as of the acquisition date or learns that more information is not obtainable. The Company is currently in the process of obtaining fair values for certain acquired assets and assumed liabilities and therefore the following estimates are preliminary.

|                                                    | As of<br>July 1, 2012<br>(In thousands) |
|----------------------------------------------------|-----------------------------------------|
| Cash and due from banks                            | \$ 98,720                               |
| Federal funds sold                                 | 202,810                                 |
| Total cash and cash equivalents                    | 301,530                                 |
| Securities available for sale                      | 524,959                                 |
| Securities held to maturity                        | 994,873                                 |
| Loans held for sale                                | 13,770                                  |
| Loans held for investment                          | 1,133,867                               |
| Bank premises and equipment                        | 36,502                                  |
| Other real estate owned                            | 1,232                                   |
| Goodwill                                           | 266,679                                 |
| Core deposit intangibles                           | 12,393                                  |
| Federal Home Loan Bank stock                       | 2,355                                   |
| Other assets                                       | 91,242                                  |
| Total assets acquired                              | \$ 3,379,402                            |
| Deposits                                           | 2,495,652                               |
| Other borrowings                                   | 318,692                                 |
| Other liabilities                                  | 28,252                                  |
| Total liabilities assumed                          | 2,842,596                               |
| Common stock and capital surplus                   | 536,806                                 |
| Total liabilities assumed and shareholders' equity | \$ 3,379,402                            |

The Company recognized goodwill of \$266.7 million which is calculated as the excess of both the consideration exchanged and liabilities assumed as compared to the fair value of identifiable assets acquired. Goodwill resulted from a combination of expected operational synergies, an enhanced branching network, and cross-selling opportunities. Goodwill is not expected to be deductible for tax purposes while the core

deposit intangible is expected to be deductible over 10 years.

**MERGER RELATED EXPENSES AND PRO FORMA INFORMATION:** For the three and nine months ended September 30, 2012, the Company incurred \$5.1 million and \$5.4 million of pre-tax merger related expenses related to the ASB acquisition, respectively and estimates total merger related expenses will range from \$5.4 to \$6.0 million, pre-tax. The merger expenses are reflected on the Company's income statement for the applicable periods and are reported primarily in the categories of salaries and benefits, data processing and professional fees.

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Operations of ASB have been included in the consolidated financial statements since July 1, 2012. The Company does not consider ASB a separate reporting segment and does not track the amount of revenue and net income attributable to ASB since acquisition. As such, it is impracticable to determine such amounts for the three and nine months ended September 30, 2012.

The following pro forma information presents the results of operations for the three and nine months ended September 30, 2012 and 2011, as if the ASB acquisition had occurred on January 1, 2011. The previously completed acquisitions of Texas Bankers, Inc. and The Bank Arlington are not deemed material in the aggregate and are therefore excluded from the pro forma information in the table below.

|                            | <b>Three Months Ended<br/>September 30</b>           |             | <b>Nine Months Ended<br/>September 30</b> |             |
|----------------------------|------------------------------------------------------|-------------|-------------------------------------------|-------------|
|                            | <b>2012</b>                                          | <b>2011</b> | <b>2012</b>                               | <b>2011</b> |
|                            | <b>(Dollars in thousands, except per share data)</b> |             |                                           |             |
| Net interest income        | \$ 106,893                                           | \$ 113,858  | \$ 336,249                                | \$ 337,096  |
| Net income                 | \$ 49,479                                            | \$ 48,081   | \$ 163,333                                | \$ 149,425  |
| Basic earnings per share   | \$ 0.88                                              | \$ 0.87     | \$ 2.78                                   | \$ 2.70     |
| Diluted earnings per share | \$ 0.88                                              | \$ 0.87     | \$ 2.77                                   | \$ 2.69     |

The above pro forma results are presented for illustrative purposes and are not intended to represent or be indicative of the actual results of operations of the merged companies that would have been achieved had the acquisition occurred at January 1, 2011, nor are they intended to represent or be indicative of future results of operations. These pro forma results require significant estimates and judgments particularly as it relates to accretion of income associated with acquired loans. Pro forma adjustments principally included:

Reversing interest income and interest expense as previously recorded by ASB and recording interest income and interest expense based on impact of estimated fair values of the acquired interest earning assets and assumed interest bearing liabilities.

Reversing depreciation and amortization expense recorded by ASB and reporting depreciation and amortization based on estimated fair values and remaining lives of acquired premises, equipment, and leasehold improvements.

Reversing core deposit intangible amortization as previously recorded by ASB and recording amortization expense as it relates to the core deposit intangible recognized from the acquisition.

Reporting acquisition-related charges and professional fees related to the acquisition as if they were incurred in 2011.

**ACQUIRED LOANS AND PURCHASE CREDIT IMPAIRED LOANS:** Acquired loans were preliminarily recorded at fair value based on a discounted cash flow valuation methodology that considers, among other things, projected default rates, loss given defaults and recovery rates. No allowance for credit losses was carried over from ASB.

The Company has identified certain loans which have experienced credit deterioration since origination ( purchased credit impaired loans or PCI loans ). PCI loan identification considers the following factors: payment history and past due status, debt service coverage, loan grading, collateral values and other factors that may indicate deterioration of credit quality since origination. Accretion of purchased discounts on PCI loans will be based on estimated future cash flows, regardless of contractual maturities. Accretion of purchased discounts on non-PCI loans will be recognized on a level-yield basis based on contractual maturity of individual loans per ASC Topic 310-30. See Note 4 Loans.

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The following table discloses the preliminary fair value and contractual value of loans acquired as of July 1, 2012:

|                                   | Purchased<br>Credit Impaired<br>Loans | Non-PCI<br>Loans | Total<br>Acquired<br>Loans |
|-----------------------------------|---------------------------------------|------------------|----------------------------|
|                                   | (Dollars in thousands)                |                  |                            |
| Commercial and industrial         | \$ 3,568                              | \$ 221,341       | \$ 224,909                 |
| Real estate                       |                                       |                  |                            |
| Construction and land development | 1,326                                 | 112,011          | 113,337                    |
| 1-4 family residential            | 155                                   | 126,954          | 127,109                    |
| Home equity                       |                                       | 24,851           | 24,851                     |
| Commercial mortgage               | 22,454                                | 460,378          | 482,832                    |
| Agriculture real estate           |                                       | 53,979           | 53,979                     |
| Multi-family residential          |                                       | 48,423           | 48,423                     |
| Agriculture                       | 78                                    |                  | 78                         |
| Consumer                          |                                       | 72,119           | 72,119                     |
| Other                             |                                       |                  |                            |
| Total fair value                  | \$ 27,581                             | \$ 1,120,056     | \$ 1,147,637               |
| Contractual principal balance     | \$ 54,403                             | \$ 1,195,741     | \$ 1,250,144               |

The following presents additional information on purchased credit impaired loans (dollars in thousands):

|                                               |           |
|-----------------------------------------------|-----------|
| Contractually required principal and interest | \$ 60,167 |
| Non-accretable difference                     | (24,429)  |
| Cash flows expected to be collected           | 35,738    |
| Accretable difference                         | (8,157)   |
| Fair value of purchased credit impaired loans | \$ 27,581 |

The process for identifying, valuing and determining pools (if any) of the loans that were (or may be) considered PCI loans as of the acquisition date remains on-going. Income recognition on PCI loans is subject to the Company's ability to reasonably estimate both the timing and amount of future cash flows. PCI loans for which the Company is accruing interest income are not considered non-performing or impaired. The non-accretable difference represents contractual principal and interest the Company does not expect to collect.

*Acquisition of The Bank Arlington* On April 1, 2012, the Company completed the previously announced acquisition of The Bank Arlington. The Bank Arlington operated one banking office in Arlington, Texas, in the Dallas/Fort Worth CMSA. The Company acquired The Bank Arlington to increase its market share in the Dallas/Fort Worth area. The acquisition is not considered significant to the Company's financial statements and therefore pro forma financial data and related disclosures are not included. The Company incurred approximately \$163,000 in expense related to this acquisition which is primarily recorded in legal and professional fees and data processing.

As of March 31, 2012, The Bank Arlington reported total assets of \$37.3 million, total loans of \$22.8 million and total deposits of \$33.2 million. Under the terms of the agreement, the Company issued 135,347 shares of Company common stock for all outstanding shares of The Bank Arlington capital stock, which resulted in an initial premium of \$2.8 million.

*Acquisition of Texas Bankers, Inc.* On January 1, 2012, the Company completed the previously announced acquisition of Texas Bankers, Inc. and its wholly-owned subsidiary, Bank of Texas, Austin, Texas. The three (3) Bank of Texas banking offices in the Austin, Texas CMSA consisted of a location in Rollingwood, which was consolidated with the Company's Westlake location and remains in Bank of Texas Rollingwood banking office; one banking center in downtown Austin, which was consolidated into the Company's downtown Austin location; and another banking center in Thorndale. The Company acquired Texas Bankers, Inc. to increase its market share in the Central Texas area.

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The acquisition is not considered significant to the Company's financial statements and therefore pro forma financial data and related disclosures are not included. The Company incurred approximately \$352,000 in expense related to this acquisition which is primarily recorded in legal and professional fees and data processing.

Texas Bankers, Inc. on a consolidated basis, reported total assets of \$77.0 million, total loans of \$27.6 million and total deposits of \$70.4 million as of December 31, 2011. Under the terms of the agreement, the Company issued 314,953 shares of Company common stock for all outstanding shares of Texas Bankers capital stock, which resulted in an initial premium of \$5.2 million.

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**12. SUBSEQUENT EVENTS**

*Acquisition of Community National Bank* On October 1, 2012, the Company completed the previously announced acquisition of Community National Bank, Bellaire, Texas. Community National Bank operated one (1) banking office in Bellaire, Texas, in the Houston Metropolitan Area. The acquisition is not considered significant to the Company's financial statements and therefore pro forma financial data is not included. The Company incurred approximately \$326,000 in expense related to this acquisition which is primarily recorded in legal and professional fees and data processing.

As of September 30, 2012, Community National Bank reported total assets of \$183.0 million, total loans of \$68.0 million and total deposits of \$164.6 million. Under the terms of the acquisition agreement, the Company issued 372,282 shares of Company common stock plus \$11.4 million in cash for all outstanding shares of Community National Bank capital stock which resulted in a premium of \$10.6 million.

