

PROSPERITY BANCSHARES INC

Form 10-Q

November 08, 2013

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**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20549**

**FORM 10-Q**

(Mark One)

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

**FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2013**

**OR**

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

**FOR THE TRANSITION PERIOD FROM TO**

**COMMISSION FILE NUMBER: 001-35388**

**PROSPERITY BANCSHARES, INC.®**

**(Exact name of registrant as specified in its charter)**

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

**74-2331986**  
**(I.R.S. Employer**

**Identification No.)**

**Prosperity Bank Plaza**

**4295 San Felipe**

**Houston, Texas 77027**

**(Address of principal executive offices, including zip code)**

**(713) 693-9300**

**(Registrant's telephone number, including area code)**

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

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

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

Large Accelerated Filer ☒

Accelerated Filer ☐

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

Smaller Reporting Company ☐

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

As of November 1, 2013, there were 65,953,559 outstanding shares of the registrant's Common Stock, par value \$1.00 per share.



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

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

|                                                                                                | September 30,<br>2013  | December 31,<br>2012 |
|------------------------------------------------------------------------------------------------|------------------------|----------------------|
|                                                                                                | (Dollars in thousands) |                      |
| ASSETS                                                                                         |                        |                      |
| Cash and due from banks                                                                        | \$ 269,987             | \$ 325,952           |
| Federal funds sold                                                                             | 1,121                  | 352                  |
| Total cash and cash equivalents                                                                | 271,108                | 326,304              |
| Available for sale securities, at fair value                                                   | 164,776                | 226,670              |
| Held to maturity securities, at cost (fair value of \$7,556,171 and \$7,418,695, respectively) | 7,606,569              | 7,215,395            |
| Total securities                                                                               | 7,771,345              | 7,442,065            |
| Loans held for sale                                                                            | 4,892                  | 10,433               |
| Loans held for investment                                                                      | 6,177,697              | 5,169,507            |
| Total loans                                                                                    | 6,182,589              | 5,179,940            |
| Less: allowance for credit losses                                                              | (59,913)               | (52,564)             |
| Loans, net                                                                                     | 6,122,676              | 5,127,376            |
| Accrued interest receivable                                                                    | 38,183                 | 42,337               |
| Goodwill                                                                                       | 1,351,782              | 1,217,162            |
| Core deposit intangibles, net                                                                  | 25,233                 | 26,159               |
| Bank premises and equipment, net                                                               | 232,240                | 205,268              |
| Other real estate owned                                                                        | 7,432                  | 7,234                |
| Bank owned life insurance (BOLI)                                                               | 122,123                | 109,108              |
| Federal Home Loan Bank of Dallas stock                                                         | 43,058                 | 34,461               |
| Other assets                                                                                   | 69,099                 | 46,099               |
| TOTAL ASSETS                                                                                   | \$ 16,054,279          | \$ 14,583,573        |

**LIABILITIES AND SHAREHOLDERS EQUITY****LIABILITIES:**

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Deposits:

|                     |              |              |
|---------------------|--------------|--------------|
| Noninterest-bearing | \$ 3,368,357 | \$ 3,016,205 |
| Interest-bearing    | 9,087,442    | 8,625,639    |

|                                             |            |            |
|---------------------------------------------|------------|------------|
| Total deposits                              | 12,455,799 | 11,641,844 |
| Other borrowings                            | 605,951    | 256,753    |
| Securities sold under repurchase agreements | 431,969    | 454,502    |
| Junior subordinated debentures              | 85,055     | 85,055     |
| Accrued interest payable                    | 2,267      | 1,904      |
| Other liabilities                           | 84,126     | 54,126     |

|                   |            |            |
|-------------------|------------|------------|
| Total liabilities | 13,665,167 | 12,494,184 |
|-------------------|------------|------------|

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; 60,419,980 and 56,484,234 shares issued at September 30, 2013 and December 31, 2012, respectively; 60,382,892 and 56,447,146 shares outstanding at September 30, 2013 and December 31, 2012, respectively | 60,420 | 56,484 |
|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|--------|--------|

|                 |           |           |
|-----------------|-----------|-----------|
| Capital surplus | 1,453,263 | 1,274,290 |
|-----------------|-----------|-----------|

|                   |         |         |
|-------------------|---------|---------|
| Retained earnings | 870,454 | 750,236 |
|-------------------|---------|---------|

|                                                                                                                                              |       |       |
|----------------------------------------------------------------------------------------------------------------------------------------------|-------|-------|
| Accumulated other comprehensive income net unrealized gain on available for sale securities, net of tax of \$3,006 and \$4,839, respectively | 5,582 | 8,986 |
|----------------------------------------------------------------------------------------------------------------------------------------------|-------|-------|

|                                             |       |       |
|---------------------------------------------|-------|-------|
| Less treasury stock, at cost, 37,088 shares | (607) | (607) |
|---------------------------------------------|-------|-------|

|                            |           |           |
|----------------------------|-----------|-----------|
| Total shareholders' equity | 2,389,112 | 2,089,389 |
|----------------------------|-----------|-----------|

|                                            |               |               |
|--------------------------------------------|---------------|---------------|
| TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY | \$ 16,054,279 | \$ 14,583,573 |
|--------------------------------------------|---------------|---------------|

See notes to interim consolidated financial statements.

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

|                                                       | Three Months Ended<br>September 30,<br>20132012 |           | Nine Months Ended<br>September 30,<br>20132012 |            |
|-------------------------------------------------------|-------------------------------------------------|-----------|------------------------------------------------|------------|
|                                                       | (Dollars in thousands, except per share data)   |           |                                                |            |
| INTEREST INCOME:                                      |                                                 |           |                                                |            |
| Loans, including fees                                 | \$ 94,236                                       | \$ 80,587 | \$ 265,542                                     | \$ 188,597 |
| Securities                                            | 41,961                                          | 37,025    | 117,893                                        | 113,418    |
| Federal funds sold                                    | 16                                              | 21        | 111                                            | 108        |
| Total interest income                                 | 136,213                                         | 117,633   | 383,546                                        | 302,123    |
| INTEREST EXPENSE:                                     |                                                 |           |                                                |            |
| Deposits                                              | 8,314                                           | 9,395     | 26,174                                         | 26,269     |
| Other borrowings                                      | 439                                             | 379       | 1,273                                          | 1,076      |
| Securities sold under repurchase agreements           | 317                                             | 315       | 921                                            | 411        |
| Junior subordinated debentures                        | 610                                             | 651       | 1,821                                          | 1,962      |
| Total interest expense                                | 9,680                                           | 10,740    | 30,189                                         | 29,718     |
| NET INTEREST INCOME                                   | 126,533                                         | 106,893   | 353,357                                        | 272,405    |
| PROVISION FOR CREDIT LOSSES                           | 4,025                                           | 1,800     | 9,375                                          | 2,550      |
| NET INTEREST INCOME AFTER PROVISION FOR CREDIT LOSSES | 122,508                                         | 105,093   | 343,982                                        | 269,855    |
| NONINTEREST INCOME:                                   |                                                 |           |                                                |            |
| Nonsufficient funds (NSF) fees                        | 8,649                                           | 9,265     | 25,504                                         | 19,050     |
| Credit card, debit card and ATM card income           | 4,307                                           | 6,246     | 17,801                                         | 14,374     |
| Service charges on deposit accounts                   | 3,169                                           | 3,362     | 9,404                                          | 9,006      |
| Trust income                                          | 901                                             | 831       | 2,814                                          | 831        |
| Mortgage income                                       | 931                                             | 1,437     | 3,489                                          | 1,350      |
| Other                                                 | 3,597                                           | 2,687     | 11,257                                         | 6,818      |
| Total noninterest income                              | 21,554                                          | 23,828    | 70,269                                         | 51,429     |
| NONINTEREST EXPENSE:                                  |                                                 |           |                                                |            |
| Salaries and employee benefits                        | 37,135                                          | 36,701    | 107,861                                        | 83,525     |
| Net occupancy and equipment                           | 5,094                                           | 4,614     | 14,041                                         | 11,663     |
| Debit card, data processing and software amortization | 2,756                                           | 2,901     | 8,575                                          | 6,339      |
| Regulatory assessments and FDIC insurance             | 2,516                                           | 2,107     | 7,490                                          | 5,314      |

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|                                                           |           |           |            |            |
|-----------------------------------------------------------|-----------|-----------|------------|------------|
| Core deposit intangibles amortization                     | 1,455     | 2,007     | 4,551      | 5,297      |
| Depreciation                                              | 2,679     | 2,369     | 7,521      | 6,432      |
| Communications (including telephone, courier and postage) | 2,397     | 2,226     | 7,003      | 5,777      |
| Other real estate expense                                 | 75        | 271       | 535        | 2,619      |
| Other                                                     | 7,430     | 7,046     | 21,027     | 14,523     |
| Total noninterest expense                                 | 61,537    | 60,242    | 178,604    | 141,489    |
| INCOME BEFORE INCOME TAXES                                | 82,525    | 68,679    | 235,647    | 179,795    |
| PROVISION FOR INCOME TAXES                                | 27,247    | 22,503    | 77,220     | 60,160     |
| NET INCOME                                                | \$ 55,278 | \$ 46,176 | \$ 158,427 | \$ 119,635 |
| EARNINGS PER SHARE:                                       |           |           |            |            |
| Basic                                                     | \$ 0.92   | \$ 0.83   | \$ 2.68    | \$ 2.38    |
| Diluted                                                   | \$ 0.91   | \$ 0.82   | \$ 2.67    | \$ 2.37    |

See notes to interim consolidated financial statements.

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

|                                                            | Three Months<br>Ended<br>September 30,<br>2013      2012 |           | Nine Months Ended<br>September 30,<br>2013      2012 |            |
|------------------------------------------------------------|----------------------------------------------------------|-----------|------------------------------------------------------|------------|
|                                                            | (Dollars in thousands)                                   |           |                                                      |            |
| Net income                                                 | \$ 55,278                                                | \$ 46,176 | \$ 158,427                                           | \$ 119,635 |
| Other comprehensive loss, before tax:                      |                                                          |           |                                                      |            |
| Securities available for sale:                             |                                                          |           |                                                      |            |
| Change in unrealized gain during period                    | (1,136)                                                  | (718)     | (5,237)                                              | (3,736)    |
| Total other comprehensive loss                             | (1,136)                                                  | (718)     | (5,237)                                              | (3,736)    |
| Deferred tax benefit related to other comprehensive income | 398                                                      | 251       | 1,833                                                | 1,308      |
| Other comprehensive loss, net of tax                       | (738)                                                    | (467)     | (3,404)                                              | (2,428)    |
| Comprehensive income                                       | \$ 54,540                                                | \$ 45,709 | \$ 155,023                                           | \$ 117,207 |

See notes to interim consolidated financial statements.

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

|                                                                                                           | <b>Common Stock<br/>Shares</b> | <b>Common Stock<br/>Amount</b> | <b>Capital<br/>Surplus</b> | <b>Retained<br/>Earnings</b> | <b>Accumulated<br/>Other<br/>Comprehensive<br/>Income</b> | <b>Treasury<br/>Stock</b> | <b>Total<br/>Shareholders'<br/>Equity</b> |
|-----------------------------------------------------------------------------------------------------------|--------------------------------|--------------------------------|----------------------------|------------------------------|-----------------------------------------------------------|---------------------------|-------------------------------------------|
| <b>(In thousands, except share and per share data)</b>                                                    |                                |                                |                            |                              |                                                           |                           |                                           |
| BALANCE AT<br>DECEMBER 31, 2011                                                                           | 46,947,415                     | \$ 46,947                      | \$ 883,575                 | \$ 623,878                   | \$ 13,472                                                 | \$ (607)                  | \$ 1,567,265                              |
| Net income                                                                                                |                                |                                |                            | 119,635                      |                                                           |                           | 119,635                                   |
| Other comprehensive loss                                                                                  |                                |                                |                            |                              | (2,428)                                                   |                           | (2,428)                                   |
| Common stock issued in<br>connection with the<br>exercise of stock options<br>and restricted stock awards | 172,698                        | 173                            | 2,518                      |                              |                                                           |                           | 2,691                                     |
| Common stock issued in<br>connection with the<br>acquisition of Texas<br>Bankers, Inc.                    | 314,953                        | 315                            | 12,393                     |                              |                                                           |                           | 12,708                                    |
| Common stock issued in<br>connection with the<br>acquisition of The Bank<br>Arlington                     | 135,347                        | 135                            | 6,063                      |                              |                                                           |                           | 6,198                                     |
| Common stock issued in<br>connection with the<br>acquisition of American<br>State Financial Corporation   | 8,524,835                      | 8,525                          | 349,774                    |                              |                                                           |                           | 358,299                                   |
| Stock based compensation<br>expense                                                                       |                                |                                | 3,218                      |                              |                                                           |                           | 3,218                                     |
| Cash dividends declared,<br>\$0.585 per share                                                             |                                |                                |                            | (29,410)                     |                                                           |                           | (29,410)                                  |
| BALANCE AT<br>SEPTEMBER 30, 2012                                                                          | 56,095,248                     | \$ 56,095                      | \$ 1,257,541               | \$ 714,103                   | \$ 11,044                                                 | \$ (607)                  | \$ 2,038,176                              |
| BALANCE AT<br>DECEMBER 31, 2012                                                                           | 56,484,234                     | \$ 56,484                      | \$ 1,274,290               | \$ 750,236                   | \$ 8,986                                                  | \$ (607)                  | \$ 2,089,389                              |
| Net income                                                                                                |                                |                                |                            | 158,427                      |                                                           |                           | 158,427                                   |
| Other comprehensive loss                                                                                  |                                |                                |                            |                              | (3,404)                                                   |                           | (3,404)                                   |
| Common stock issued in<br>connection with the<br>exercise of stock options                                | 146,088                        | 146                            | 2,893                      |                              |                                                           |                           | 3,039                                     |

and restricted stock awards

|                                                                                               |                   |                  |                     |                   |                 |                 |                     |
|-----------------------------------------------------------------------------------------------|-------------------|------------------|---------------------|-------------------|-----------------|-----------------|---------------------|
| Common stock issued in connection with the acquisition of East Texas Financial Services, Inc. | 530,940           | 531              | 21,769              |                   |                 |                 | 22,300              |
| Common stock issued in connection with the acquisition of Coppermark Bancshares, Inc.         | 3,258,718         | 3,259            | 151,172             |                   |                 |                 | 154,431             |
| Stock based compensation expense                                                              |                   |                  | 3,139               |                   |                 |                 | 3,139               |
| Cash dividends declared, \$0.645 per share                                                    |                   |                  |                     | (38,209)          |                 |                 | (38,209)            |
| <b>BALANCE AT SEPTEMBER 30, 2013</b>                                                          | <b>60,419,980</b> | <b>\$ 60,420</b> | <b>\$ 1,453,263</b> | <b>\$ 870,454</b> | <b>\$ 5,582</b> | <b>\$ (607)</b> | <b>\$ 2,389,112</b> |

See notes to interim consolidated financial statements.

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

|                                                                                                | Nine Months Ended<br>September 30, |             |
|------------------------------------------------------------------------------------------------|------------------------------------|-------------|
|                                                                                                | 2013                               | 2012        |
|                                                                                                | (Dollars in thousands)             |             |
| CASH FLOWS FROM OPERATING ACTIVITIES:                                                          |                                    |             |
| Net income                                                                                     | \$ 158,427                         | \$ 119,635  |
| Adjustments to reconcile net income to net cash provided by operating activities:              |                                    |             |
| Depreciation and core deposit intangibles amortization                                         | 12,072                             | 11,729      |
| Provision for credit losses                                                                    | 9,375                              | 2,550       |
| Net amortization of premium on investments                                                     | 56,825                             | 42,897      |
| Loss on sale or write down of premises, equipment and other real estate                        | 785                                | 331         |
| Net accretion of discount on loans                                                             | (42,744)                           | (11,988)    |
| Proceeds from sale of loans held for sale                                                      | 143,745                            | 9,438       |
| Originations of loans held for sale                                                            | (140,715)                          |             |
| Stock based compensation expense                                                               | 3,139                              | 3,218       |
| Decrease (increase) in accrued interest receivable and other assets                            | 25,058                             | (19,623)    |
| Increase in accrued interest payable and other liabilities                                     | 22,716                             | 42,510      |
| Net cash provided by operating activities                                                      | 248,683                            | 200,697     |
| CASH FLOWS FROM INVESTING ACTIVITIES:                                                          |                                    |             |
| Proceeds from maturities and principal paydowns of held to maturity securities                 | 1,814,877                          | 1,238,538   |
| Purchase of held to maturity securities                                                        | (2,245,685)                        | (2,499,561) |
| Proceeds from maturities, sales and principal paydowns of available for sale securities        | 2,012,178                          | 1,703,676   |
| Purchase of available for sale securities                                                      | (1,954,999)                        | (1,109,999) |
| Net increase in loans held for investment                                                      | (47,466)                           | (128,225)   |
| Purchase of bank premises and equipment                                                        | (20,937)                           | (7,924)     |
| Proceeds from sale of bank premises, equipment and other real estate                           | 11,232                             | 12,004      |
| Net cash and cash equivalents acquired in the purchase of Texas Bankers, Inc.                  |                                    | 44,550      |
| Net cash and cash equivalents acquired in the purchase of The Bank Arlington                   |                                    | 12,037      |
| Net cash and cash equivalents acquired in the purchase of American State Financial Corporation |                                    | 123,022     |
| Net cash and cash equivalents acquired in the purchase of East Texas Financial Services, Inc.  | 3,471                              |             |
| Net cash and cash equivalents acquired in the purchase of Coppermark Bancharres, Inc.          | 288,795                            |             |
| Net cash used in investing activities                                                          | (138,534)                          | (611,882)   |

**CASH FLOWS FROM FINANCING ACTIVITIES:**

|                                                                        |           |          |
|------------------------------------------------------------------------|-----------|----------|
| Net increase in noninterest-bearing deposits                           | 43,221    | 193,360  |
| Net (decrease) increase in interest-bearing deposits                   | (459,351) | 101,866  |
| Net proceeds from other short-term borrowings                          | 349,583   | 100,000  |
| Repayments of other long-term borrowings                               | (41,095)  | (772)    |
| Net (decrease) increase in securities sold under repurchase agreements | (22,533)  | 37,711   |
| Proceeds from stock option exercises                                   | 3,039     | 2,691    |
| Payments of cash dividends                                             | (38,209)  | (29,410) |

|                                                     |           |         |
|-----------------------------------------------------|-----------|---------|
| Net cash (used in) provided by financing activities | (165,345) | 405,446 |
|-----------------------------------------------------|-----------|---------|

|                                           |          |         |
|-------------------------------------------|----------|---------|
| NET DECREASE IN CASH AND CASH EQUIVALENTS | (55,196) | (5,739) |
|-------------------------------------------|----------|---------|

|                                                |         |         |
|------------------------------------------------|---------|---------|
| CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD | 326,304 | 213,442 |
|------------------------------------------------|---------|---------|

|                                          |            |            |
|------------------------------------------|------------|------------|
| CASH AND CASH EQUIVALENTS, END OF PERIOD | \$ 271,108 | \$ 207,703 |
|------------------------------------------|------------|------------|

**NONCASH ACTIVITIES:**

|                                                                                      |         |           |
|--------------------------------------------------------------------------------------|---------|-----------|
| Stock issued in connection with the Texas Bankers, Inc. acquisition                  | \$      | \$ 12,708 |
| Stock issued in connection with the The Bank Arlington acquisition                   |         | 6,198     |
| Stock issued in connection with the American State Financial Corporation acquisition |         | 358,299   |
| Stock issued in connection with the East Texas Financial Services, Inc. acquisition  | 22,300  |           |
| Stock issued in connection with the Coppermark Bancshares, Inc. acquisition          | 154,431 |           |
| Acquisition of real estate through foreclosure of collateral                         | 3,044   | 11,354    |

**SUPPLEMENTAL INFORMATION:**

|                   |           |           |
|-------------------|-----------|-----------|
| Income taxes paid | \$ 69,659 | \$ 53,737 |
| Interest paid     | 29,674    | 30,434    |

See notes to interim consolidated financial statements.

