PROSPERITY BANCSHARES INC
Form 10-Q
November 09, 2011
Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

SEPTEMBER 30, 2011 FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2011

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: 000-25051

PROSPERITY BANCSHARES, INC.®

(Exact name of registrant as specified in its charter)

TEXAS	**74-2331986**
(State or other jurisdiction of incorporation or organization)	**(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 x 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 x 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	x	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 x

As of November 1, 2011, there were 46,892,944 outstanding shares of the registrant s Common Stock, par value $1.00 per share.

Table of Contents

PROSPERITY BANCSHARES, INC. ® AND SUBSIDIARIES

INDEX TO FORM 10-Q

		Page
PART I FINANCIAL INFORMATION		
Item 1.	Financial Statements	3
	Condensed Consolidated Balance Sheets as of September 30, 2011 and December 31, 2010 (unaudited)	3
	Condensed Consolidated Statements of Income for the Three and Nine Months Ended September 30, 2011 and 2010 (unaudited)	4
	Condensed Consolidated Statements of Changes in Shareholders Equity for the Year Ended December 31, 2010 and for the Nine Months Ended September 30, 2011 (unaudited)	5
	Condensed Consolidated Statements of Cash Flows for the Nine Months Ended September 30, 2011 and 2010 (unaudited)	6
	Notes to Interim Condensed Consolidated Financial Statements (unaudited)	8
Item 2.	Management s Discussion and Analysis of Financial Condition and Results of Operations	26
Item 3.	Quantitative and Qualitative Disclosures about Market Risk	41
Item 4.	Controls and Procedures	41
PART II OTHER INFORMATION		
Item 1.	Legal Proceedings	42
Item 1A.	Risk Factors	42
Item 2.	Unregistered Sales of Equity Securities and Use of Proceeds	42
Item 3.	Defaults upon Senior Securities	42
Item 4.	Removed and Reserved	42
Item 5.	Other Information	42
Item 6.	Exhibits	42
Signatures		44

Table of Contents

PART I FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

PROSPERITY BANCSHARES, INC.® AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS

(UNAUDITED)

	September 30, 2011	December 31, 2010
	(In thousands, except share data)	
ASSETS		
Cash and due from banks	$ 211,261	$ 158,975
Federal funds sold	294	393
Total cash and cash equivalents	211,555	159,368
Securities available for sale, at fair value (amortized cost of $331,875 and $406,546, respectively)	356,153	428,553
Securities held to maturity, at cost (fair value of $4,252,814 and $4,310,807, respectively)	4,074,377	4,188,563
Loans held for investment	3,737,630	3,485,023
Allowance for credit losses	(52,513)	(51,584)
Loans, net	3,685,117	3,433,439
Accrued interest receivable	27,878	29,935
Goodwill	924,537	924,258
Core deposit intangibles, net of accumulated amortization of $56,279 and $50,378, respectively	22,874	28,775
Bank premises and equipment, net	160,099	159,053
Other real estate owned	8,216	11,053
Bank Owned Life Insurance (BOLI)	49,695	48,697
Federal Home Loan Bank stock	14,136	24,982
Other assets	32,450	39,896
TOTAL ASSETS	$ 9,567,087	$ 9,476,572
LIABILITIES AND SHAREHOLDERS EQUITY		
LIABILITIES:		
Deposits:		
Noninterest-bearing	$ 1,861,907	$ 1,673,190
Interest-bearing	5,936,832	5,781,730
Total deposits	7,798,739	7,454,920
Other borrowings	13,583	374,433
Securities sold under repurchase agreements	66,166	60,659
Accrued interest payable	3,067	4,014
Other liabilities	59,138	37,942
Junior subordinated debentures	85,055	92,265
Total liabilities	8,025,748	8,024,233
COMMITMENTS AND CONTINGENCIES		
SHAREHOLDERS EQUITY:		

Preferred stock, $1 par value; 20,000,000 shares authorized; none issued or outstanding		
Common stock, $1 par value; 200,000,000 shares authorized; 46,930,032 and 46,721,114 shares issued at September 30, 2011 and December 31, 2010, respectively; 46,892,944 and 46,684,026 shares outstanding at September 30, 2011 and December 31, 2010, respectively	46,930	46,721
Capital surplus	882,620	876,050
Retained earnings	596,615	515,871
Accumulated other comprehensive income net unrealized gain on available for sale securities, net of tax of $8,497 and $7,702 respectively	15,781	14,304
Less treasury stock, at cost, 37,088 shares	(607)	(607)
Total shareholders equity	1,541,339	1,452,339
TOTAL LIABILITIES AND SHAREHOLDERS EQUITY	$ 9,567,087	$ 9,476,572

See notes to interim condensed consolidated financial statements.

Table of Contents

PROSPERITY BANCSHARES, INC. ® AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF INCOME

(UNAUDITED)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
	(Dollars in thousands, except per share data)			
INTEREST INCOME:				
Loans, including fees	$ 54,471	$ 52,855	$ 160,374	$ 156,989
Securities	38,714	43,382	121,861	134,999
Federal funds sold	4	10	15	113
Total interest income	93,189	96,247	282,250	292,101
INTEREST EXPENSE:				
Deposits	9,717	14,702	32,293	49,760
Junior subordinated debentures	607	857	2,352	2,447
Federal funds purchased and other borrowings	200	259	718	770
Securities sold under repurchase agreements	127	162	306	485
Total interest expense	10,651	15,980	35,669	53,462
NET INTEREST INCOME	82,538	80,267	246,581	238,639
PROVISION FOR CREDIT LOSSES	950	3,000	4,050	10,685
NET INTEREST INCOME AFTER PROVISION FOR CREDIT LOSSES	81,588	77,267	242,531	227,954
NONINTEREST INCOME:				
Customer service fees	12,662	13,201	37,250	37,470
Other	1,919	453	4,728	2,458
Total noninterest income	14,581	13,654	41,978	39,928
NONINTEREST EXPENSE:				
Salaries and employee benefits	23,601	22,016	70,799	65,559
Net occupancy expense	3,784	4,036	10,979	11,178
Debit card, data processing and software amortization	1,954	1,550	5,406	4,707
Core deposit intangible amortization	1,924	2,274	5,901	6,844
Depreciation expense	2,041	2,161	6,099	6,314
Other	7,847	10,556	26,176	30,765
Total noninterest expense	41,151	42,593	125,360	125,367
INCOME BEFORE INCOME TAXES	55,018	48,328	159,149	142,515
PROVISION FOR INCOME TAXES	18,645	16,162	53,806	47,605
NET INCOME AVAILABLE TO COMMON SHAREHOLDERS	$ 36,373	$ 32,166	$ 105,343	$ 94,910
EARNINGS PER SHARE				
Basic	$ 0.78	$ 0.69	$ 2.25	$ 2.04

Diluted	$	0.77	$	0.69	$	2.24	$	2.03

See notes to interim condensed consolidated financial statements.

Table of Contents

PROSPERITY BANCSHARES, INC.® AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS EQUITY

(UNAUDITED)

	Common Stock		Capital	Retained	Accumulated Other Comprehensive	Treasury	Total Shareholders
	Shares	Amount	Surplus	Earnings	Income	Stock	Equity
	(In thousands, except share and per share data)						
BALANCE AT JANUARY 1, 2010	46,577,968	$ 46,578	$ 870,460	$ 418,008	$ 16,806	$ (607)	$ 1,351,245
Comprehensive income:							
Net income available to common shareholders				127,708			127,708
Net change in unrealized gain on available for sale securities (net of tax of $1,347)					(2,502)		(2,502)
Total comprehensive income							125,206
Common stock issued in connection with the exercise of stock options and restricted stock awards	143,146	143	2,553				2,696
Stock based compensation expense			3,037				3,037
Cash dividends declared, $0.64 per share				(29,845)			(29,845)
BALANCE AT DECEMBER 31, 2010	46,721,114	46,721	876,050	515,871	14,304	(607)	1,452,339
Comprehensive income:							
Net income available to common shareholders				105,343			105,343
Net change in unrealized gain on available for sale securities (net of tax of $795)					1,477		1,477
Total comprehensive income							106,820
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 condensed consolidated financial statements.

