

PROSPERITY BANCSHARES INC

Form 10-Q

November 07, 2014

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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

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FORM 10-Q

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(Mark One)

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

**FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2014**

**OR**

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

**FOR THE TRANSITION PERIOD FROM                      TO**

**COMMISSION FILE NUMBER: 001-35388**

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**PROSPERITY BANCSHARES, INC.®**

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

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**TEXAS**

**74-2331986**

**(State or other jurisdiction of incorporation or organization) (I.R.S. Employer Identification No.)**

**Prosperity Bank Plaza**

**4295 San Felipe**

**Houston, Texas 77027**

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

**(713) 693-9300**

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

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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 4, 2014, there were 69,769,522 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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## PART I—FINANCIAL INFORMATION

## ITEM 1. INTERIM CONSOLIDATED FINANCIAL STATEMENTS

**PROSPERITY BANCSHARES, INC.® AND SUBSIDIARIES****CONSOLIDATED BALANCE SHEETS****(UNAUDITED)**

	<b>September 30, 2014</b>	<b>December 31, 2013</b>
	<b>(Dollars in thousands, except par value)</b>	
<b>ASSETS</b>		
Cash and due from banks	\$330,952	\$380,990
Federal funds sold	484	400
Total cash and cash equivalents	331,436	381,390
Available for sale securities, at fair value	155,216	157,478
Held to maturity securities, at cost (fair value of \$8,671,934 and \$7,987,342, respectively)	8,690,693	8,066,970
Total securities	8,845,909	8,224,448
Loans held for sale	8,524	2,210
Loans held for investment	9,360,364	7,773,011
Total loans	9,368,888	7,775,221
Less: allowance for credit losses	(77,613 )	(67,282 )
Loans, net	9,291,275	7,707,939
Accrued interest receivable	50,019	49,246
Goodwill	1,892,255	1,671,520
Core deposit intangibles, net	34,474	42,049
Bank premises and equipment, net	283,011	282,925
Other real estate owned	5,504	7,299
Bank owned life insurance (BOLI)	228,704	160,056
Federal Home Loan Bank of Dallas stock	44,747	24,499
Other assets	109,980	90,657
<b>TOTAL ASSETS</b>	<b>\$21,117,314</b>	<b>\$18,642,028</b>

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

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Deposits:		
Noninterest-bearing	\$4,968,867	\$4,108,835
Interest-bearing	12,045,160	11,182,436
Total deposits	17,014,027	15,291,271
Other borrowings	289,972	10,689
Securities sold under repurchase agreements	358,053	364,357
Junior subordinated debentures	167,531	124,231
Accrued interest payable	2,569	2,500
Other liabilities	102,212	62,162
Total liabilities	17,934,364	15,855,210
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; 69,793,335 and 66,085,179 shares issued at September 30, 2014 and December 31, 2013, respectively; 69,756,247 and 66,048,091 shares outstanding at September 30, 2014 and December 31, 2013, respectively	69,793	66,085
Capital surplus	2,022,586	1,798,862
Retained earnings	1,087,437	917,595
Accumulated other comprehensive income—net unrealized gain on available for sale securities, net of tax of \$2,015 and \$2,630, respectively	3,741	4,883
Less treasury stock, at cost, 37,088 shares	(607 )	(607 )
Total shareholders' equity	3,182,950	2,786,818
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	\$21,117,314	\$18,642,028

See notes to interim consolidated financial statements.

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

	Three Months Ended September 30, 2014      2013		Nine Months Ended September 30, 2014      2013	
	(Dollars in thousands, except per share data)			
INTEREST INCOME:				
Loans, including fees	\$ 140,521	\$ 94,236	\$ 386,320	\$ 265,542
Securities	46,910	41,961	141,636	117,893
Federal funds sold	35	16	261	111
Total interest income	187,466	136,213	528,217	383,546
INTEREST EXPENSE:				
Deposits	10,240	8,314	30,545	26,174
Securities sold under repurchase agreements	245	439	736	1,273
Junior subordinated debentures	1,099	317	2,961	921
Other borrowings	225	610	572	1,821
Total interest expense	11,809	9,680	34,814	30,189
NET INTEREST INCOME	175,657	126,533	493,403	353,357
PROVISION FOR CREDIT LOSSES	5,000	4,025	11,925	9,375
NET INTEREST INCOME AFTER PROVISION FOR CREDIT LOSSES	170,657	122,508	481,478	343,982
NONINTEREST INCOME:				
Nonsufficient funds (NSF) fees	9,734	8,649	27,703	25,504
Credit card, debit card and ATM card income	5,921	4,307	17,103	17,801
Service charges on deposit accounts	4,255	3,169	12,189	9,404
Trust income	2,099	901	5,943	2,814
Mortgage income	1,414	931	3,215	3,489
Brokerage income	1,743	233	4,413	798
Net gain (loss) on sale of assets	23	126	4,634	(53 )
Other	4,972	3,238	17,566	10,512
Total noninterest income	30,161	21,554	92,766	70,269
NONINTEREST EXPENSE:				
Salaries and employee benefits	52,179	37,135	149,713	107,861
Net occupancy and equipment	6,801	5,094	18,136	14,041
Debit card, data processing and software amortization	4,044	2,756	11,237	8,575
Regulatory assessments and FDIC insurance	4,051	2,516	10,663	7,490
Core deposit intangibles amortization	2,598	1,455	7,273	4,551