*Pending Acquisition of East Texas Financial Services, Inc.* On December 9, 2011, the Company entered into a definitive agreement to acquire East Texas Financial Services, Inc. (OTC BB: FFBT) and its wholly-owned subsidiary, First Federal Bank Texas (Firstbank). Firstbank operates four banking offices in the Tyler MSA, including three locations in Tyler, Texas and one location in Gilmer, Texas.

As of September 30, 2012, Firstbank reported total assets of \$191.1 million, total loans of \$139.2 million and total deposits of \$116.0 million. Under the terms of the definitive agreement, the Company will issue up to 531,000 shares of Company common stock for all outstanding shares of East Texas Financial Services capital stock, subject to certain conditions and potential adjustments. Pending the satisfaction of closing conditions, the closing is expected to occur in early 2013.

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

***Special Cautionary Notice Regarding Forward-Looking Statements***

Statements and financial discussion and analysis contained in this quarterly report on Form 10-Q that are not historical facts are forward-looking statements made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. Forward-looking statements are based on assumptions and involve a number of risks and uncertainties, many of which are beyond the Company's control. Many possible events or factors could affect the future financial results and performance of the Company and could cause such results or performance to differ materially from those expressed in the forward-looking statements. These possible events or factors include, without limitation:

changes in the strength of the United States economy in general and the strength of the local economies in which the Company conducts operations resulting in, among other things, a deterioration in credit quality or reduced demand for credit, including the result and effect on the Company's loan portfolio and allowance for credit losses;

changes in interest rates and market prices, which could reduce the Company's net interest margins, asset valuations and expense expectations;

changes in the levels of loan prepayments and the resulting effects on the value of the Company's loan portfolio;

changes in local economic and business conditions which adversely affect the Company's customers and their ability to transact profitable business with the company, including the ability of the Company's borrowers to repay their loans according to their terms or a change in the value of the related collateral;

increased competition for deposits and loans adversely affecting rates and terms;

the timing, impact and other uncertainties of any future acquisitions, including the Company's ability to identify suitable future acquisition candidates, the success or failure in the integration of their operations, and the ability to enter new markets successfully and capitalize on growth opportunities;

the possible impairment of goodwill associated with an acquisition and possible adverse short-term effects on the results of operations;

increased credit risk in the Company's assets and increased operating risk caused by a material change in commercial, consumer and/or real estate loans as a percentage of the total loan portfolio;

the concentration of the Company's loan portfolio in loans collateralized by real estate;

the failure of assumptions underlying the establishment of and provisions made to the allowance for credit losses;

changes in the availability of funds resulting in increased costs or reduced liquidity;

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a deterioration or downgrade in the credit quality and credit agency ratings of the securities in the Company's securities portfolio;

increased asset levels and changes in the composition of assets and the resulting impact on the Company's capital levels and regulatory capital ratios;

the Company's ability to acquire, operate and maintain cost effective and efficient systems without incurring unexpectedly difficult or expensive but necessary technological changes;

the loss of senior management or operating personnel and the potential inability to hire qualified personnel at reasonable compensation levels;

government intervention in the U.S. financial system;

changes in statutes and government regulations or their interpretations applicable to financial holding companies and the Company's present and future banking and other subsidiaries, including changes in tax requirements and tax rates;

increases in FDIC deposit insurance assessments;

acts of terrorism, an outbreak of hostilities or other international or domestic calamities, weather or other acts of God and other matters beyond the Company's control; and

other risks and uncertainties listed from time to time in the Company's reports and documents filed with the Securities and Exchange Commission.

A forward-looking statement may include a statement of the assumptions or bases underlying the forward-looking statement. The Company believes it has chosen these assumptions or bases in good faith and that they are reasonable. However, the Company cautions you that assumptions or bases almost always vary from actual results, and the differences between assumptions or bases and actual results can be material. The Company undertakes no obligation to publicly update or otherwise revise any forward-looking statements, whether as a result of new information, future events or otherwise.

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Management's Discussion and Analysis of Financial Condition and Results of Operations analyzes the major elements of the Company's interim consolidated financial statements and accompanying notes. This section should be read in conjunction with the Company's interim consolidated financial statements and accompanying notes included elsewhere in this report and with the consolidated financial statements and accompanying notes and other detailed information appearing in the Company's Annual Report on Form 10-K for the year ended December 31, 2011.

## ***OVERVIEW***

The Company, a Texas corporation, was formed in 1983 as a vehicle to acquire the former Allied First Bank in Edna, Texas which was chartered in 1949 as The First National Bank of Edna. The Company is a registered financial holding company that derives substantially all of its revenues and income from the operation of its bank subsidiary, Prosperity Bank® ( Prosperity Bank or the Bank ). The Bank provides a wide array of financial products and services to small and medium-sized businesses and consumers. As of September 30, 2012, the Bank operated two hundred thirteen (213) full-service banking locations; with ten (10) in the Bryan/College Station area, thirty-four (34) in the Central Texas area, thirty-five (35) in the Dallas/Fort Worth area, twenty-one (21) in East Texas, fifty-nine (59) in the Houston area, twenty (20) in the South Texas area including Corpus Christi and Victoria, and thirty-four (34) in the West Texas area. The Company's headquarters are located at Prosperity Bank Plaza, 4295 San Felipe in Houston, Texas and its telephone number is (281) 269-7199. The Company's website address is [www.prosperitybanktx.com](http://www.prosperitybanktx.com). Information contained on the Company's website is not incorporated by reference into this quarterly report on Form 10-Q and is not part of this or any other report.

The Company generates the majority of its revenues from interest income on loans, service charges on customer accounts and income from investment in securities. The revenues are partially offset by interest expense paid on deposits and other borrowings and non-interest expenses such as administrative and occupancy expenses. Net interest income is the difference between interest income on earning assets such as loans and securities and interest expense on liabilities such as deposits and borrowings which are used to fund those assets. The level of interest rates and the volume and mix of earning assets and interest-bearing liabilities impact net interest income and margin.

Three principal components of the Company's growth strategy are internal growth, stringent cost control practices and strategic merger transactions. The Company focuses on continual internal growth. Each banking center is operated as a separate profit center, maintaining separate data with respect to its net interest income, efficiency ratio, deposit growth, loan growth and overall profitability. Banking center presidents and managers are accountable for performance in these areas and compensated accordingly. The Company also focuses on maintaining stringent cost control practices and policies. The Company has invested significantly in the infrastructure required to centralize many of its critical operations, such as data processing and loan application processing. Management believes that this centralized infrastructure can accommodate substantial additional growth while enabling the Company to minimize operational costs through certain economies of scale. The Company also intends to continue to seek expansion opportunities. On January 1, 2012, the Company completed the acquisition of Texas Bankers, Inc. which added three banking centers, of which two were consolidated with nearby existing banking centers. On April 1, 2012, the Company completed the acquisition of The Bank Arlington which added one banking center. On July 1, 2012, the Company completed the acquisition of American State Financial Corporation ( ASB ), which added 37 banking centers. On October 1, 2012, the Company completed the acquisition of Community National Bank which added one banking center. In addition, the Company has previously announced the pending acquisition of East Texas Financial Services, Inc.

Total assets were \$13.71 billion at September 30, 2012 compared with \$9.82 billion at December 31, 2011, an increase of \$3.89 billion or 39.6%. Total loans were \$5.08 billion at September 30, 2012 compared with \$3.77 billion at December 31, 2011, an increase of \$1.31 billion or 34.9%. Total deposits were \$10.95 billion at September 30, 2012 compared with \$8.06 billion December 31, 2011, an increase of \$2.89 billion or 35.9%. Total shareholders' equity was \$2.04 billion at September 30, 2012 compared with \$1.57 billion at December 31, 2011, an increase of \$470.9 million or 30.0%. The increases were primarily due to the acquisition of ASB on July 1, 2012.

## ***RECENT AND PENDING ACQUISITIONS***

*Acquisition of American State Financial Corporation* On July 1, 2012, the Company completed the previously announced acquisition of American State Financial Corporation and its wholly owned subsidiary American State Bank (collectively referred to as ASB ). ASB operated thirty-seven (37) full service banking offices in eighteen (18) counties across West Texas.

As of June 30, 2012, ASB, on a consolidated basis, reported total assets of \$3.16 billion, total loans of \$1.24 billion and total deposits of \$2.51 billion. Under the terms of the merger agreement, the Company issued 8,524,835 shares of Company common stock plus \$178.5 million in cash for all outstanding shares of American State Financial Corporation capital stock, for total merger consideration of \$536.8 million and an initial premium of \$240.4 million.



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*Acquisition of Community National Bank* On October 1, 2012, the Company completed the previously announced acquisition of Community National Bank, Bellaire, Texas. Community National Bank operated one (1) banking office in Bellaire, Texas, in the Houston Metropolitan Area. The acquisition is not considered significant to the Company's financial statements and therefore pro forma financial data is not included. The Company incurred approximately \$326,000 in expense related to this acquisition which is primarily recorded in legal and professional fees and data processing.

As of September 30, 2012, Community National Bank reported total assets of \$183.0 million, total loans of \$68.0 million and total deposits of \$164.6 million. Under the terms of the acquisition agreement, the Company issued 372,282 shares of Company common stock plus \$11.4 million in cash for all outstanding shares of Community National Bank capital stock which resulted in a premium of \$10.6 million.

*Pending Acquisition of East Texas Financial Services, Inc.* On December 9, 2011, the Company entered into a definitive agreement to acquire East Texas Financial Services, Inc. (OTC BB: FFBT) and its wholly-owned subsidiary, First Federal Bank Texas (Firstbank). Firstbank operates four banking offices in the Tyler MSA, including three locations in Tyler, Texas and one location in Gilmer, Texas.

As of September 30, 2012, Firstbank reported total assets of \$191.1 million, total loans of \$139.2 million and total deposits of \$116.0 million. Under the terms of the definitive agreement, the Company will issue up to 531,000 shares of Company common stock for all outstanding shares of East Texas Financial Services capital stock, subject to certain conditions and potential adjustments. Pending the satisfaction of closing conditions, the closing is expected to occur in early 2013.