Table of Contents

PROSPERITY BANCSHARES, INC.® AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(UNAUDITED)

	Nine Months Ended September 30,	
	2011	2010
	(Dollars in thousands)	
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$ 105,343	$ 94,910
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	11,999	13,158
Provision for credit losses	4,050	10,685
Securities premium amortization, net	19,686	13,858
Net accretion loan and time deposit discount	(27)	(970)
Net loss on sale of other real estate	431	3,347
Net gain on sale of premises, equipment and other assets	(377)	(400)
Stock-based compensation expense	2,604	2,211
Decrease in other assets and accrued interest receivable	19,352	6,517
Increase in accrued interest payable and other liabilities	19,315	5,369
Net cash provided by operating activities	182,376	148,685
CASH FLOWS FROM INVESTING ACTIVITIES:		
Proceeds from maturities and principal paydowns of held to maturity securities	875,900	846,929
Purchase of held to maturity securities	(781,978)	(1,345,874)
Proceeds from maturities and principal paydowns of available for sale securities	1,075,249	1,131,749
Purchase of available for sale securities	(1,000,000)	(999,998)
Net (increase) decrease in loans	(263,587)	52,740
Purchase of bank premises and equipment	(7,621)	(12,253)
Proceeds from sale of bank premises, equipment, other real estate and other assets	10,699	28,184
Cash and cash equivalents acquired in the purchase of U.S. Bank branches		344,722
Premium paid for U.S. Bank branches		(13,136)
Cash and cash equivalents acquired in the purchase of First Bank branches		379,771
Premium paid for First Bank branches		(26,876)
Net cash (used in) provided by investing activities	(91,338)	385,958

6

Table of Contents

	Nine Months Ended September 30, 2011	Nine Months Ended September 30, 2010
	(Dollars in thousands)	
CASH FLOWS FROM FINANCING ACTIVITIES:		
Net increase in noninterest-bearing deposits	$ 188,717	$ 1,954
Net increase (decrease) in interest-bearing deposits	155,408	(636,787)
Net (repayments of) proceeds from other short-term borrowings	(360,000)	57,000
Repayments of other long-term borrowings	(850)	(11,454)
Net increase in securities sold under repurchase agreements	5,507	20,013
Redemption of junior subordinated debentures	(7,210)	
Proceeds from exercise of stock options	4,175	2,220
Payments of cash dividends	(24,599)	(21,675)
Net cash used in financing activities	(38,852)	(588,729)
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	$ 52,186	$ (54,086)
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	159,369	195,317
CASH AND CASH EQUIVALENTS, END OF PERIOD	$ 211,555	$ 141,231
NONCASH ACTIVITIES:		
SUPPLEMENTAL DISCLOSURES:		
Cash paid for income taxes	$ 51,438	$ 48,977
Cash paid for interest	36,616	55,659
Noncash investing and financing activities acquisition of real estate through foreclosure of collateral	9,414	33,540

See notes to interim condensed consolidated financial statements.

Table of Contents

PROSPERITY BANCSHARES, INC.® AND SUBSIDIARIES

NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

SEPTEMBER 30, 2011

(UNAUDITED)

1. BASIS OF PRESENTATION

The interim condensed 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 condensed 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, 2010. Operating results for the nine month period ended September 30, 2011 are not necessarily indicative of the results that may be expected for the year ending December 31, 2011 or any other period.

2. EARNINGS PER SHARE

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
	(In thousands, except per share amounts)			
Net income available to common shareholders	$ 36,373	$ 32,166	$ 105,343	$ 94,910
Weighted average common shares outstanding	46,890	46,640	46,830	46,604
Potential dilutive common shares	143	134	183	231
Weighted average common shares and equivalents outstanding	47,033	46,774	47,013	46,835
Basic earnings per common share	$ 0.78	$ 0.69	$ 2.25	$ 2.04
Diluted earnings per common share	$ 0.77	$ 0.69	$ 2.24	$ 2.03

Basic earnings per share is computed by dividing net income by the weighted average number of shares outstanding during the applicable period. 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, 2011 and 2010 that would have had an anti-dilutive effect on the above computation.

3. NEW ACCOUNTING STANDARDS

Accounting Standards Updates (ASU)

ASU No. 2010-20, *Receivables (Topic 310) Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses.* ASU 2010-20 requires entities to provide disclosures designed to facilitate financial statement users evaluation of (i) the nature of credit risk inherent in the entity s portfolio of financing receivables, (ii) how that risk is analyzed and assessed in arriving at the allowance for

credit losses and (iii) the changes and reasons for those changes in the allowance for credit losses. Disclosures must be disaggregated by portfolio segment, the level at which an entity develops and documents a systematic method for determining its allowance for credit losses, and class of financing receivable, which is generally a disaggregation of portfolio segment. The required disclosures include, among other things, a rollforward of the allowance for credit losses as well as information about modified, impaired, non-accrual and past due loans and credit quality indicators. ASU 2010-20 became effective for the Company s financial statements as of December 31, 2010, as it relates to disclosures required as of the end of a reporting period. Disclosures that relate to activity during a reporting period became effective for the Company s financial statements beginning on January 1, 2011. ASU 2011-01, Receivables (Topic 310) - Deferral of the Effective Date of Disclosures about Troubled Debt Restructurings in Update No. 2010-20, temporarily

PROSPERITY BANCSHARES, INC. ® AND SUBSIDIARIES

NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS

SEPTEMBER 30, 2011

(UNAUDITED)

deferred the effective date for disclosures related to troubled debt restructurings to coincide with the effective date of the then proposed ASU 2011-02, Receivables (Topic 310) A Creditor s Determination of Whether a Restructuring Is a Troubled Debt Restructuring, which is further discussed below.

ASU No. 2010-28, *Intangibles Goodwill and Other (Topic 350) When to Perform Step 2 of the Goodwill Impairment Test for Reporting Units with Zero or Negative Carrying Amounts.* ASU 2010-28 modifies Step 1 of the goodwill impairment test for reporting units with zero or negative carrying amounts. For those reporting units, an entity is required to perform Step 2 of the goodwill impairment test if it is more likely than not that a goodwill impairment exists. In determining whether it is more likely than not that a goodwill impairment exists, an entity should consider whether there are any adverse qualitative factors indicating that an impairment may exist such as if an event occurs or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying amount. ASU 2010-28 became effective for the Company on January 1, 2011 and did not have a significant impact on the Company s financial statements.

ASU No. 2011-02, *A Creditor s Determination of Whether a Restructuring is a Troubled Debt Restructuring* . ASU 2011-02 provides additional guidance or clarification to help determine whether a creditor has granted a concession and whether a debtor is experiencing financial difficulties for purposes of determining whether a restructuring constitutes a troubled debt restructuring. ASU 2011-02 was adopted by the Company on July 1, 2011, and applied retrospectively to restructurings occurring on or after January 1, 2011. The adoption of ASU 2011-02 did not have a significant impact on the Company s financial statements.

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 is effective for annual periods beginning after December 15, 2011, and is not expected to have a significant impact on the Company s financial statements.

ASU 2011-05*, Comprehensive Income (Topic 220) Presentation of Comprehensive Income.* ASU 2011-05 amends Topic 220, Comprehensive Income, to require that all nonowner changes in shareholders 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 shareholders equity was eliminated. ASU 2011-05 is effective for annual periods beginning after December 15, 2011, and is not expected to have a significant impact on the Company s financial statements.

PROSPERITY BANCSHARES, INC. ® AND SUBSIDIARIES

NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS

SEPTEMBER 30, 2011

(UNAUDITED)

4. LOANS AND ALLOWANCE FOR CREDIT LOSSES

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

	September 30, 2011	December 31, 2010
	(Dollars in thousands)	
Commercial and industrial	$ 422,011	$ 409,426
Real estate:		
Construction and land development	490,193	502,327
1-4 family residential	981,388	824,057
Home equity	139,553	118,781
Commercial mortgage	1,341,628	1,288,023
Agriculture real estate	129,467	98,871
Multi-family residential	85,076	82,626
Agriculture	38,544	41,881
Consumer (net of unearned discount)	80,240	87,977
Other	29,530	31,054
Total	$ 3,737,630	$ 3,485,023

(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 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. 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, 2011, approximately 35.7% of the outstanding principal balance of the Company s commercial real estate loans was secured by owner-occupied properties. At September 30, 2011, the Company had commercial real estate loans totaling $1.92 billion which include the categories of construction and land development loans, commercial mortgage loans and multi-family residential loans.

PROSPERITY BANCSHARES, INC. ® AND SUBSIDIARIES

NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS

SEPTEMBER 30, 2011

(UNAUDITED)

(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. 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.

(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 and commercial and industrial loans. As of September 30, 2011 and December 31, 2010, there were no concentrations of loans related to any

single industry in excess of 10% of total loans.

PROSPERITY BANCSHARES, INC. ® AND SUBSIDIARIES

NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS

SEPTEMBER 30, 2011

(UNAUDITED)

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, 2011 or December 31, 2010.