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Depreciation	3,516	2,679	10,239	7,521
Communications	2,960	2,397	8,616	7,003
Other real estate expense	72	75	656	535
Other	9,289	7,430	28,707	21,027
Total noninterest expense	85,510	61,537	245,240	178,604
INCOME BEFORE INCOME TAXES	115,308	82,525	329,004	235,647
PROVISION FOR INCOME TAXES	38,738	27,247	109,791	77,220
NET INCOME	\$76,570	\$55,278	\$219,213	\$158,427
EARNINGS PER SHARE:				
Basic	\$1.10	\$0.92	\$3.20	\$2.68
Diluted	\$1.10	\$0.91	\$3.19	\$2.67

See notes to interim consolidated financial statements.



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

**CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**

**(UNAUDITED)**

	Three Months Ended September 30, 2014		Nine Months Ended September 30, 2014	
	2013		2013	
	(Dollars in thousands)			
Net income	\$76,570	\$55,278	\$219,213	\$158,427
Other comprehensive loss, before tax:				
Securities available for sale:				
Change in unrealized gain during period	(951 )	(1,136 )	(1,757 )	(5,237 )
Total other comprehensive loss	(951 )	(1,136 )	(1,757 )	(5,237 )
Deferred tax benefit related to other comprehensive loss	333	398	615	1,833
Other comprehensive loss, net of tax	(618 )	(738 )	(1,142 )	(3,404 )
Comprehensive income	\$75,952	\$54,540	\$218,071	\$155,023

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 Shares</b>	<b>Amount</b>	<b>Capital Surplus</b>	<b>Retained Earnings</b>	<b>Accumulated Other Comprehensive Income</b>	<b>Treasury Stock</b>	<b>Total Shareholders' Equity</b>
<b>(In thousands, except share and per share data)</b>							
BALANCE AT 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 connection with the exercise of stock options and restricted stock awards	146,088	146	2,893				3,039
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, \$0.65 per share				(38,209 )			(38,209 )
BALANCE AT SEPTEMBER 30, 2013	60,419,980	\$60,420	\$1,453,263	\$870,454	\$ 5,582	\$ (607 )	\$ 2,389,112
BALANCE AT DECEMBER 31, 2013	66,085,179	\$66,085	\$1,798,862	\$917,595	\$ 4,883	\$ (607 )	\$ 2,786,818
Net income				219,213			219,213
Other comprehensive loss					(1,142 )		(1,142 )
Common stock issued in connection with the exercise of stock options and restricted stock awards	410,134	410	2,925				3,335
	3,298,022	3,298	214,866				218,164

Common stock issued in  
connection with the  
acquisition of F&M  
Bancorporation Inc.

Stock based compensation expense			5,933				5,933
Cash dividends declared, \$0.72 per share				(49,371 )			(49,371 )
BALANCE AT SEPTEMBER 30, 2014	69,793,335	\$69,793	\$2,022,586	\$1,087,437	\$ 3,741	\$ (607 )	\$3,182,950

See notes to interim consolidated financial statements.

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	<b>Nine Months Ended September 30, 2014                  2013 (Dollars in thousands)</b>	
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>		
Net income	\$219,213	\$158,427
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and core deposit intangibles amortization	17,512	12,072
Provision for credit losses	11,925	9,375
Net amortization of premium on investments	38,647	56,825
(Gain) loss on sale of other real estate	(1,315 )	785
(Gain) loss on sale of assets	(4,634 )	53
Net accretion of discount on loans	(67,285 )	(42,744 )
Gain on sale of loans	(3,096 )	(3,218 )
Proceeds from sale of loans held for sale	140,611	146,963
Originations of loans held for sale	(143,829 )	(140,715 )
Stock based compensation expense	5,933	3,139
(Increase) decrease in accrued interest receivable and other assets	(11,110 )	25,058
Increase in accrued interest payable and other liabilities	77,458	22,663
Net cash provided by operating activities	280,030	248,683
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Proceeds from maturities and principal paydowns of held to maturity securities	3,521,830	1,814,877
Purchase of held to maturity securities	(4,152,203 )	(2,245,685 )
Proceeds from maturities and principal paydowns of available for sale securities	3,140,424	2,012,178
Purchase of available for sale securities	(3,099,998 )	(1,954,999 )
Net decrease (increase) in loans held for investment	75,213	(47,466 )
Purchase of bank premises and equipment	(8,864 )	(20,937 )
Proceeds from sale of bank premises, equipment and other real estate	22,239	11,232
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 Bancshares, Inc.	-	288,795
Net cash and cash equivalents acquired in the purchase of F&M Bancorporation Inc.	487,599	-
Net cash used in investing activities	(13,760 )	(138,534 )
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>		
Net increase in noninterest-bearing deposits	208,924	43,221
Net decrease in interest-bearing deposits	(752,091 )	(459,351 )
Net proceeds from other short-term borrowings	280,000	349,583