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**PROSPERITY BANCSHARES, INC. ® AND SUBSIDIARIES**  
**NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS**

**SEPTEMBER 30, 2013**

**(UNAUDITED)**

**1. BASIS OF PRESENTATION**

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

The accompanying unaudited interim consolidated financial statements have been prepared in accordance with generally accepted accounting principles for interim financial information and with the rules and regulations of the Securities and Exchange Commission. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of management, the statements reflect all adjustments necessary for a fair presentation of the financial position, results of operations and cash flows of the Company on a consolidated basis, and all such adjustments are of a normal recurring nature. These financial statements and the notes thereto should be read in conjunction with the Company's Annual Report on Form 10-K for the year ended December 31, 2012. Operating results for the nine-month period ended September 30, 2013 are not necessarily indicative of the results that may be expected for the year ending December 31, 2013 or any other period.

**2. INCOME PER COMMON SHARE**

Outstanding stock options issued by the Company represent the only dilutive effect reflected in diluted weighted average shares. The following table illustrates the computation of basic and diluted earnings per share:

|                                       | Three Months Ended September 30, |         |           |         | Nine Months Ended September 30, |         |            |         |
|---------------------------------------|----------------------------------|---------|-----------|---------|---------------------------------|---------|------------|---------|
|                                       | 2013                             |         | 2012      |         | 2013                            |         | 2012       |         |
|                                       | Per Share                        |         | Per Share |         | Per Share                       |         | Per Share  |         |
|                                       | Amount                           | Amount  | Amount    | Amount  | Amount                          | Amount  | Amount     | Amount  |
| (In thousands, except per share data) |                                  |         |           |         |                                 |         |            |         |
| Net income                            | \$ 55,278                        |         | \$ 46,176 |         | \$ 158,427                      |         | \$ 119,635 |         |
| Basic:                                |                                  |         |           |         |                                 |         |            |         |
| Weighted average shares outstanding   | 60,344                           | \$ 0.92 | 55,958    | \$ 0.83 | 59,207                          | \$ 2.68 | 50,239     | \$ 2.38 |
| Diluted:                              |                                  |         |           |         |                                 |         |            |         |
| Add incremental shares for:           |                                  |         |           |         |                                 |         |            |         |
| Effect of dilutive securities options | 160                              |         | 135       |         | 155                             |         | 154        |         |

|       |        |         |        |         |        |         |        |         |
|-------|--------|---------|--------|---------|--------|---------|--------|---------|
| Total | 60,504 | \$ 0.91 | 56,093 | \$ 0.82 | 59,362 | \$ 2.67 | 50,393 | \$ 2.37 |
|-------|--------|---------|--------|---------|--------|---------|--------|---------|

There were no stock options exercisable during the three and nine months ended September 30, 2013 or 2012 that would have had an anti-dilutive effect on the above computation.

### 3. NEW ACCOUNTING STANDARDS

#### *Accounting Standards Updates ( ASU )*

*ASU 2012-02 Intangibles Goodwill and Other (Topic 350) Testing Indefinite-Lived Intangible Assets for Impairment.* ASU 2012-02 gives entities the option to first assess qualitative factors to determine whether the existence of events or circumstances leads to a determination that it is more likely than not that an indefinite-lived intangible asset is impaired. If, after assessing the totality of events or circumstances, an entity determines it is more likely than not that an indefinite-lived intangible asset is impaired, then the entity must perform the quantitative impairment test. If, under the quantitative impairment test, the carrying amount of the intangible asset exceeds its fair value, an entity should recognize an impairment loss in the amount of that excess permitting an entity to assess qualitative factors when testing indefinite-lived intangible assets for impairment results in guidance that is similar to the goodwill impairment testing guidance in ASU 2011-08. ASU 2012-02 became effective for the Company on January 1, 2013 and did not have a significant impact on the Company's financial statements.

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*ASU 2013-02 Comprehensive Income (Topic 220) Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income.* ASU 2013-02 amends recent guidance related to the reporting of comprehensive income to enhance the reporting of reclassifications out of accumulated other comprehensive income. ASU 2013-02 became effective for the Company on January 1, 2013 and did not have a significant impact on the Company's financial statements. See Note 10 Other Comprehensive (Loss) Income for applicable disclosures.

**4. SECURITIES**

The amortized cost and fair value of investment securities were as follows:

|                                                                         | Amortized<br>Cost | September 30, 2013<br>Gross<br>Unrealized<br>Gains<br>(Dollars in thousands) | Gross<br>Unrealized<br>Losses | Fair<br>Value |
|-------------------------------------------------------------------------|-------------------|------------------------------------------------------------------------------|-------------------------------|---------------|
| Available for Sale                                                      |                   |                                                                              |                               |               |
| States and political subdivisions                                       | \$ 29,130         | \$ 1,002                                                                     | \$                            | \$ 30,132     |
| Collateralized mortgage obligations                                     | 512               | 3                                                                            | (1)                           | 514           |
| Mortgage-backed securities                                              | 119,259           | 7,602                                                                        | (24)                          | 126,837       |
| Other securities                                                        | 7,288             | 5                                                                            |                               | 7,293         |
| Total                                                                   | \$ 156,189        | \$ 8,612                                                                     | \$ (25)                       | \$ 164,776    |
| Held to Maturity                                                        |                   |                                                                              |                               |               |
| U.S. Treasury securities and obligations of<br>U.S. Government agencies | \$ 3,252          | \$ 23                                                                        | \$                            | \$ 3,275      |
| States and political subdivisions                                       | 333,380           | 1,640                                                                        | (2,175)                       | 332,845       |
| Corporate debt securities                                               | 518               | 7                                                                            |                               | 525           |
| Collateralized mortgage obligations                                     | 59,724            | 1,327                                                                        | (48)                          | 61,003        |
| Mortgage-backed securities                                              | 7,186,737         | 98,915                                                                       | (151,079)                     | 7,134,573     |
| Qualified School Construction Bonds (QSCB)                              | 22,958            | 1,270                                                                        | (278)                         | 23,950        |
| Total                                                                   | \$ 7,606,569      | \$ 103,182                                                                   | \$ (153,580)                  | \$ 7,556,171  |

**December 31, 2012**

|                                                                         | <b>Amortized<br/>Cost</b> | <b>Gross<br/>Unrealized<br/>Gains<br/>(Dollars in thousands)</b> | <b>Gross<br/>Unrealized<br/>Losses</b> | <b>Fair<br/>Value</b> |
|-------------------------------------------------------------------------|---------------------------|------------------------------------------------------------------|----------------------------------------|-----------------------|
| <b>Available for Sale</b>                                               |                           |                                                                  |                                        |                       |
| States and political subdivisions                                       | \$ 34,743                 | \$ 1,691                                                         | \$                                     | \$ 36,434             |
| Collateralized mortgage obligations                                     | 616                       |                                                                  | (12)                                   | 604                   |
| Mortgage-backed securities                                              | 168,701                   | 11,742                                                           | (27)                                   | 180,416               |
| Other securities                                                        | 8,786                     | 430                                                              |                                        | 9,216                 |
| Total                                                                   | \$ 212,846                | \$ 13,863                                                        | \$ (39)                                | \$ 226,670            |
| <b>Held to Maturity</b>                                                 |                           |                                                                  |                                        |                       |
| U.S. Treasury securities and obligations of<br>U.S. Government agencies | \$ 7,061                  | \$ 160                                                           | \$                                     | \$ 7,221              |
| States and political subdivisions                                       | 391,510                   | 7,074                                                            | (354)                                  | 398,230               |
| Corporate debt securities                                               | 1,500                     | 28                                                               |                                        | 1,528                 |
| Collateralized mortgage obligations                                     | 125,912                   | 2,304                                                            | (50)                                   | 128,166               |
| Mortgage-backed securities                                              | 6,676,512                 | 196,206                                                          | (4,517)                                | 6,868,201             |
| Qualified School Construction Bonds (QSCB)                              | 12,900                    | 2,449                                                            |                                        | 15,349                |
| Total                                                                   | \$ 7,215,395              | \$ 208,221                                                       | \$ (4,921)                             | \$ 7,418,695          |

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Management evaluates securities for other-than-temporary impairment ( OTTI ) at least on a quarterly basis, and more frequently when economic or market conditions warrant such an evaluation. The investment securities portfolio is evaluated for OTTI by segregating the portfolio into two general segments and applying the appropriate OTTI model.

In determining OTTI, 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.

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

As of September 30, 2013, the Company does not intend to sell any debt securities and management believes that the Company more likely than not will not be required to sell any debt securities before their anticipated recovery, at which time the Company will receive full value for the securities. Furthermore, as of September 30, 2013, management does not have the intent to sell any of its securities and believes that it is more likely than not that the Company will not have to sell any such securities before a recovery of cost. The unrealized losses are largely due to increases in market interest rates over the yields available at the time the underlying securities were purchased. The fair value is expected to recover as the securities approach their maturity date or repricing date or if market yields for such investments decline. Management does not believe any of the securities are impaired due to reasons of credit quality. Accordingly, as of September 30, 2013, management believes any impairment in the Company's securities is temporary and no impairment loss has been realized in the Company's consolidated statements of income.



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Securities, with unrealized losses segregated by length of time, that have been in a continuous loss position at September 30, 2013 and December 31, 2012 were as follows:

|                                     | <b>September 30, 2013</b>   |                          |                             |                          |                             |                          |
|-------------------------------------|-----------------------------|--------------------------|-----------------------------|--------------------------|-----------------------------|--------------------------|
|                                     | <b>Less than 12 Months</b>  |                          | <b>More than 12 Months</b>  |                          | <b>Total</b>                |                          |
|                                     | <b>Estimated Fair Value</b> | <b>Unrealized Losses</b> | <b>Estimated Fair Value</b> | <b>Unrealized Losses</b> | <b>Estimated Fair Value</b> | <b>Unrealized Losses</b> |
| <b>(Dollars in thousands)</b>       |                             |                          |                             |                          |                             |                          |
| <b>Available for Sale</b>           |                             |                          |                             |                          |                             |                          |
| Collateralized mortgage obligations | \$ 15                       | \$                       | \$ 53                       | \$ (1)                   | \$ 68                       | \$ (1)                   |
| Mortgage-backed securities          | 409                         |                          | 3,539                       | (24)                     | 3,948                       | (24)                     |
| Other securities                    |                             |                          |                             |                          |                             |                          |
| <b>Total</b>                        | <b>\$ 424</b>               | <b>\$</b>                | <b>\$ 3,592</b>             | <b>\$ (25)</b>           | <b>\$ 4,016</b>             | <b>\$ (25)</b>           |

**Held to Maturity**

|                                     |                     |                     |                   |                   |                     |                     |
|-------------------------------------|---------------------|---------------------|-------------------|-------------------|---------------------|---------------------|
| States and political subdivisions   | \$ 164,268          | \$ (2,222)          | \$ 10,264         | \$ (231)          | \$ 174,532          | \$ (2,453)          |
| Collateralized mortgage obligations | 1,391               | (42)                | 437               | (6)               | 1,828               | (48)                |
| Mortgage-backed securities          | 3,507,024           | (145,835)           | 102,028           | (5,244)           | 3,609,052           | (151,079)           |
| <b>Total</b>                        | <b>\$ 3,672,683</b> | <b>\$ (148,099)</b> | <b>\$ 112,729</b> | <b>\$ (5,481)</b> | <b>\$ 3,785,412</b> | <b>\$ (153,580)</b> |

|                                     | <b>December 31, 2012</b>    |                          |                             |                          |                             |                          |
|-------------------------------------|-----------------------------|--------------------------|-----------------------------|--------------------------|-----------------------------|--------------------------|
|                                     | <b>Less than 12 Months</b>  |                          | <b>More than 12 Months</b>  |                          | <b>Total</b>                |                          |
|                                     | <b>Estimated Fair Value</b> | <b>Unrealized Losses</b> | <b>Estimated Fair Value</b> | <b>Unrealized Losses</b> | <b>Estimated Fair Value</b> | <b>Unrealized Losses</b> |
| <b>(Dollars in thousands)</b>       |                             |                          |                             |                          |                             |                          |
| <b>Available for Sale</b>           |                             |                          |                             |                          |                             |                          |
| Collateralized mortgage obligations | \$                          | \$                       | \$ 603                      | \$ (12)                  | \$ 603                      | \$ (12)                  |
| Mortgage-backed securities          | 224                         |                          | 3,964                       | (27)                     | 4,188                       | (27)                     |

|       |    |     |    |  |    |       |    |      |    |       |    |      |
|-------|----|-----|----|--|----|-------|----|------|----|-------|----|------|
| Total | \$ | 224 | \$ |  | \$ | 4,567 | \$ | (39) | \$ | 4,791 | \$ | (39) |
|-------|----|-----|----|--|----|-------|----|------|----|-------|----|------|

**Held to Maturity**

|                                   |    |        |    |       |    |       |    |      |    |        |    |       |
|-----------------------------------|----|--------|----|-------|----|-------|----|------|----|--------|----|-------|
| States and political subdivisions | \$ | 37,322 | \$ | (335) | \$ | 1,140 | \$ | (19) | \$ | 38,462 | \$ | (354) |
|-----------------------------------|----|--------|----|-------|----|-------|----|------|----|--------|----|-------|

|                                     |  |       |  |      |  |  |  |  |  |       |  |      |
|-------------------------------------|--|-------|--|------|--|--|--|--|--|-------|--|------|
| Collateralized mortgage obligations |  | 2,366 |  | (50) |  |  |  |  |  | 2,366 |  | (50) |
|-------------------------------------|--|-------|--|------|--|--|--|--|--|-------|--|------|

|                            |  |           |  |         |  |     |  |     |  |           |  |         |
|----------------------------|--|-----------|--|---------|--|-----|--|-----|--|-----------|--|---------|
| Mortgage-backed securities |  | 1,081,414 |  | (4,516) |  | 234 |  | (1) |  | 1,081,648 |  | (4,517) |
|----------------------------|--|-----------|--|---------|--|-----|--|-----|--|-----------|--|---------|

|       |    |           |    |         |    |       |    |      |    |           |    |         |
|-------|----|-----------|----|---------|----|-------|----|------|----|-----------|----|---------|
| Total | \$ | 1,121,102 | \$ | (4,901) | \$ | 1,374 | \$ | (20) | \$ | 1,122,476 | \$ | (4,921) |
|-------|----|-----------|----|---------|----|-------|----|------|----|-----------|----|---------|

At September 30, 2013, approximately 18.6% of securities were in an unrealized loss position for more than 12 months.

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The amortized cost and fair value of investment securities at September 30, 2013, by contractual maturity, are shown below. Actual maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations at any time with or without call or prepayment penalties.

|                                                                    | <b>Held to Maturity</b>       |                       | <b>Available for Sale</b> |                       |
|--------------------------------------------------------------------|-------------------------------|-----------------------|---------------------------|-----------------------|
|                                                                    | <b>Amortized<br/>Cost</b>     | <b>Fair<br/>Value</b> | <b>Amortized<br/>Cost</b> | <b>Fair<br/>Value</b> |
|                                                                    | <b>(Dollars in thousands)</b> |                       |                           |                       |
| Due in one year or less                                            | \$ 26,450                     | \$ 26,523             | \$ 7,383                  | \$ 7,392              |
| Due after one year through five years                              | 120,137                       | 120,135               | 4,990                     | 5,175                 |
| Due after five years through ten years                             | 138,529                       | 138,049               | 20,997                    | 21,721                |
| Due after ten years                                                | 74,992                        | 75,888                | 3,048                     | 3,137                 |
| <b>Subtotal</b>                                                    | <b>360,108</b>                | <b>360,595</b>        | <b>36,418</b>             | <b>37,425</b>         |
| Mortgage-backed securities and collateralized mortgage obligations | 7,246,461                     | 7,195,576             | 119,771                   | 127,351               |
| <b>Total</b>                                                       | <b>\$ 7,606,569</b>           | <b>\$ 7,556,171</b>   | <b>\$ 156,189</b>         | <b>\$ 164,776</b>     |

The Company had no gain or loss on sale of securities for the three and nine months ended September 30, 2013 and 2012. As of September 30, 2013, the Company had eight non-agency CMOs remaining with a total book value of \$1.8 million and total market value of \$1.8 million.

At September 30, 2013 and December 31, 2012, the Company did not own securities of any one issuer (other than the U.S. government and its agencies) for which aggregate adjusted cost exceeded 10% of the consolidated shareholders equity at such respective dates.

Securities with an amortized cost of \$4.22 billion and \$4.13 billion and a fair value of \$4.20 billion and \$4.27 billion at September 30, 2013 and December 31, 2012, respectively, were pledged to collateralize public deposits and for other purposes required or permitted by law.

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

The loan portfolio consists of various types of loans made principally to borrowers located in Texas and Oklahoma and is classified by major type as follows:

|                                                             | <b>September 30,<br/>2013</b> | <b>December 31,<br/>2012</b> |
|-------------------------------------------------------------|-------------------------------|------------------------------|
|                                                             | <b>(Dollars in thousands)</b> |                              |
| Residential mortgage loans held for sale                    | \$ 4,892                      | \$ 10,433                    |
| Commercial and industrial                                   | 1,028,799                     | 771,114                      |
| Real estate:                                                |                               |                              |
| Construction and land development                           | 703,193                       | 550,768                      |
| 1-4 family residential (including home equity)              | 1,710,621                     | 1,432,133                    |
| Commercial real estate (including multi-family residential) | 2,304,862                     | 1,990,642                    |
| Farmland                                                    | 235,049                       | 211,156                      |
| Agriculture                                                 | 86,469                        | 74,481                       |
| Consumer and other (net of unearned discount)               | 108,704                       | 139,213                      |
| Total loans held for investment                             | 6,177,697                     | 5,169,507                    |
| Total                                                       | \$ 6,182,589                  | \$ 5,179,940                 |

*(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 Real Estate.** The Company makes commercial real estate related loans collateralized by owner-occupied and non-owner-occupied real estate to finance the purchase of real estate. The Company's commercial real estate related 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, 2013, approximately 38.0% of the outstanding principal balance of the Company's commercial real estate related loans was secured by owner-occupied properties.