## ***CRITICAL ACCOUNTING POLICIES***

The Company's accounting policies are integral to understanding the financial results reported. Accounting policies are described in detail in Note 1 to the consolidated financial statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2011. The Company believes that of its significant accounting policies, the following may involve a higher degree of judgment and complexity:

*Allowance for Credit Losses* The allowance for credit losses is established through charges to earnings in the form of a provision for credit losses. Management has established an allowance for credit losses which it believes is adequate for estimated losses in the Company's loan portfolio. Based on an evaluation of the loan portfolio, management presents a monthly review of the allowance for credit losses to the Bank's Board of Directors, indicating any change in the allowance since the last review and any recommendations as to adjustments in the allowance. In making its evaluation, management considers factors such as historical loan loss experience, industry diversification of the Company's commercial loan portfolio, the amount of nonperforming assets and related collateral, the volume, growth and composition of the Company's loan portfolio, current economic conditions that may affect the borrower's ability to pay and the value of collateral, the evaluation of the Company's loan portfolio through its internal loan review process and other relevant factors. Portions of the allowance may be allocated for specific credits; however, the entire allowance is available for any credit that, in management's judgment, should be charged off. Charge-offs occur when loans are deemed to be uncollectible. The allowance for credit losses includes allowance allocations calculated in accordance with FASB ASC Topic 310, *Receivables*, and allowance allocations determined in accordance with FASB ASC Topic 450, *Contingencies*.

*Goodwill and Intangible Assets* Goodwill and intangible assets that have indefinite useful lives are subject to an impairment test at least annually, or more often, if events or circumstances indicate that it is more likely than not that the fair value of Prosperity Bank, the Company's only reporting unit with assigned goodwill, is below the carrying value of its equity. Goodwill is tested for impairment using a two-step process that begins with an estimation of the fair value of the Company's reporting unit compared with its carrying value. If the carrying amount exceeds the fair value of the reporting unit, a second test is completed comparing the implied fair value of the reporting unit's goodwill to its carrying value to measure the amount of impairment. The Company estimated the fair value of its reporting unit through several valuation techniques that consider, among other things, the historical and current financial position and results of operations of the Company, general economic and market conditions and exit prices for recent market transactions. The Company had no intangible assets with indefinite useful lives at September 30, 2012. Other identifiable intangible assets that are subject to amortization are amortized on an accelerated basis over the years expected to be benefited, which the Company believes is between eight and ten years. These amortizable intangible assets are reviewed for impairment if circumstances indicate their value may not be recoverable based on a comparison of fair value to carrying value. Based on the Company's annual goodwill impairment test as of September 30, 2012, management does not believe any of its goodwill is impaired as of September 30, 2012 because the fair value of the Company's equity exceeded its carrying value. While the Company believes no impairment existed at September 30, 2012, under accounting standards applicable at that date, different conditions or assumptions, or changes in cash flows or profitability, if significantly negative or unfavorable, could have a material adverse effect on the outcome of the Company's impairment evaluation and financial condition or future results of operations.

*Stock-Based Compensation* The Company accounts for stock-based employee compensation plans using the fair value-based method of accounting in accordance with FASB ASC Topic 718, *Stock Compensation*. ASC 718 was effective for companies in 2006; however, the Company had been recognizing compensation expense since January 1, 2003. The Company's results of operations reflect compensation expense

for all employee stock-based compensation, including the unvested portion of stock options granted

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prior to 2003. ASC 718 requires that management make assumptions including stock price volatility and employee turnover that are utilized to measure compensation expense. The fair value of stock options granted is estimated at the date of grant using the Black-Scholes option-pricing model. This model requires the input of subjective assumptions.

*Other-Than-Temporarily Impaired Securities* The Company's available for sale securities portfolio is reported at fair value. When the fair value of a security is below its amortized cost, and depending on the length of time the condition exists and the extent the fair market value is below amortized cost, additional analysis is performed to determine whether an impairment exists. Available for sale and held to maturity securities are analyzed quarterly for possible other-than-temporary impairment. The analysis considers (i) the length of time and the extent to which the fair value has been less than cost, (ii) the financial condition and near-term prospects of the issuer, (iii) whether the market decline was affected by macroeconomic conditions, and (iv) whether the entity has the intent to sell the debt security or more likely than not will be required to sell the debt security before its anticipated recovery. Often, the information available to conduct these assessments is limited and rapidly changing, making estimates of fair value subject to judgment. If actual information or conditions are different than estimated, the extent of the impairment of the security may be different than previously estimated, which could have a material effect on the Company's results of operations and financial condition.

## **RESULTS OF OPERATIONS**

Net income available to common shareholders was \$46.2 million (\$0.82 per common share on a diluted basis) for the quarter ended September 30, 2012 compared with \$36.4 million (\$0.77 per common share on a diluted basis) for the quarter ended September 30, 2011, an increase in net income of \$9.8 million, or 27.0%. The increase is primarily due to the acquisition of ASB. The Company posted returns on average common equity of 9.10% and 9.51%, returns on average assets of 1.32% and 1.52% and efficiency ratios of 46.07% and 42.38% for the quarters ended September 30, 2012 and 2011, respectively. The efficiency ratio is calculated by dividing total noninterest expense (excluding credit loss provisions) by net interest income plus noninterest income (excluding net gains and losses on the sale of assets). Additionally, taxes are not part of this calculation.

For the nine months ended September 30, 2012, net income available to common shareholders was \$119.6 million (\$2.37 per common share on a diluted basis) compared with \$105.3 million (\$2.24 per common share on a diluted basis) for the same period in 2011, an increase in net income of \$14.3 million or 13.6%. The increase is primarily due to the acquisition of ASB. The Company posted returns on average common equity of 9.08% and 9.37%, returns on average assets of 1.35% and 1.46% and efficiency ratios of 43.69% and 43.41% for the nine months ended September 30, 2012 and 2011, respectively.

### *Net Interest Income*

The Company's net interest income is affected by changes in the amount and mix of interest-earning assets and interest-bearing liabilities, referred to as a volume change. It is also affected by changes in yields earned on interest-earning assets and rates paid on interest-bearing deposits and other borrowed funds, referred to as a rate change.

Net interest income was \$106.9 million for the quarter ended September 30, 2012 compared with \$82.5 million for the quarter ended September 30, 2011, an increase of \$24.4 million, or 29.5%. Included in net interest income for the quarter ended September 30, 2012 is loan discount accretion of \$11.2 million related to loans acquired in the 2012 acquisitions. Net interest income increased primarily as a result of an increase in average net interest-earning assets. Interest-earning assets increased to \$12.33 billion for the quarter ended September 30, 2012 compared with \$8.24 billion for the quarter ended September 30, 2011, an increase of \$4.09 billion, or 49.7%. Additionally, the average yield on earning assets decreased 69 basis points from 4.49% for the quarter ended September 30, 2011 compared with 3.80% for the quarter ended September 30, 2012 while the average rate paid on interest-bearing liabilities decreased 22 basis points from 0.69% for the quarter ended September 30, 2011 compared with 0.47% for the quarter ended September 30, 2012. Average interest-bearing liabilities increased \$2.99 billion or 48.7% for the same periods. The increases in volumes were due to the acquisition of ASB.

The net interest margin on a tax equivalent basis decreased 50 basis points to 3.52% for the quarter ended September 30, 2012 compared with 4.02% for the quarter ended September 30, 2011. The decrease in the net interest margin primarily resulted from the decrease in the overall yield on interest-earning assets not being matched by a corresponding decrease in the average cost of funds. The average cost of funds was 0.36% for the three months ended September 30, 2012.

Net interest income increased \$25.8 million, or 10.5%, to \$272.4 million for the nine months ended September 30, 2012 compared with \$246.6 million for the same period in 2011. Included in net interest income for the nine months ended September 30, 2012 is loan discount accretion of \$11.9 million related to loans acquired in the 2012 acquisitions. The increase in net interest income was mainly attributable to higher average net interest-earning assets for the same periods. The yield on average interest-earning assets decreased at a faster pace than the rates paid on average

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interest-bearing liabilities. The average yield on earning assets decreased 67 basis points from 4.57% for the nine months ended September 30, 2011 compared with 3.90% for the nine months ended September 30, 2012, while the average rate paid on interest-bearing liabilities decreased 25 basis points from 0.76% for the nine months ended September 30, 2011 compared with 0.51% for the same period in 2012. The net interest margin on a tax equivalent basis for the nine months ended September 30, 2012 decreased 47 basis points to 3.56% compared with 4.03% for the same period in 2011.

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The following tables set forth, for each category of interest-earning assets and interest-bearing liabilities, the average amounts outstanding, the interest earned or paid on such amounts, and the average rate earned or paid for the quarters ended September 30, 2012 and 2011 and the nine months ended September 30, 2012 and 2011. The tables also set forth the average rate paid on total interest-bearing liabilities, and the net interest margin on average total interest-earning assets for the same periods. Except as indicated in the footnotes, no tax-equivalent adjustments were made and all average balances are daily average balances. Any nonaccruing loans have been included in the table as loans carrying a zero yield.