Related Party Loans. As of September 30, 2011 and December 31, 2010, loans outstanding to directors, officers and their affiliates totaled $10.3 million and $12.8 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:

	For the Nine Months Ended September 30, 2011	For the Year Ended December 31, 2010
	(Dollars in thousands)	
Beginning balance	$ 12,783	$ 15,540
New loans and reclassified related loans	4,068	910
Repayments	(6,577)	(3,667)
Ending balance	$ 10,274	$ 12,783

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:

	September 30, 2011	December 31, 2010
	(Dollars in thousands)	
Construction and land development	$ 487	$ 1,417
Agriculture and agriculture real estate	51	11

1-4 family (includes home equity)	2,193	1,559
Commercial real estate (commercial mortgage and multi-family residential)	909	235
Commercial and industrial	1,418	1,179
Consumer and other	47	38
Total	$ 5,105	$ 4,439

12

PROSPERITY BANCSHARES, INC. ® AND SUBSIDIARIES

NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS

SEPTEMBER 30, 2011

(UNAUDITED)

An age analysis of past due loans, segregated by class of loans, as of September 30, 2011 was as follows:

	As of September 30, 2011				
	Loans 30-89 Days Past Due	Loans 90 or More Days Past Due	Total Past Due Loans	Current Loans	Accruing Loans 90 or More Days Past Due
	(Dollars in thousands)				
Construction and land development	$ 1,320	$ 398	$ 1,718	$ 488,475	$
Agriculture and agriculture real estate	366	9	375	167,636	
1-4 family (includes home equity)	2,820	1,362	4,182	1,116,759	16
Commercial real estate (commercial mortgage and multi-family residential)	6,893	898	7,791	1,418,913	
Commercial and industrial	690	1,365	2,055	419,956	
Consumer and other	125	44	169	109,601	4
Total	$ 12,214	$ 4,076	$ 16,290	$ 3,721,340	$ 20

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

	September 30, 2011	December 31, 2010
	(Dollars in thousands)	
Nonaccrual loans	$ 5,105	$ 4,439
Accruing loans 90 or more days past due	20	189
Total nonperforming loans	5,125	4,628
Repossessed assets	22	161
Other real estate	8,216	11,053
Total nonperforming assets	$ 13,363	$ 15,842
Nonperforming assets to total loans and other real estate	0.36%	0.45%

The Company had $13.4 million in nonperforming assets at September 30, 2011 compared with $15.8 million at December 31, 2010. If interest on nonaccrual loans had been accrued under the original loan terms, approximately $156,000 would have been recorded as income for the nine months ended September 30, 2011.

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.

PROSPERITY BANCSHARES, INC. ® AND SUBSIDIARIES

NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS

SEPTEMBER 30, 2011

(UNAUDITED)

Impaired loans as of September 30, 2011 are set forth in the following table. No interest income was recognized on impaired loans subsequent to their classification as impaired.

	September 30, 2011				
	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment Quarter to Date	Average Recorded Investment Year to Date
	(Dollars in thousands)				
With no related allowance recorded:					
Construction and land development	$ 48	$ 48	$	$ 33	$ 48
Agriculture and agriculture real estate	6	7		6	5
1-4 family (includes home equity)	704	735		452	349
Commercial real estate (commercial mortgage and multi-family residential)	579	606		783	578
Commercial and industrial	51	52		175	258
Consumer and other	5	5		4	4
With an allowance recorded:					
Construction and land development	476	476	122	292	510
Agriculture and agriculture real estate	45	47	40	28	19
1-4 family (includes home equity)	1,579	1,602	638	941	818
Commercial real estate (commercial mortgage and multi-family residential)	693	693	222	499	314
Commercial and industrial	1,378	2,580	624	949	779
Consumer and other	42	53	29	27	25
Total:					
Construction and land development	524	524	122	325	558
Agriculture and agriculture real estate	51	54	40	34	24
1-4 family (includes home equity)	2,283	2,337	638	1,393	1,167
Commercial real estate (commercial mortgage and multi-family residential)	1,272	1,299	222	1,282	892
Commercial and industrial	1,429	2,632	624	1,124	1,037
Consumer and other	47	58	29	31	29

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.

PROSPERITY BANCSHARES, INC. ® AND SUBSIDIARIES

NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS

SEPTEMBER 30, 2011

(UNAUDITED)

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.

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, 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	$	$ 3,172	$	$	$ 51,111	$ 29,633	$ 83,916
Grade 2	472,450	164,484	1,105,416	1,388,799	367,774	80,087	3,579,010
Grade 3	2,473	304	9,453	12,355	991		25,576
Grade 4	14,746		3,789	24,279	705	4	43,523
Grade 5	524	51	2,240	1,271	1,061	46	5,193
Grade 6			43		369		412
Grade 7							
Total	$ 490,193	$ 168,011	$ 1,120,941	$ 1,426,704	$ 422,011	$ 109,770	$ 3,737,630

Table of Contents

PROSPERITY BANCSHARES, INC. ® AND SUBSIDIARIES

NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS

SEPTEMBER 30, 2011

(UNAUDITED)

The following table presents risk grades and classified loans by class of loan at December 31, 2010. 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	$	$ 4,057	$	$	$ 41,455	$ 35,188	$ 80,700
Grade 2	479,443	136,607	930,110	1,335,222	364,150	83,798	3,329,330
Grade 3	4,492		6,571	13,165	858	1	25,087
Grade 4	16,937	77	4,663	22,041	1,882	14	45,614
Grade 5	1,455	11	1,425	221	287	30	3,429
Grade 6			69		794		863
Grade 7							
Total	$ 502,327	$ 140,752	$ 942,838	$ 1,370,649	$ 409,426	$ 119,031	$ 3,485,023

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 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.

Table of Contents

PROSPERITY BANCSHARES, INC. ® AND SUBSIDIARIES

NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS

SEPTEMBER 30, 2011

(UNAUDITED)

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.

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, 2011, the allowance for credit losses totaled $52.5 million or 1.40% of total loans. At December 31, 2010, the allowance aggregated $51.6 million or 1.48% of total loans.

PROSPERITY BANCSHARES, INC. ® AND SUBSIDIARIES

NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS

SEPTEMBER 30, 2011

(UNAUDITED)

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, 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 and Land Development	Agriculture and Agriculture Real Estate	1-4 Family (Including Home Equity)	Commercial Real Estate (Commercial Mortgage and Multi-Family)	Commercial and Industrial	Consumer and Other	Total
				(Dollars in thousands)			
Allowance for credit losses:							
Beginning balance	$ 15,304	$ 271	$ 9,724	$ 21,239	$ 3,891	$ 1,155	$ 51,584
Provision for credit losses	(1,894)	237	1,919	2,307	887	594	4,050
Charge-offs	(1,325)		(524)	(774)	(909)	(908)	(4,440)
Recoveries	370	1	6	6	416	520	1,319
Net charge-offs	(955)	1	(518)	(768)	(493)	(388)	(3,121)
Ending balance	12,455	509	11,125	22,778	4,285	1,361	52,513
Ending balance: individually evaluated for impairment	122	40	638	222	624	29	1,675
Ending balance: collectively evaluated for impairment	$ 12,333	$ 469	$ 10,487	$ 22,556	$ 3,661	$ 1,332	$ 50,838
Loans:							
Ending balance: individually evaluated for impairment	17,742	354	15,526	37,905	3,126	50	74,703
Ending balance: collectively evaluated for impairment	472,451	167,657	1,105,415	1,388,799	418,885	109,720	3,662,927
Ending balance	$ 490,193	$ 168,011	$ 1,120,941	$ 1,426,704	$ 422,011	$ 109,770	$ 3,737,630

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.

Table of Contents

PROSPERITY BANCSHARES, INC. ® AND SUBSIDIARIES

NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS

SEPTEMBER 30, 2011

(UNAUDITED)

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

	As of September 30,					
	2011			2010		
	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
	(Dollars in thousands)					
Troubled Debt Restructurings						
Construction and land development		$	$		$	$
Agriculture and agriculture real estate						
1-4 Family (includes home equity)	4	109	91			
Commercial real estate (commercial mortgage and multi-family)	2	5,264	5,218	1	2,560	2,517
Commercial and industrial	3	114	96	1	90	73
Consumer and other	1	15	13	1	15	13
Total	10	5,502	5,418	3	2,665	2,603

As of September 30, 2011, 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 includes loans modified during bankruptcy. The Company did not grant principal reductions on any restructured loan. Loans restructured during the nine months ended September 30, 2011 on non-accrual status as of September 30, 2011 totaled $128,000. 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.