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Repayments of other long-term borrowings	(717 )	(41,095 )
Net increase in securities sold under repurchase agreements	(6,304 )	(22,533 )
Proceeds from stock option exercises	3,335	3,039
Payments of cash dividends	(49,371 )	(38,209 )
Net cash used in financing activities	(316,224 )	(165,345 )
 NET DECREASE IN CASH AND CASH EQUIVALENTS	 (49,954 )	 (55,196 )
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	381,390	326,304
CASH AND CASH EQUIVALENTS, END OF PERIOD	\$331,436	\$271,108
 NONCASH ACTIVITIES:		
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
Stock issued in connection with the F&M Bancorporation Inc. acquisition	218,164	-
Acquisition of real estate through foreclosure of collateral	5,900	3,044
 SUPPLEMENTAL INFORMATION:		
Income taxes paid	\$77,995	\$69,659
Interest paid	34,719	29,673

See notes to interim consolidated financial statements.

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

**NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS**

**SEPTEMBER 30, 2014**

**(UNAUDITED)**

**1. BASIS OF PRESENTATION**

The interim consolidated financial statements include the accounts of Prosperity Bancshares, Inc.® (the “Company”) and its wholly-owned subsidiary, Prosperity Bank® (the “Bank”). 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, 2013. Operating results for the nine-month period ended September 30, 2014 are not necessarily indicative of the results that may be expected for the year ending December 31, 2014 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:

<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
<b>2014</b>	<b>2013</b>	<b>2014</b>	<b>2013</b>

	Per Share		Per Share		Per Share		Per Share	
	Amount	Amount	Amount	Amount	Amount	Amount	Amount	Amount
(Amounts in thousands, except per share data)								
Net income	\$76,570		\$55,278		\$219,213		\$158,427	
Basic:								
Weighted average shares outstanding	69,751	\$ 1.10	60,344	\$ 0.92	68,548	\$ 3.20	59,207	\$ 2.68
Diluted:								
Add incremental shares for:								
Effect of dilutive securities - options	40		160		66		155	
Total	69,791	\$ 1.10	60,504	\$ 0.91	68,614	\$ 3.19	59,362	\$ 2.67

There were no stock options exercisable during the three and nine months ended September 30, 2014 or 2013 that would have had an anti-dilutive effect on the above computation.

### 3. NEW ACCOUNTING STANDARDS

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

ASU 2014-12 "Compensation-Stock Compensation (Topic 718) - Accounting for Share-Based Payments When the Terms of an Award Provide That a Performance Target Could Be Achieved after the Requisite Service Period." ASU 2014-12 requires that a performance target that affects vesting and that could be achieved after the requisite service period be treated as a performance condition. The performance target should not be reflected in estimating the grant-date fair value of the award. Compensation cost should be recognized in the period in which it becomes probable that the performance target will be achieved and should represent the compensation cost attributable to the period(s) for which the requisite service has already been rendered. If the performance target becomes probable of being achieved before the end of the requisite service period, the remaining unrecognized compensation cost should be recognized prospectively over the remaining requisite service period. The total amount of compensation cost recognized during and after the requisite service period should reflect the number of awards that are expected to vest and should be adjusted to reflect those awards that ultimately vest. The requisite service period ends when the employee can cease rendering service and still be eligible to vest in the award if the performance target is achieved. ASU 2014-12 is effective for the Company beginning January 1, 2016 and is not expected to have a significant impact on the Company's consolidated financial statements.