|                                                           | Three Months Ended September 30,  |                                     |                               |                                   |                                     |                               |
|-----------------------------------------------------------|-----------------------------------|-------------------------------------|-------------------------------|-----------------------------------|-------------------------------------|-------------------------------|
|                                                           | Average<br>Outstanding<br>Balance | 2012<br>Interest<br>Earned/<br>Paid | Average<br>Yield/<br>Rate (4) | Average<br>Outstanding<br>Balance | 2011<br>Interest<br>Earned/<br>Paid | Average<br>Yield/<br>Rate (4) |
|                                                           | (Dollars in thousands)            |                                     |                               |                                   |                                     |                               |
| Assets                                                    |                                   |                                     |                               |                                   |                                     |                               |
| Interest-earning assets:                                  |                                   |                                     |                               |                                   |                                     |                               |
| Loans                                                     | \$ 5,169,101                      | \$ 80,587                           | 6.20%                         | \$ 3,694,039                      | \$ 54,471                           | 5.85%                         |
| Securities (1)                                            | 7,106,871                         | 37,025                              | 2.08                          | 4,524,213                         | 38,714                              | 3.42                          |
| Federal funds sold and other temporary investments        | 53,111                            | 21                                  | 0.16                          | 18,636                            | 4                                   | 0.09                          |
| Total interest-earning assets                             | 12,329,083                        | 117,633                             | 3.80%                         | 8,236,888                         | 93,189                              | 4.49%                         |
| Less allowance for credit losses                          | (53,944)                          |                                     |                               | (52,208)                          |                                     |                               |
| Total interest-earning assets, net of allowance           | 12,275,139                        |                                     |                               | 8,184,680                         |                                     |                               |
| Noninterest-earning assets                                | 1,730,120                         |                                     |                               | 1,375,394                         |                                     |                               |
| Total assets                                              | \$ 14,005,259                     |                                     |                               | \$ 9,560,074                      |                                     |                               |
| Liabilities and shareholders' equity                      |                                   |                                     |                               |                                   |                                     |                               |
| Interest-bearing liabilities:                             |                                   |                                     |                               |                                   |                                     |                               |
| Interest-bearing demand deposits                          | \$ 2,181,928                      | \$ 2,273                            | 0.41%                         | \$ 1,319,800                      | \$ 1,667                            | 0.50%                         |
| Savings and money market accounts                         | 3,516,601                         | 2,987                               | 0.34                          | 2,369,745                         | 2,702                               | 0.45                          |
| Certificates of deposit                                   | 2,387,279                         | 4,135                               | 0.69                          | 2,134,082                         | 5,348                               | 0.99                          |
| Junior subordinated debentures                            | 85,055                            | 651                                 | 3.04                          | 85,055                            | 607                                 | 2.83                          |
| Securities sold under repurchase agreements               | 438,410                           | 315                                 | 0.29                          | 90,821                            | 127                                 | 0.55                          |
| Federal funds purchased and other borrowings              | 512,739                           | 379                                 | 0.29                          | 135,336                           | 200                                 | 0.59                          |
| Total interest-bearing liabilities                        | 9,122,012                         | 10,740                              | 0.47%                         | 6,134,839                         | 10,651                              | 0.69%                         |
| Noninterest-bearing liabilities:                          |                                   |                                     |                               |                                   |                                     |                               |
| Noninterest-bearing demand deposits                       | 2,760,405                         |                                     |                               | 1,828,957                         |                                     |                               |
| Other liabilities                                         | 92,873                            |                                     |                               | 66,560                            |                                     |                               |
| Total liabilities                                         | 11,975,290                        |                                     |                               | 8,030,356                         |                                     |                               |
| Shareholders' equity                                      | 2,029,969                         |                                     |                               | 1,529,718                         |                                     |                               |
| Total liabilities and shareholders' equity                | \$ 14,005,259                     |                                     |                               | \$ 9,560,074                      |                                     |                               |
| Net interest rate spread                                  |                                   |                                     | 3.33%                         |                                   |                                     | 3.80%                         |
| Net interest income and margin (2)                        |                                   | \$ 106,893                          | 3.45%                         |                                   | \$ 82,538                           | 3.98%                         |
| Net interest income and margin (tax-equivalent basis) (3) |                                   | \$ 109,031                          | 3.52%                         |                                   | \$ 83,440                           | 4.02%                         |

- (1) Yield is based on amortized cost and does not include any component of unrealized gains or losses.
- (2) The net interest margin is equal to net interest income divided by average interest-earning assets.
- (3) In order to make pretax income and resultant yields on tax-exempt investments and loans comparable to those on taxable investments and loans, a tax-equivalent adjustment has been computed using a federal income tax rate of 35%.
- (4) Annualized. Average yield and average rate are calculated on an actual/365 or 366 day basis except for the average yield on securities which is calculated on a 30/360 day basis.

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|                                                           | Nine Months Ended September 30,   |                                     |                               |                                   |                                     |                               |
|-----------------------------------------------------------|-----------------------------------|-------------------------------------|-------------------------------|-----------------------------------|-------------------------------------|-------------------------------|
|                                                           | Average<br>Outstanding<br>Balance | 2012<br>Interest<br>Earned/<br>Paid | Average<br>Yield/<br>Rate (4) | Average<br>Outstanding<br>Balance | 2011<br>Interest<br>Earned/<br>Paid | Average<br>Yield/<br>Rate (4) |
| (Dollars in thousands)                                    |                                   |                                     |                               |                                   |                                     |                               |
| <b>Assets</b>                                             |                                   |                                     |                               |                                   |                                     |                               |
| Interest-earning assets:                                  |                                   |                                     |                               |                                   |                                     |                               |
| Loans                                                     | \$ 4,303,984                      | \$ 188,597                          | 5.85%                         | \$ 3,614,590                      | \$ 160,374                          | 5.93%                         |
| Securities (1)                                            | 5,983,102                         | 113,418                             | 2.53                          | 4,635,880                         | 121,861                             | 3.50                          |
| Federal funds sold and other temporary investments        | 66,771                            | 108                                 | 0.22                          | 15,031                            | 15                                  | 0.13                          |
| Total interest-earning assets                             | 10,353,857                        | 302,123                             | 3.90%                         | 8,265,501                         | 282,250                             | 4.57%                         |
| Less allowance for credit losses                          | (52,104)                          |                                     |                               | (51,924)                          |                                     |                               |
| Total interest-earning assets, net of allowance           | 10,301,753                        |                                     |                               | 8,213,577                         |                                     |                               |
| Noninterest-earning assets                                | 1,498,332                         |                                     |                               | 1,388,905                         |                                     |                               |
| Total assets                                              | \$ 11,800,085                     |                                     |                               | \$ 9,602,482                      |                                     |                               |
| <b>Liabilities and shareholders equity</b>                |                                   |                                     |                               |                                   |                                     |                               |
| Interest-bearing liabilities:                             |                                   |                                     |                               |                                   |                                     |                               |
| Interest-bearing demand deposits                          | \$ 1,861,954                      | \$ 6,425                            | 0.46%                         | \$ 1,403,477                      | \$ 5,966                            | 0.57%                         |
| Savings and money market accounts                         | 3,031,269                         | 8,020                               | 0.35                          | 2,377,423                         | 9,386                               | 0.53                          |
| Certificates of deposit                                   | 2,080,606                         | 11,824                              | 0.76                          | 2,162,112                         | 16,941                              | 1.05                          |
| Junior subordinated debentures                            | 85,055                            | 1,962                               | 3.08                          | 87,058                            | 2,352                               | 3.61                          |
| Securities sold under repurchase agreements               | 197,775                           | 411                                 | 0.28                          | 70,425                            | 306                                 | 0.58                          |
| Federal funds purchased and other borrowings              | 465,505                           | 1,076                               | 0.31                          | 181,656                           | 718                                 | 0.53                          |
| Total interest-bearing liabilities                        | 7,722,164                         | 29,718                              | 0.51%                         | 6,282,151                         | 35,669                              | 0.76%                         |
| Noninterest-bearing liabilities:                          |                                   |                                     |                               |                                   |                                     |                               |
| Noninterest-bearing demand deposits                       | 2,267,876                         |                                     |                               | 1,758,182                         |                                     |                               |
| Other liabilities                                         | 53,320                            |                                     |                               | 62,765                            |                                     |                               |
| Total liabilities                                         | 10,043,360                        |                                     |                               | 8,103,098                         |                                     |                               |
| Shareholders equity                                       | 1,756,725                         |                                     |                               | 1,499,384                         |                                     |                               |
| Total liabilities and shareholders equity                 | \$ 11,800,085                     |                                     |                               | \$ 9,602,482                      |                                     |                               |
| Net interest rate spread                                  |                                   |                                     | 3.41%                         |                                   |                                     | 3.81%                         |
| Net interest income and margin (2)                        |                                   | \$ 272,405                          | 3.51%                         |                                   | \$ 246,581                          | 3.99%                         |
| Net interest income and margin (tax-equivalent basis) (3) |                                   | \$ 276,271                          | 3.56%                         |                                   | \$ 249,345                          | 4.03%                         |

(1) Yield is based on amortized cost and does not include any component of unrealized gains or losses.

(2) The net interest margin is equal to net interest income divided by average interest-earning assets.

(3) In order to make pretax income and resultant yields on tax-exempt investments and loans comparable to those on taxable investments and loans, a tax-equivalent adjustment has been computed using a federal income tax rate of 35%.

(4) Annualized. Average yield and average rate are calculated on an actual/365 or 366 day basis except for the average yield on securities which is calculated on a 30/360 day basis.



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The following tables present the dollar amount of changes in interest income and interest expense for the major components of interest-earning assets and interest-bearing liabilities and distinguish between the increase (decrease) related to outstanding balances and the volatility of interest rates. For purposes of these tables, changes attributable to both rate and volume which cannot be segregated have been allocated to rate.

| Three Months Ended September 30,<br>2012 vs. 2011  |           |             |           |
|----------------------------------------------------|-----------|-------------|-----------|
| Increase (Decrease)                                |           |             |           |
| Due to                                             |           |             |           |
|                                                    | Volume    | Rate        | Total     |
| (Dollars in thousands)                             |           |             |           |
| Interest-earning assets:                           |           |             |           |
| Loans                                              | \$ 21,751 | \$ 4,365    | \$ 26,116 |
| Securities                                         | 22,100    | (23,789)    | (1,689)   |
| Federal funds sold and other temporary investments | 7         | 10          | 17        |
| Total increase (decrease) in interest income       | 43,858    | (19,414)    | 24,444    |
| Interest-bearing liabilities:                      |           |             |           |
| Interest-bearing demand deposits                   | 1,089     | (483)       | 606       |
| Savings and money market accounts                  | 1,308     | (1,023)     | 285       |
| Certificates of deposit                            | 635       | (1,848)     | (1,213)   |
| Junior subordinated debentures                     |           | 44          | 44        |
| Securities sold under repurchase agreements        | 486       | (298)       | 188       |
| Federal funds purchased and other borrowings       | 558       | (379)       | 179       |
| Total increase (decrease) in interest expense      | 4,076     | (3,987)     | 89        |
| Increase (decrease) in net interest income         | \$ 39,782 | \$ (15,427) | \$ 24,355 |

| Nine Months Ended September 30,<br>2012 vs. 2011   |           |            |           |
|----------------------------------------------------|-----------|------------|-----------|
| Increase (Decrease)                                |           |            |           |
| Due to                                             |           |            |           |
|                                                    | Volume    | Rate       | Total     |
| (Dollars in thousands)                             |           |            |           |
| Interest-earning assets:                           |           |            |           |
| Loans                                              | \$ 30,587 | \$ (2,364) | \$ 28,223 |
| Securities                                         | 35,414    | (43,857)   | (8,443)   |
| Federal funds sold and other temporary investments | 52        | 41         | 93        |
| Total increase (decrease) in interest income       | 66,053    | (46,180)   | 19,873    |
| Interest-bearing liabilities:                      |           |            |           |
| Interest-bearing demand deposits                   | 1,949     | (1,490)    | 459       |
| Savings and money market accounts                  | 2,581     | (3,947)    | (1,366)   |
| Certificates of deposit                            | (639)     | (4,478)    | (5,117)   |
| Junior subordinated debentures                     | (54)      | (336)      | (390)     |
| Securities sold under repurchase agreements        | 553       | (448)      | 105       |
| Federal funds purchased and other borrowings       | 1,122     | (764)      | 358       |
| Total decrease in interest expense                 | 5,512     | (11,463)   | (5,951)   |