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, municipal bonds and CRA funds.

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 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.

Table of Contents

PROSPERITY BANCSHARES, INC. ® AND SUBSIDIARIES

NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS

SEPTEMBER 30, 2011

(UNAUDITED)

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

	Level 1	Level 2	Level 3	Total
		(Dollars in thousands)		
Available for sale securities (at fair value):				
States and political subdivisions (including QZAB)	$	$ 47,935	$	$ 47,935
Corporate debt securities and other		9,306		9,306
Collateralized mortgage obligations		808		808
Mortgage-backed securities		298,104		298,104
TOTAL	$	$ 356,153	$	$ 356,153

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). These instruments include other real estate owned, repossessed assets and impaired loans per ASC Topic 310, *Receivables*. For the nine months ended September 30, 2011, the Company had additions to impaired loans of $5.8 million and additions to other real estate owned of $9.4 million, of which $4.4 million and $2.6 million were outstanding at September 30, 2011, respectively. The remaining financial assets and financial liabilities measured at fair value on a non-recurring basis that were recorded in 2011 and remained outstanding at September 30, 2011 were not significant.

The fair value of an asset or liability is the price that would be received to sell that asset or paid to transfer that liability in an orderly transaction occurring in the principal market (or most advantageous market in the absence of a principal market) for such asset or liability. In estimating fair value, the Company utilizes valuation techniques that are consistent with the market approach, the income approach and/or the cost approach. Such valuation techniques are consistently applied. Inputs to valuation techniques include the assumptions that market participants would use in pricing an asset or liability. FASB ASC Topic 820 establishes a fair value hierarchy for valuation inputs that gives the highest priority to quoted prices in active markets for identical assets or liabilities and the lowest priority to unobservable inputs.

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.

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.

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. The carrying value of variable rate loans approximates fair value because the loans reprice frequently to current market rates.

Table of Contents

PROSPERITY BANCSHARES, INC. ® AND SUBSIDIARIES

NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS

SEPTEMBER 30, 2011

(UNAUDITED)

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 carrying amount and estimated fair values of the Company s financial instruments for the dates indicated are as follows:

	September 30, 2011		December 31, 2010	
	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
	(Dollars in thousands)			
Financial assets:				
Cash and due from banks	$ 211,261	$ 211,261	$ 158,975	$ 158,975
Federal funds sold	294	294	393	393
Available for sale securities	356,153	356,153	428,553	428,553
Held to maturity securities	4,074,377	4,252,814	4,188,563	4,310,807
Loans held for investment (net of allowance for credit losses)	3,685,117	3,695,945	3,433,439	3,421,488
Total	$ 8,327,202	$ 8,516,467	$ 8,209,923	$ 8,320,216
Financial liabilities:				
Deposits	$ 7,798,739	$ 7,808,917	$ 7,454,920	$ 7,467,523
Other borrowings	13,583	15,912	374,433	375,882
Securities sold under repurchase agreements	66,166	66,166	60,659	60,659
Junior subordinated debentures	85,055	79,485	92,265	92,284
Total	$ 7,963,543	$ 7,970,480	$ 7,982,277	$ 7,996,348

The fair value estimates presented herein are based on pertinent information available to management as of the dates indicated. 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.

Table of Contents

PROSPERITY BANCSHARES, INC. ® AND SUBSIDIARIES

NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS

SEPTEMBER 30, 2011

(UNAUDITED)

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, 2011 were as follows:

	Goodwill	Core Deposit Intangibles
	(Dollars in thousands)	
Balance as of December 31, 2010	$ 924,258	$ 28,775
Amortization		(5,901)
Acquisition of First Bank branches	279	
Balance as of September 30, 2011	$ 924,537	$ 22,874

Purchase accounting adjustments to prior year acquisitions were made to adjust deferred tax asset and liability balances. 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, liabilities, shareholders equity, net income or cash flows. 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, 2011, there were no impairments recorded on goodwill or other intangibles.

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 $79.2 million at September 30, 2011 and December 31, 2010. Net core deposit intangibles outstanding were $22.9 million and $28.8 million at the same dates, respectively. Amortization expense related to intangible assets totaled $1.9 million and $2.3 million for the three months ended September 30, 2011 and 2010, respectively, and $5.9 million and $6.8 million for the nine months ended September 30, 2011 and 2010, respectively.

The estimated aggregate future amortization expense for intangible assets remaining as of September 30, 2011 is as follows (dollars in thousands):

Remaining 2011	$ 1,879
2012	6,347
2013	4,465
2014	3,314
2015	2,804
Thereafter	4,065
Total	$ 22,874

PROSPERITY BANCSHARES, INC. ® AND SUBSIDIARIES

NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS

SEPTEMBER 30, 2011

(UNAUDITED)

7. STOCK BASED COMPENSATION

At September 30, 2011, the Company had three stock-based employee compensation plans and one stock option plan assumed in connection with acquisitions under which no additional options will be granted. Two of the three 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 $2.6 million and $2.2 million in stock-based compensation expense for the nine months ended September 30, 2011 and 2010, respectively, and $961,000 and $729,000 in stock-based compensation expense for the three months ended September 30, 2011 and 2010, respectively. There was approximately $870,000 and $684,000 of income tax benefit recorded for the stock-based compensation expense for the nine months ended September 30, 2011 and 2010, respectively, and $322,000 and $214,000 of income tax benefit recorded for the stock-based compensation expense for the three months ended September 30, 2011 and 2010, respectively.

The Company has granted shares of common stock subject to forfeiture restrictions (restricted stock) to certain directors and associates under the Company s 2004 Stock Incentive Plan. The awardee is not entitled to the delivery of the shares until the forfeiture restrictions lapse, which is generally over a 1 to 5 year period; however, the awardee is entitled to receive dividends on and vote the shares prior to the lapse of such restrictions. The shares granted do not have a cost to the awardee and the only requirement of the lapse of the forfeiture restriction 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 forfeiture restrictions lapse, the unvested shares are forfeited. As of September 30, 2011, there were 385,150 shares of restricted stock outstanding with a weighted average grant date fair value of $37.31.

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,	
	2011	**2010**
Expected life in years	5.30	5.18
Risk free interest rate	3.67%	3.86%
Volatility	20.98%	21.20%
Dividend yield	1.25%	1.25%

23

PROSPERITY BANCSHARES, INC. ® AND SUBSIDIARIES

NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS

SEPTEMBER 30, 2011

(UNAUDITED)

A summary of changes in outstanding vested and unvested options during the nine months ended September 30, 2011 is set forth below:

	Number of Options (In thousands)	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value (In thousands)
Options outstanding, beginning of period	696	$ 27.24		
Options granted				
Options forfeited				
Options exercised	(171)	24.48		
Options outstanding, end of period	525	$ 28.18	4.11	$ 2,362
Options vested or expected to vest	509	$ 27.90	4.07	$ 2,432
Options exercisable, end of period	271	$ 27.06	3.49	$ 1,520

No options were granted during the nine months ended September 30, 2011 and 2010. The total intrinsic value of the options exercised during both the nine month periods ended September 30, 2011 and 2010 was $1.4 million. The total fair value of options vested during the nine month periods ended September 30, 2011 and 2010 was $368,000 and $302,000, respectively.

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

	Nine Months Ended September 30,			
	2011		2010	
	Number of Options (In thousands)	Weighted Average Grant Date Fair Value	Number of Options (In thousands)	Weighted Average Grant Date Fair Value
Unvested options outstanding, beginning of period	313	$ 6.89	376	$ 6.78
Options granted				
Unvested options forfeited			(15)	6.94
Options vested	(59)	6.31	(51)	5.94
Unvested options outstanding, end of period	254	$ 6.96	310	$ 6.88

The Company received $4.2 million and $2.2 million in cash from the exercise of stock options during the nine month periods ended September 30, 2011 and 2010, respectively. There was no tax benefit realized from option exercises of the stock-based compensation

arrangements during the nine month periods ended September 30, 2011 and 2010.

As of September 30, 2011, there was $9.4 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 2.7 years.

PROSPERITY BANCSHARES, INC. ® AND SUBSIDIARIES

NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS

SEPTEMBER 30, 2011

(UNAUDITED)

8. 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, 2011 (other than deposit obligations). The payments do not include prepayment 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 notes payable and operating leases as of September 30, 2011 are summarized below. Payments for junior subordinated debentures include interest of $49.5 million that will be paid over the future periods. The future floating rate interest payments were determined based on the 3-month LIBOR in effect at September 30, 2011. The current principal balance of the junior subordinated debentures at September 30, 2011 was $85.1 million. Payments for FHLB notes payable include interest of $3.6 million that will be paid over the future periods. Payments related to leases are based on actual payments specified in underlying contracts.