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**(iii) 1-4 Family Residential Loans.** The Company originates 1-4 family residential mortgage loans and home equity 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, 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 entail 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.

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*Concentrations of Credit.* Most of the Company's lending activity occurs within the states of Texas and Oklahoma. The majority of the Company's loan portfolio consists of commercial and industrial, commercial real estate and 1-4 family residential loans. As of September 30, 2013 and December 31, 2012, there were no concentrations of loans related to any single industry in excess of 10% of total loans.

*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, 2013 or December 31, 2012.

*Related Party Loans.* As of September 30, 2013 and December 31, 2012, loans outstanding to directors, officers and their affiliates totaled \$6.3 million and \$6.7 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:

|                                          | September 30,<br>2013  | December 31,<br>2012 |
|------------------------------------------|------------------------|----------------------|
|                                          | (Dollars in thousands) |                      |
| Beginning balance on January 1           | \$ 6,682               | \$ 9,809             |
| New loans and reclassified related loans | 306                    | 967                  |
| Repayments                               | (676)                  | (4,094)              |
| Ending balance                           | \$ 6,312               | \$ 6,682             |

*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.

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An aging analysis of past due loans, segregated by class of loans, is as follows:

|                                                             | <b>September 30, 2013</b>       |               |                   |                   |                     |                     |
|-------------------------------------------------------------|---------------------------------|---------------|-------------------|-------------------|---------------------|---------------------|
|                                                             | <b>Loans Past Due and Still</b> |               |                   |                   |                     |                     |
|                                                             | <b>Accruing</b>                 |               |                   |                   |                     |                     |
|                                                             | <b>90 or More</b>               |               |                   |                   |                     |                     |
|                                                             | <b>30-89 Days</b>               | <b>Days</b>   | <b>Total Past</b> | <b>Nonaccrual</b> | <b>Current</b>      | <b>Total</b>        |
|                                                             | <b>(Dollars in thousands)</b>   |               |                   |                   |                     |                     |
| Construction and land development                           | \$ 3,465                        | \$            | \$ 3,465          | \$ 469            | \$ 699,259          | \$ 703,193          |
| Agriculture and agriculture real estate (includes farmland) | 557                             |               | 557               | 23                | 320,938             | 321,518             |
| 1-4 family (includes home equity) (1)                       | 5,655                           | 90            | 5,745             | 1,037             | 1,708,731           | 1,715,513           |
| Commercial real estate (includes multi-family residential)  | 7,065                           | 34            | 7,099             | 2,223             | 2,295,540           | 2,304,862           |
| Commercial and industrial                                   | 9,230                           | 148           | 9,378             | 1,069             | 1,018,352           | 1,028,799           |
| Consumer and other                                          | 391                             | 11            | 402               | 133               | 108,169             | 108,704             |
| <b>Total</b>                                                | <b>\$ 26,363</b>                | <b>\$ 283</b> | <b>\$ 26,646</b>  | <b>\$ 4,954</b>   | <b>\$ 6,150,989</b> | <b>\$ 6,182,589</b> |

|                                                             | <b>December 31, 2012</b>        |             |                   |                   |                |              |
|-------------------------------------------------------------|---------------------------------|-------------|-------------------|-------------------|----------------|--------------|
|                                                             | <b>Loans Past Due and Still</b> |             |                   |                   |                |              |
|                                                             | <b>Accruing</b>                 |             |                   |                   |                |              |
|                                                             | <b>90 or More</b>               |             |                   |                   |                |              |
|                                                             | <b>30-89 Days</b>               | <b>Days</b> | <b>Total Past</b> | <b>Nonaccrual</b> | <b>Current</b> | <b>Total</b> |
|                                                             | <b>(Dollars in thousands)</b>   |             |                   |                   |                |              |
| Construction and land development                           | \$ 3,863                        | \$          | \$ 3,863          | \$ 1,170          | \$ 545,735     | \$ 550,768   |
| Agriculture and agriculture real estate (includes farmland) | 310                             | 21          | 331               | 396               | 284,910        | 285,637      |
| 1-4 family (includes home equity) (1)                       | 2,307                           | 310         | 2,617             | 1,598             | 1,438,351      | 1,442,566    |
| Commercial real estate (includes multi-family residential)  | 9,163                           |             | 9,163             |                   | 1,981,479      | 1,990,642    |
| Commercial and industrial                                   | 4,843                           |             | 4,843             | 1,469             | 764,802        | 771,114      |
| Consumer and other                                          | 856                             |             | 856               | 749               | 137,608        | 139,213      |

|       |           |        |           |          |              |              |
|-------|-----------|--------|-----------|----------|--------------|--------------|
| Total | \$ 21,342 | \$ 331 | \$ 21,673 | \$ 5,382 | \$ 5,152,885 | \$ 5,179,940 |
|-------|-----------|--------|-----------|----------|--------------|--------------|

- (1) Includes \$4.9 million and \$10.4 million of residential mortgage loans held for sale at September 30, 2013 and December 31, 2012, respectively.

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**(UNAUDITED)**

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

|                                                                      | September 30,<br>2013  | December 31,<br>2012 |
|----------------------------------------------------------------------|------------------------|----------------------|
|                                                                      | (Dollars in thousands) |                      |
| Nonaccrual loans                                                     | \$ 4,954               | \$ 5,382             |
| Accruing loans 90 or more days past due                              | 283                    | 331                  |
| <b>Total nonperforming loans</b>                                     | <b>5,237</b>           | <b>5,713</b>         |
| Reposessed assets                                                    | 18                     | 68                   |
| Other real estate                                                    | 7,432                  | 7,234                |
| <b>Total nonperforming assets</b>                                    | <b>\$ 12,687</b>       | <b>\$ 13,015</b>     |
| <b>Nonperforming assets to total loans and other<br/>real estate</b> | <b>0.20%</b>           | <b>0.25%</b>         |

The Company believes its conservative lending approach has resulted in sound asset quality. The Company had \$12.7 million in nonperforming assets at September 30, 2013 compared with \$13.0 million at December 31, 2012. If interest on nonaccrual loans had been accrued under the original loan terms, approximately \$341,000 and \$252,000 would have been recorded as income for the nine months ended September 30, 2013 and 2012, respectively.

*Purchased Credit-Impaired (PCI) Loans.* In connection with the acquisition of American State Financial Corporation (ASB) on July 1, 2012, Community National Bank on October 1, 2012, East Texas Financial Services, Inc. on January 1, 2013 and Coppermark Bancshares, Inc. on April 1, 2013, the Company acquired loans both with and without evidence of credit quality deterioration since origination. The acquired loans were initially recorded at fair value with no carryover of any allowance for loan losses.

Loans acquired with evidence of credit quality deterioration at acquisition for which it was probable that the Company would not be able to collect all contractual amounts due were accounted for as PCI.

The carrying amount of acquired PCI loans included in the consolidated balance sheet and the related outstanding balance at September 30, 2013 and December 31, 2012 were as follows:

**September 30,      December 31,**

|                     | <b>2013</b>                   | <b>2012</b> |
|---------------------|-------------------------------|-------------|
|                     | <b>(Dollars in thousands)</b> |             |
| Acquired PCI loans: |                               |             |
| Carrying amount     | \$ 36,204                     | \$ 22,880   |
| Outstanding balance | 77,303                        | 46,914      |

The outstanding balance represents the total amount owed as of September 30, 2013 and December 31, 2012, including accrued but unpaid interest and any amounts previously charged off. No allowance for loan losses was required on the acquired PCI loans at both September 30, 2013 and December 31, 2012.

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Changes in the accretable yield for acquired PCI loans for the three and nine month periods ended September 30, 2013 and 2012 were as follows:

|                                      | <b>Three Month Periods Ended September 30,</b> |             | <b>Nine Month Periods Ended September 30,</b> |             |
|--------------------------------------|------------------------------------------------|-------------|-----------------------------------------------|-------------|
|                                      | <b>2013</b>                                    | <b>2012</b> | <b>2013</b>                                   | <b>2012</b> |
|                                      | <b>(Dollars in thousands)</b>                  |             |                                               |             |
| Balance at beginning of period       | \$ 13,011                                      | \$          | \$ 7,459                                      | \$          |
| Additions                            | 349                                            | 8,157       | 7,877                                         | 8,157       |
| Reclassifications from nonaccretable | 3,088                                          |             | 4,343                                         |             |
| Accretion                            | (5,840)                                        | (1,160)     | (9,071)                                       | (1,160)     |
| Balance at September 30              | \$ 10,608                                      | \$ 6,997    | \$ 10,608                                     | \$ 6,997    |

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

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Impaired loans as of September 30, 2013 are set forth in the following table. No interest income was recognized on impaired loans subsequent to their classification as impaired. The average recorded investment presented in the table below is reported on a year-to-date basis.

|                                                             |                     | September 30, 2013       |                   |                             |
|-------------------------------------------------------------|---------------------|--------------------------|-------------------|-----------------------------|
|                                                             | Recorded Investment | Unpaid Principal Balance | Related Allowance | Average Recorded Investment |
| (Dollars in thousands)                                      |                     |                          |                   |                             |
| With no related allowance recorded:                         |                     |                          |                   |                             |
| Construction and land development                           | \$ 257              | \$ 265                   | \$                | \$ 701                      |
| Agriculture and agriculture real estate (includes farmland) |                     |                          |                   | 39                          |
| 1-4 family (includes home equity)                           | 310                 | 279                      |                   | 401                         |
| Commercial real estate (includes multi-family residential)  | 1,213               | 1,237                    |                   | 832                         |
| Commercial and industrial                                   | 194                 | 54                       |                   | 141                         |
| Consumer and other                                          |                     |                          |                   | 5                           |
| Total                                                       | 1,974               | 1,835                    |                   | 2,119                       |
| With an allowance recorded:                                 |                     |                          |                   |                             |
| Construction and land development                           |                     |                          |                   |                             |
| Agriculture and agriculture real estate (includes farmland) | 23                  | 30                       | 20                | 29                          |
| 1-4 family (includes home equity)                           | 71                  | 96                       | 53                | 535                         |
| Commercial real estate (includes multi-family residential)  | 17                  | 18                       | 17                | 1,234                       |
| Commercial and industrial                                   | 832                 | 842                      | 741               | 938                         |
| Consumer and other                                          | 80                  | 87                       | 69                | 73                          |
| Total                                                       | 1,023               | 1,073                    | 900               | 2,809                       |
| Total:                                                      |                     |                          |                   |                             |
| Construction and land development                           | 257                 | 265                      |                   | 701                         |
|                                                             | 23                  | 30                       | 20                | 68                          |

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|                                                             |          |          |        |          |
|-------------------------------------------------------------|----------|----------|--------|----------|
| Agriculture and agriculture real estate (includes farmland) |          |          |        |          |
| 1-4 family (includes home equity)                           | 381      | 375      | 53     | 936      |
| Commercial real estate (includes multi-family residential)  | 1,230    | 1,255    | 17     | 2,066    |
| Commercial and industrial                                   | 1,026    | 896      | 741    | 1,079    |
| Consumer and other                                          | 80       | 87       | 69     | 78       |
|                                                             | \$ 2,997 | \$ 2,908 | \$ 900 | \$ 4,928 |

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Impaired loans as of December 31, 2012 are set forth in the following tables. No interest income was recognized on impaired loans subsequent to their classification as impaired. The average recorded investment is reported on a year-to-date basis.

|                                                             |                     | December 31, 2012        |                   |                             |
|-------------------------------------------------------------|---------------------|--------------------------|-------------------|-----------------------------|
|                                                             | Recorded Investment | Unpaid Principal Balance | Related Allowance | Average Recorded Investment |
| (Dollars in thousands)                                      |                     |                          |                   |                             |
| With no related allowance recorded:                         |                     |                          |                   |                             |
| Construction and land development                           | \$ 1,144            | \$ 1,175                 | \$                | \$ 368                      |
| Agriculture and agriculture real estate (includes farmland) | 77                  | 77                       |                   | 34                          |
| 1-4 family (includes home equity)                           | 491                 | 522                      |                   | 381                         |
| Commercial real estate (includes multi-family residential)  | 450                 | 476                      |                   | 676                         |
| Commercial and industrial                                   | 87                  | 89                       |                   | 75                          |
| Consumer and other                                          | 10                  | 10                       |                   | 3                           |
| Total                                                       | 2,259               | 2,349                    |                   | 1,537                       |
| With an allowance recorded:                                 |                     |                          |                   |                             |
| Construction and land development                           |                     |                          |                   | 451                         |
| Agriculture and agriculture real estate (includes farmland) | 34                  | 41                       | 29                | 45                          |
| 1-4 family (includes home equity)                           | 999                 | 1,017                    | 273               | 720                         |
| Commercial real estate (includes multi-family residential)  | 2,450               | 2,451                    | 610               | 2,725                       |
| Commercial and industrial                                   | 1,043               | 1,079                    | 1,002             | 782                         |
| Consumer and other                                          | 66                  | 81                       | 67                | 21                          |
| Total                                                       | 4,592               | 4,669                    | 1,981             | 4,744                       |
| Total:                                                      |                     |                          |                   |                             |
| Construction and land development                           | 1,144               | 1,175                    |                   | 819                         |
|                                                             | 111                 | 118                      | 29                | 79                          |

|                                                             |          |          |          |          |
|-------------------------------------------------------------|----------|----------|----------|----------|
| Agriculture and agriculture real estate (includes farmland) |          |          |          |          |
| 1-4 family (includes home equity)                           | 1,490    | 1,539    | 273      | 1,101    |
| Commercial real estate (includes multi-family residential)  | 2,900    | 2,927    | 610      | 3,401    |
| Commercial and industrial                                   | 1,130    | 1,168    | 1,002    | 857      |
| Consumer and other                                          | 76       | 91       | 67       | 24       |
|                                                             | \$ 6,851 | \$ 7,018 | \$ 1,981 | \$ 6,281 |

*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 grades to be used as credit quality indicators. The following is a general description of the loan 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 for 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.

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**Grade 3** Credits in this category 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 Company to risk at a future date. Credits graded 3 are monitored on the Company'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 Company 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 Company deems collectable.

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

The following table presents risk grades and classified loans by class of loan at September 30, 2013. Classified loans include loans in risk grades 5, 6 and 7.

|         | <b>Construction and Land Development</b> | <b>Agriculture and Real Estate (includes Farmland)</b> | <b>1-4 Family Home Equity (includes Family Residential)</b> | <b>Commercial Real Estate (includes Multi-Family Residential and Industrial)</b> | <b>Commercial Consumer and Other</b> | <b>Total</b> |
|---------|------------------------------------------|--------------------------------------------------------|-------------------------------------------------------------|----------------------------------------------------------------------------------|--------------------------------------|--------------|
|         | <b>(Dollars in thousands)</b>            |                                                        |                                                             |                                                                                  |                                      |              |
| Grade 1 | \$                                       | \$ 4,771                                               | \$                                                          | \$                                                                               | \$ 48,879                            | \$ 84,937    |
| Grade 2 | 694,446                                  | 313,890                                                | 1,701,525                                                   | 2,248,498                                                                        | 962,941                              | 5,998,414    |
| Grade 3 | 3,850                                    | 1,044                                                  | 4,287                                                       | 12,483                                                                           | 7,453                                | 29,250       |
| Grade 4 | 1,551                                    | 1,369                                                  | 6,165                                                       | 15,736                                                                           | 5,876                                | 30,787       |

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|           |            |            |              |              |              |            |              |
|-----------|------------|------------|--------------|--------------|--------------|------------|--------------|
| Grade 5   | 257        | 23         | 370          | 1,230        | 1,026        | 80         | 2,986        |
| Grade 6   |            |            | 11           |              |              |            | 11           |
| Grade 7   |            |            |              |              |              |            |              |
| PCI Loans |            |            |              |              |              |            |              |
| (2)       | 3,089      | 421        | 3,155        | 26,915       | 2,624        |            | 36,204       |
| Total     | \$ 703,193 | \$ 321,518 | \$ 1,715,513 | \$ 2,304,862 | \$ 1,028,799 | \$ 108,704 | \$ 6,182,589 |

(1) Includes \$4.9 million of residential mortgage loans held for sale at September 30, 2013.

(2) Of the total PCI loans, \$24.9 million were classified as substandard at September 30, 2013.

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The following table presents risk grades and classified loans by class of loan at December 31, 2012. Classified loans include loans in risk grades 5, 6 and 7.

|                               | <b>Construction<br/>and<br/>Land<br/>Development</b> | <b>Agriculture and<br/>Real Estate<br/>(includes<br/>Farmland)</b> | <b>1-4 Family<br/>(includes<br/>Home Equity)</b> | <b>Commercial<br/>Real Estate<br/>(includes Multi-<br/>Family Residential)</b> | <b>Commercial<br/>and Industrial</b> | <b>Consumer and<br/>Other</b> | <b>Total</b>        |
|-------------------------------|------------------------------------------------------|--------------------------------------------------------------------|--------------------------------------------------|--------------------------------------------------------------------------------|--------------------------------------|-------------------------------|---------------------|
| <b>(Dollars in thousands)</b> |                                                      |                                                                    |                                                  |                                                                                |                                      |                               |                     |
| Grade 1                       | \$ 476                                               | \$ 4,195                                                           | \$ 515                                           | \$                                                                             | \$ 53,965                            | \$ 38,789                     | \$ 97,940           |
| Grade 2                       | 537,340                                              | 277,333                                                            | 1,431,095                                        | 1,945,319                                                                      | 702,587                              | 100,163                       | 4,993,837           |
| Grade 3                       | 7,250                                                | 2,024                                                              | 4,947                                            | 11,760                                                                         | 8,926                                |                               | 34,907              |
| Grade 4                       | 4,256                                                | 1,694                                                              | 4,303                                            | 11,711                                                                         | 1,385                                | 176                           | 23,525              |
| Grade 5                       | 1,144                                                | 111                                                                | 1,477                                            | 2,900                                                                          | 1,130                                | 76                            | 6,838               |
| Grade 6                       |                                                      |                                                                    | 13                                               |                                                                                |                                      |                               | 13                  |
| Grade 7                       |                                                      |                                                                    |                                                  |                                                                                |                                      |                               |                     |
| PCI Loans                     | 302                                                  | 280                                                                | 216                                              | 18,952                                                                         | 3,121                                | 9                             | 22,880              |
| <b>Total</b>                  | <b>\$ 550,768</b>                                    | <b>\$ 285,637</b>                                                  | <b>\$ 1,442,566</b>                              | <b>\$ 1,990,642</b>                                                            | <b>\$ 771,114</b>                    | <b>\$ 139,213</b>             | <b>\$ 5,179,940</b> |

(1) Includes \$10.4 million of residential mortgage loans held for sale at December 31, 2012.

*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 requiring a reserve. The specific reserves are determined on an individual loan basis. Impaired loans 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.

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 impaired loan. The Company uses this information to establish the amount of the general valuation allowance.