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|                                            |           |             |           |
|--------------------------------------------|-----------|-------------|-----------|
| Increase (decrease) in net interest income | \$ 60,541 | \$ (34,717) | \$ 25,824 |
|--------------------------------------------|-----------|-------------|-----------|

### *Provision for Credit Losses*

Management actively monitors the Company's asset quality and provides specific loss provisions when necessary. Provisions for credit losses are charged to income to bring the total allowance for credit losses to a level deemed appropriate by management of the Company based on such factors as historical credit loss experience, industry diversification of the commercial loan portfolio, the amount of nonperforming loans and related collateral, the volume growth and composition of the loan portfolio, current economic conditions that may affect the borrower's ability to pay and the value of collateral, the evaluation of the loan portfolio through the internal loan review function and other relevant factors.

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Loans are charged-off against the allowance for credit losses when appropriate. Although management believes it uses the best information available to make determinations with respect to the provision for credit losses, future adjustments may be necessary if economic conditions differ from the assumptions used in making the initial determinations.

The Company made a \$1.8 million provision for credit losses for the quarter ended September 30, 2012 and a \$950,000 provision for the quarter ended September 30, 2011. The Company made a \$2.6 million provision for credit losses for the nine months ended September 30, 2012 and a \$4.1 million provision for the nine months ended September 30, 2011. The ratio of the allowance for credit losses to end of period nonperforming loans was 980.3% at September 30, 2012 compared with 1,442.0% at December 31, 2011. The ratio of allowance for credit losses to total loans was 1.00% at September 30, 2012 compared with 1.37% at December 31, 2011. For the quarter ended September 30, 2012, net charge-offs were \$1.3 million compared with net charge-offs of \$368,000 for the quarter ended September 30, 2011. Net charge-offs were \$3.2 million for the nine months ended September 30, 2012 compared with \$3.1 million for the nine months ended September 30, 2011.

*Noninterest Income*

The Company's primary sources of recurring noninterest income are non-sufficient funds fees (NSF fees), debit and ATM card income and service charges on deposit accounts. Noninterest income does not include loan origination fees on loans held for investment which are recognized over the life of the related loan as an adjustment to yield using the interest method. However mortgage origination fees on loans held for sale originated in the mortgage lending departments assumed in the ASB acquisition are included in noninterest income. Noninterest income totaled \$23.8 million for the three months ended September 30, 2012 compared with \$14.6 million for the same period in 2011, an increase of \$9.2 million, or 63.4%. Noninterest income increased \$9.5 million, or 22.5%, to \$51.4 million for the nine months ended September 30, 2012 compared with \$42.0 million for the same period in 2011. The increases during both periods were primarily due to increases in NSF fees, debit card and ATM card income and service charges on deposit accounts resulting from the acquisition of ASB.

Additionally, noninterest income for the three and nine months ended September 30, 2012 includes income generated from several lines of business assumed in the ASB acquisition, including (i) trust operations reflected under trust income (ii) mortgage lending operations which originates residential mortgages and sells into the secondary market, reflected under held for sale mortgage origination fees and; (iii) Independent Sales Organization (ISO) sponsorship operations, in which the Bank sponsors ISOs (non-bank entities which own ATM's throughout the United States) into various payment networks such as VISA and Mastercard, reflected under other noninterest income.

The following table presents, for the periods indicated, the major categories of noninterest income:

|                                              | Three Months Ended<br>September 30, |           | Nine Months Ended<br>September 30, |           |
|----------------------------------------------|-------------------------------------|-----------|------------------------------------|-----------|
|                                              | 2012                                | 2011      | 2012                               | 2011      |
|                                              | (Dollars in thousands)              |           |                                    |           |
| Non-sufficient funds (NSF)                   | \$ 9,265                            | \$ 6,249  | \$ 19,821                          | \$ 18,582 |
| Debit card and ATM card income               | 6,246                               | 3,941     | 14,374                             | 11,202    |
| Service charges on deposit accounts          | 3,362                               | 2,472     | 8,235                              | 7,466     |
| Banking related service fees                 | 818                                 | 565       | 1,923                              | 1,589     |
| Bank owned life insurance (BOLI)             | 736                                 | 355       | 1,430                              | 1,035     |
| Trust income                                 | 831                                 |           | 831                                |           |
| Held for sale mortgage origination fees      | 1,350                               |           | 1,350                              |           |
| Net (loss) gain on sale of assets            | (50)                                | 17        | 13                                 | 377       |
| Net (loss) gain on sale of other real estate | (597)                               | 95        | (344)                              | (431)     |
| Net loss on sale of securities               |                                     |           |                                    | (581)     |
| Other noninterest income                     | 1,867                               | 887       | 3,796                              | 2,739     |
| Total noninterest income                     | \$ 23,828                           | \$ 14,581 | \$ 51,429                          | \$ 41,978 |

*Noninterest Expense*

Noninterest expense totaled \$60.2 million for the quarter ended September 30, 2012 compared with \$41.2 million for the quarter ended September 30, 2011, an increase of \$19.1 million, or 46.4%. Noninterest expense totaled \$141.5 million and \$125.4 million for the nine months ended September 30, 2012 and September 30, 2011, respectively. The increases were primarily due to increases in salaries and employee

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benefits and general administrative expenses related to the acquisition of ASB. The Company also incurred one-time merger expenses of \$5.1 million and \$5.4 million, for the respective periods, which are included in total noninterest expenses primarily in the categories of salaries and employee benefits and professional fees.

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The following table presents, for the periods indicated, the major categories of noninterest expense:

|                                                       | Three Months Ended<br>September 30, |           | Nine Months Ended<br>September 30, |            |
|-------------------------------------------------------|-------------------------------------|-----------|------------------------------------|------------|
|                                                       | 2012                                | 2011      | 2012                               | 2011       |
|                                                       | (Dollars in thousands)              |           |                                    |            |
| Salaries and employee benefits (1)                    | \$ 36,701                           | \$ 23,601 | \$ 83,525                          | \$ 70,799  |
| Non-staff expenses:                                   |                                     |           |                                    |            |
| Occupancy and equipment                               | 4,614                               | 3,784     | 11,663                             | 10,979     |
| Depreciation                                          | 2,369                               | 2,041     | 6,432                              | 6,099      |
| Debit card, data processing and software amortization | 2,901                               | 1,954     | 6,339                              | 5,406      |
| Communications                                        | 2,226                               | 1,749     | 5,777                              | 5,188      |
| Printing and supplies                                 | 601                                 | 467       | 1,546                              | 1,371      |
| Professional fees                                     | 1,686                               | 674       | 3,231                              | 1,918      |
| Regulatory assessments and FDIC insurance             | 2,107                               | 1,488     | 5,314                              | 7,383      |
| Ad valorem and franchise taxes                        | 1,290                               | 1,005     | 3,333                              | 3,016      |
| Core deposit intangibles amortization                 | 2,007                               | 1,924     | 5,297                              | 5,901      |
| Other real estate                                     | 271                                 | 235       | 1,345                              | 821        |
| Other                                                 | 3,469                               | 2,229     | 7,687                              | 6,479      |
| Total non-staff expenses                              | 23,541                              | 17,550    | 57,964                             | 54,561     |
| Total noninterest expense                             | \$ 60,242                           | \$ 41,151 | \$ 141,489                         | \$ 125,360 |

(1) Includes stock-based compensation expense of \$1.1 million and \$961,000 for the three months ended September 30, 2012 and 2011, respectively, and \$3.2 million and \$2.6 million for the nine months ended September 30, 2012 and 2011, respectively. Salaries and employee benefit expenses were \$36.7 million for the quarter ended September 30, 2012 compared with \$23.6 million for the quarter ended September 30, 2011, an increase of \$13.1 million, or 55.5%. For the nine months ended September 30, 2012, salaries and employee benefit expenses were \$83.5 million, an increase of \$12.7 million or 18.0% compared with \$70.8 million for the nine months ended September 30, 2011. The increase during both periods was principally due to the acquisition of ASB. The number of full-time equivalent (FTE) associates employed by the Company was 2,260 at September 30, 2012 and 1,678 at September 30, 2011.

Non-staff expenses increased \$6.0 million, or 34.1%, to \$23.5 million for the quarter ended September 30, 2012 compared with \$17.6 million during the same period in 2011. Non-staff expenses increased \$3.4 million, or 6.2%, to \$58.0 million for the nine months ended September 30, 2012 compared to \$54.6 million during the same period in 2011. The increases for both periods were primarily due to the ASB acquisition and also include expenses related to the new lines of business acquired in the ASB acquisition described under *Noninterest Income* above.

*Income Taxes*

Income tax expense increased \$3.9 million, or 20.7%, to \$22.5 million for the quarter ended September 30, 2012 compared with \$18.6 million for the same period in 2011. For the nine months ended September 30, 2012, income tax expense totaled \$60.2 million, an increase of \$6.4 million or 11.8% compared with \$53.8 million for the same period in 2011. Both increases were primarily attributable to higher pretax net earnings for the quarter and nine months ended September 30, 2012 when compared to the same periods in 2011. The effective tax rates for the three months ended September 30, 2012 and 2011 were 32.8% and 33.9%, respectively and the effective tax rates for the nine months ended September 30, 2012 and 2011 were 33.5% and 33.8%, respectively.