	Payments due in:				
	Remaining Fiscal 2011	Fiscal 2012-2013	Fiscal 2014-2015	Thereafter	Total
	(Dollars in thousands)				
Junior subordinated debentures	$ 1,108	$ 4,431	$ 4,431	$ 124,615	$ 134,585
Federal Home Loan Bank notes payable	827	3,356	3,836	9,212	17,231
Operating leases	1,342	9,435	5,254	1,426	17,457
Total	$ 3,277	$ 17,222	$ 13,521	$ 135,253	$ 169,273

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, 2011 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 Fiscal 2011	Fiscal 2012-2013	Fiscal 2014-2015	Thereafter	Total
	(Dollars in thousands)				
Standby letters of credit	$ 2,517	$ 9,286	$ 3,357	$ 54	$ 15,214
Commitments to extend credit	78,931	245,131	8,301	120,371	452,734
Total	$ 81,448	$ 254,417	$ 11,658	$ 120,425	$ 467,948

9. PENDING ACQUISTION

On September 13, 2011, the Company announced the signing of a definitive agreement to acquire Texas Bankers, Inc. and its wholly-owned subsidiary, Bank of Texas, Austin, Texas.

Texas Bankers, Inc. operates three (3) banking offices in the Austin, Texas CMSA including a location in Rollingwood, which will be consolidated with the Company s Westlake location and remain in Bank of Texas Rollingwood banking office; one in downtown Austin which will be consolidated into the Company s downtown Austin location and another in Thorndale. As of September 30, 2011, Texas Bankers reported total assets of $70.8 million, loans of $30.5 million and deposits of $63.1 million.

Under the terms of the definitive agreement, the Company will issue 315,000 shares of common stock for all outstanding shares of Texas Bankers capital stock, subject to certain conditions and potential adjustments. The transaction is expected to be consummated during the first quarter of 2012, although delays may occur.

Table of Contents

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;

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.

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, 2010.

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, 2011, the Bank operated one hundred seventy-five (175) full-service banking locations; with sixty (60) in the Houston area, twenty (20) in the South Texas area including Corpus Christi and Victoria, thirty-three (33) in the Central Texas, ten (10) in the Bryan/College Station area, twenty-one (21) in East Texas and thirty-one (31) in the Dallas/Fort Worth, 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. 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.

Total assets were $9.57 billion at September 30, 2011 compared with $9.48 billion at December 31, 2010, an increase of $90.5 million or 1.0%. Total loans were $3.74 billion at September 30, 2011 compared with $3.49 billion at December 31, 2010, an increase of $252.6 million or 7.2%. Total deposits were $7.80 billion at September 30, 2011 compared with $7.45 billion at December 31, 2010, an increase of $343.8 million or 4.6%. Shareholders equity increased $89.0 million or 6.1%, to $1.54 billion at September 30, 2011 compared with $1.45 billion at December 31, 2010.

PENDING ACQUISTION

On September 13, 2011, the Company announced the signing of a definitive agreement to acquire Texas Bankers, Inc. and its wholly-owned subsidiary, Bank of Texas, Austin, Texas.

Texas Bankers, Inc. operates three (3) banking offices in the Austin, Texas CMSA including a location in Rollingwood, which will be consolidated with the Company s Westlake location and remain in Bank of Texas Rollingwood banking office; one in downtown Austin which will be consolidated into the Company s downtown Austin location and another in Thorndale. As of September 30, 2011, Texas Bankers reported total assets of $70.8 million, loans of $30.5 million and deposits of $63.1 million.

Under the terms of the definitive agreement, the Company will issue 315,000 shares of common stock for all outstanding shares of Texas Bankers capital stock, subject to certain conditions and potential adjustments. The transaction is expected to be consummated during the first quarter of 2012, although delays may occur.

Table of Contents

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, 2010. 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, 2011. 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, 2011, management does not believe any of its goodwill is impaired as of September 30, 2011 because the fair value of the Company s equity exceeded its carrying value. While the Company believes no impairment existed at September 30, 2011, 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 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.

Table of Contents

RESULTS OF OPERATIONS

Net income available to common shareholders was $36.4 million ($0.77 per common share on a diluted basis) for the quarter ended September 30, 2011 compared with $32.2 million ($0.69 per common share on a diluted basis) for the quarter ended September 30, 2010, an increase in net income of $4.2 million, or 13.1%. The Company posted returns on average common equity of 9.51% and 9.06%, returns on average assets of 1.52% and 1.36% and efficiency ratios of 42.38% and 45.35% for the quarters ended September 30, 2011 and 2010, 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, 2011, net income available to common shareholders was $105.3 million ($2.24 per common share on a diluted basis) compared with $94.9 million ($2.03 per common share on a diluted basis) for the same period in 2010, an increase in net income of $10.4 million or 11.0%. The Company posted returns on average common equity of 9.37% and 9.08%, returns on average assets of 1.46% and 1.36% and efficiency ratios of 43.41% and 45.07% for the nine months ended September 30, 2011 and 2010, 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 $82.5 million for the quarter ended September 30, 2011 compared with $80.3 million for the quarter ended September 30, 2010, an increase of $2.3 million, or 2.8%. Net interest income increased primarily as a result of an increase in average interest-earning assets. Interest-earning assets increased to $8.24 billion for the quarter ended September 30, 2011 compared with $8.09 billion for the quarter ended September 30, 2010, an increase of $148.1 million, or 1.8%. Additionally, the average rate paid on interest-bearing liabilities decreased 30 basis points from 0.99% for the quarter ended September 30, 2010 compared with 0.69% for the quarter ended September 30, 2011, while the average yield on earning assets decreased 23 basis points from 4.72% for the quarter ended September 30, 2010 compared with 4.49% for the quarter ended September 30, 2011. Average interest-bearing liabilities decreased $242.3 million or 3.8% for the same periods. The net interest margin on a tax equivalent basis increased 5 basis points to 4.02% for the quarter ended September 30, 2011 compared with 3.97% for the quarter ended September 30, 2010.

Net interest income increased $7.9 million, or 3.3%, to $246.6 million for the nine months ended September 30, 2011 compared with $238.6 million for the same period in 2010. This increase was mainly attributable to higher average interest-earning assets and rates paid on interest-bearing liabilities decreasing at a faster pace than the yield on interest-earning assets. The net interest margin on a tax equivalent basis for the nine months ended September 30, 2011 decreased 2 basis points to 4.03% compared with 4.05% for the same period in 2010. The average rate paid on interest-bearing liabilities decreased 38 basis points from 1.14% for the nine months ended September 30, 2010 compared with 0.76% for the same period in 2011 and the average yield on earning assets decreased 35 basis points from 4.92% for the nine months ended September 30, 2010 compared with 4.57% for the nine months ended September 30, 2011.

Table of Contents

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, 2011 and 2010 and the nine months ended September 30, 2011 and 2010. 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,					
	2011			2010		
	Average Outstanding Balance	Interest Earned/ Paid	Average Yield/ Rate (4)	Average Outstanding Balance	Interest Earned/ Paid	Average Yield/ Rate (4)
	(Dollars in thousands)					
Assets						
Interest-earning assets:						
Loans	$ 3,694,039	$ 54,471	5.85%	$ 3,408,322	$ 52,855	6.15%
Securities (1)	4,524,213	38,714	3.42	4,667,697	43,382	3.72
Federal funds sold and other temporary investments	18,636	4	0.09	12,812	10	0.31
Total interest-earning assets	8,236,888	93,189	4.49%	8,088,831	96,247	4.72%
Less allowance for credit losses	(52,208)			(52,577)		
Total interest-earning assets, net of allowance	8,184,680			8,036,254		
Noninterest-earning assets	1,375,394			1,401,467		
Total assets	$ 9,560,074			$ 9,437,721		
Liabilities and shareholders equity						
Interest-bearing liabilities:						
Interest-bearing demand deposits	$ 1,319,800	$ 1,667	0.50%	$ 1,290,299	$ 1,967	0.60%
Savings and money market accounts	2,369,745	2,702	0.45	2,240,630	3,658	0.65
Certificates of deposit	2,134,082	5,348	0.99	2,500,341	9,077	1.44
Junior subordinated debentures	85,055	607	2.83	92,265	857	3.69
Securities sold under repurchase agreements	90,821	127	0.55	94,181	162	0.68
Federal funds purchased and other borrowings	135,336	200	0.59	159,423	259	0.64
Total interest-bearing liabilities	6,134,839	10,651	0.69%	6,377,139	15,980	0.99%
Noninterest-bearing liabilities:						
Noninterest-bearing demand deposits	1,828,957			1,577,013		
Other liabilities	66,560			63,785		
Total liabilities	8,030,356			8,017,937		
Shareholders equity	1,529,718			1,419,784		
Total liabilities and shareholders equity	$ 9,560,074			$ 9,437,721		
Net interest rate spread			3.80%			3.73%
Net interest income and margin (2)		$ 82,538	3.98%		$ 80,267	3.94%

Net interest income and margin (tax-equivalent basis) (3)	$ 83,440	4.02%	$ 81,014	3.97%

(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 day basis except for the average yield on securities which is calculated on a 30/360 day basis.