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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 real estate 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 agriculture 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 agriculture 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, 2013, the allowance for credit losses totaled \$59.9 million or 0.97% of total loans. At December 31, 2012, the allowance aggregated \$52.6 million or 1.01% of total loans.

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The following table details the recorded investment in loans and activity in the allowance for credit losses by portfolio segment for the three and nine months ended September 30, 2013. Allocation of a portion of the allowance to one category of loans does not preclude its availability to absorb losses in other categories.

|                                     | Construction<br>and<br>Land<br>Development | Agriculture<br>and<br>Real<br>Estate<br>(includes<br>Farmland) | 1-4 Family<br>(includes<br>Home<br>Equity) | Commercial<br>Real Estate<br>(includes<br>Multi-Family<br>Residential) | Commercial<br>and<br>Industrial | Consumer<br>and<br>Other | Total     |
|-------------------------------------|--------------------------------------------|----------------------------------------------------------------|--------------------------------------------|------------------------------------------------------------------------|---------------------------------|--------------------------|-----------|
| (Dollars in thousands)              |                                            |                                                                |                                            |                                                                        |                                 |                          |           |
| <b>Allowance for credit losses:</b> |                                            |                                                                |                                            |                                                                        |                                 |                          |           |
| <b>Three Months Ended</b>           |                                            |                                                                |                                            |                                                                        |                                 |                          |           |
| Balance June 30, 2013               | \$ 11,991                                  | \$ 982                                                         | \$ 13,435                                  | \$ 22,831                                                              | \$ 6,293                        | \$ 644                   | \$ 56,176 |
| Provision for credit losses         | 1,024                                      | 129                                                            | 1,262                                      | (658)                                                                  | 1,356                           | 912                      | 4,025     |
| Charge-offs                         | (14)                                       | (23)                                                           | (20)                                       |                                                                        | (188)                           | (897)                    | (1,142)   |
| Recoveries                          | 44                                         | 10                                                             | 5                                          | 471                                                                    | 69                              | 255                      | 854       |
| Net charge-offs                     | 30                                         | (13)                                                           | (15)                                       | 471                                                                    | (119)                           | (642)                    | (288)     |
| Balance September 30, 2013          | \$ 13,045                                  | \$ 1,098                                                       | \$ 14,682                                  | \$ 22,644                                                              | \$ 7,530                        | \$ 914                   | \$ 59,913 |
| <b>Nine Months Ended</b>            |                                            |                                                                |                                            |                                                                        |                                 |                          |           |
| Balance January 1, 2013             | \$ 11,909                                  | \$ 764                                                         | \$ 13,942                                  | \$ 19,607                                                              | \$ 5,777                        | \$ 565                   | \$ 52,564 |
| Provision for credit losses         | 1,173                                      | 352                                                            | 892                                        | 3,309                                                                  | 2,070                           | 1,579                    | 9,375     |
| Charge-offs                         | (270)                                      | (36)                                                           | (182)                                      | (894)                                                                  | (592)                           | (2,100)                  | (4,074)   |
| Recoveries                          | 233                                        | 18                                                             | 30                                         | 622                                                                    | 275                             | 870                      | 2,048     |
| Net charge-offs                     | (37)                                       | (18)                                                           | (152)                                      | (272)                                                                  | (317)                           | (1,230)                  | (2,026)   |

|                    |           |          |           |           |          |        |           |  |  |
|--------------------|-----------|----------|-----------|-----------|----------|--------|-----------|--|--|
| Balance            |           |          |           |           |          |        |           |  |  |
| September 30, 2013 | \$ 13,045 | \$ 1,098 | \$ 14,682 | \$ 22,644 | \$ 7,530 | \$ 914 | \$ 59,913 |  |  |

**Allowance for credit losses related to:**

**September 30, 2013**

|                                       |        |       |        |        |        |       |        |  |  |
|---------------------------------------|--------|-------|--------|--------|--------|-------|--------|--|--|
| Individually evaluated for impairment | \$     | \$ 20 | \$ 53  | \$ 17  | \$ 741 | \$ 69 | \$ 900 |  |  |
| Collectively evaluated for impairment | 13,045 | 1,078 | 14,629 | 22,627 | 6,789  | 845   | 59,013 |  |  |
| PCI loans                             |        |       |        |        |        |       |        |  |  |

|                                   |           |          |           |           |          |        |           |  |  |
|-----------------------------------|-----------|----------|-----------|-----------|----------|--------|-----------|--|--|
| Total allowance for credit losses | \$ 13,045 | \$ 1,098 | \$ 14,682 | \$ 22,644 | \$ 7,530 | \$ 914 | \$ 59,913 |  |  |
|-----------------------------------|-----------|----------|-----------|-----------|----------|--------|-----------|--|--|

**Recorded investment in loans:**

**September 30, 2013**

|                                       |         |         |           |           |           |         |           |  |  |
|---------------------------------------|---------|---------|-----------|-----------|-----------|---------|-----------|--|--|
| Individually evaluated for impairment | \$ 257  | \$ 23   | \$ 381    | \$ 1,230  | \$ 1,026  | \$ 80   | \$ 2,997  |  |  |
| Collectively evaluated for impairment | 699,847 | 321,074 | 1,711,977 | 2,276,717 | 1,025,149 | 108,624 | 6,143,388 |  |  |
| PCI loans                             | 3,089   | 421     | 3,155     | 26,915    | 2,624     |         | 36,204    |  |  |

|                                      |            |            |              |              |              |            |              |  |  |
|--------------------------------------|------------|------------|--------------|--------------|--------------|------------|--------------|--|--|
| Total loans evaluated for impairment | \$ 703,193 | \$ 321,518 | \$ 1,715,513 | \$ 2,304,862 | \$ 1,028,799 | \$ 108,704 | \$ 6,182,589 |  |  |
|--------------------------------------|------------|------------|--------------|--------------|--------------|------------|--------------|--|--|

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

|                                     | Construction<br>and<br>Land<br>Development | Agriculture<br>and<br>Agriculture<br>Real<br>Estate<br>(includes<br>Farmland) | 1-4 Family<br>(includes<br>Home<br>Equity) | Commercial<br>Real Estate<br>(includes<br>Multi-Family<br>Residential) | Commercial<br>and<br>Industrial | Consumer<br>and<br>Other | Total     |
|-------------------------------------|--------------------------------------------|-------------------------------------------------------------------------------|--------------------------------------------|------------------------------------------------------------------------|---------------------------------|--------------------------|-----------|
| (Dollars in thousands)              |                                            |                                                                               |                                            |                                                                        |                                 |                          |           |
| <b>Allowance for credit losses:</b> |                                            |                                                                               |                                            |                                                                        |                                 |                          |           |
| <b>Three Months Ended</b>           |                                            |                                                                               |                                            |                                                                        |                                 |                          |           |
| Balance June 30, 2012               | \$ 10,065                                  | \$ 742                                                                        | \$ 13,326                                  | \$ 21,406                                                              | \$ 4,238                        | \$ 605                   | \$ 50,382 |
| Provision for credit losses         | 359                                        | (2)                                                                           | 299                                        | (509)                                                                  | 660                             | 993                      | 1,800     |
| Charge-offs                         | (159)                                      |                                                                               | (327)                                      | (909)                                                                  | (55)                            | (1,663)                  | (3,113)   |
| Recoveries                          | 4                                          | 30                                                                            | 76                                         | 109                                                                    | 565                             | 1,074                    | 1,858     |
| Net charge-offs                     | (155)                                      | 30                                                                            | (251)                                      | (800)                                                                  | 510                             | (589)                    | (1,255)   |
| Balance September 30, 2012          | \$ 10,269                                  | \$ 770                                                                        | \$ 13,374                                  | \$ 20,097                                                              | \$ 5,408                        | \$ 1,009                 | \$ 50,927 |
| <b>Nine Months Ended</b>            |                                            |                                                                               |                                            |                                                                        |                                 |                          |           |
| Balance January 1, 2012             | \$ 12,094                                  | \$ 511                                                                        | \$ 12,645                                  | \$ 21,460                                                              | \$ 3,826                        | \$ 1,058                 | \$ 51,594 |
| Provision for credit losses         | (469)                                      | 226                                                                           | 1,121                                      | (250)                                                                  | 1,237                           | 685                      | 2,550     |
| Charge-offs                         | (1,368)                                    |                                                                               | (478)                                      | (1,278)                                                                | (376)                           | (2,101)                  | (5,601)   |
| Recoveries                          | 12                                         | 33                                                                            | 86                                         | 165                                                                    | 721                             | 1,367                    | 2,384     |
| Net charge-offs                     | (1,356)                                    | 33                                                                            | (392)                                      | (1,113)                                                                | 345                             | (734)                    | (3,217)   |

|                            |           |        |           |           |          |          |           |
|----------------------------|-----------|--------|-----------|-----------|----------|----------|-----------|
| Balance September 30, 2012 | \$ 10,269 | \$ 770 | \$ 13,374 | \$ 20,097 | \$ 5,408 | \$ 1,009 | \$ 50,927 |
|----------------------------|-----------|--------|-----------|-----------|----------|----------|-----------|

**Allowance for credit losses related to:**

**September 30, 2012**

|                                       |        |       |        |        |          |       |          |
|---------------------------------------|--------|-------|--------|--------|----------|-------|----------|
| Individually evaluated for impairment | \$ 26  | \$ 61 | \$ 336 | \$ 567 | \$ 1,180 | \$ 20 | \$ 2,190 |
| Collectively evaluated for impairment | 10,243 | 709   | 13,038 | 19,530 | 4,228    | 989   | 48,737   |
| PCI loans                             |        |       |        |        |          |       |          |

|                                   |           |        |           |           |          |          |           |
|-----------------------------------|-----------|--------|-----------|-----------|----------|----------|-----------|
| Total allowance for credit losses | \$ 10,269 | \$ 770 | \$ 13,374 | \$ 20,097 | \$ 5,408 | \$ 1,009 | \$ 50,927 |
|-----------------------------------|-----------|--------|-----------|-----------|----------|----------|-----------|

**Recorded investment in loans:**

**September 30, 2012**

|                                       |         |         |           |           |          |         |           |
|---------------------------------------|---------|---------|-----------|-----------|----------|---------|-----------|
| Individually evaluated for impairment | \$ 86   | \$ 143  | \$ 1,448  | \$ 3,170  | \$ 1,395 | \$ 20   | \$ 6,262  |
| Collectively evaluated for impairment | 495,005 | 303,913 | 1,396,114 | 1,950,488 | 751,379  | 148,361 | 5,045,260 |
| PCI loans                             | 1,326   | 78      | 155       | 22,454    | 3,568    |         | 27,581    |

|                                      |            |            |              |              |            |            |              |
|--------------------------------------|------------|------------|--------------|--------------|------------|------------|--------------|
| Total loans evaluated for impairment | \$ 496,417 | \$ 304,134 | \$ 1,397,717 | \$ 1,976,112 | \$ 756,342 | \$ 148,381 | \$ 5,079,103 |
|--------------------------------------|------------|------------|--------------|--------------|------------|------------|--------------|

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*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.

During the nine months ended September 30, 2013, a \$249,000 loan was restructured. Default is determined at 90 or more days past due. The restructured loans from prior periods are performing and accruing loans.

**6. FAIR VALUE**

The Company uses fair value measurements to record fair value adjustments to certain assets and to determine fair value disclosures. Fair values represent the estimated price that would be received from selling an asset or paid to transfer a liability, otherwise known as an exit price. Securities available for sale are recorded at fair value on a recurring basis. Additionally, from time to time, the Company may be required to record at fair value other assets on a nonrecurring basis such as certain loans including loans held-for-sale, goodwill and other intangible assets and other real estate owned. These nonrecurring fair value adjustments typically involve application of lower-of-cost-or-market accounting or write downs of individual assets.

*Fair Value Hierarchy*

The Company groups financial assets and financial liabilities measured at fair value in three levels, based on the markets in which the assets and liabilities are traded and the reliability of the assumptions used to determine fair value. These levels are:

Level 1 Quoted prices in active markets for identical assets or liabilities.

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.

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.

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 Accounting Standards Codification ( 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 and liabilities and the lowest priority to unobservable inputs.

The fair value disclosures below 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.

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The following tables present fair values for assets measured at fair value on a recurring basis:

|                                     | <b>As of September 30, 2013</b> |                |                |              |
|-------------------------------------|---------------------------------|----------------|----------------|--------------|
|                                     | <b>Level 1</b>                  | <b>Level 2</b> | <b>Level 3</b> | <b>Total</b> |
|                                     | <b>(Dollars in thousands)</b>   |                |                |              |
| Available for sale securities:      |                                 |                |                |              |
| States and political subdivisions   | \$                              | \$ 30,132      | \$             | \$ 30,132    |
| Collateralized mortgage obligations |                                 | 514            |                | 514          |
| Mortgage-backed securities          |                                 | 126,837        |                | 126,837      |
| Other securities                    | 7,293                           |                |                | 7,293        |
| Total                               | \$ 7,293                        | \$ 157,483     | \$             | \$ 164,776   |

|                                     | <b>As of December 31, 2012</b> |                |                |              |
|-------------------------------------|--------------------------------|----------------|----------------|--------------|
|                                     | <b>Level 1</b>                 | <b>Level 2</b> | <b>Level 3</b> | <b>Total</b> |
|                                     | <b>(Dollars in thousands)</b>  |                |                |              |
| Available for sale securities:      |                                |                |                |              |
| States and political subdivisions   | \$                             | \$ 36,434      | \$             | \$ 36,434    |
| Collateralized mortgage obligations |                                | 604            |                | 604          |
| Mortgage-backed securities          |                                | 180,416        |                | 180,416      |
| Other securities                    | 7,688                          | 1,528          |                | 9,216        |
| Total                               | \$ 7,688                       | \$ 218,982     | \$             | \$ 226,670   |

Certain financial assets and financial liabilities are measured at fair value on a nonrecurring basis; that is, the instruments are not measured at fair value on an ongoing basis but are subject to fair value adjustments in certain circumstances (for example, when there is evidence of impairment). Financial assets measured at fair value on a non-recurring basis during the reported periods include certain impaired loans reported at the fair value of the underlying collateral if repayment is expected solely from the collateral. Collateral values are estimated using Level 2 inputs based on observable market data, typically in the case of real estate collateral. For the nine months ended September 30, 2013, the Company had additions to impaired loans of \$5.5 million, of which \$1.4 million were outstanding at September 30, 2013.

Financial assets measured at fair value on a nonrecurring basis during the reported periods also include other real estate owned and repossessed assets. For the three and nine months ended September 30, 2013, the Company had

additions to other real estate owned of \$305,000 and \$2.7 million, of which \$305,000 and \$1.1 million were outstanding at September 30, 2013, respectively. The remaining financial assets and financial liabilities measured at fair value on a non-recurring basis that were recorded in 2013 and remained outstanding at September 30, 2013 were not significant. During the reported periods, all fair value measurements for other real estate owned and repossessed assets utilized Level 2 inputs based on observable market data. There were no transfers between Level 1 and Level 2 assets during the nine months ended September 30, 2013.

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 due from banks** For these short-term instruments, the carrying amount is a reasonable estimate of fair value. The Company classifies the estimated fair value of these instruments as Level 1.

**Federal funds sold** For these short-term instruments, the carrying amount is a reasonable estimate of fair value. The Company classifies the estimated fair value of these instruments as Level 1.

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**Securities** Fair value measurements based upon quoted prices are considered Level 1 inputs. Level 1 securities consist of U.S. Treasury securities and certain equity securities which are included in the available for sale portfolio. For all other available for sale and held to maturity securities, if quoted prices are not available, fair values are measured using Level 2 inputs. For these securities, the Company generally obtains fair value measurements from an independent pricing service. The fair value measurements consider observable data that may include dealer quotes, market spreads, cash flows, the U.S. Treasury yield curve, live trading levels, trade execution data, market consensus prepayment speeds, credit information and the bond's terms and conditions, among other things. The Company reviews the prices supplied by the independent pricing service, as well as their underlying pricing methodologies, for reasonableness.

Securities available for sale are recorded at fair value on a recurring basis.

**Loans held for investment** The Company does not record loans at fair value on a recurring basis. As such, valuation techniques discussed herein for loans are primarily for estimating fair value disclosures. However, from time to time, the Company records nonrecurring fair value adjustments to impaired loans to reflect (1) partial write downs that are based on the observable market price or current appraised value of the collateral, or (2) the full charge-off of the loan carrying value. Where appraisals are not available, estimated cash flows are discounted using a rate commensurate with the credit risk associated with those cash flows. Assumptions regarding credit risk, cash flows and discount rates are judgmentally determined using available market information and specific borrower information.

The estimated fair value approximates carrying value for variable-rate loans that reprice frequently and with no significant change in credit risk. The fair value of fixed-rate loans and variable-rate loans which reprice on an infrequent basis is estimated by discounting future cash flows using the current interest rates at which similar loans with similar terms would be made to borrowers of similar credit quality. An overall valuation adjustment is made for specific credit risks as well as general portfolio credit risk. The Company classifies the estimated fair value of loans held for investment as Level 3.

**Loans held for sale** Loans held for sale are carried at the lower of cost or estimated fair value. Fair value for consumer mortgages held for sale is based on commitments on hand from investors or prevailing market prices. As such, the Company classifies loans subjected to nonrecurring fair value adjustments as Level 1.

**Federal Home Loan Bank of Dallas Stock** The fair value of FHLB stock is estimated to be equal to its carrying amount as reported in the accompanying Consolidated Balance Sheets, given it is not a publicly traded equity security, it has an adjustable dividend rate, and all transactions in the stock are executed at the stated par value. FHLB stock is considered a Level 1 fair value.

**Other real estate owned** Other real estate owned is primarily foreclosed properties securing residential loans and commercial real estate. Foreclosed assets are adjusted to fair value less estimated costs to sell upon transfer of the

loans to other real estate owned. Subsequently, these assets are carried at the lower of carrying value or fair value less estimated costs to sell. Other real estate carried at fair value based on an observable market price or a current appraised value is classified by the Company as Level 2. When management determines that the fair value of other real estate requires additional adjustments, either as a result of a non-current appraisal or when there is no observable market price, the Company classifies the other real estate as Level 3.

**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. Deposits fair value measurements utilize Level 2 inputs.

**Junior subordinated debentures** The fair value of the junior subordinated debentures was 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. Junior subordinated debentures fair value measurements utilize Level 2 inputs.

**Other borrowings** Rates currently available to the Company for debt with similar terms and remaining maturities are used to estimate the fair value of other borrowings using a discounted cash flows methodology and are measured utilizing Level 2 inputs.

**Securities sold under repurchase agreements** The fair value of securities sold under repurchase agreements is the amount payable on demand at the reporting date and are measured utilizing Level 2 inputs.

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**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 has reviewed the unfunded portion of commitments to extend credit as well as standby and other letters of credit, and has determined that the fair value of such financial instruments is not material. The Company classifies the estimated fair value of credit-related financial instruments as Level 3.