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Total loans were \$5.08 billion at September 30, 2012, an increase of \$1.31 billion or 34.9% compared with \$3.77 billion at December 31, 2011. Loan growth was impacted by the acquisition of Texas Bankers, Inc., The Bank Arlington and ASB. Loans attributed to these acquisitions totaled \$24.2 million, \$21.8 million and \$1.13 billion at September 30, 2012, respectively.

The following table summarizes the loan portfolio of the Company by type of loan as of September 30, 2012 and December 31, 2011:

|                                       | September 30,<br>2012  | December 31,<br>2011 |
|---------------------------------------|------------------------|----------------------|
|                                       | (Dollars in thousands) |                      |
| Commercial and industrial             | \$ 756,342             | \$ 406,433           |
| Real estate:                          |                        |                      |
| Construction and land development     | 496,417                | 482,140              |
| 1-4 family residential <sup>(1)</sup> | 1,213,873              | 1,007,266            |
| Home equity                           | 183,844                | 146,999              |
| Commercial mortgage                   | 1,837,224              | 1,351,986            |
| Agriculture real estate               | 205,333                | 136,008              |
| Multi-family residential              | 138,888                | 89,240               |
| Agriculture                           | 98,801                 | 34,226               |
| Consumer (net of unearned discount)   | 112,476                | 78,187               |
| Other                                 | 35,905                 | 33,421               |
| Total                                 | \$ 5,079,103           | \$ 3,765,906         |

(1) Includes \$4.3 million in loans held for sale carried at the lower of cost or market.

*Nonperforming Assets*

The Company had \$14.1 million in nonperforming assets at September 30, 2012 and \$12.1 million in nonperforming assets at December 31, 2011, an increase of \$2.0 million or 16.6%. The ratio of nonperforming assets to loans and other real estate was 0.28% at September 30, 2012 compared with 0.32% at December 31, 2011.

The Company generally places a loan on nonaccrual status and ceases accruing interest when the payment of principal or interest is delinquent for 90 days, or earlier in some cases if the collection of the principal is deemed unlikely, unless the loan is in the process of collection and the underlying collateral fully supports the carrying value of the loan. The Company generally charges off all loans before attaining nonaccrual status.

The following table presents information regarding nonperforming assets as of the dates indicated:

|                                         | September 30,<br>2012  | December 31,<br>2011 |
|-----------------------------------------|------------------------|----------------------|
|                                         | (Dollars in thousands) |                      |
| Nonaccrual loans                        | \$ 5,063               | \$ 3,578             |
| Accruing loans 90 or more days past due | 132                    |                      |
| Total nonperforming loans               | 5,195                  | 3,578                |
| Reposessed assets                       | 10                     | 146                  |

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|                                                           |           |           |
|-----------------------------------------------------------|-----------|-----------|
| Other real estate                                         | 8,846     | 8,328     |
| Total nonperforming assets                                | \$ 14,051 | \$ 12,052 |
| Nonperforming assets to total loans and other real estate | 0.28%     | 0.32%     |
| Nonperforming assets to average earning assets            | 0.14%     | 0.15%     |

### *Allowance for Credit Losses*

Management actively monitors the Company's asset quality and provides specific loss allowances when necessary. Loans are charged-off against the allowance for credit losses when appropriate. Although management believes it uses the best information available to make determinations with respect to the allowance for credit losses, future adjustments may be necessary if economic conditions differ from the assumptions used in making the initial determinations. As of September 30, 2012, the allowance for credit losses amounted to \$50.9 million, or 1.00% of total loans, compared with \$51.6 million, or 1.37% of total loans, at December 31, 2011.

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Set forth below is an analysis of the allowance for credit losses for the nine months ended September 30, 2012 and the year ended December 31, 2011:

|                                                         | As of and for the<br>Nine Months Ended<br>September 30,<br>2012 | As of and for the<br>Year Ended<br>December 31, 2011 |
|---------------------------------------------------------|-----------------------------------------------------------------|------------------------------------------------------|
| (Dollars in thousands)                                  |                                                                 |                                                      |
| Average loans outstanding                               | \$ 4,303,984                                                    | \$ 3,648,701                                         |
| Gross loans outstanding at end of period                | \$ 5,079,103                                                    | \$ 3,765,906                                         |
| Allowance for credit losses at beginning of period      | \$ 51,594                                                       | \$ 51,584                                            |
| Provision for credit losses                             | 2,550                                                           | 5,200                                                |
| Charge-offs:                                            |                                                                 |                                                      |
| Commercial and industrial                               | (376)                                                           | (1,694)                                              |
| Real estate and agriculture                             | (3,123)                                                         | (3,927)                                              |
| Consumer                                                | (2,102)                                                         | (1,229)                                              |
| Recoveries:                                             |                                                                 |                                                      |
| Commercial and industrial                               | 722                                                             | 481                                                  |
| Real estate and agriculture                             | 262                                                             | 472                                                  |
| Consumer                                                | 1,400                                                           | 707                                                  |
| Net charge-offs                                         | (3,217)                                                         | (5,190)                                              |
| Allowance for credit losses at end of period            | \$ 50,927                                                       | \$ 51,594                                            |
| Ratio of allowance to end of period loans               | 1.00%                                                           | 1.37%                                                |
| Ratio of net charge-offs to average loans (annualized)  | 0.10%                                                           | 0.14%                                                |
| Ratio of allowance to end of period nonperforming loans | 980.3%                                                          | 1,442.0%                                             |

*Securities*

The carrying cost of securities totaled \$6.80 billion at September 30, 2012 compared with \$4.66 billion at December 31, 2011, an increase of \$2.14 billion or 45.9%. The increase is due to securities acquired from ASB. At September 30, 2012, securities represented 49.6% of total assets compared with 47.4% of total assets at December 31, 2011.

The Company had no gain or loss on sale of securities for the three months ended September 30, 2012 or 2011 and had no gain or loss on sale of securities for the nine months ended September 30, 2012 compared with a net loss of \$581,000 for the nine months ended September 30, 2011. The Company sold two non-agency CMOs with a total book value of \$3.2 million due to a downgrade of the CMOs to less than investment grade in the second quarter of 2011. As of September 30, 2012, the Company had eight non-agency CMOs remaining with a total book value of \$2.7 million and total market value of \$2.5 million.

The following table summarizes the amortized cost of securities as of the dates shown (available for sale securities are not adjusted for unrealized gains or losses):

|                                                                      | September 30,<br>2012 | December 31,<br>2011 |
|----------------------------------------------------------------------|-----------------------|----------------------|
| (In thousands)                                                       |                       |                      |
| U.S. Treasury securities and obligations of U.S. government agencies | \$ 10,597             | \$ 8,696             |
| States and political subdivisions                                    | 409,608               | 74,974               |
| Corporate debt securities                                            | 2,996                 | 2,990                |

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|                                            |                  |                  |
|--------------------------------------------|------------------|------------------|
| Collateralized mortgage obligations        | 161,129          | 282,565          |
| Mortgage-backed securities                 | 6,178,004        | 4,248,796        |
| Qualified School Construction Bonds (QSCB) | 12,900           | 12,900           |
| Equity securities                          | 7,288            | 7,288            |
| <br>Total amortized cost                   | <br>\$ 6,782,522 | <br>\$ 4,638,209 |
| <br>Total fair value                       | <br>\$ 7,022,538 | <br>\$ 4,815,304 |

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Management evaluates securities for other-than-temporary impairment ( OTTI ) at least on a quarterly basis, and more frequently when economic or market conditions warrant such an evaluation. The investment securities portfolio is evaluated for OTTI by segregating the portfolio into two general segments and applying the appropriate OTTI model. Investment securities classified as available for sale or held to maturity are generally evaluated for OTTI under FASB ASC Topic 320, *Investments- Debt and Equity Securities*. Certain purchased beneficial interests, including non-agency mortgage-backed securities, asset-backed securities, and collateralized debt obligations, that had credit ratings at the time of purchase of below AA are evaluated using the model outlined in ASC Topic 325, *Investments-Other*. The Company currently does not own any securities that are accounted for under ASC Topic 325.

In determining OTTI under ASC Topic 320, management considers many factors, including: (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, (3) whether the market decline was affected by macroeconomic conditions, and (4) whether the entity has the intent to sell the debt security or more likely than not will be required to sell the debt security before its anticipated recovery. The assessment of whether an other-than-temporary decline exists involves a high degree of subjectivity and judgment and is based on the information available to management at a point in time. If applicable, the second segment of the portfolio uses the OTTI guidance provided by ASC Topic 325 that is specific to purchased beneficial interests that, on the purchase date, were rated below AA. Under the ASC Topic 325 model, the Company compares the present value of the remaining cash flows as estimated at the preceding evaluation date to the current expected remaining cash flows. An OTTI is deemed to have occurred if there has been an adverse change in the remaining expected future cash flows.

When OTTI occurs under either model, the amount of the other-than-temporary-impairment recognized in earnings depends on whether an entity intends to sell the security or more likely than not will be required to sell the security before recovery of its amortized cost basis less any current-period credit loss. If an entity intends to sell or more likely than not will be required to sell the security before recovery of its amortized cost basis less any current-period credit loss, the OTTI shall be recognized in earnings equal to the entire difference between the investment's amortized cost basis and its fair value at the balance sheet date. If an entity does not intend to sell the security and it is not more likely than not that the entity will be required to sell the security before recovery of its amortized cost basis less any current-period loss, the OTTI shall be separated into the amount representing the credit loss and the amount related to all other factors. The amount of the total OTTI related to the credit loss is determined based on the present value of cash flows expected to be collected and is recognized in earnings. The amount of the total OTTI related to other factors shall be recognized in other comprehensive income, net of applicable taxes. The previous amortized cost basis less the OTTI recognized in earnings shall become the new amortized cost basis of the investment.