Table of Contents

	Nine Months Ended September 30,					
	2011			2010		
	Average Outstanding Balance	Interest Earned/ Paid	Average Yield/ Rate (4)	Average Outstanding Balance	Interest Earned/ Paid	Average Yield/ Rate (4)
	(Dollars in thousands)					
Assets						
Interest-earning assets:						
Loans	$ 3,614,590	$ 160,374	5.93%	$ 3,385,337	$ 156,989	6.20%
Securities (1)	4,635,880	121,861	3.50	4,497,623	134,999	4.00
Federal funds sold and other temporary investments	15,031	15	0.13	60,618	113	0.25
Total interest-earning assets	8,265,501	282,250	4.57%	7,943,578	292,101	4.92%
Less allowance for credit losses	(51,924)			(52,354)		
Total interest-earning assets, net of allowance	8,213,577			7,891,224		
Noninterest-earning assets	1,388,905			1,380,203		
Total assets	$ 9,602,482			$ 9,271,427		
Liabilities and shareholders equity						
Interest-bearing liabilities:						
Interest-bearing demand deposits	$ 1,403,477	$ 5,966	0.57%	$ 1,351,595	$ 7,222	0.71%
Savings and money market accounts	2,377,423	9,386	0.53	2,176,350	11,970	0.74
Certificates of deposit	2,162,112	16,941	1.05	2,495,534	30,568	1.64
Junior subordinated debentures	87,058	2,352	3.61	92,265	2,447	3.55
Securities sold under repurchase agreements	70,425	306	0.58	82,925	485	0.78
Federal funds purchased and other borrowings	181,656	718	0.53	79,127	770	1.30
Total interest-bearing liabilities	6,282,151	35,669	0.76%	6,277,796	53,462	1.14%
Noninterest-bearing liabilities:						
Noninterest-bearing demand deposits	1,758,182			1,535,936		
Other liabilities	62,765			64,433		
Total liabilities	8,103,098			7,878,165		
Shareholders equity	1,499,384			1,393,262		
Total liabilities and shareholders equity	$ 9,602,482			$ 9,271,427		
Net interest rate spread			3.81%			3.78%
Net interest income and margin (2)		$ 246,581	3.99%		$ 238,639	4.02%
Net interest income and margin (tax-equivalent basis) (3)		$ 249,345	4.03%		$ 240,811	4.05%

(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 day basis except for the average yield on securities which is calculated on a 30/360 day basis.

31

Table of Contents

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, 2011 vs. 2010 Increase (Decrease) Due to		
	Volume	Rate	Total
	(Dollars in thousands)		
Interest-earning assets:			
Loans	$ 4,431	$ (2,815)	$ 1,616
Securities	(1,334)	(3,334)	(4,668)
Federal funds sold and other temporary investments	5	(11)	(6)
Total increase (decrease) in interest income	3,102	(6,160)	(3,058)
Interest-bearing liabilities:			
Interest-bearing demand deposits	45	(345)	(300)
Savings and money market accounts	211	(1,167)	(956)
Certificates of deposit	(1,330)	(2,399)	(3,729)
Junior subordinated debentures	(67)	(183)	(250)
Securities sold under repurchase agreements	(6)	(29)	(35)
Federal funds purchased and other borrowings	(39)	(20)	(59)
Total decrease in interest expense	(1,186)	(4,143)	(5,329)
Increase (decrease) in net interest income	$ 4,288	$ (2,017)	$ 2,271

	Nine Months Ended September 30, 2011 vs. 2010 Increase (Decrease) Due to		
	Volume	Rate	Total
	(Dollars in thousands)		
Interest-earning assets:			
Loans	$ 10,631	$ (7,246)	$ 3,385
Securities	4,150	(17,288)	(13,138)
Federal funds sold and other temporary investments	(85)	(13)	(98)
Total increase (decrease) in interest income	14,696	(24,547)	(9,851)
Interest-bearing liabilities:			
Interest-bearing demand deposits	277	(1,533)	(1,256)
Savings and money market accounts	1,106	(3,690)	(2,584)
Certificates of deposit	(4,084)	(9,543)	(13,627)
Junior subordinated debentures	(138)	43	(95)
Securities sold under repurchase agreements	(73)	(106)	(179)
Federal funds purchased and other borrowings	998	(1,050)	(52)
Total decrease in interest expense	(1,914)	(15,879)	(17,793)
Increase (decrease) in net interest income	$ 16,610	$ (8,668)	$ 7,942

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.

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 $950,000 provision for credit losses for the quarter ended September 30, 2011 and a $3.0 million provision for the quarter ended September 30, 2010. The Company made a $4.1 million provision for credit losses for the nine months ended September 30, 2011 and a $10.7 million provision for the nine months ended September 30, 2010. The ratio of the allowance for credit losses to end of period nonperforming loans was 1,024.6% at September 30, 2011 compared with 1,114.6% at December 31, 2010. The ratio of allowance for credit losses to total loans was 1.40% at September 30, 2011 compared with 1.48% at December 31, 2010. For the quarter ended September 30, 2011, net charge-offs were $368,000 compared with net charge-offs of $4.4 million for the quarter ended September 30, 2010. Net charge-offs were $3.1 million for the nine months ended September 30, 2011 compared with $11.2 million for the nine months ended September 30, 2010.

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 which are recognized over the life of the related loan as an adjustment to yield using the interest method. Noninterest income totaled $14.6 million for the three months ended September 30, 2011 compared with $13.7 million for the same period in 2010, an increase of $927,000, or 6.8%. Noninterest income increased $2.1 million, or 5.1%, to $42.0 million for the nine months ended September 30, 2011 compared with $39.9 million for the same period in 2010. The increases during both periods were primarily due to reductions in net loss on the sale of other real estate and increases in debit card and ATM card income partially offset by decreases in NSF fees.

The net gain on sale of other real estate was $95,000 for the three months ended September 30, 2011 compared with a net loss of $1.4 million for the three months ended September 30, 2010. The net loss on sale of other real estate was $431,000 for the nine months ended September 30, 2011 compared with a net loss of $3.3 million for the same period in 2010.

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
	(Dollars in thousands)			
Non-sufficient funds (NSF)	$ 6,249	$ 7,274	$ 18,582	$ 20,675
Debit card and ATM card income	3,941	3,393	11,202	9,321
Service charges on deposit accounts	2,472	2,534	7,466	7,474
Banking related service fees	565	567	1,589	1,582
Bank owned life insurance (BOLI)	355	349	1,035	1,274
Net gain (loss) on sale of assets	17	1	377	400
Net (loss) gain on sale of other real estate	95	(1,364)	(431)	(3,347)
Net loss on sale of securities			(581)	
Other noninterest income	887	900	2,739	2,549
Total noninterest income	$ 14,581	$ 13,654	$ 41,978	$ 39,928

Noninterest Expense

Noninterest expense totaled $41.2 million for the quarter ended September 30, 2011 compared with $42.6 million for the quarter ended September 30, 2010, a decrease of $1.4 million, or 3.4%. The decrease was primarily due to a decrease in other real estate expenses and reduced regulatory and FDIC assessments partially offset by an increase in salaries and employee benefits. Noninterest expense totaled $125.4 million for the nine months ended September 30, 2011 and September 30, 2010.

Table of Contents

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
	(Dollars in thousands)			
Salaries and employee benefits (1)	$ 23,601	$ 22,016	$ 70,799	$ 65,559
Non-staff expenses:				
Occupancy and equipment	3,784	4,036	10,979	11,178
Depreciation	2,041	2,161	6,099	6,314
Debit card, data processing and software amortization	1,954	1,550	5,406	4,707
Communications	1,749	1,933	5,188	5,968
Printing and supplies	467	496	1,371	1,460
Professional fees	674	688	1,918	2,309
Regulatory assessments and FDIC insurance	1,488	2,817	7,383	8,227
Ad valorem and franchise taxes	1,005	1,039	3,016	2,957
Core deposit intangibles amortization	1,924	2,274	5,901	6,844
Other real estate	235	1,053	821	2,470
Other	2,229	2,530	6,479	7,374
Total non-staff expenses	17,550	20,577	54,561	59,808
Total noninterest expense	$ 41,151	$ 42,593	$ 125,360	$ 125,367

(1) Includes stock-based compensation expense of $961,000 and $729,000 for the three months ended September 30, 2011 and 2010, respectively, and $2.6 million and $2.2 million for the nine months ended September 30, 2011 and 2010, respectively.