The following table summarizes the carrying values and estimated fair values of certain financial instruments not recorded at fair value on a regular basis:

|                                             | As of September 30, 2013 |                      |              |           |              |
|---------------------------------------------|--------------------------|----------------------|--------------|-----------|--------------|
|                                             | Carrying<br>Amount       | Estimated Fair Value |              |           | Total        |
|                                             |                          | Level 1              | Level 2      | Level 3   |              |
| (Dollars in thousands)                      |                          |                      |              |           |              |
| Assets                                      |                          |                      |              |           |              |
| Cash and due from banks                     | \$ 269,987               | \$ 269,987           | \$           | \$        | \$ 269,987   |
| Federal funds sold                          | 1,121                    | 1,121                |              |           | 1,121        |
| Held to maturity securities                 | 7,606,569                |                      | 7,556,171    |           | 7,556,171    |
| Loans held for sale                         | 4,892                    | 4,892                |              |           | 4,892        |
| Loans held for investment, net of allowance | 6,117,784                |                      |              | 6,143,355 | 6,143,355    |
| Federal Home Loan Bank of Dallas stock      | 43,058                   | 43,058               |              |           | 43,058       |
| Liabilities                                 |                          |                      |              |           |              |
| Deposits:                                   |                          |                      |              |           |              |
| Noninterest-bearing                         | \$ 3,368,357             | \$                   | \$ 3,368,687 | \$        | \$ 3,368,687 |
| Interest-bearing                            | 9,087,442                |                      | 8,286,130    |           | 8,286,130    |
| Other borrowings                            | 605,951                  |                      | 607,471      |           | 607,471      |
| Securities sold under repurchase agreements | 431,969                  |                      | 431,692      |           | 431,692      |
| Junior subordinated debentures              | 85,055                   |                      | 81,696       |           | 81,696       |

|        |          | As of December 31, 2012 |         |         |       |
|--------|----------|-------------------------|---------|---------|-------|
|        | Carrying | Estimated Fair Value    |         |         |       |
|        | Amount   | Level 1                 | Level 2 | Level 3 | Total |
|        |          | (Dollars in thousands)  |         |         |       |
| Assets |          |                         |         |         |       |

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|                                             |              |            |              |           |              |
|---------------------------------------------|--------------|------------|--------------|-----------|--------------|
| Cash and due from banks                     | \$ 325,952   | \$ 325,952 | \$           | \$        | \$ 325,952   |
| Federal funds sold                          | 352          | 352        |              |           | 352          |
| Held to maturity securities                 | 7,215,395    |            | 7,418,695    |           | 7,418,695    |
| Loans held for sale                         | 10,433       | 10,433     |              |           | 10,433       |
| Loans held for investment, net of allowance | 5,116,943    |            |              | 5,186,779 | 5,186,779    |
| Federal Home Loan Bank of Dallas stock      | 34,461       | 34,461     |              |           | 34,461       |
| Liabilities                                 |              |            |              |           |              |
| Deposits:                                   |              |            |              |           |              |
| Noninterest-bearing                         | \$ 3,016,205 | \$         | \$ 3,016,205 | \$        | \$ 3,016,205 |
| Interest-bearing                            | 8,625,639    |            | 8,640,625    |           | 8,640,625    |
| Other borrowings                            | 256,753      |            | 258,819      |           | 258,819      |
| Securities sold under repurchase agreements | 454,502      |            | 454,596      |           | 454,596      |
| Junior subordinated debentures              | 85,055       |            | 72,705       |           | 72,705       |

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The Company's off-balance sheet commitments including letters of credit, which totaled \$1.19 billion at September 30, 2013, are funded at current market rates at the date they are drawn upon. It is management's opinion that the fair value of these commitments would approximate their carrying value, if drawn upon.

The fair value estimates presented herein are based on pertinent information available to management at September 30, 2013. 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.

## **7. 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, 2013 and the year ended December 31, 2012 were as follows:

|                                                          | <b>Goodwill</b>               | <b>Core Deposit</b> |
|----------------------------------------------------------|-------------------------------|---------------------|
|                                                          | <b>(Dollars in thousands)</b> | <b>Intangibles</b>  |
| Balance as of December 31, 2011                          | \$ 924,537                    | \$ 20,996           |
| Less:                                                    |                               |                     |
| Amortization                                             |                               | (7,229)             |
| Add:                                                     |                               |                     |
| Acquisition of Texas Bankers, Inc.                       | 6,077                         |                     |
| Acquisition of The Bank Arlington                        | 2,102                         |                     |
| Acquisition of ASB                                       | 274,119                       | 12,392              |
| Acquisition of Community National Bank                   | 10,327                        |                     |
| Balance as of December 31, 2012                          | 1,217,162                     | 26,159              |
| Less:                                                    |                               |                     |
| Amortization                                             |                               | (4,551)             |
| Add:                                                     |                               |                     |
| Measurement period adjustment of The Bank Arlington      | (130)                         |                     |
| Measurement period adjustment of ASB                     | (3,094)                       | 2,110               |
| Measurement period adjustment of Community National Bank | 1,999                         |                     |

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|                                                    |              |           |
|----------------------------------------------------|--------------|-----------|
| Acquisition of East Texas Financial Services, Inc. | 16,658       |           |
| Acquisition of Coppermark Bancshares, Inc.         | 119,187      | 1,515     |
| Balance as of September 30, 2013                   | \$ 1,351,782 | \$ 25,233 |

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, 2013, there were no impairments recorded on goodwill.

The measurement period for the Company to determine the fair value of acquired identifiable assets and assumed liabilities will be at the end of the earlier of (i) twelve months from the date of acquisition or (ii) as soon as the Company receives the information it

was seeking about facts and circumstances that existed as of the date of acquisition. As such, certain acquisitions completed during 2012 and 2013 may be subject to adjustment.

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Core deposit intangibles are amortized on an accelerated basis over their estimated lives, which the Company believes is between 8 and 15 years. Amortization expense related to intangible assets totaled \$1.5 million and \$2.0 million for the three months ended September 30, 2013 and 2012, respectively, and \$4.6 million and \$5.3 million for the nine months ended September 30, 2013 and 2012, respectively. The estimated aggregate future amortization expense for intangible assets remaining as of September 30, 2013 was as follows (dollars in thousands):

|                |                  |
|----------------|------------------|
| Remaining 2013 | \$ 1,483         |
| 2014           | 4,841            |
| 2015           | 4,201            |
| 2016           | 3,761            |
| 2017           | 2,076            |
| Thereafter     | 8,871            |
| <b>Total</b>   | <b>\$ 25,233</b> |

**8. STOCK BASED COMPENSATION**

At September 30, 2013, the Company had four stock-based employee compensation plans and one stock option plan assumed in connection with an acquisition under which no additional options will be granted. Two of the four plans adopted by the Company have expired and therefore no additional awards may be issued under those plans.

During 2004, the Company's Board of Directors adopted the Prosperity Bancshares, Inc. 2004 Stock Incentive Plan (the "2004 Plan") which authorizes the issuance of up to 1,250,000 shares of common stock pursuant to the exercise or grant, as the case may be, of awards under such plan and the shareholders approved the 2004 Plan in 2005. The Company has granted shares with forfeiture restrictions ("restricted stock") to certain directors, officers and associates under the 2004 Plan. The awardee is not entitled to the shares until they vest, which is generally over a one to five year period, but the awardee is entitled to receive dividends on and vote the shares prior to vesting. The shares granted do not have a cost to the awardee and the only requirement of vesting is continued service to the Company. Compensation cost related to restricted stock is calculated based on the fair value of the shares at the date of grant. If the awardee leaves the Company before the shares vest, the unvested shares are forfeited.

On February 22, 2012, the Company's Board of Directors adopted the Prosperity Bancshares, Inc. 2012 Stock Incentive Plan (the "2012 Plan"), subject to approval by the Company's shareholders. The Company's shareholders approved the 2012 Plan at the annual meeting of shareholders on April 17, 2012. The 2012 Plan authorizes the issuance of up to 1,250,000 shares of common stock upon the exercise of options granted under the 2012 Plan or pursuant to the grant or exercise, as the case may be, of other awards granted under the 2012 Plan, including restricted

stock, stock appreciation rights, phantom stock awards and performance awards. As of September 30, 2013, no options or other awards have been granted under the 2012 Plan.

The Company received \$1.2 million and \$300,000 in cash from the exercise of stock options during the three-month periods ended September 30, 2013 and 2012, respectively, and \$3.0 million and \$2.7 million during the nine-month periods ended September 30, 2013 and 2012, respectively. There was no tax benefit realized from option exercises of the share-based payment arrangements during the three and nine month periods ended September 30, 2013 and 2012.

As of September 30, 2013, there was \$7.0 million of total unrecognized compensation expense related to stock-based compensation arrangements. That cost is expected to be recognized over a weighted average period of 2.5 years.

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

The following table summarizes the Company's contractual obligations and other commitments to make future payments as of September 30, 2013 (other than deposit obligations). The payments do not include pre-payment options that may be available to the Company. The Company's future cash payments associated with its contractual obligations pursuant to its junior subordinated debentures, FHLB borrowings and operating leases as of September 30, 2013 are summarized below. Payments for junior subordinated debentures include interest of \$46.2 million that will be paid over the future periods. The future interest payments were calculated using the current rate in effect at September 30, 2013. The current principal balance of the junior subordinated debentures at September 30, 2013 was \$85.1 million. Payments for FHLB borrowings include interest of \$2.5 million that will be paid over the future periods. Payments related to leases are based on actual payments specified in underlying contracts.

|                                                           | 1 year or less         | More than 1<br>year but less<br>than 3 years | 3 years or<br>more but less<br>than 5<br>years | 5 years<br>or more | Total      |
|-----------------------------------------------------------|------------------------|----------------------------------------------|------------------------------------------------|--------------------|------------|
|                                                           | (Dollars in thousands) |                                              |                                                |                    |            |
| Junior subordinated debentures                            | \$ 578                 | \$ 4,624                                     | \$ 4,623                                       | \$ 121,438         | \$ 131,263 |
| Federal Home Loan Bank notes payable and other borrowings | 595,407                | 3,836                                        | 2,312                                          | 6,899              | 608,454    |
| Operating leases                                          | 1,247                  | 7,785                                        | 3,264                                          | 380                | 12,676     |
| Total                                                     | \$ 597,232             | \$ 16,245                                    | \$ 10,199                                      | \$ 128,717         | \$ 752,393 |

*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, 2013 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.

|                              | <b>1 year or less</b>         | <b>More than 1<br/>year but less<br/>than 3 years</b> | <b>3 years or<br/>more but less<br/>than 5<br/>years</b> | <b>5 years<br/>or more</b> | <b>Total</b>        |
|------------------------------|-------------------------------|-------------------------------------------------------|----------------------------------------------------------|----------------------------|---------------------|
|                              | <b>(Dollars in thousands)</b> |                                                       |                                                          |                            |                     |
| Standby letters of credit    | \$ 37,537                     | \$ 5,291                                              | \$ 30                                                    | \$                         | \$ 42,858           |
| Commitments to extend credit | 159,906                       | 609,923                                               | 49,941                                                   | 323,938                    | 1,143,708           |
| <b>Total</b>                 | <b>\$ 197,443</b>             | <b>\$ 615,214</b>                                     | <b>\$ 49,971</b>                                         | <b>\$ 323,938</b>          | <b>\$ 1,186,566</b> |

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

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

|                                         | Three Months Ended September 30,<br>2013 |             |                                                | 2012                 |             |                      |
|-----------------------------------------|------------------------------------------|-------------|------------------------------------------------|----------------------|-------------|----------------------|
|                                         | Before Tax<br>Amount                     | Tax Benefit | Net of Tax<br>Amount<br>(Dollars in thousands) | Before Tax<br>Amount | Tax Benefit | Net of Tax<br>Amount |
| Other comprehensive loss:               |                                          |             |                                                |                      |             |                      |
| Securities available for sale:          |                                          |             |                                                |                      |             |                      |
| Change in unrealized gain during period | \$ (1,136)                               | \$ 398      | \$ (738)                                       | \$ (718)             | \$ 251      | \$ (467)             |
| Total securities available for sale     | (1,136)                                  | 398         | (738)                                          | (718)                | 251         | (467)                |
| Total other comprehensive loss          | \$ (1,136)                               | \$ 398      | \$ (738)                                       | \$ (718)             | \$ 251      | \$ (467)             |

|                                         | Nine Months Ended September 30,<br>2013 |             |                                                | 2012                 |             |                      |
|-----------------------------------------|-----------------------------------------|-------------|------------------------------------------------|----------------------|-------------|----------------------|
|                                         | Before Tax<br>Amount                    | Tax Benefit | Net of Tax<br>Amount<br>(Dollars in thousands) | Before Tax<br>Amount | Tax Benefit | Net of Tax<br>Amount |
| Other comprehensive loss:               |                                         |             |                                                |                      |             |                      |
| Securities available for sale:          |                                         |             |                                                |                      |             |                      |
| Change in unrealized gain during period | \$ (5,237)                              | \$ 1,833    | \$ (3,404)                                     | \$ (3,736)           | \$ 1,308    | \$ (2,428)           |
| Total securities available for sale     | (5,237)                                 | 1,833       | (3,404)                                        | (3,736)              | 1,308       | (2,428)              |
| Total other comprehensive loss          | \$ (5,237)                              | \$ 1,833    | \$ (3,404)                                     | \$ (3,736)           | \$ 1,308    | \$ (2,428)           |

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

|                               | <b>Securities<br/>Available for<br/>Sale<br/>(Dollars in thousands)</b> | <b>Accumulated<br/>Other<br/>Comprehensive<br/>Income</b> |
|-------------------------------|-------------------------------------------------------------------------|-----------------------------------------------------------|
| Balance at January 1, 2013    | \$ 8,986                                                                | \$ 8,986                                                  |
| Other comprehensive loss      | (3,404)                                                                 | (3,404)                                                   |
| Balance at September 30, 2013 | \$ 5,582                                                                | \$ 5,582                                                  |
| Balance at January 1, 2012    | \$ 13,472                                                               | \$ 13,472                                                 |
| Other comprehensive loss      | (2,428)                                                                 | (2,428)                                                   |
| Balance at September 30, 2012 | \$ 11,044                                                               | \$ 11,044                                                 |

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**11. ACQUISITIONS**

*Pending Acquisition of F&M Bancorporation Inc.* On August 29, 2013, the Company announced the signing of a definitive merger agreement to acquire F&M Bancorporation Inc. ( FMBC ) and its wholly-owned subsidiary The F&M Bank & Trust Company ( F&M Bank ) headquartered in Tulsa, Oklahoma. F&M Bank operates 13 banking locations; 10 in Tulsa, Oklahoma and surrounding areas and 3 in Dallas, Texas. As of September 30, 2013, FMBC on a consolidated basis, reported total assets of \$2.47 billion, total loans of \$1.88 billion and total deposits of \$2.26 billion. Under the terms of the definitive agreement, the Company will issue approximately 3,298,246 shares of Company common stock plus \$47.0 million in cash for all outstanding shares of FMBC capital stock, subject to certain conditions and potential adjustments. The transaction is subject to customary closing conditions, including the receipt of customary regulatory approvals and approval by FMBC s shareholders.

*Acquisition of FVNB Corp.* On November 1, 2013, the Company completed the acquisition of FVNB Corp. and its wholly owned subsidiary, First Victoria National Bank (collectively, FVNB ) headquartered in Victoria, Texas. The acquisition was not considered significant to the Company s financial statements and therefore pro forma financial data and related disclosures are not included. Refer to Note 12 Subsequent Events for further information regarding the FVNB acquisition.

*Acquisition of Coppermark Bancshares, Inc.* On April 1, 2013, the Company completed the acquisition of Coppermark Bancshares, Inc. and its wholly-owned subsidiary, Coppermark Bank (collectively, Coppermark ). Coppermark operated 9 full-service banking offices: 6 in Oklahoma City, Oklahoma and surrounding areas and 3 in the Dallas, Texas area. The Company acquired Coppermark to expand its market into Oklahoma. The acquisition was not considered significant to the Company s financial statements and therefore pro forma financial data and related disclosures are not included.

As of March 31, 2013, Coppermark reported, on a consolidated basis, total assets of \$1.25 billion, total loans of \$847.6 million and total deposits of \$1.11 billion. Under the terms of the acquisition agreement, the Company issued 3,258,718 shares of Company common stock plus \$60.0 million in cash for all outstanding shares of Coppermark Bancshares, Inc. capital stock, for total merger consideration of \$214.4 million based on the Company s closing stock price of \$47.39. The Company recognized initial goodwill of \$91.7 million which does not include subsequent fair value adjustments that are still being finalized. Goodwill is calculated as the excess of both the consideration exchanged and liabilities assumed as compared to the fair value of identifiable assets acquired, none of which is expected to be deductible for tax purposes. Additionally, the Company recognized \$1.5 million of core deposit intangibles. For the nine months ended September 30, 2013, the Company incurred approximately \$787,000 of pre-tax merger related expenses related to the Coppermark acquisition.

*Acquisition of East Texas Financial Services, Inc.* On January 1, 2013, the Company completed the acquisition of East Texas Financial Services, Inc. (OTC BB: FFBT) and its wholly-owned subsidiary, First Federal Bank Texas

(collectively, East Texas Financial Services ). East Texas Financial Services operated 4 banking offices in the Tyler MSA, including three locations in Tyler, Texas and one location in Gilmer, Texas. The Company acquired East Texas Financial Services to increase its market share in the East Texas area. The acquisition was not considered significant to the Company's financial statements and therefore pro forma financial data and related disclosures are not included.

As of December 31, 2012, East Texas Financial Services reported, on a consolidated basis, total assets of \$165.0 million, total loans of \$129.3 million and total deposits of \$112.3 million. Under the terms of the acquisition agreement, the Company issued 530,940 shares of Company common stock for all outstanding shares of East Texas Financial Services capital stock, for total merger consideration of \$22.3 million based on the Company's closing stock price of \$42.00. The Company recognized initial goodwill of \$7.0 million which does not include subsequent fair value adjustments that are still being finalized. Goodwill is calculated as the excess of both the consideration exchanged and liabilities assumed as compared to the fair value of identifiable assets acquired, none of which is expected to be deductible for tax purposes.

*Acquisition of Community National Bank* On October 1, 2012, the Company completed the acquisition of Community National Bank, Bellaire, Texas. Community National Bank operated 1 banking office in Bellaire, Texas, in the Houston Metropolitan Area. The Company acquired Community National Bank to increase its market share in the Houston area. The acquisition is not considered significant to the Company's financial statements and therefore pro forma financial data is not included.

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As of September 30, 2012, Community National Bank reported total assets of \$182.0 million, total loans of \$68.0 million and total deposits of \$164.6 million. Under the terms of the acquisition agreement, the Company issued 372,282 shares of Company common stock plus \$11.4 million in cash for all outstanding shares of Community National Bank capital stock, for total merger consideration of \$27.3 million, based on the Company's closing stock price of \$42.62. The Company recognized initial goodwill of \$10.6 million which does not include subsequent fair value adjustments that are still being finalized. Goodwill is calculated as the excess of both the consideration exchanged and liabilities assumed as compared to the fair value of identifiable assets acquired, none of which is expected to be deductible for tax purposes.