Management believes the Company does not intend to sell any debt securities or more likely than not will not be required to sell any debt securities before their anticipated recovery, at which time the Company will receive full value for the securities. Furthermore, management has the ability and intent to hold the securities classified as available for sale that were in a loss position as of September 30, 2012 for a period of time sufficient for an entire recovery of the cost basis of the securities. The unrealized losses are largely due to increases in market interest rates over the yields available at the time the underlying securities were purchased. The fair value is expected to recover as the securities approach their maturity date or repricing date or if market yields for such investments decline. Management does not believe any of the securities are impaired due to reasons of credit quality. Accordingly, as of September 30, 2012, management believes any impairment in the Company's securities are temporary and no impairment loss has been realized in the Company's consolidated statements of income.

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The following tables present the amortized cost and fair value of securities classified as available for sale and held to maturity at September 30, 2012:

|                                                                      | Amortized<br>Cost | September 30, 2012<br>Gross<br>Unrealized<br>Gains<br>(Dollars in thousands) | September 30, 2012<br>Gross<br>Unrealized<br>Losses<br>(Dollars in thousands) | Fair<br>Value |
|----------------------------------------------------------------------|-------------------|------------------------------------------------------------------------------|-------------------------------------------------------------------------------|---------------|
| <b>Available for Sale</b>                                            |                   |                                                                              |                                                                               |               |
| States and political subdivisions                                    | \$ 35,262         | \$ 1,937                                                                     | \$ (11)                                                                       | \$ 37,188     |
| Collateralized mortgage obligations                                  | 651               |                                                                              | (13)                                                                          | 638           |
| Mortgage-backed securities                                           | 188,699           | 14,618                                                                       | (56)                                                                          | 203,261       |
| Corporate debt securities and other                                  | 8,784             | 516                                                                          |                                                                               | 9,300         |
| Total                                                                | \$ 233,396        | \$ 17,071                                                                    | \$ (80)                                                                       | \$ 250,387    |
| <b>Held to Maturity</b>                                              |                   |                                                                              |                                                                               |               |
| U.S. Treasury securities and obligations of U.S. government agencies | \$ 10,597         | \$ 213                                                                       | \$                                                                            | \$ 10,810     |
| States and political subdivisions (including QSCB)                   | 387,246           | 9,355                                                                        | (151)                                                                         | 396,450       |
| Corporate debt securities                                            | 1,500             | 53                                                                           |                                                                               | 1,553         |
| Collateralized mortgage obligations                                  | 160,478           | 2,994                                                                        | (215)                                                                         | 163,257       |
| Mortgage-backed securities                                           | 5,989,305         | 211,153                                                                      | (377)                                                                         | 6,200,081     |
| Total                                                                | \$ 6,549,126      | \$ 223,768                                                                   | \$ (743)                                                                      | \$ 6,772,151  |

### Bank Premises and Equipment

Premises and equipment, net of accumulated depreciation, totaled \$201.4 million and \$159.7 million at September 30, 2012 and December 31, 2011, respectively, an increase of \$41.8 million or 26.2%. The increase is primarily due to the addition of the ASB banking centers.

### Deposits

Total deposits were \$10.95 billion at September 30, 2012 compared with \$8.06 billion at December 31, 2011, an increase of \$2.89 billion or 35.9%. Deposit growth was impacted by the acquisition of Texas Bankers, Inc., The Bank Arlington and ASB. Deposits for these acquisitions totaled \$69.8 million, \$33.6 million and \$2.52 billion at September 30, 2012, respectively. At September 30, 2012, noninterest-bearing deposits accounted for approximately 25.8% of total deposits compared with 24.5% of total deposits at December 31, 2011. Interest-bearing demand deposits totaled \$8.13 billion or 74.2% of total deposits at September 30, 2012 compared with \$6.09 billion or 75.5% of total deposits at December 31, 2011.

The following table summarizes the daily average balances and weighted average rates paid on deposits for the periods presented below:

|                         | Nine Months Ended<br>September 30,<br>2012 |                 | Year Ended<br>December 31,<br>2011 |                 |
|-------------------------|--------------------------------------------|-----------------|------------------------------------|-----------------|
|                         | Average<br>Balance                         | Average<br>Rate | Average<br>Balance                 | Average<br>Rate |
| (Dollars in thousands)  |                                            |                 |                                    |                 |
| Interest-bearing demand | \$ 1,861,954                               | 0.46%           | \$ 1,393,501                       | 0.53%           |
| Regular savings         | 785,883                                    | 0.23            | 472,983                            | 0.32            |
| Money market savings    | 2,245,386                                  | 0.40            | 1,948,752                          | 0.53            |
| Time deposits           | 2,080,606                                  | 0.76            | 2,135,858                          | 1.02            |

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|                                 |              |       |              |       |
|---------------------------------|--------------|-------|--------------|-------|
| Total interest-bearing deposits | 6,973,829    | 0.50  | 5,951,094    | 0.69  |
| Noninterest-bearing deposits    | 2,267,876    |       | 1,800,102    |       |
| Total deposits                  | \$ 9,241,705 | 0.38% | \$ 7,751,196 | 0.53% |

**Table of Contents***Other Borrowings*

The Company utilizes borrowings to supplement deposits to fund its lending and investment activities. Borrowings consist of funds from the Federal Home Loan Bank ( FHLB ) and correspondent banks. FHLB advances are considered short-term, overnight borrowings. At September 30, 2012, the Company had \$100.0 million in FHLB advances compared with no FHLB advances at December 31, 2011. The highest outstanding balance of FHLB advances during the nine months ended September 30, 2012 was \$1.01 billion compared with \$474.0 million for the year ended December 31, 2011. The annualized average rate paid on FHLB advances for the quarter ended September 30, 2012 was 0.17%. At September 30, 2012, the Company had \$12.0 million in FHLB long-term notes payable compared with \$12.8 million at December 31, 2011. The weighted average interest rate paid on the FHLB notes payable at September 30, 2012 was 5.3%. The maturity dates on the FHLB notes payable range from the years 2013 to 2028 and have interest rates ranging from 4.1% to 6.1%. FHLB borrowings are available to the Company under a security and pledge agreement. At September 30, 2012, the Company had total funds of \$2.92 billion available under this agreement, of which \$112.0 million was outstanding.

At September 30, 2012, the Company had \$443.9 million in securities sold under repurchase agreements compared with \$54.9 million at December 31, 2011, an increase of \$389.0 million or 708.7%. The weighted average rates paid on securities sold under repurchase agreements were 0.28% and 0.54% for the same periods, respectively. The increase is due to the acquisition of ASB. Of the \$443.9 million in securities sold under repurchase agreements outstanding at September 30, 2012, \$26.4 million were time deposits with maturities ranging from 2012 to 2014.

The following table presents the Company's borrowings at September 30, 2012 and December 31, 2011:

|                                             | September 30,<br>2012 | December 31,<br>2011 |
|---------------------------------------------|-----------------------|----------------------|
|                                             | (In thousands)        |                      |
| FHLB advances                               | \$ 100,000            | \$                   |
| FHLB long-term notes payable                | 12,017                | 12,790               |
| Total other borrowings                      | 112,017               | 12,790               |
| Securities sold under repurchase agreements | 443,856               | 54,883               |
| Total                                       | \$ 555,873            | \$ 67,673            |

*Junior Subordinated Debentures*

At September 30, 2012 and December 31, 2011, the Company had outstanding \$85.1 million in junior subordinated debentures issued to the Company's unconsolidated subsidiary trusts.

A summary of pertinent information related to the Company's seven issues of junior subordinated debentures outstanding at September 30, 2012 is set forth in the table below:

| Description                         | Issuance Date  | Trust Preferred Securities Outstanding | Interest Rate <sup>(1)</sup> | Junior Subordinated Debt Owed to Trusts | Maturity Date <sup>(2)</sup> |
|-------------------------------------|----------------|----------------------------------------|------------------------------|-----------------------------------------|------------------------------|
| Prosperity Statutory Trust II       | July 31, 2001  | \$ 15,000,000                          | 3 month LIBOR+               | \$ 15,464,000                           | July 31, 2031                |
|                                     |                |                                        | 3.58%, not to exceed         |                                         |                              |
|                                     |                |                                        | 12.50%                       |                                         |                              |
| Prosperity Statutory Trust III      | Aug. 15, 2003  | 12,500,000                             | 3 month LIBOR + 3.00%        | 12,887,000                              | Sept. 17, 2033               |
| Prosperity Statutory Trust IV       | Dec. 30, 2003  | 12,500,000                             | 3 month LIBOR + 2.85%        | 12,887,000                              | Dec. 30, 2033                |
| SNB Capital Trust IV <sup>(3)</sup> | Sept. 25, 2003 | 10,000,000                             | 3 month LIBOR + 3.00%        | 10,310,000                              | Sept. 25, 2033               |

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|                                         |               |            |                       |            |               |
|-----------------------------------------|---------------|------------|-----------------------|------------|---------------|
| TXUI Statutory Trust II <sup>(4)</sup>  | Dec. 19, 2003 | 5,000,000  | 3 month LIBOR + 2.85% | 5,155,000  | Dec. 19, 2033 |
| TXUI Statutory Trust III <sup>(4)</sup> | Nov. 30, 2005 | 15,500,000 | 3 month LIBOR + 1.39% | 15,980,000 | Dec. 15, 2035 |
| TXUI Statutory Trust IV <sup>(4)</sup>  | Mar. 31, 2006 | 12,000,000 | 3 month LIBOR + 1.39% | 12,372,000 | June 30, 2036 |

\$ 85,055,000

- (1) The 3-month LIBOR in effect as of September 30, 2012 was 0.359%.
- (2) All debentures are callable five years from issuance date.
- (3) Assumed in connection with the SNB acquisition on April 1, 2006.
- (4) Assumed in connection with the TXUI acquisition on January 31, 2007.

**Table of Contents***Liquidity*

Liquidity involves the Company's ability to raise funds to support asset growth or reduce assets to meet deposit withdrawals and other payment obligations, to maintain reserve requirements and otherwise to operate the Company on an ongoing basis. The Company's largest source of funds is deposits and its largest use of funds is loans. The Company does not expect a change in the source or use of its funds in the foreseeable future. Although access to purchased funds from correspondent banks and overnight advances from the Federal Home Loan Bank-Dallas is available and has been utilized on occasion to take advantage of investment opportunities, the Company does not generally rely on these external funding sources. The cash and federal funds sold position, supplemented by amortizing investment and loan portfolios, has generally created an adequate liquidity position.