Salaries and employee benefit expenses were $23.6 million for the quarter ended September 30, 2011 compared with $22.0 million for the quarter ended September 30, 2010, an increase of $1.6 million, or 7.2%. For the nine months ended September 30, 2011, salaries and employee benefit expenses were $70.8 million, an increase of $5.2 million or 8.0% compared with $65.6 million for the nine months ended September 30, 2010. The increase during both periods was principally due to annual employee incentives. The number of full-time equivalent (FTE) associates employed by the Company was 1,678 at September 30, 2011 and 1,719 at September 30, 2010.

Non-staff expenses decreased $3.0 million, or 14.7%, to $17.6 million for the quarter ended September 30, 2011 compared with $20.6 million during the same period in 2010. Non-staff expenses decreased $5.2 million, or 8.8%, to $54.6 million for the nine months ended September 30, 2011 compared to $59.8 million during the same period in 2010. The decreases for both periods were primarily due to decreases in regulatory assessments and FDIC insurance premiums and decreases in other real estate expenses.

Income Taxes

Income tax expense increased $2.5 million, or 15.4%, to $18.6 million for the quarter ended September 30, 2011 compared with $16.2 million for the same period in 2010. For the nine months ended September 30, 2011, income tax expense totaled $53.8 million, an increase of $6.2 million or 13.0% compared with $47.6 million for the same period in 2010. Both increases were primarily attributable to higher pretax net earnings for the quarter and nine months ended September 30, 2011 when compared to the same periods in 2010. The effective tax rates for the three months ended September 30, 2011 and 2010 were 33.9% and 33.4%, respectively and the effective tax rates for the nine months ended September 30, 2011 and 2010 were 33.8% and 33.4%, respectively.

FINANCIAL CONDITION

Loan Portfolio

Total loans were $3.74 billion at September 30, 2011, an increase of $252.6 million or 7.2% compared with $3.49 billion at December 31, 2010.

Table of Contents

The following table summarizes the loan portfolio of the Company by type of loan as of September 30, 2011 and December 31, 2010:

	September 30, 2011	December 31, 2010
	(Dollars in thousands)	
Commercial and industrial	$ 422,011	$ 409,426
Real estate:		
Construction and land development	490,193	502,327
1-4 family residential	981,388	824,057
Home equity	139,553	118,781
Commercial mortgage	1,341,628	1,288,023
Agriculture real estate	129,467	98,871
Multi-family residential	85,076	82,626
Agriculture	38,544	41,881
Consumer (net of unearned discount)	80,240	87,977
Other	29,530	31,054
Total	$ 3,737,630	$ 3,485,023

Nonperforming Assets

The Company had $13.4 million in nonperforming assets at September 30, 2011 and $15.8 million in nonperforming assets at December 31, 2010, a decrease of $2.5 million or 15.6%. The ratio of nonperforming assets to loans and other real estate was 0.36% at September 30, 2011 compared with 0.45% at December 31, 2010.

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, 2011	December 31, 2010
	(Dollars in thousands)	
Nonaccrual loans	$ 5,105	$ 4,439
Accruing loans 90 or more days past due	20	189
Total nonperforming loans	5,125	4,628
Repossessed assets	22	161
Other real estate	8,216	11,053
Total nonperforming assets	$ 13,363	$ 15,842
Nonperforming assets to total loans and other real estate	0.36%	0.45%
Nonperforming assets to average earning assets	0.16%	0.20%

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, 2011, the allowance for credit losses amounted to $52.5 million, or 1.40% of total loans,

compared with $51.6 million, or 1.48% of total loans, at December 31, 2010.

Table of Contents

Set forth below is an analysis of the allowance for credit losses for the nine months ended September 30, 2011 and the year ended December 31, 2010:

	As of and for the Nine Months Ended September 30, 2011	As of and for the Year Ended December 31, 2010
	(Dollars in thousands)	
Average loans outstanding	$ 3,614,590	$ 3,394,502
Gross loans outstanding at end of period	$ 3,737,630	$ 3,485,023
Allowance for credit losses at beginning of period	$ 51,584	$ 51,863
Provision for credit losses	4,050	13,585
Charge-offs:		
Commercial and industrial	(909)	(2,863)
Real estate and agriculture	(2,621)	(10,549)
Consumer	(909)	(2,071)
Recoveries:		
Commercial and industrial	372	346
Real estate and agriculture	382	444
Consumer	564	829
Net charge-offs	(3,121)	(13,864)
Allowance for credit losses at end of period	$ 52,513	$ 51,584
Ratio of allowance to end of period loans	1.40%	1.48%
Ratio of net charge-offs to average loans (annualized)	0.12%	0.41%
Ratio of allowance to end of period nonperforming loans	1,024.6%	1,114.6%

Securities

Carrying cost of securities totaled $4.43 billion at September 30, 2011 compared with $4.62 billion at December 31, 2010, a decrease of $186.6 million or 4.0%. At September 30, 2011, securities represented 46.3% of total assets compared with 48.7% of total assets at December 31, 2010.

The Company recorded a loss on sale of securities of $581,000 for the nine months ended September 30, 2011 compared with no loss on sale of securities for the nine months ended September 30, 2010. 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. At September 30, 2011, the Company had nine investment grade non-agency CMOs remaining with a book value of $3.7 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, 2011	December 31, 2010
	(In thousands)	

U.S. Treasury securities and obligations of U.S. government agencies	$ 8,686	$ 10,996
States and political subdivisions	72,421	76,031
Corporate debt securities	2,989	2,984
Collateralized mortgage obligations	335,104	444,827
Mortgage-backed securities	3,958,864	4,032,083
Qualified Zone Academy Bond (QZAB) and Qualified School Construction Bonds (QSCB)	20,900	20,900
Equity securities	7,288	7,288
Total amortized cost	$ 4,406,252	$ 4,595,109
Total fair value	$ 4,608,967	$ 4,739,360

Table of Contents

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, 2011 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, 2011, management believes any impairment in the Company s securities are temporary and no impairment loss has been realized in the Company s consolidated income statement.

The following tables present the amortized cost and fair value of securities classified as available for sale at September 30, 2011:

	September 30, 2011			
	Amortized Cost	**Gross Unrealized Gains**	**Gross Unrealized Losses**	**Fair Value**
	(Dollars in thousands)			
States and political subdivisions (including QZAB)	$ 45,061	$ 2,879	$ (5)	$ 47,935
Corporate debt securities and other	8,777	529		9,306
Collateralized mortgage obligations	832		(24)	808
Mortgage-backed securities	277,205	20,965	(66)	298,104
Total	$ 331,875	$ 24,373	$ (95)	$ 356,153

Table of Contents

The following tables present the amortized cost and fair value of securities classified as held to maturity at September 30, 2011:

	September 30, 2011			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
	(Dollars in thousands)			
U.S. Treasury securities and obligations of U.S. government agencies.	$ 8,685	$ 560	$	$ 9,245
States and political subdivisions	48,260	3,430	(123)	51,567
Corporate debt securities	1,500	138		1,638
Collateralized mortgage obligations	334,273	6,134	(186)	340,221
Mortgage-backed securities	3,681,659	168,487	(3)	3,850,143
Total	$ 4,074,377	$ 178,749	$ (312)	$ 4,252,814

Bank Premises and Equipment

Premises and equipment, net of accumulated depreciation, totaled $160.1 million and $159.1 million at September 30, 2011 and December 31, 2010, respectively, an increase of $1.0 million or 0.7%.

Deposits

Total deposits were $7.80 billion at September 30, 2011 compared with $7.45 billion at December 31, 2010, an increase of $343.8 million or 4.6%. At September 30, 2011, noninterest-bearing deposits accounted for approximately 23.9% of total deposits compared with 22.4% of total deposits at December 31, 2010. Interest-bearing demand deposits totaled $5.94 billion or 76.1% of total deposits at September 30, 2011 compared with $5.78 billion or 77.6% of total deposits at December 31, 2010.