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

**NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS**

**SEPTEMBER 30, 2014**

**(UNAUDITED)**

*ASU 2014-11 “Transfers and Servicing (Topic 860) - Repurchase-to-Maturity Transactions, Repurchase Financings, and Disclosure.”* ASU 2014-11 changes the accounting for repurchase-to-maturity transactions to secured borrowing accounting. It also requires separate accounting for a transfer of a financial asset executed contemporaneously with a repurchase agreement with the same counterparty, which will result in secured borrowing accounting and disclosure for the repurchase agreement. ASU 2014-11 is effective for the Company beginning January 1, 2016 and is not expected to have a significant impact on the Company’s consolidated financial statements.

*ASU 2014-09 “Revenue from Contract with Customers (Topic 606).”* ASU 2014-09 supersedes the revenue recognition requirements in Revenue Recognition (Topic 605), and most industry-specific guidance throughout the Industry Topics of the Codification. Additionally, ASU 2014-09 supersedes some cost guidance included in Revenue Recognition—Construction-Type and Production-Type Contracts (Subtopic 605-35). In addition, the existing requirements for the recognition of a gain or loss on the transfer of nonfinancial assets that are not in a contract with a customer are amended to be consistent with the guidance on recognition and measurement. The core principle of ASU 2014-09 is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. ASU 2014-09 is effective for the Company beginning January 1, 2017, with retrospective application to each prior reporting period presented, and is not expected to have a significant impact on the Company’s consolidated financial statements.

*ASU 2014-04 “Receivables—Troubled Debt Restructurings by Creditors (Subtopic 310-40) — Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure.”* ASU 2014-04 intends to reduce diversity by clarifying when an in substance repossession or foreclosure occurs, that is, when a creditor should be considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan such that the loan receivable should be derecognized and the real estate property recognized. ASU 2014-04 will become effective for the Company on January 1, 2015 and is not expected to have a significant impact on the Company’s consolidated financial statements.





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

	<b>September 30, 2014</b>			
	<b>Amortized Cost</b>	<b>Gross Unrealized Gains</b>	<b>Gross Unrealized Losses</b>	<b>Fair Value</b>
	<b>(Dollars in thousands)</b>			
<b>Available for Sale</b>				
States and political subdivisions	\$ 15,410	\$ 294	\$ -	\$ 15,704
Collateralized mortgage obligations	35,688	100	(39)	35,749
Mortgage-backed securities	85,774	5,538	(16)	91,296
Other securities	12,588	-	(121)	12,467
Total	\$ 149,460	\$ 5,932	\$ (176)	\$ 155,216
<b>Held to Maturity</b>				
U.S. Treasury securities and obligations of U.S. Government sponsored entities	\$ 58,559	\$ 218	\$ (136)	\$ 58,641
States and political subdivisions	406,437	5,547	(1,657)	410,327
Collateralized mortgage obligations	27,306	357	(32)	27,631
Mortgage-backed securities	8,198,391	82,239	(105,295)	8,175,335
Total	\$ 8,690,693	\$ 88,361	\$ (107,120)	\$ 8,671,934
	<b>December 31, 2013</b>			
	<b>Amortized Cost</b>	<b>Gross Unrealized Gains</b>	<b>Gross Unrealized Losses</b>	<b>Fair Value</b>
	<b>(Dollars in thousands)</b>			
<b>Available for Sale</b>				
States and political subdivisions	\$ 28,578	\$ 797	\$ -	\$ 29,375
Collateralized mortgage obligations	483	7	(1)	489

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Mortgage-backed securities	108,316	6,843	(22	)	115,137
Other securities	12,589	14	(126	)	12,477
Total	\$ 149,966	\$ 7,661	\$ (149	)	\$ 157,478

**Held to Maturity**

U.S. Treasury securities and obligations of U.S. Government sponsored entities	\$ 62,931	\$ 46	\$ (935	)	\$ 62,042
States and political subdivisions	439,235	4,317	(2,207	)	441,345
Corporate debt securities	513	5	-		518
Collateralized mortgage obligations	50,034	1,017	(58	)	50,993
Mortgage-backed securities	7,514,257	84,166	(165,979	)	7,432,444
Total	\$ 8,066,970	\$ 89,551	\$ (169,179	)	\$ 7,987,342

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

**NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS**

**SEPTEMBER 30, 2014**

**(UNAUDITED)**

Management evaluates debt securities for other-than-temporary impairment (“OTTI”) on a quarterly basis, and more frequently when economic or market conditions warrant such an evaluation. The investment securities portfolio is evaluated for OTTI by segregating the portfolio into two general segments and applying the appropriate OTTI model. Investment securities classified as available for sale or held to maturity are evaluated for OTTI under Financial Accounting Standards Board (“FASB”): Accounting Standards Codification (“ASC”) Topic 320, *“Investments-Debt and Equity Securities.”*

In determining OTTI, for a majority of the Company's debt securities, 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, 2014, 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 in the Company's securities as of September 30, 2014 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, 2014, management believes any impairment in the Company's securities is temporary, and therefore 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 were as follows:

	September 30, 2014					
	Less than 12 Months		More than 12 Months		Total	
	Estimated	Unrealized	Estimated	Unrealized	Estimated	Unrealized
	Fair Value	Losses	Fair Value	Losses	Fair Value	Losses
	(Dollars in thousands)					
Available for Sale						
Collateralized mortgage obligations	\$6,998	\$ (38 )	\$47	\$ (1 )	\$7,045	\$ (39 )
Mortgage-backed securities	709	(1 )	2,920	(15 )	3,629	(16 )
Other securities	12,467	(121 )	-	-	12,467	(121 )
Total	\$20,174	\$ (160 )	\$2,967	\$ (16 )	\$23,141	\$ (176 )

**Held to Maturity**

U.S. Treasury securities and obligations of U.S. Government sponsored entities	\$27,559	\$ (136 )	\$-	\$-	\$27,559	\$ (136 )
States and political subdivisions	64,902	(599 )	46,133	(1,058 )	111,035	(1,657 )
Collateralized mortgage obligations	675	(9 )	1,534	(23 )	2,209	(32 )
Mortgage-backed securities	1,407,286	(4,160 )	3,023,150	(101,135 )	4,430,436	(105,295 )
Total	\$1,500,422	\$ (4,904 )	\$3,070,817	\$ (102,216 )	\$4,571,239	\$ (107,120 )

**December 31, 2013**

	Less than 12 Months		More than 12 Months		Total	
	Estimated	Unrealized	Estimated	Unrealized	Estimated	Unrealized
	Fair Value	Losses	Fair Value	Losses	Fair Value	Losses
	(Dollars in thousands)					
Available for Sale						
Collateralized mortgage obligations	\$5	\$-	\$50	\$ (1	) \$55	\$(1
Mortgage-backed securities	651	(1	) 3,313	(21	) 3,964	(22
Other securities	6,911	(126	) -	-	6,911	(126
Total	\$7,567	\$(127	) \$3,363	\$ (22	) \$10,930	\$(149

**Held to Maturity**

U.S. Treasury securities and obligations of U.S. Government sponsored entities	\$48,389	\$ (935 )	\$ -	\$ -	\$48,389	\$ (935 )
States and political subdivisions	113,063	(1,581 )	28,639	(626 )	141,702	(2,207 )
Collateralized mortgage obligations	2,109	(32 )	433	(26 )	2,542	(58 )
Mortgage-backed securities	3,702,569	(106,816 )	998,380	(59,163 )	4,700,949	(165,979 )
Total	\$3,866,130	\$ (109,364 )	\$1,027,452	\$ (59,815 )	\$4,893,582	\$ (169,179 )

At September 30, 2014 and December 31, 2013, there were 503 securities and 450 securities, respectively, 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, 2014, 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</b>	<b>Fair</b>	<b>Amortized</b>	<b>Fair</b>
	<b>Cost</b>	<b>Value</b>	<b>Cost</b>	<b>Value</b>
	<b>(Dollars in thousands)</b>			
Due in one year or less	\$33,042	\$33,097	\$12,689	\$12,571
Due after one year through five years	179,743	180,662	5,520	5,621
Due after five years through ten years	187,065	189,586	9,158	9,332
Due after ten years	65,146	65,623	631	647
Subtotal	464,996	468,968	27,998	28,171
Mortgage-backed securities and collateralized mortgage obligations	8,225,697	8,202,966	121,462	127,045
Total	\$8,690,693	\$8,671,934	\$149,460	\$155,216

The Company recorded no gain or loss on sale of securities for the three and nine months ended September 30, 2014 and 2013. As of September 30, 2014, the Company had 8 non-agency collateralized mortgage obligations remaining with a total book value of \$1.3 million and total market value of \$1.3 million.

At September 30, 2014 and December 31, 2013, 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 \$5.13 billion and \$4.46 billion and a fair value of \$5.11 billion and \$4.47 billion at September 30, 2014 and December 31, 2013, respectively, were pledged to collateralize public deposits and for other purposes required or permitted by law.





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The loan portfolio consists of various types of loans made primarily to borrowers located within the states of Texas and Oklahoma and is classified by major type as follows:

	<b>September 30, 2014</b>	<b>December 31, 2013</b>
	<b>(Dollars in thousands)</b>	
Residential mortgage loans held for sale	\$8,524	\$2,210
Commercial and industrial	2,061,589	1,279,777
Real estate:		
Construction, land development and other land loans	1,041,300	865,511
1-4 family residential (including home equity)	2,471,467	2,129,510
Commercial real estate (including multi-family residential)	3,091,090	2,753,797
Farmland	348,640	332,648
Agriculture	186,032	198,610
Consumer and other	160,246	213,158
Total loans held for investment	9,360,364	7,773,011
Total	\$9,368,888	\$7,775,221

**(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) Construction, Land Development and Other Land 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.