*Acquisition of American State Financial Corporation* On July 1, 2012, the Company completed the acquisition of American State Financial Corporation and its wholly owned subsidiary American State Bank (collectively referred to as ASB). ASB operated 37 full service banking offices in 18 counties across West Texas. The Company acquired ASB to increase its market share in the West Texas area.

Under the terms of the acquisition agreement, the Company issued 8,524,835 shares of Company common stock plus \$178.5 million in cash for all outstanding shares of American State Financial Corporation capital stock, for total merger consideration of \$536.8 million based on the Company's closing stock price of \$42.03. The Company recognized goodwill of \$271.0 million which is calculated as the excess of both the consideration exchanged and liabilities assumed as compared to the fair value of identifiable assets acquired. Goodwill resulted from a combination of expected operational synergies, an enhanced branching network, and cross-selling opportunities. Goodwill is not expected to be deductible for tax purposes. Additionally, the Company recognized \$14.5 million of core deposit intangibles.

*Acquisition of The Bank Arlington* On April 1, 2012, the Company completed the acquisition of The Bank Arlington. The Bank Arlington operated one banking office in Arlington, Texas, in the Dallas/Fort Worth CMSA. The Company acquired The Bank Arlington to increase its market share in the Dallas/Fort Worth area. The acquisition is not considered significant to the Company's financial statements and therefore pro forma financial data and related disclosures are not included.

As of March 31, 2012, The Bank Arlington reported total assets of \$37.3 million, total loans of \$22.9 million and total deposits of \$33.2 million. Under the terms of the acquisition agreement, the Company issued 135,347 shares of Company common stock for all outstanding shares of The Bank Arlington capital stock, for total merger consideration of \$6.2 million, based on the Company's closing stock price of \$45.80. The Company recognized goodwill of \$2.0 million which is calculated as the excess of both the consideration exchanged and liabilities assumed as compared to the fair value of identifiable assets acquired, none of which is expected to be deductible for tax purposes.

*Acquisition of Texas Bankers, Inc.* On January 1, 2012, the Company completed the acquisition of Texas Bankers, Inc. and its wholly-owned subsidiary, Bank of Texas, Austin, Texas. The three Bank of Texas banking offices in the

Austin, Texas CMSA consisted of a location in Rollingwood, which was consolidated with the Company's Westlake location and remains in Bank of Texas Rollingwood banking office; one banking center in downtown Austin, which was consolidated into the Company's downtown Austin location; and another banking center in Thorndale. The Company acquired Texas Bankers, Inc. to increase its market share in the Central Texas area. The acquisition is not considered significant to the Company's financial statements and therefore pro forma financial data and related disclosures are not included.

Texas Bankers, Inc. on a consolidated basis, reported total assets of \$77.0 million, total loans of \$27.6 million and total deposits of \$70.4 million as of December 31, 2011. Under the terms of the acquisition agreement, the Company issued 314,953 shares of Company common stock for all outstanding shares of Texas Bankers capital stock, for total merger consideration of \$12.7 million, based on the Company's closing stock price of \$40.35. The Company recognized goodwill of \$6.1 million which is calculated as the excess of both the consideration exchanged and liabilities assumed as compared to the fair value of identifiable assets acquired, none of which is expected to be deductible for tax purposes.

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The following pro forma information presents the results of operations for the three and nine months ended September 30, 2013 and 2012, as if the Coppermark, East Texas Financial Services, Community National Bank, ASB and The Bank Arlington acquisitions had occurred on January 1, 2012.

|                            | <b>Three months ended September 30,</b>              |                 | <b>Nine months ended September 30,</b>               |                 |
|----------------------------|------------------------------------------------------|-----------------|------------------------------------------------------|-----------------|
|                            | <b>2013</b>                                          | <b>2012 (1)</b> | <b>2013</b>                                          | <b>2012 (1)</b> |
|                            | <b>(Dollars in thousands, except per share data)</b> |                 | <b>(Dollars in thousands, except per share data)</b> |                 |
| Net interest income        | \$ 126,533                                           | \$ 127,501      | \$ 375,699                                           | \$ 403,983      |
| Net income                 | 55,278                                               | 53,266          | 165,090                                              | 184,368         |
| Basic earnings per share   | 0.92                                                 | 0.89            | 2.64                                                 | 2.92            |
| Diluted earnings per share | 0.91                                                 | 0.88            | 2.64                                                 | 2.92            |

(1) Includes a nonrecurring gain on sale of securities of \$23.4 million, or \$0.37 earnings per share, by ASB during the second quarter of 2012.

## **12. SUBSEQUENT EVENT**

**Acquisition of FVNB Corp.** On November 1, 2013, the Company completed the acquisition of FVNB Corp. and its wholly owned subsidiary, First Victoria National Bank (collectively, FVNB) headquartered in Victoria, Texas. FVNB operated 33 banking locations; 4 in Victoria, Texas, 7 in the South Texas area including Corpus Christi; 6 in the Bryan/College Station area; 5 in the Central Texas area including New Braunfels; and 11 in the Houston area including The Woodlands and Huntsville.

As of September 30, 2013, FVNB, on a consolidated basis, reported total assets of \$2.47 billion, total loans of \$1.65 billion and total deposits of \$2.20 billion. Under the terms of the acquisition agreement, the Company issued 5,570,667 shares of Company common stock plus \$91.3 million in cash for all outstanding shares of FVNB Corp. capital stock for total merger consideration of \$439.1 million based on the Company's closing stock price of \$62.45. The Company recognized initial goodwill of \$278.3 million which does not include subsequent fair value adjustments that are still being finalized. Goodwill is calculated as the excess of both the consideration exchanged and liabilities assumed as compared to the fair value of identifiable assets acquired, none of which is expected to be deductible for tax purposes. For the nine months ended September 30, 2013, the Company incurred approximately \$121,000 of pre-tax merger related expenses related to the FVNB acquisition.

## **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;

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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, 2012.

## **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 and is now known as Prosperity Bank. 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, 2013, the Bank operated 218 full-service banking locations; with 57 in the Houston area; 20 in the South Texas area including Corpus Christi and Victoria; 35 in the Dallas/Fort Worth area; 22 in the East Texas area; 34 in the Central Texas area including Austin and San Antonio; 34 in the West Texas area including Lubbock, Midland-Odessa and Abilene; 10 in the Bryan/College Station area and 6 in the Central Oklahoma area. The Company's headquarters are located at Prosperity Bank Plaza, 4295 San Felipe in Houston, Texas and its telephone number is (713) 693-9300. The Company's website address is [www.prosperitybankusa.com](http://www.prosperitybankusa.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.

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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 noninterest 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 acquisitions, including strategic merger transactions and FDIC assisted transactions. The Company focuses on continuous 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 centralized many of its critical operations, such as data processing and loan 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. During 2012, the Company completed four acquisitions including Texas Bankers, Inc., The Bank Arlington, ASB and Community National Bank. In 2013, the Company completed the acquisitions of East Texas Financial Services, Coppermark and on November 1, 2013, FVNB Corp. The Company has announced the pending acquisition of FMBC.

Total assets were \$16.05 billion at September 30, 2013 compared with \$14.58 billion at December 31, 2012, an increase of \$1.47 billion or 10.1%. Total loans were \$6.18 billion at September 30, 2013 compared with \$5.18 billion at December 31, 2012, an increase of \$1.0 billion or 19.4%. Total deposits were \$12.46 billion at September 30, 2013 compared with \$11.64 billion December 31, 2012, an increase of \$814.0 million or 7.0%. Total shareholders' equity was \$2.39 billion at September 30, 2013 compared with \$2.09 billion at December 31, 2012, an increase of \$299.7 million or 14.3%.

## ***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, 2012. 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.

*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. The Company has the option to first assess qualitative factors to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount as a basis for determining the need to perform step one of the annual test for goodwill impairment. An entity has an unconditional option to bypass the qualitative assessment described in the preceding paragraph for any reporting unit in any period and proceed directly to performing the first step of the goodwill impairment test. An entity may resume performing the qualitative assessment in any subsequent period.

If the Company bypasses the qualitative assessment, a two-step goodwill impairment test is performed. The two-step process 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.

Estimating the fair value of the Company's reporting unit is a subjective process involving the use of estimates and judgments, particularly related to future cash flows of the reporting unit, discount rates (including market risk premiums) and market multiples. Material assumptions used in the valuation models include the comparable public company price multiples used in the terminal value, future cash flows and the market risk premium component of the discount rate. The estimated fair values of the reporting unit is

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determined using a blend of two commonly used valuation techniques: the market approach and the income approach. The Company gives consideration to both valuation techniques, as either technique can be an indicator of value. For the market approach, valuations of the reporting unit were based on an analysis of relevant price multiples in market trades in companies with similar characteristics. For the income approach, estimated future cash flows (derived from internal forecasts and economic expectations) and terminal value (value at the end of the cash flow period, based on price multiples) were discounted. The discount rate was based on the imputed cost of equity capital.

The Company had no intangible assets with indefinite useful lives at September 30, 2013. 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 fifteen 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, 2013, management does not believe any of its goodwill is impaired as of September 30, 2013 because the fair value of the Company's equity substantially exceeded its carrying value. While the Company believes no impairment existed at September 30, 2013, 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. 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. 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 including stock price volatility and employee turnover that are utilized to measure compensation expense.

*Other-Than-Temporarily Impaired Securities* 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.

*Fair Values of Financial Instruments* The Company determines the fair market values of financial instruments based on the fair value hierarchy established which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. There are three levels of inputs that may be used to measure fair value. Level 1 inputs include quoted market prices in active markets, where available. If such quoted market prices are not available Level 2 inputs are used. These inputs are based upon internally developed models that primarily use observable market-based parameters. Level 3 inputs are unobservable inputs which are typically based on an entity's own assumptions, as there is little, if any, related market activity. The Company's assessment of the significance of a particular input to the fair value measurement in its entirety requires judgment, and considers factors specific to the asset or liability.

## **RECENT AND PENDING ACQUISITIONS**

*Acquisition of East Texas Financial Services, Inc.* On January 1, 2013, the Company completed the acquisition of East Texas Financial Services, Inc. (OTC BB: FFBT) and its wholly-owned subsidiary, First Federal Bank Texas. East Texas Financial Services operated 4 banking offices in the Tyler MSA, including three locations in Tyler, Texas and one location in Gilmer, Texas. As of December 31, 2012, East Texas Financial Services reported, on a consolidated basis, total assets of \$165.0 million, total loans of \$129.3 million and total deposits of \$112.3 million.

*Acquisition of Coppermark Bancshares, Inc.* On April 1, 2013, the Company completed the acquisition of Coppermark Bancshares, Inc. and its wholly-owned subsidiary, Coppermark Bank (collectively Coppermark ) headquartered in Oklahoma City, Oklahoma. Coppermark operated 9 full-service banking offices: 6 in Oklahoma City, Oklahoma and surrounding areas and 3 in the Dallas, Texas area. As of March 31, 2013, Coppermark reported, on a consolidated basis, total assets of \$1.25 billion, total loans of \$847.6 million and total deposits of \$1.11 billion.

*Pending Acquisition of F&M Bancorporation Inc.* On August 29, 2013, the Company announced the signing of a definitive merger agreement to acquire F&M Bancorporation Inc. ( FMBC ) and its wholly-owned subsidiary The F&M Bank & Trust Company ( F&M Bank ) headquartered in Tulsa, Oklahoma. F&M Bank operates 13 banking locations; 10 in Tulsa, Oklahoma and surrounding

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areas and 3 in Dallas, Texas. As of September 30, 2013, FMBC on a consolidated basis, reported total assets of \$2.47 billion, total loans of \$1.88 billion and total deposits of \$2.26 billion. Under the terms of the definitive agreement, the Company will issue approximately 3,298,246 shares of Company common stock plus \$47.0 million in cash for all outstanding shares of FMBC capital stock, subject to certain conditions and potential adjustments. The transaction is subject to customary closing conditions, including the receipt of customary regulatory approvals and approval by FMBC's shareholders.

## **SUBSEQUENT EVENT**

**Acquisition of FVNB Corp.** On November 1, 2013, the Company completed the acquisition of FVNB Corp. and its wholly owned subsidiary, First Victoria National Bank (collectively, FVNB) headquartered in Victoria, Texas. FVNB operated 33 banking locations; 4 in Victoria, Texas, 7 in the South Texas area including Corpus Christi; 6 in the Bryan/College Station area; 5 in the Central Texas area including New Braunfels; and 11 in the Houston area including The Woodlands and Huntsville.

As of September 30, 2013, FVNB, on a consolidated basis, reported total assets of \$2.47 billion, total loans of \$1.65 billion and total deposits of \$2.20 billion. Under the terms of the acquisition agreement, the Company issued 5,570,667 shares of Company common stock plus \$91.3 million in cash for all outstanding shares of FVNB Corp. capital stock for total merger consideration of \$439.1 million based on the Company's closing stock price of \$62.45. The Company recognized initial goodwill of \$278.3 million which does not include subsequent fair value adjustments that are still being finalized. Goodwill is calculated as the excess of both the consideration exchanged and liabilities assumed as compared to the fair value of identifiable assets acquired, none of which is expected to be deductible for tax purposes. For the nine months ended September 30, 2013, the Company incurred approximately \$121,000 of pre-tax merger related expenses related to the FVNB acquisition.

## **RESULTS OF OPERATIONS**

Net income available to common shareholders was \$55.3 million (\$0.91 per common share on a diluted basis) for the quarter ended September 30, 2013 compared with \$46.2 million (\$0.82 per common share on a diluted basis) for the quarter ended September 30, 2012, an increase in net income of \$9.1 million or 19.7%. The Company posted returns on average common equity of 9.31% and 9.10%, returns on average assets of 1.37% and 1.32% and efficiency ratios of 41.59% and 46.07% for the quarters ended September 30, 2013 and 2012, respectively. The efficiency ratio is calculated by dividing total non-interest expense, excluding credit loss provisions, by net interest income plus non-interest income, excluding net gains and losses on the sale of securities and assets. Additionally, taxes are not part of this calculation.

For the nine months ended September 30, 2013, net income available to common shareholders was \$158.4 million (\$2.67 per common share on a diluted basis) compared with \$119.6 million (\$2.37 per common share on a diluted basis) for the same period in 2012, an increase in net income of \$38.8 million or 32.4%. The Company posted returns on average common equity of 9.29% and 9.08%, returns on average assets of 1.35% and 1.35% and efficiency ratios of 42.16% and 43.69% for the nine months ended September 30, 2013 and 2012, 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 before the provision for credit losses was \$126.5 million for the quarter ended September 30, 2013 compared with \$106.9 million for the quarter ended September 30, 2012, an increase of \$19.6 million, or 18.4%. This increase includes \$16.4 million related to purchase accounting accretion during the three months ended September 30, 2013 compared to \$11.2 million recorded during the same period in 2012. The average rate paid on interest-bearing liabilities decreased 10 basis points from 0.47% for the quarter ended September 30, 2012 compared with 0.37% for the quarter ended September 30, 2013, while the average yield on interest-earning assets remained at 3.80% for both periods. The average volume of interest-bearing liabilities increased \$1.31 billion and the average volume of interest-earning assets increased \$1.89 billion for the same period as a result of the acquisitions over the past year. The net interest margin on a tax equivalent basis increased 7 basis points from 3.52% for the quarter ended September 30, 2012 to 3.59% for the quarter ended September 30, 2013. The impact on net interest margin of the purchase accounting accretion was an increase of 46 basis points for the quarter ended September 30, 2013.

Net interest income before the provision for credit losses increased \$81.0 million, or 29.7%, to \$353.4 million for the nine months ended September 30, 2013 compared with \$272.4 million for the same period in 2012. This increase includes \$42.7 million related to purchase accounting accretion during the nine months ended September 30, 2013. During the nine months ended September 30, 2012, \$11.2 million of purchase accounting accretion was recorded. The increase in net interest income was primarily attributable to higher average interest-earning assets as a result of the acquisitions over the past year. The average volume of interest-earning assets increased \$3.45 billion for the nine months ended September 30, 2013 compared with the same period in 2012. The net interest margin on a tax equivalent basis decreased to 3.48% for the nine months ended September 30, 2013 compared with 3.56% for the same period in 2012. The impact on the net interest margin of the purchase accounting accretion was an increase of 41 basis points for the nine months ended September 30, 2013.

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The following tables set forth, for each category of interest-earning assets and interest-bearing liabilities, the average amounts outstanding, the interest earned or paid on such amounts, and the average rate earned or paid for the three and nine month periods ended September 30, 2013 and 2012. The tables also set forth the average rate paid on total interest-bearing liabilities, and the net interest margin on average total interest-earning assets for the same periods. Except as indicated in the footnotes, no tax-equivalent adjustments were made and all average balances are daily average balances. Any nonaccruing loans have been included in the table as loans carrying a zero yield.

|                                              | Three Months Ended September 30,  |                                                 |                              |                                   |                                                 |                              |
|----------------------------------------------|-----------------------------------|-------------------------------------------------|------------------------------|-----------------------------------|-------------------------------------------------|------------------------------|
|                                              | Average<br>Outstanding<br>Balance | 2013<br>Interest<br>Earned/<br>Interest<br>Paid | Average<br>Yield/Rate<br>(4) | Average<br>Outstanding<br>Balance | 2012<br>Interest<br>Earned/<br>Interest<br>Paid | Average<br>Yield/Rate<br>(4) |
| (Dollars in thousands)                       |                                   |                                                 |                              |                                   |                                                 |                              |
| <b>Assets</b>                                |                                   |                                                 |                              |                                   |                                                 |                              |
| Interest-Earning Assets:                     |                                   |                                                 |                              |                                   |                                                 |                              |
| Loans                                        | \$ 6,173,394                      | \$ 94,236                                       | 6.06%                        | \$ 5,169,101                      | \$ 80,587                                       | 6.20%                        |
| Investment securities                        | 8,015,221                         | 41,961                                          | 2.08%                        | 7,106,871                         | 37,025                                          | 2.08%                        |
| Federal funds sold and other earning assets  | 27,451                            | 16                                              | 0.22%                        | 53,111                            | 21                                              | 0.16%                        |
| Total interest-earning assets                | 14,216,066                        | 136,213                                         | 3.80%                        | 12,329,083                        | 117,633                                         | 3.80%                        |
| Allowance for credit losses                  | (56,765)                          |                                                 |                              | (53,944)                          |                                                 |                              |
| Noninterest-earning assets                   | 2,034,968                         |                                                 |                              | 1,730,120                         |                                                 |                              |
| Total assets                                 | \$ 16,194,269                     |                                                 |                              | \$ 14,005,259                     |                                                 |                              |
| <b>Liabilities and Shareholders Equity</b>   |                                   |                                                 |                              |                                   |                                                 |                              |
| Interest-Bearing Liabilities:                |                                   |                                                 |                              |                                   |                                                 |                              |
| Interest-bearing demand deposits             | \$ 2,400,555                      | 1,708                                           | 0.28%                        | \$ 2,181,928                      | 2,273                                           | 0.41%                        |
| Savings and money market deposits            | 4,233,911                         | 2,911                                           | 0.27%                        | 3,516,601                         | 2,987                                           | 0.34%                        |
| Certificates and other time deposits         | 2,489,848                         | 3,695                                           | 0.59%                        | 2,387,279                         | 4,135                                           | 0.69%                        |
| Securities sold under repurchase agreements  | 455,276                           | 317                                             | 0.28%                        | 438,410                           | 315                                             | 0.29%                        |
| Federal funds purchased and other borrowings | 772,083                           | 439                                             | 0.23%                        | 512,739                           | 379                                             | 0.29%                        |
| Junior subordinated debentures               | 85,055                            | 610                                             | 2.85%                        | 85,055                            | 651                                             | 3.04%                        |
| Total interest-bearing liabilities           | 10,436,728                        | 9,680                                           | 0.37%                        | 9,122,012                         | 10,740                                          | 0.47%                        |
| Noninterest-Bearing liabilities:             |                                   |                                                 |                              |                                   |                                                 |                              |
| Noninterest-bearing demand deposits          | 3,308,158                         |                                                 |                              | 2,760,405                         |                                                 |                              |
| Other liabilities                            | 73,571                            |                                                 |                              | 92,873                            |                                                 |                              |

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|                                                     |               |       |               |       |
|-----------------------------------------------------|---------------|-------|---------------|-------|
| Total liabilities                                   | 13,818,457    |       | 11,975,290    |       |
| Shareholders' equity                                | 2,375,812     |       | 2,029,969     |       |
| Total liabilities and shareholders' equity          | \$ 16,194,269 |       | \$ 14,005,259 |       |
| Net interest rate spread                            |               | 3.43% |               | 3.33% |
| Net interest income and margin (1) (2)              | \$ 126,533    | 3.53% | \$ 106,893    | 3.45% |
| Net interest income and margin (tax equivalent) (3) | \$ 128,561    | 3.59% | \$ 109,031    | 3.52% |

- (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 and based on an actual/365 day basis for the three months ended September 30, 2013 and on an actual/366 day basis for the three months ended September 30, 2012.