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

	Nine Months Ended September 30, 2011		Year Ended December 31, 2010	
	Average Balance	Average Rate	Average Balance	Average Rate
	(Dollars in thousands)			
Interest-bearing demand	$ 1,403,477	0.57%	$ 1,336,400	0.67%
Regular savings	461,361	0.37	377,456	0.46
Money market savings	1,916,062	0.57	1,812,239	0.74
Time deposits	2,162,112	1.05	2,438,968	1.53
Total interest-bearing deposits	5,943,012	0.73	5,965,063	1.03
Noninterest-bearing deposits	1,758,182		1,567,676	
Total deposits	$ 7,701,194	0.56%	$ 7,532,739	0.82%

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, 2011, the Company had no FHLB advances and $13.6 million in FHLB long-term notes payable compared with $360.0 million in FHLB advances and $14.4 million in FHLB long-term notes payable at December 31, 2010. FHLB advances are available to the Company under

a security and pledge agreement. At September 30, 2011, the Company had total funds of $2.74 billion available under this agreement, of which $13.6 million was outstanding. The weighted average interest rate paid on the FHLB notes payable at period end was 5.3%. The maturity dates on the FHLB notes payable range from the years 2011 to 2028 and have interest rates ranging from 4.08% to 6.10%. The highest outstanding balance of FHLB advances during the nine months ended September 30, 2011 was $474.0 million

Table of Contents

compared with $465.0 million for the year ended December 31, 2010. The average rate paid on FHLB advances for the nine months ended September 30, 2011 was 0.13%.

At September 30, 2011, the Company had $66.2 million in securities sold under repurchase agreements compared with $60.7 million at December 31, 2010, an increase of $5.5 million or 9.1%.

The following table presents the Company s borrowings at September 30, 2011 and December 31, 2010:

	September 30, 2011	December 31, 2010
	(In thousands)	
FHLB advances	$	$ 360,000
FHLB long-term notes payable	13,583	14,433
Total other borrowings	13,583	374,433
Securities sold under repurchase agreements	66,166	60,659
Total	$ 79,749	$ 435,092

Junior Subordinated Debentures

At September 30, 2011 and December 31, 2010, the Company had outstanding $85.1 million and $92.3 million in junior subordinated debentures issued to the Company s unconsolidated subsidiary trusts, respectively. On March 7, 2011, the Company redeemed $7.2 million in junior subordinated debentures held by TXUI Statutory Trust I that bore a fixed interest rate of 10.60%. A penalty of $383,000 was incurred in connection with the payoff and recorded as interest expense.

A summary of pertinent information related to the Company s seven issues of junior subordinated debentures outstanding at September 30, 2011 is set forth in the table below:

Description	Issuance Date	Trust Preferred Securities Outstanding	Interest Rate(1)	Junior Subordinated Debt Owed to Trusts	Maturity Date (2)
Prosperity Statutory Trust II	July 31, 2001	$ 15,000,000	3 month LIBOR + 3.58%, not to exceed 12.50%	$ 15,464,000	July 31, 2031
Prosperity Statutory Trust III	Aug. 15, 2003	12,500,000	3 month LIBOR + 3.00%(3)	12,887,000	Sept. 17, 2033
Prosperity Statutory Trust IV	Dec. 30, 2003	12,500,000	3 month LIBOR + 2.85%(4)	12,887,000	Dec. 30, 2033
SNB Capital Trust IV(5)	Sept. 25, 2003	10,000,000	3 month LIBOR + 3.00%	10,310,000	Sept. 25, 2033
TXUI Statutory Trust II(6)	Dec. 19, 2003	5,000,000	3 month LIBOR + 2.85%(7)	5,155,000	Dec. 19, 2033
TXUI Statutory Trust III(6)	Nov. 30, 2005	15,500,000	3 month LIBOR + 1.39%	15,980,000	Dec. 15, 2035
TXUI Statutory Trust IV(6)	Mar. 31, 2006	12,000,000	3 month LIBOR	12,372,000	June 30, 2036

	+ 1.39%

(1) The 3-month LIBOR in effect as of September 30, 2011 was 0.37%.
(2) All debentures are callable five years from issuance date.
(3) The debentures bore a fixed interest rate of 6.50% until September 17, 2008, when the rate began to float on a quarterly basis based on the 3-month LIBOR plus 3.00%.
(4) The debentures bore a fixed interest rate of 6.50% until December 30, 2008, when the rate began to float on a quarterly basis based on the 3-month LIBOR plus 2.85%.
(5) Assumed in connection with the SNB acquisition on April 1, 2006.
(6) Assumed in connection with the TXUI acquisition on January 31, 2007.
(7) The debentures bore a fixed interest rate of 6.45% until January 23, 2009, when the rate began to float on a quarterly basis based on the 3-month LIBOR plus 2.85%.

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.

Table of Contents

As of September 30, 2011, the Company had outstanding $452.7 million in commitments to extend credit and $15.2 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, 2011, the Company had cash and cash equivalents of $211.6 million compared with $159.4 million at December 31, 2010, an increase of $52.2 million. The increase was primarily due to an increase in deposits of $344.1 million, proceeds from the maturities and repayments of securities of $1.95 billion, net premium amortization of securities of $19.7 million, depreciation and amortization of $12.0 million, a net decrease in other assets and accrued interest payable of $19.4 million, a net increase in interest payable and other liabilities of $19.3 million and net earnings of $105.3 million partially offset by purchases of securities of $1.78 billion, dividends paid of $24.6 million, repayments of short-term borrowings of $360.0 million and an increase in loans of $263.6 million.

Contractual Obligations

The following table summarizes the Company s contractual obligations and other commitments to make future payments as of September 30, 2011 (other than deposit obligations). The payments do not include prepayment 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 notes payable and operating leases as of September 30, 2011 are summarized below. Payments for junior subordinated debentures include interest of $49.5 million that will be paid over the future periods. The future floating rate interest payments were determined based on the 3-month LIBOR in effect at September 30, 2011. The current principal balance of the junior subordinated debentures at September 30, 2011 was $85.1 million. Payments for FHLB notes payable include interest of $3.6 million that will be paid over the future periods. Payments related to leases are based on actual payments specified in underlying contracts.

	Payments due in:				
	Remaining Fiscal 2011	Fiscal 2012-2013	Fiscal 2014-2015	Thereafter	Total
	(Dollars in thousands)				
Junior subordinated debentures	$ 1,108	$ 4,431	$ 4,431	$ 124,615	$ 134,585
Federal Home Loan Bank notes payable	827	3,356	3,836	9,212	17,231
Operating leases	1,342	9,435	5,254	1,426	17,457
Total	$ 3,277	$ 17,222	$ 13,521	$ 135,253	$ 169,273

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.

Table of Contents

The Company s commitments associated with outstanding standby letters of credit and commitments to extend credit as of September 30, 2011 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 Fiscal 2011	Fiscal 2012-2013	Fiscal 2014-2015	Thereafter	Total
			(Dollars in thousands)		
Standby letters of credit	$ 2,517	$ 9,286	$ 3,357	$ 54	$ 15,214
Commitments to extend credit	78,931	245,131	8,301	120,371	452,734
Total	$ 81,448	$ 254,417	$ 11,658	$ 120,425	$ 467,948

Capital Resources

Total shareholders equity was $1.54 billion at September 30, 2011 compared with $1.45 billion at December 31, 2010, an increase of $89.0 million or 6.1%. The increase was due primarily to net earnings of $105.3 million and the issuance of common stock in connection with the exercise of stock options of $4.2 million, partially offset by dividends paid of $24.6 million for the nine months ended September 30, 2011.

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, 2011:

Consolidated Capital Ratios:	
Total capital (to risk weighted assets)	16.69%
Tier 1 capital (to risk weighted assets)	15.47%
Tier 1 capital (to average assets)	7.70%

As of September 30, 2011, 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, 2011:

Capital Ratios (Bank Only):	
Total capital (to risk weighted assets)	16.42%
Tier 1 capital (to risk weighted assets)	15.19%
Tier 1 capital (to average assets)	7.56%

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 March 1, 2011 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 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, 2011 that have materially affected, or are reasonably likely to materially affect, the Company s internal control over financial reporting.

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, 2010.

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. REMOVED AND RESERVED

ITEM 5. OTHER INFORMATION

Not applicable

ITEM 6. EXHIBITS

a. Exhibits:

Exhibit	Description of Exhibit

Number	
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))
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

Table of Contents

Exhibit Number	Description of Exhibit
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.

Table of Contents

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: 11/09/11

/s/ DAVID ZALMAN
David Zalman

Chairman and Chief Executive Officer

Date: 11/09/11

/s/ DAVID HOLLAWAY
David Hollaway

Chief Financial Officer