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**(iii) 1-4 Family Residential Loans.** The Company originates 1-4 family residential mortgage loans (including home equity loans and residential mortgage loans held for sale) collateralized by owner-occupied residential properties located in the Company's market areas. The Company offers a variety of mortgage loan portfolio 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 retains these portfolio loans for its own account rather than selling them into the secondary market. By doing so, the Company incurs interest rate risk as well as the risks associated with nonpayments on such loans. The Company's Mortgage Department offers a variety of mortgage loan products which are generally amortized over 30 years, including FHA and VA loans. The Company sells the loans originated by the Mortgage Department into the secondary market.

**(vi) 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, 2014, approximately 50.5% of the outstanding principal balance of the Company's commercial real estate related loans was secured by owner-occupied properties.

**(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 “A” 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 180 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 real estate, 1-4 family residential loans, and commercial and industrial loans. As of September 30, 2014 and December 31, 2013, 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, 2014 or December 31, 2013.

*Related Party Loans.* As of September 30, 2014 and December 31, 2013, loans outstanding to directors, officers and their affiliates totaled \$3.1 million and \$6.2 million, respectively. All transactions entered into between the Company and such related parties are done in the ordinary course of business, made on the same terms and conditions as similar transactions with unaffiliated persons.

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

	<b>September 30, 2014</b>	<b>December 31, 2013</b>
	<b>(Dollars in thousands)</b>	
Beginning balance on January 1	\$6,187	\$ 6,682
New loans and reclassified related loans	2,952	306
Repayments	(6,078)	(801 )
Ending balance	\$3,061	\$ 6,187

*Nonperforming Assets and 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 presented below:

	<b>September 30, 2014</b>					
	<b>Loans Past Due and Still</b>					
	<b>Accruing</b>					
	<b>30-89</b>	<b>90 or</b>	<b>Total</b>	<b>Nonaccrual</b>	<b>Current</b>	<b>Total</b>
	<b>Days</b>	<b>More</b>	<b>Past</b>	<b>Loans</b>	<b>Loans</b>	<b>Loans</b>
	<b>(Dollars in thousands)</b>					
Construction, land development and other land loans other land loans	\$ 14,387	\$ 3,531	\$ 17,918	\$ 745	\$ 1,022,637	\$ 1,041,300
Agriculture and agriculture real estate (includes farmland)	4,209	78	4,287	104	530,281	534,672
1-4 family (includes home equity) (1)	7,545	968	8,513	4,228	2,467,250	2,479,991
Commercial real estate (includes multi-family residential)	7,379	4,336	11,715	3,930	3,075,445	3,091,090
Commercial and industrial	52,215	8,839	61,054	17,327	1,983,208	2,061,589
Consumer and other	1,695	1	1,696	470	158,080	160,246
Total	\$ 87,430	\$ 17,753	\$ 105,183	\$ 26,804	\$ 9,236,901	\$ 9,368,888

	<b>December 31, 2013</b>					
	<b>Loans Past Due and Still</b>					
	<b>Accruing</b>					
	<b>30-89</b>	<b>90 or</b>	<b>Total</b>	<b>Nonaccrual</b>	<b>Current</b>	<b>Total</b>
	<b>Days</b>	<b>More</b>	<b>Past</b>	<b>Loans</b>	<b>Loans</b>	<b>Loans</b>
	<b>(Dollars in thousands)</b>					
Construction, land development and other land loans	\$ 6,258	\$ 2	\$ 6,260	\$ 386	\$ 858,865	\$ 865,511



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Agriculture and agriculture real estate (includes farmland)	5,634	218	5,852	62	525,344	531,258
1-4 family (includes home equity) (1)	8,684	2,012	10,696	3,086	2,117,938	2,131,720
Commercial real estate (includes multi-family residential)	8,163	1,752	9,915	4,333	2,739,549	2,753,797
Commercial and industrial	9,552	933	10,485	2,208	1,267,084	1,279,777
Consumer and other	1,344	30	1,374	156	211,628	213,158
Total	\$39,635	\$4,947	\$44,582	\$ 10,231	\$7,720,408	\$7,775,221

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(1) Includes \$8.5 million and \$2.2 million of residential mortgage loans held for sale at September 30, 2014 and December 31, 2013, respectively.