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| Nine Months Ended September 30,              |               |                             |            |               |                             |            |
|----------------------------------------------|---------------|-----------------------------|------------|---------------|-----------------------------|------------|
|                                              | Average       | 2013                        | Average    | Average       | 2012                        | Average    |
|                                              | Outstanding   | Interest                    | Yield/Rate | Outstanding   | Interest                    | Yield/Rate |
|                                              | Balance       | Earned/<br>Interest<br>Paid | (4)        | Balance       | Earned/<br>Interest<br>Paid | (4)        |
| (Dollars in thousands)                       |               |                             |            |               |                             |            |
| <b>Assets</b>                                |               |                             |            |               |                             |            |
| Interest-Earning Assets:                     |               |                             |            |               |                             |            |
| Loans                                        | \$ 5,853,924  | \$ 265,542                  | 6.06%      | \$ 4,303,984  | \$ 188,597                  | 5.85%      |
| Investment securities                        | 7,912,599     | 117,893                     | 1.99%      | 5,983,102     | 113,418                     | 2.53%      |
| Federal funds sold and other earning assets  | 32,426        | 111                         | 0.46%      | 66,771        | 108                         | 0.22%      |
| Total interest-earning assets                | 13,798,949    | 383,546                     | 3.72%      | 10,353,857    | 302,123                     | 3.90%      |
| Allowance for credit losses                  | (55,933)      |                             |            | (52,104)      |                             |            |
| Noninterest-earning assets                   | 2,000,425     |                             |            | 1,498,332     |                             |            |
| Total assets                                 | \$ 15,743,441 |                             |            | \$ 11,800,085 |                             |            |
| <b>Liabilities and Shareholders Equity</b>   |               |                             |            |               |                             |            |
| Interest-Bearing Liabilities:                |               |                             |            |               |                             |            |
| Interest-bearing demand deposits             | \$ 2,545,983  | 6,018                       | 0.32%      | \$ 1,861,954  | 6,425                       | 0.46%      |
| Savings and money market deposits            | 4,096,889     | 8,912                       | 0.29%      | 3,031,269     | 8,020                       | 0.35%      |
| Certificates and other time deposits         | 2,468,518     | 11,244                      | 0.61%      | 2,080,606     | 11,824                      | 0.76%      |
| Securities sold under repurchase agreements  | 458,441       | 921                         | 0.27%      | 197,775       | 411                         | 0.28%      |
| Federal funds purchased and other borrowings | 558,594       | 1,273                       | 0.30%      | 465,505       | 1,076                       | 0.31%      |
| Junior subordinated debentures               | 85,055        | 1,821                       | 2.86%      | 85,055        | 1,962                       | 3.08%      |
| Total interest-bearing liabilities           | 10,213,480    | 30,189                      | 0.40%      | 7,722,164     | 29,718                      | 0.51%      |
| Noninterest-Bearing liabilities:             |               |                             |            |               |                             |            |
| Noninterest-bearing demand deposits          | 3,182,349     |                             |            | 2,267,876     |                             |            |
| Other liabilities                            | 68,721        |                             |            | 53,320        |                             |            |
| Total liabilities                            | 13,464,550    |                             |            | 10,043,360    |                             |            |
| Shareholders equity                          | 2,278,891     |                             |            | 1,756,725     |                             |            |
| Total liabilities and shareholders equity    | \$ 15,743,441 |                             |            | \$ 11,800,085 |                             |            |
| Net interest rate spread                     |               |                             | 3.32%      |               |                             | 3.41%      |
| Net interest income and margin (1) (2)       |               | \$ 353,357                  | 3.42%      |               | \$ 272,405                  | 3.51%      |
|                                              |               | \$ 359,573                  | 3.48%      |               | \$ 276,271                  | 3.56%      |

Net interest income and margin (tax equivalent) (3)

- (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 and based on an actual/365 day basis for the nine months ended September 30, 2013 and on an actual/366 day basis for the nine months ended September 30, 2012.

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

|                                               | Three Months Ended September 30,<br>2013 vs. 2012 |            |           | Nine Months Ended<br>September 30,<br>2013 vs. 2012 |             |           |
|-----------------------------------------------|---------------------------------------------------|------------|-----------|-----------------------------------------------------|-------------|-----------|
|                                               | Increase<br>(Decrease)<br>Due to Change in        |            |           | Increase<br>(Decrease)<br>Due to Change in          |             |           |
|                                               | Volume                                            | Rate       | Total     | Volume                                              | Rate        | Total     |
|                                               | (Dollars in thousands)                            |            |           | (Dollars in thousands)                              |             |           |
| Interest-Earning assets:                      |                                                   |            |           |                                                     |             |           |
| Loans (1)                                     | \$ 15,887                                         | \$ (2,238) | \$ 13,649 | \$ 67,541                                           | \$ 9,404    | \$ 76,945 |
| Investment securities (1)                     | 4,996                                             | (60)       | 4,936     | 36,312                                              | (31,837)    | 4,475     |
| Federal funds sold and other earning assets   | (9)                                               | 4          | (5)       | (54)                                                | 57          | 3         |
| Total increase (decrease) in interest income  |                                                   |            |           |                                                     |             |           |
|                                               | 20,874                                            | (2,294)    | 18,580    | 103,799                                             | (22,376)    | 81,423    |
| Interest-Bearing liabilities:                 |                                                   |            |           |                                                     |             |           |
| Interest-bearing demand deposits              | 208                                               | (773)      | (565)     | 2,335                                               | (2,742)     | (407)     |
| Savings and money market deposits             | 641                                               | (717)      | (76)      | 2,705                                               | (1,813)     | 892       |
| Certificates and other time deposits (1)      | 195                                               | (635)      | (440)     | 2,208                                               | (2,788)     | (580)     |
| Junior subordinated debentures                |                                                   | (41)       | (41)      |                                                     | (141)       | (141)     |
| Securities sold under repurchase agreements   | 18                                                | (16)       | 2         | 549                                                 | (39)        | 510       |
| Fed funds purchased and other borrowings      | 185                                               | (125)      | 60        | 220                                                 | (23)        | 197       |
| Total increase (decrease) in interest expense |                                                   |            |           |                                                     |             |           |
|                                               | 1,247                                             | (2,307)    | (1,060)   | 8,017                                               | (7,546)     | 471       |
| Increase (decrease) in net interest income    | \$ 19,627                                         | \$ 13      | \$ 19,640 | \$ 95,782                                           | \$ (14,830) | \$ 80,952 |

(1) Includes impact of purchase accounting adjustments.

*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 Company's 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 process 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 recorded a \$4.0 million provision for credit losses for the quarter ended September 30, 2013 and a \$1.8 million provision for the quarter ended September 30, 2012. Net charge-offs were \$288,000 for the quarter ended September 30, 2013 compared with net charge-offs of \$1.3 million for the quarter ended September 30, 2012. The Company made a \$9.4 million provision for credit losses for the nine months ended September 30, 2013 and a \$2.6 million provision for the nine months ended September 30, 2012. Net charge-offs were \$2.0 million for the nine months ended September 30, 2013 compared with \$3.2 million for the nine months ended September 30, 2012.

#### *Noninterest Income*

The Company's primary sources of recurring noninterest income are NSF fees, credit card, debit card 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 \$21.6 million for the three months ended September 30, 2013 compared with \$23.8 million for the same period in 2012, a decrease of \$2.3 million or 9.5%. This decrease was primarily due to a decrease in debit card income as a result of the Durbin Amendment that became effective on July 1,

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2013. This Federal Reserve rule is applicable to financial institutions that have assets of \$10 billion or more and imposes limits on the amount of interchange, or swipe, fees that can be collected. The rule provides that the maximum permissible interchange fee for an electronic debit transaction is limited to \$0.24. The fee is calculated as the sum of \$0.21 per transaction and 5 basis points multiplied by the value of the transaction. If the card issuer develops and implements certain fraud protection policies and procedures, it may increase its debit card interchange fee up to an additional one cent.

Noninterest income totaled \$70.3 million for the nine months ended September 30, 2013 compared with \$51.4 million for the same period in 2012, an increase of \$18.8 million or 36.6%. This increase was primarily due to increased NSF fees and service charges and income earned on the additional products and services acquired through the acquisition of ASB. The increase in NSF fees and service charges was mainly the result of the additional accounts acquired in the acquisitions consummated in 2012 and the first half of 2013.

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

|                                             | <b>Three Months Ended September 30,</b> |             | <b>Nine Months Ended September 30,</b> |             |
|---------------------------------------------|-----------------------------------------|-------------|----------------------------------------|-------------|
|                                             | <b>2013</b>                             | <b>2012</b> | <b>2013</b>                            | <b>2012</b> |
|                                             | <b>(Dollars in thousands)</b>           |             | <b>(Dollars in thousands)</b>          |             |
| Nonsufficient funds (NSF) fees              | \$ 8,649                                | \$ 9,265    | \$ 25,504                              | \$ 19,050   |
| Credit card, debit card and ATM card income | 4,307                                   | 6,246       | 17,801                                 | 14,374      |
| Service charges on deposit accounts         | 3,169                                   | 3,362       | 9,404                                  | 9,006       |
| Trust income                                | 901                                     | 831         | 2,814                                  | 831         |
| Mortgage income                             | 931                                     | 1,437       | 3,489                                  | 1,350       |
| Bank owned life insurance income            | 916                                     | 736         | 2,624                                  | 1,430       |
| Net gain (loss) on sale of assets           | 126                                     | (50)        | (53)                                   | 13          |
| Net loss on sale of other real estate       | (864)                                   | (597)       | (732)                                  | (344)       |
| Other                                       | 3,419                                   | 2,598       | 9,418                                  | 5,719       |
| Total noninterest income                    | \$ 21,554                               | \$ 23,828   | \$ 70,269                              | \$ 51,429   |

**Table of Contents***Noninterest Expense*

Noninterest expense totaled \$61.5 million for the quarter ended September 30, 2013 compared with \$60.2 million for the quarter ended September 30, 2012, an increase of \$1.3 million or 2.1%. Noninterest expense totaled \$178.6 million for the nine months ended September 30, 2013 compared with \$141.5 million for the nine months ended September 30, 2012, an increase of \$37.1 million or 26.2%. Both increases are primarily due to increases in salaries and employee benefits and general and administrative expenses related to the recent acquisitions. The Company also incurred one-time merger expenses of approximately \$300,000 and \$1.2 million for the three and nine months ended September 30, 2013.

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

|                                                           | <b>Three Months Ended September 30,</b> |                  | <b>Nine Months Ended September 30,</b> |                   |
|-----------------------------------------------------------|-----------------------------------------|------------------|----------------------------------------|-------------------|
|                                                           | <b>2013</b>                             | <b>2012</b>      | <b>2013</b>                            | <b>2012</b>       |
|                                                           | <b>(Dollars in thousands)</b>           |                  | <b>(Dollars in thousands)</b>          |                   |
| Salaries and employee benefits <sup>(1)</sup>             | \$ 37,135                               | \$ 36,701        | \$ 107,861                             | \$ 83,525         |
| Non-staff expenses:                                       |                                         |                  |                                        |                   |
| Net occupancy and equipment                               | 5,094                                   | 4,614            | 14,041                                 | 11,663            |
| Debit card, data processing and software amortization     | 2,756                                   | 2,901            | 8,575                                  | 6,339             |
| Regulatory assessments and FDIC insurance                 | 2,516                                   | 2,107            | 7,490                                  | 5,314             |
| Core deposit intangibles amortization                     | 1,455                                   | 2,007            | 4,551                                  | 5,297             |
| Depreciation                                              | 2,679                                   | 2,369            | 7,521                                  | 6,432             |
| Communications (including telephone, courier and postage) | 2,397                                   | 2,226            | 7,003                                  | 5,777             |
| Other real estate expense                                 | 75                                      | 271              | 535                                    | 2,619             |
| Professional fees                                         | 1,150                                   | 1,686            | 3,081                                  | 3,231             |
| Printing and supplies                                     | 606                                     | 601              | 1,627                                  | 1,546             |
| Other                                                     | 5,674                                   | 4,759            | 16,319                                 | 9,746             |
| <b>Total noninterest expense</b>                          | <b>\$ 61,537</b>                        | <b>\$ 60,242</b> | <b>\$ 178,604</b>                      | <b>\$ 141,489</b> |

(1) Includes stock based compensation expense of \$1.0 million and \$1.1 million for the three months ended September 30, 2013 and 2012, respectively, and \$3.1 million and \$3.2 million for the nine months ended September 30, 2013 and 2012, respectively.

*Income Taxes*

Income tax expense increased \$4.7 million or 21.1% to \$27.2 million for the quarter ended September 30, 2013 compared with \$22.5 million for the same period in 2012. For the nine months ended September 30, 2013, income tax expense totaled \$77.2 million, an increase of \$17.1 million or 28.4% compared with \$60.2 million for the same period in 2012. The increase was primarily attributable to higher pretax net earnings for the three and nine months ended September 30, 2013 compared with the same periods in 2012. The Company's effective tax rate for the three months ended September 30, 2013 and 2012 was 33.0% and 32.8%, respectively. The Company's effective tax rate for the nine months ended September 30, 2013 and 2012 was 32.8% and 33.5%, respectively.

## FINANCIAL CONDITION

### *Loan Portfolio*

Total loans were \$6.18 billion at September 30, 2013, an increase of \$1.0 billion or 19.4% compared with \$5.18 billion at December 31, 2012. Loan growth was impacted by the acquisitions of East Texas Financial Services and Coppermark. Loans attributed to these acquisitions totaled \$129.3 million and \$847.6 million, respectively, at acquisition date. Outstanding loans at September 30, 2013 comprised 43.5% of average earning assets for the quarter ended September 30, 2013.

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The following table summarizes the loan portfolio of the Company by type of loan as of September 30, 2013 and December 31, 2012:

|                                                             | September 30,<br>2013  | December 31,<br>2012 |
|-------------------------------------------------------------|------------------------|----------------------|
|                                                             | (Dollars in thousands) |                      |
| Residential mortgage loans held for sale                    | \$ 4,892               | \$ 10,433            |
| Commercial and industrial                                   | 1,028,799              | 771,114              |
| Real estate:                                                |                        |                      |
| Construction and land development                           | 703,193                | 550,768              |
| 1-4 family residential (including home equity)              | 1,710,621              | 1,432,133            |
| Commercial real estate (including multi-family residential) | 2,304,862              | 1,990,642            |
| Farmland                                                    | 235,049                | 211,156              |
| Agriculture                                                 | 86,469                 | 74,481               |
| Consumer and other (net of unearned discount)               | 108,704                | 139,213              |
| Total loans held for investment                             | 6,177,697              | 5,169,507            |
| Total                                                       | \$ 6,182,589           | \$ 5,179,940         |

*Nonperforming Assets*

The Company had \$12.7 million in nonperforming assets at September 30, 2013 and \$13.0 million in nonperforming assets at December 31, 2012, a decrease of \$328,000 or 2.5%. The ratio of nonperforming assets to loans and other real estate was 0.20% at September 30, 2013 compared with 0.25% at December 31, 2012.

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 generally charges off loans before attaining nonaccrual status.

The following table presents information regarding nonperforming loans as of the date indicated:

|                                   | September 30, 2013       |                 |                      |                  |               |             |
|-----------------------------------|--------------------------|-----------------|----------------------|------------------|---------------|-------------|
|                                   | Loans Past Due and Still |                 |                      |                  |               |             |
|                                   | Accruing                 |                 |                      |                  |               |             |
|                                   | 30-89 Days               | 90 or More Days | Total Past Due Loans | Nonaccrual Loans | Current Loans | Total Loans |
|                                   | (Dollars in thousands)   |                 |                      |                  |               |             |
| Construction and land development | \$ 3,465                 | \$              | \$ 3,465             | \$ 469           | \$ 699,259    | \$ 703,193  |
|                                   | 557                      |                 | 557                  | 23               | 320,938       | 321,518     |

Agriculture and agriculture real estate (includes farmland)

|                                                            |           |        |           |          |              |              |
|------------------------------------------------------------|-----------|--------|-----------|----------|--------------|--------------|
| 1-4 family (includes home equity) (1)                      | 5,655     | 90     | 5,745     | 1,037    | 1,708,731    | 1,715,513    |
| Commercial real estate (includes multi-family residential) | 7,065     | 34     | 7,099     | 2,223    | 2,295,540    | 2,304,862    |
| Commercial and industrial                                  | 9,230     | 148    | 9,378     | 1,069    | 1,018,352    | 1,028,799    |
| Consumer and other                                         | 391       | 11     | 402       | 133      | 108,169      | 108,704      |
| Total                                                      | \$ 26,363 | \$ 283 | \$ 26,646 | \$ 4,954 | \$ 6,150,989 | \$ 6,182,589 |

(1) Includes \$4.9 million of residential mortgage loans held for sale at September 30, 2013.

**Table of Contents***Allowance for Credit Losses*

Management actively monitors the Company's asset quality and provides specific loss allowances when necessary. The allowance for credit losses is a reserve established through charges to earnings in the form of a provision for credit losses. 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, 2013, the allowance for credit losses amounted to \$59.9 million or 0.97% of total loans compared with \$52.6 million or 1.01% of total loans at December 31, 2012.