As of September 30, 2012, the Company had outstanding \$886.1 million in commitments to extend credit and \$25.4 million in commitments associated with outstanding standby letters of credit. Since commitments associated with letters of credit and commitments to extend credit may expire unused, the total outstanding may not necessarily reflect the actual future cash funding requirements.

The Company has no exposure to future cash requirements associated with known uncertainties or capital expenditures of a material nature.

Asset liquidity is provided by cash and assets which are readily marketable or which will mature in the near future. As of September 30, 2012, the Company had cash and cash equivalents of \$207.7 million compared with \$213.4 million at December 31, 2011, a decrease of \$5.7 million. The decrease was primarily due to an increase in deposits of \$295.2 million, proceeds from the maturities and repayments of securities of \$2.94 billion, net amortization of investments of \$42.9 million, a net increase in securities sold under repurchase agreements of \$37.7 million, proceeds from short-term borrowings of \$100.0 million, cash acquired in acquisitions of \$179.6 million and net earnings of \$119.6 million partially offset by purchases of securities of \$3.61 billion, dividends paid of \$29.4 million and an increase in loans of \$84.9 million.

*Contractual Obligations*

The following table summarizes the Company's contractual obligations and other commitments to make future payments as of September 30, 2012 (other than deposit obligations). The payments do not include pre-payment options that may be available to the Company. The Company's future cash payments associated with its contractual obligations pursuant to its junior subordinated debentures, FHLB borrowings and operating leases as of September 30, 2012 are summarized below. Payments for junior subordinated debentures include interest of \$52.0 million that will be paid over the future periods. The future interest payments were calculated using the current rate in effect at September 30, 2012. The current principal balance of the junior subordinated debentures at September 30, 2012 was \$85.1 million. Payments for FHLB borrowings include interest of \$3.0 million that will be paid over the future periods. Payments related to leases are based on actual payments specified in underlying contracts.

|                                   | Remaining<br>Fiscal 2012 | Fiscal<br>2013-2014 | Fiscal<br>2015-2016 | Payments due in:<br>Thereafter | Total                  |
|-----------------------------------|--------------------------|---------------------|---------------------|--------------------------------|------------------------|
|                                   |                          |                     |                     |                                | (Dollars in thousands) |
| Junior subordinated debentures    | \$ 1,222                 | \$ 4,888            | \$ 4,888            | \$ 126,017                     | \$ 137,015             |
| Federal Home Loan Bank borrowings | 100,282                  | 3,258               | 3,456               | 8,001                          | 114,997                |
| Operating leases                  | 1,324                    | 8,547               | 4,013               | 759                            | 14,643                 |
| Total                             | \$ 102,828               | \$ 16,693           | \$ 12,357           | \$ 134,777                     | \$ 266,655             |

*Off-Balance Sheet Items*

In the normal course of business, the Company enters into various transactions, which, in accordance with accounting principles generally accepted in the United States, are not included in its consolidated balance sheets. The Company enters into these transactions to meet the financing needs of its customers. These transactions include commitments to extend credit and standby letters of credit, which involve, to varying degrees, elements of credit risk and interest rate risk in excess of the amounts recognized in the consolidated balance sheets.

The Company's commitments associated with outstanding standby letters of credit and commitments to extend credit as of September 30, 2012 are summarized below. Since commitments associated with letters of credit and commitments to extend credit may expire unused, the amounts shown do not necessarily reflect the actual future cash funding requirements.



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|                              | Remaining<br>Fiscal 2012 | Fiscal<br>2013-2014 | Fiscal<br>2015-2016 | Thereafter | Total      |
|------------------------------|--------------------------|---------------------|---------------------|------------|------------|
|                              | (Dollars in thousands)   |                     |                     |            |            |
| Standby letters of credit    | \$ 4,472                 | \$ 20,399           | \$ 564              | \$         | \$ 25,435  |
| Commitments to extend credit | 114,567                  | 445,549             | 50,391              | 275,538    | 886,045    |
| Total                        | \$ 119,039               | \$ 465,948          | \$ 50,955           | \$ 275,538 | \$ 911,480 |

*Capital Resources*

Total shareholders' equity was \$2.04 billion at September 30, 2012 compared with \$1.57 billion at December 31, 2011, an increase of \$470.9 million or 30.0%. The increase was due primarily to net earnings of \$119.6 million and the issuance of common stock in connection with acquisitions and the exercise of stock options of \$379.9 million, partially offset by dividends paid of \$29.4 million for the nine months ended September 30, 2012.

Both the Board of Governors of the Federal Reserve System with respect to the Company, and the Federal Deposit Insurance Corporation (FDIC) with respect to the Bank, have established certain minimum risk-based capital standards that apply to bank holding companies and federally insured banks. The following table sets forth the Company's total risk-based capital, Tier 1 risk-based capital, and Tier 1 to average assets (leverage) ratios as of September 30, 2012:

|                                          |        |
|------------------------------------------|--------|
| <b>Consolidated Capital Ratios:</b>      |        |
| Total capital (to risk weighted assets)  | 15.26% |
| Tier 1 capital (to risk weighted assets) | 14.43% |
| Tier 1 capital (to average assets)       | 6.92%  |

As of September 30, 2012, the Bank's risk-based capital ratios were above the levels required for the Bank to be designated as "well capitalized" by the FDIC. To be designated as "well capitalized", the minimum ratio requirements for the Bank's total risk-based capital, Tier 1 risk-based capital, and Tier 1 to average assets (leverage) capital ratios must be 10.0%, 6.0% and 5.0%, respectively. The following table sets forth the Bank's total risk-based capital, Tier 1 risk-based capital, and Tier 1 to average assets (leverage) capital ratios as of September 30, 2012:

|                                          |        |
|------------------------------------------|--------|
| <b>Capital Ratios (Bank Only):</b>       |        |
| Total capital (to risk weighted assets)  | 14.82% |
| Tier 1 capital (to risk weighted assets) | 13.99% |
| Tier 1 capital (to average assets)       | 6.68%  |

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

The Company manages market risk, which for the Company is primarily interest rate risk, through its Asset Liability Committee which is composed of senior officers of the Company, in accordance with policies approved by the Company's Board of Directors.

The Company uses simulation analysis to examine the potential effects of market changes on net interest income and market value. The Company considers macroeconomic variables, Company strategy, liquidity and other factors as it quantifies market risk. See the Company's Annual Report on Form 10-K, Item 7 Management's Discussion and Analysis of Financial Condition and Results of Operations-Interest Rate Sensitivity and Liquidity which was filed on February 29, 2012 for further discussion.

**ITEM 4. CONTROLS AND PROCEDURES**

*Evaluation of disclosure controls and procedures.* As of the end of the period covered by this report, the Company carried out an evaluation, under the supervision and with the participation of its management, including its Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of its disclosure controls and procedures. In designing and evaluating the disclosure controls and procedures, management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable

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assurance of achieving the desired control objectives, and management was required to apply judgment in evaluating its controls and procedures. Based on this evaluation, the Company's Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934 (the "Exchange Act")) were effective as of the end of the period covered by this report.

*Changes in internal control over financial reporting.* There were no changes in the Company's internal control over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) during the quarter ended September 30, 2012 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

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**PART II OTHER INFORMATION**

**ITEM 1. LEGAL PROCEEDINGS**

The Company and the Bank are defendants, from time to time, in legal actions arising from transactions conducted in the ordinary course of business. The Company and Bank believe, after consultations with legal counsel, that the ultimate liability, if any, arising from such actions will not have a material adverse effect on their financial statements.

**ITEM 1A. RISK FACTORS**

There have been no material changes in the Company's risk factors from those disclosed in the Company's Annual Report on Form 10-K for the year ended December 31, 2011.

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

a. Not applicable

b. Not applicable

c. Not applicable

**ITEM 3. DEFAULTS UPON SENIOR SECURITIES**

Not applicable

**ITEM 4. MINE SAFETY DISCLOSURES**

None.

**ITEM 5. OTHER INFORMATION**

Not applicable

**ITEM 6. EXHIBITS**

a. Exhibits:

**Exhibit**

**Number**

**Description of Exhibit**

|     |                                                                                                                                                                                                                                                 |
|-----|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 3.1 | Amended and Restated Articles of Incorporation of Prosperity Bancshares, Inc. (incorporated herein by reference to Exhibit 3.1 to the Company's Registration Statement on Form S-1 (Registration No. 333-63267) (the "Registration Statement")) |
|-----|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|

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|        |                                                                                                                                                                                                                                              |
|--------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 3.2    | Articles of Amendment to Amended and Restated Articles of Incorporation of Prosperity Bancshares, Inc. (incorporated herein by reference to Exhibit 3.2 to the Company's Quarterly Report on Form 10-Q for the quarter ended March 31, 2006) |
| 3.3    | Amended and Restated Bylaws of Prosperity Bancshares, Inc. (incorporated herein by reference to Exhibit 3.1 to the Company's Current Report on Form 8-K filed on October 19, 2007)                                                           |
| 4.1    | Form of certificate representing shares of the Company's common stock (incorporated by reference to Exhibit 4 to the Registration Statement)                                                                                                 |
| 31.1*  | Certification of the Chief Executive Officer pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended                                                                                                                   |
| 31.2*  | Certification of the Chief Financial Officer pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended                                                                                                                   |
| 32.1** | Certification of the Chief Executive Officer pursuant to 18 U.S.C. Section 1350, adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002                                                                                           |
| 32.2** | Certification of the Chief Financial Officer pursuant to 18 U.S.C. Section 1350, adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002                                                                                           |
| 101*   | Interactive Financial Data                                                                                                                                                                                                                   |

\* Filed with this Quarterly Report on Form 10-Q.

\*\* Furnished with this Quarterly Report on Form 10-Q.

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**SIGNATURES**

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

PROSPERITY BANCSHARES, INC. ®

(Registrant)

Date: 11/09/12

/s/ DAVID ZALMAN  
**David Zalman**

**Chairman and Chief Executive Officer**

Date: 11/09/12

/s/ DAVID HOLLAWAY  
**David Hollaway**

**Chief Financial Officer**