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

	<b>September 30, 2014</b>	<b>December 31, 2013</b>		
			<b>(Dollars in thousands)</b>	
Nonaccrual loans	\$26,804	\$ 10,231		
Accruing loans 90 or more days past due	17,753	4,947		
Total nonperforming loans	44,557	15,178		
Reposessed assets	21	27		
Other real estate	5,504	7,299		
Total nonperforming assets	\$50,082	\$ 22,504		
Nonperforming assets to total loans and other real estate	0.53	%	0.29	%

The Company's conservative lending approach has resulted in sound asset quality. The Company had \$50.1 million in nonperforming assets at September 30, 2014 compared with \$22.5 million at December 31, 2013 of which \$42.8 million and \$8.6 million were originated by acquired banks, respectively.

If interest on nonaccrual loans had been accrued under the original loan terms, approximately \$1.4 million and \$341 thousand would have been recorded as income for the nine months ended September 30, 2014 and 2013, 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, Coppermark Bancshares, Inc. on April 1, 2013, FVNB Corp. on November 1, 2013 and F&M Bancorporation Inc. on April 1, 2014, 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 loans.

The carrying amount of PCI loans included in the consolidated balance sheet and the related outstanding balance as of the dates indicated are presented in the table below.

	<b>September 30, 2014</b>	<b>December 31, 2013</b>
	<b>(Dollars in thousands)</b>	
PCI loans:		
Outstanding balance	\$ 162,001	\$ 87,089
Discount	(90,694 )	(45,497 )
Recorded investment	\$ 71,307	\$ 41,592

The outstanding balance represents the total amount owed as of September 30, 2014 and December 31, 2013, including accrued but unpaid interest and any amounts previously charged off. Based on the Company's periodic monitoring and assessment of the portfolio, \$440 thousand of allowance for loan losses was required on the PCI loans at September 30, 2014 and no allowance for loan losses was required on PCI loans at December 31, 2013.

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Changes in the accretable yield for PCI loans as of the dates indicated below were as follows:

	<b>Three Months Ended September 30, 2014      2013</b>		<b>Nine Months Ended September 30, 2014      2013</b>	
	<b>(Dollars in thousands)</b>			
Balance at beginning of period	\$14,689	\$13,011	\$9,855	\$7,459
Additions	-	349	7,158	7,877
Reclassifications from nonaccretable	7,168	3,088	13,203	4,343
Accretion	(9,336 )	(5,840 )	(17,695)	(9,071 )
Balance at September 30	\$12,521	\$10,608	\$12,521	\$10,608

*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 determined, 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 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 presented in the tables below is reported on a year-to-date basis.

	September 30, 2014			
	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment
	(Dollars in thousands)			
<b>With no related allowance recorded:</b>				
Construction, land development and other land loans	\$469	\$ 494	\$ -	\$ 373
Agriculture and agriculture real estate (includes farmland)	-	-	-	7
1-4 family (includes home equity)	1,194	1,289	-	889
Commercial real estate (includes multi-family residential)	1,429	1,460	-	1,960
Commercial and industrial	4,296	4,472	-	2,200
Consumer and other	8,822	8,822	-	4,419
<b>Total</b>	16,210	16,537	-	9,848
<b>With an allowance recorded:</b>				
Construction, land development and other land loans	-	-	-	-
Agriculture and agriculture real estate (includes farmland)	50	58	28	36
1-4 family (includes home equity)	495	533	168	1,507
Commercial real estate (includes multi-family residential)	305	307	267	959
Commercial and industrial	9,006	9,115	3,850	5,059
Consumer and other	195	209	166	145
<b>Total</b>	10,051	10,222	4,479	7,705
<b>Total:</b>				
Construction, land development and other land loans	469	494	-	373
Agriculture and agriculture real estate (includes farmland)	50	58	28	43
1-4 family (includes home equity)	1,689	1,822	168	2,396
Commercial real estate (includes multi-family residential)	1,734	1,767	267	2,919
Commercial and industrial	13,302	13,587	3,850	7,258
Consumer and other	9,017	9,031	166	4,564
	\$26,261	\$ 26,759	\$ 4,479	\$ 17,553