Set forth below is an analysis of the allowance for credit losses as of the dates indicated:

|                                                            | <b>As of and<br/>for<br/>the Nine<br/>Months Ended<br/>September 30,<br/>2013</b> | <b>As of and for<br/>the Nine<br/>Months Ended<br/>September 30,<br/>2012</b> |
|------------------------------------------------------------|-----------------------------------------------------------------------------------|-------------------------------------------------------------------------------|
|                                                            | <b>(Dollars in thousands)</b>                                                     |                                                                               |
| Average loans outstanding                                  | \$ 5,853,924                                                                      | \$ 4,303,984                                                                  |
| Gross loans outstanding at end of period                   | \$ 6,182,589                                                                      | \$ 5,079,103                                                                  |
| Allowance for credit losses at beginning of period         | \$ 52,564                                                                         | \$ 51,594                                                                     |
| Provision for credit losses                                | 9,375                                                                             | 2,550                                                                         |
| Charge-offs:                                               |                                                                                   |                                                                               |
| Commercial and industrial                                  | (592)                                                                             | (376)                                                                         |
| Real estate and agriculture                                | (1,382)                                                                           | (3,124)                                                                       |
| Consumer and other                                         | (2,100)                                                                           | (2,101)                                                                       |
| Recoveries:                                                |                                                                                   |                                                                               |
| Commercial and industrial                                  | 275                                                                               | 721                                                                           |
| Real estate and agriculture                                | 903                                                                               | 296                                                                           |
| Consumer and other                                         | 870                                                                               | 1,367                                                                         |
| Net charge-offs                                            | (2,026)                                                                           | (3,217)                                                                       |
| Allowance for credit losses at end of period               | \$ 59,913                                                                         | \$ 50,927                                                                     |
| Ratio of allowance to end of period loans                  | 0.97%                                                                             | 1.00%                                                                         |
| Ratio of net charge-offs to average loans<br>(annualized)  | 0.07%                                                                             | 0.10%                                                                         |
| Ratio of allowance to end of period<br>nonperforming loans | 1144.0%                                                                           | 980.3%                                                                        |

*Securities*

The carrying cost of securities totaled \$7.77 billion at September 30, 2013 compared with \$7.44 billion at December 31, 2012, an increase of \$329.3 million or 4.4%. At September 30, 2013, securities represented 48.4% of total assets compared with 51.0% of total assets at December 31, 2012.

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The amortized cost and fair value of investment securities were as follows:

|                                     | Amortized<br>Cost | September 30, 2013<br>Gross<br>Unrealized<br>Gains<br>Unrealized<br>Losses<br>(Dollars in thousands) |         | Fair<br>Value |
|-------------------------------------|-------------------|------------------------------------------------------------------------------------------------------|---------|---------------|
| Available for Sale                  |                   |                                                                                                      |         |               |
| States and political subdivisions   | \$ 29,130         | \$ 1,002                                                                                             | \$      | \$ 30,132     |
| Collateralized mortgage obligations | 512               | 3                                                                                                    | (1)     | 514           |
| Mortgage-backed securities          | 119,259           | 7,602                                                                                                | (24)    | 126,837       |
| Other securities                    | 7,288             | 5                                                                                                    |         | 7,293         |
| Total                               | \$ 156,189        | \$ 8,612                                                                                             | \$ (25) | \$ 164,776    |

|                                                                      |              |            |              |              |
|----------------------------------------------------------------------|--------------|------------|--------------|--------------|
| <b>Held to Maturity</b>                                              |              |            |              |              |
| U.S. Treasury securities and obligations of U.S. Government agencies | \$ 3,252     | \$ 23      | \$           | \$ 3,275     |
| States and political subdivisions                                    | 333,380      | 1,640      | (2,175)      | 332,845      |
| Corporate debt securities                                            | 518          | 7          |              | 525          |
| Collateralized mortgage obligations                                  | 59,724       | 1,327      | (48)         | 61,003       |
| Mortgage-backed securities                                           | 7,186,737    | 98,915     | (151,079)    | 7,134,573    |
| Qualified School Construction Bonds (QSCB)                           | 22,958       | 1,270      | (278)        | 23,950       |
| Total                                                                | \$ 7,606,569 | \$ 103,182 | \$ (153,580) | \$ 7,556,171 |

|                                     |                | December 31, 2012      |                         |            |
|-------------------------------------|----------------|------------------------|-------------------------|------------|
|                                     | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
| (Dollars in thousands)              |                |                        |                         |            |
| Available for Sale                  |                |                        |                         |            |
| States and political subdivisions   | \$ 34,743      | \$ 1,691               | \$                      | \$ 36,434  |
| Collateralized mortgage obligations | 616            |                        | (12)                    | 604        |
| Mortgage-backed securities          | 168,701        | 11,742                 | (27)                    | 180,416    |
| Other securities                    | 8,786          | 430                    |                         | 9,216      |
| Total                               | \$ 212,846     | \$ 13,863              | \$ (39)                 | \$ 226,670 |

|                                                                      |          |        |       |          |
|----------------------------------------------------------------------|----------|--------|-------|----------|
| <b>Held to Maturity</b>                                              |          |        |       |          |
| U.S. Treasury securities and obligations of U.S. Government agencies | \$ 7,061 | \$ 160 | \$    | \$ 7,221 |
| States and political subdivisions                                    | 391,510  | 7,074  | (354) | 398,230  |
| Corporate debt securities                                            | 1,500    | 28     |       | 1,528    |
| Collateralized mortgage obligations                                  | 125,912  | 2,304  | (50)  | 128,166  |

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|                                            |              |            |            |              |
|--------------------------------------------|--------------|------------|------------|--------------|
| Mortgage-backed securities                 | 6,676,512    | 196,206    | (4,517)    | 6,868,201    |
| Qualified School Construction Bonds (QSCB) | 12,900       | 2,449      |            | 15,349       |
| Total                                      | \$ 7,215,395 | \$ 208,221 | \$ (4,921) | \$ 7,418,695 |

Management evaluates securities for other-than-temporary impairment at least on a quarterly basis, and more frequently when economic or market conditions warrant such an evaluation. In determining OTTI, 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.

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

As of September 30, 2013, the Company does not intend to sell any debt securities and management believes that the Company more likely than not will not be required to sell any debt securities before their anticipated recovery, at which time the Company will receive full value for the securities. Furthermore, as of September 30, 2013, management does not have the intent to sell any of its securities and believes that it is more likely than not that the Company will not have to sell any such securities before a recovery of cost. The unrealized losses are largely due to increases in market interest rates over the yields available at the time the underlying securities were purchased. The fair value is expected to recover as the securities approach their maturity date or repricing date or if market yields for such investments decline. Management does not believe any of the securities are impaired due to reasons of credit quality. Accordingly, as of September 30, 2013, management believes any impairment in the Company's securities are temporary and no impairment loss has been realized in the Company's consolidated statements of income.

*Deposits*

Total deposits were \$12.46 billion at September 30, 2013 compared with \$11.64 billion at December 31, 2012, an increase of \$814.0 million or 7.0%. Deposit growth was impacted by the acquisitions of East Texas Financial Services and Coppermark. Deposits for these acquisitions totaled \$112.3 million and \$1.11 billion, respectively, at acquisition date. At September 30, 2013, noninterest-bearing deposits totaled \$3.37 billion and accounted for 27.0% of total deposits compared with \$3.02 billion or 25.9% of total deposits at December 31, 2012. Interest-bearing deposits totaled \$9.09 billion or 73.0% of total deposits at September 30, 2013 compared with \$8.63 billion or 74.1% of total deposits at December 31, 2012.

Average deposits for the nine months ended were \$12.29 billion as of September 30, 2013 an increase of \$3.05 billion compared to \$9.24 billion as of September 30, 2012. Average interest-bearing deposits for the first nine months of 2013 increased \$2.14 billion compared to the same period in 2012, while average non-interest-bearing deposits for the first nine months of 2013 increased \$914.5 million compared to the same period in 2012. The ratio of average interest-bearing deposits to total average deposits was 74.1% during the first nine months of 2013 compared to 75.5% during the first nine months of 2012.

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

|                                      | Nine Months Ended September 30,<br>2013 |                 | 2012               |                 |
|--------------------------------------|-----------------------------------------|-----------------|--------------------|-----------------|
|                                      | Average<br>Balance                      | Average<br>Rate | Average<br>Balance | Average<br>Rate |
| (Dollars in thousands)               |                                         |                 |                    |                 |
| Interest-bearing demand deposits     | \$ 2,545,983                            | 0.32%           | \$ 1,861,954       | 0.46%           |
| Regular savings                      | 1,359,020                               | 0.21%           | 785,883            | 0.23%           |
| Money market savings                 | 2,737,869                               | 0.33%           | 2,245,386          | 0.40%           |
| Certificates and other time deposits | 2,468,518                               | 0.61%           | 2,080,606          | 0.76%           |
| Total interest-bearing deposits      | 9,111,390                               | 0.38%           | 6,973,829          | 0.50%           |
| Noninterest-bearing deposits         | 3,182,349                               |                 | 2,267,876          |                 |
| Total deposits                       | \$ 12,293,739                           | 0.28%           | \$ 9,241,705       | 0.38%           |

**Table of Contents***Other Borrowings*

The following table presents the Company's borrowings as of the dates indicated:

|                                             | September 30,<br>2013  | December 31,<br>2012 |
|---------------------------------------------|------------------------|----------------------|
|                                             | (Dollars in thousands) |                      |
| FHLB advances                               | \$ 595,000             | \$ 245,000           |
| FHLB long-term notes payable                | 10,951                 | 11,753               |
| Total other borrowings                      | 605,951                | 256,753              |
| Securities sold under repurchase agreements | 431,969                | 454,502              |
| Total                                       | \$ 1,037,920           | \$ 711,255           |

*FHLB advances and long-term notes payable* The Company has an available line of credit with the FHLB of Dallas, which allows the Company to borrow on a collateralized basis. FHLB advances are considered short-term, overnight borrowings and used to manage liquidity as needed. Additionally, the Company utilizes long-term FHLB notes. Maturing advances are replaced by drawing on available cash, making additional borrowings or through increased customer deposits. At September 30, 2013, the Company had total funds of \$4.18 billion available under this agreement, of which \$606.0 million was outstanding. Short-term overnight FHLB advances of \$595.0 million were outstanding at September 30, 2013, at a weighted average rate of rate of 0.15%. Long-term notes payable were \$11.0 million at September 30, 2013, with a weighted average rate of 5.24%. The maturity dates on the FHLB notes payable range from the years 2014 to 2028 and have interest rates ranging from 4.08% to 6.10%.

*Securities sold under repurchase agreements* At September 30, 2013, the Company had \$432.0 million in securities sold under repurchase agreements compared with \$454.5 million at December 31, 2012, a decrease of \$22.5 million or 5.0%. Repurchase agreements with banking customers are generally settled on the following business day. Approximately \$62.6 million of the repurchase agreements outstanding at September 30, 2013 have maturity dates ranging from one to twenty-four months. All securities sold under agreements to repurchase are collateralized by certain pledged securities.

*Junior Subordinated Debentures*

At September 30, 2013 and December 31, 2012, the Company had outstanding \$85.1 million in junior subordinated debentures issued to the Company's unconsolidated subsidiary trusts.

A summary of pertinent information related to the Company's seven issues of junior subordinated debentures outstanding at September 30, 2013 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) |
|-------------|---------------|----------------------------------------|-------------------|-----------------------------------------|-------------------|
|-------------|---------------|----------------------------------------|-------------------|-----------------------------------------|-------------------|

**(Dollars in thousands)**

|                                |                    |           |                                             |           |                    |
|--------------------------------|--------------------|-----------|---------------------------------------------|-----------|--------------------|
| Prosperity Statutory Trust II  | July 31, 2001      | \$ 15,000 | 3 month LIBOR + 3.58%, not to exceed 12.50% | \$ 15,464 | July 31, 2031      |
| Prosperity Statutory Trust III | August 15, 2003    | 12,500    | 3 month LIBOR + 3.00%                       | 12,887    | September 17, 2033 |
| Prosperity Statutory Trust IV  | December 30, 2003  | 12,500    | 3 month LIBOR + 2.85%                       | 12,887    | December 30, 2033  |
| SNB Capital Trust IV           | September 25, 2003 | 10,000    | 3 month LIBOR + 3.00%                       | 10,310    | September 25, 2033 |
| TXUI Statutory Trust II        | December 19, 2003  | 5,000     | 3 month LIBOR + 2.85%                       | 5,155     | December 19, 2033  |
| TXUI Statutory Trust III       | November 30, 2005  | 15,500    | 3 month LIBOR + 1.39%                       | 15,980    | December 15, 2035  |
| TXUI Statutory Trust IV        | March 31, 2006     | 12,000    | 3 month LIBOR + 1.39%                       | 12,372    | June 30, 2036      |
|                                |                    |           |                                             | \$ 85,055 |                    |

- (1) The 3-month LIBOR in effect as of September 30, 2013 was 0.253%.
- (2) All debentures are callable five years from issuance date.

**Table of Contents***Liquidity*

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

As of September 30, 2013, the Company had outstanding \$1.14 billion in commitments to extend credit and \$42.9 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, 2013, the Company had cash and cash equivalents of \$271.1 million compared with \$326.3 million at December 31, 2012, a decrease of \$55.2 million. The decrease was primarily due to purchases of securities of \$4.20 billion, a decrease in deposits of \$416.1 million, repayments of other long-term borrowings of \$41.1 million, a decrease in securities sold under repurchase agreements of \$22.5 million, an increase in loans of \$47.5 million and dividends paid of \$38.2 million, partially offset by proceeds from the maturities and repayments of securities of \$3.83 billion, net proceeds from short-term debt of \$349.6 million, net earnings of \$158.4 million and cash received from acquisitions of \$292.3 million.

*Contractual Obligations*

The following table summarizes the Company's contractual obligations and other commitments to make future payments as of September 30, 2013 (other than deposit obligations). The payments do not include pre-payment options that may be available to the Company. The Company's future cash payments associated with its contractual obligations pursuant to its junior subordinated debentures, FHLB borrowings and operating leases as of September 30, 2013 are summarized below. Payments for junior subordinated debentures include interest of \$46.2 million that will be paid over the future periods. The future interest payments were calculated using the current rate in effect at September 30, 2013. The current principal balance of the junior subordinated debentures at September 30, 2013 was \$85.1 million. Payments for FHLB borrowings include interest of \$2.5 million that will be paid over the future periods. Payments related to leases are based on actual payments specified in underlying contracts.

|                                | 1 year or less | More than 1 year but less than 3 years | 3 years or more but less than 5 years | 5 years or more | Total      |
|--------------------------------|----------------|----------------------------------------|---------------------------------------|-----------------|------------|
| (Dollars in thousands)         |                |                                        |                                       |                 |            |
| Junior subordinated debentures | \$ 578         | \$ 4,624                               | \$ 4,623                              | \$ 121,438      | \$ 131,263 |

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|                                                           |            |           |           |            |            |
|-----------------------------------------------------------|------------|-----------|-----------|------------|------------|
| Federal Home Loan Bank notes payable and other borrowings | 595,407    | 3,836     | 2,312     | 6,899      | 608,454    |
| Operating leases                                          | 1,247      | 7,785     | 3,264     | 380        | 12,676     |
| Total                                                     | \$ 597,232 | \$ 16,245 | \$ 10,199 | \$ 128,717 | \$ 752,393 |

*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.

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The Company's commitments associated with outstanding standby letters of credit and commitments to extend credit as of September 30, 2013 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:

|                              | 1 year or less    | More than 1 year but less than 3 years | 3 years or more but less than 5 years | 5 years or more   | Total               |
|------------------------------|-------------------|----------------------------------------|---------------------------------------|-------------------|---------------------|
| (Dollars in thousands)       |                   |                                        |                                       |                   |                     |
| Standby letters of credit    | \$ 37,537         | \$ 5,291                               | \$ 30                                 | \$                | \$ 42,858           |
| Commitments to extend credit | 159,906           | 609,923                                | 49,941                                | 323,938           | 1,143,708           |
| <b>Total</b>                 | <b>\$ 197,443</b> | <b>\$ 615,214</b>                      | <b>\$ 49,971</b>                      | <b>\$ 323,938</b> | <b>\$ 1,186,566</b> |

*Capital Resources*

Total shareholders' equity was \$2.39 billion at September 30, 2013 compared with \$2.09 billion at December 31, 2012, an increase of \$299.7 million or 14.3%. The increase was due primarily to net earnings of \$158.4 million, the issuance of common stock in connection with the exercise of stock options and restricted stock awards of \$2.9 million and the issuance of common stock in connection with the acquisitions of East Texas Financial Services and Coppermark of \$176.7 million, which was partially offset by dividends paid of \$38.2 million for the nine months ended September 30, 2013.

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, 2013:

**Consolidated Capital Ratios**

|                                          |        |
|------------------------------------------|--------|
| Total capital (to risk weighted assets)  | 15.55% |
| Tier 1 capital (to risk weighted assets) | 14.74% |
| Tier 1 capital (to average assets)       | 7.37%  |

As of September 30, 2013, 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) ratios as of September 30, 2013:

**Bank Capital Ratios**

|                                         |        |
|-----------------------------------------|--------|
| Total capital (to risk weighted assets) | 15.33% |
|-----------------------------------------|--------|

|                                          |        |
|------------------------------------------|--------|
| Tier 1 capital (to risk weighted assets) | 14.52% |
| Tier 1 capital (to average assets)       | 7.25%  |

### 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 for the year ended December 31, 2012, Item 7 Management's Discussion and Analysis of Financial Condition and Results of Operations-Interest Rate Sensitivity and Liquidity which was filed on February 28, 2013 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

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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, as amended (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, 2013 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, 2012.

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

a. Not applicable

b. Not applicable

c. Not applicable

### **ITEM 3. DEFAULTS UPON SENIOR SECURITIES**

Not applicable

### **ITEM 4. MINE SAFETY DISCLOSURES**

None.

### **ITEM 5. OTHER INFORMATION**

Not applicable

## ITEM 6. EXHIBITS

### Exhibit

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

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**Exhibit**

| <b>Number</b> | <b>Description of Exhibit</b>                                                                                                                      |
|---------------|----------------------------------------------------------------------------------------------------------------------------------------------------|
| 31.1*         | Certification of the Chief Executive Officer pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended                         |
| 31.2*         | Certification of the Chief Financial Officer pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended                         |
| 32.1**        | Certification of the Chief Executive Officer pursuant to 18 U.S.C. Section 1350, adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |
| 32.2**        | Certification of the Chief Financial Officer pursuant to 18 U.S.C. Section 1350, adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |
| 101*          | Interactive Financial Data                                                                                                                         |

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

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

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**SIGNATURES**

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

PROSPERITY BANCSHARES, INC. ®  
(Registrant)

Date: 11/08/13

/s/ DAVID ZALMAN  
**David Zalman**  
**Chairman and Chief Executive Officer**

Date: 11/08/13

/s/ DAVID HOLLAWAY  
**David Hollaway**  
**Chief Financial Officer**