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	<b>December 31, 2013</b>			
	<b>Recorded Investment</b>	<b>Unpaid Principal Balance</b>	<b>Related Allowance</b>	<b>Average Recorded Investment</b>
	<b>(Dollars in thousands)</b>			
<b>With no related allowance recorded:</b>				
Construction, land development and other land loans	\$ 277	\$ 289	\$ -	\$ 711
Agriculture and agriculture real estate (includes farmland)	14	57	-	46
1-4 family (includes home equity)	584	664	-	538
Commercial real estate (includes multi-family residential)	2,490	3,798	-	1,470
Commercial and industrial	103	122	-	95
Consumer and other	15	16	-	13
<b>Total</b>	<b>3,483</b>	<b>4,946</b>	<b>-</b>	<b>2,873</b>
<b>With an allowance recorded:</b>				
Construction, land development and other land loans	-	-	-	-
Agriculture and agriculture real estate (includes farmland)	21	27	18	28
1-4 family (includes home equity)	2,519	2,548	890	1,759
Commercial real estate (includes multi-family residential)	1,613	1,615	445	2,032
Commercial and industrial	1,111	1,192	1,029	1,077
Consumer and other	95	113	77	81
<b>Total</b>	<b>5,359</b>	<b>5,495</b>	<b>2,459</b>	<b>4,977</b>
<b>Total:</b>				
Construction, land development and other land loans	277	289	-	711
Agriculture and agriculture real estate (includes farmland)	35	84	18	74
1-4 family (includes home equity)	3,103	3,212	890	2,297
Commercial real estate (includes multi-family residential)	4,103	5,413	445	3,502
Commercial and industrial	1,214	1,314	1,029	1,172
Consumer and other	110	129	77	94
	<b>\$ 8,842</b>	<b>\$ 10,441</b>	<b>\$ 2,459</b>	<b>\$ 7,850</b>

*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:

**Grade 1** – Credits in this category have risk potential that is virtually nonexistent. These loans may be secured by insured certificates of deposit, insured savings accounts, U.S. Government securities and highly rated municipal bonds.

**Grade 2** – Credits in this category are of the highest quality. These borrowers represent top rated companies and individuals with unquestionable financial standing with excellent global cash flow coverage, net worth, liquidity and collateral coverage.



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**Grade 3** – Credits in this category are not immune from risk but are well protected by the collateral and paying capacity of the borrower. These loans may exhibit a minor unfavorable credit factor, but the overall credit is sufficiently strong to minimize the possibility of loss.

**Grade 4** – Credits in this category are considered “pass/watch”. Loans in this category have sources of repayment that remain sufficient to preclude a larger than normal probability of default and secondary sources are likewise currently of sufficient quantity, quality, and liquidity to protect the Bank against loss of principal and interest. These borrowers have specific risk factors, but the overall strength of the credit is acceptable based on other mitigating credit and/or collateral factors and can repay the debt in the normal course of business.

**Grade 5** – 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 Bank to risk at a future date. These loans are monitored on the Bank’s internally generated watch list and evaluated on a quarterly basis.

**Grade 6** – Credits in this category are considered “substandard” but “non-impaired” loans in accordance with regulatory guidelines. Loans in this category have well-defined weaknesses that, if not corrected, could make default of principal and interest possible. Loans in this category are still accruing interest and may be dependent upon secondary sources of repayment and/or collateral liquidation.

**Grade 7** – Credits in this category are deemed “substandard” and “impaired” pursuant to regulatory guidelines. As such, the Bank has determined that it is probable that less than 100% of the contractual principal and interest will be collected. These loans are individually evaluated for a specific reserve valuation and will typically have the accrual of interest stopped.

**Grade 8** – Credits in this category include “doubtful” loans in accordance with regulatory guidance. Such loans are no longer accruing interest and factors indicate a loss is imminent. These loans are also deemed “impaired.” While a

specific reserve may be in place while the loan and collateral is being evaluated, these loans are typically charged down to an amount the Bank estimates is collectible.

**Grade 9** – Credits in this category are deemed a “loss” in accordance with regulatory guidelines and have been charged off or charged down. The Bank 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, 2014. Impaired loans include loans in risk grades 7, 8 and 9.

	Construction, Land Development and other land loans (Dollars in thousands)	Agriculture and Agriculture Real Estate (includes Farmland)	1-4 Family (includes Home Equity) (1)	Commercial Real Estate (includes Multi- Family Residential)	Commercial and Industrial	Consumer and Other	Total
Grade 1	\$-	\$ 12,368	\$-	\$ -	\$ 62,157	\$ 37,822	\$ 112,347
Grade 2	-	-	-	-	-	-	-
Grade 3	1,034,912	516,646	2,460,343	3,021,250	1,946,154	113,221	9,092,526
Grade 4	-	-	-	-	-	-	-
Grade 5	765	4,103	1,963	13,287	3,481	14	23,613
Grade 6	2,230	937	8,443	25,308	5,744	172	42,834
Grade 7	469	50	1,680	1,734	13,287	9,017	26,237
Grade 8	-	-	9	-	15	-	24
Grade 9	-	-	-	-	-	-	-
PCI Loans (2)	2,924	568	7,553	29,511	30,751	-	71,307
Total	\$1,041,300	\$ 534,672	\$2,479,991	\$ 3,091,090	\$ 2,061,589	\$ 160,246	\$9,368,888

(1) Includes \$8.5 million of residential mortgage loans held for sale at September 30, 2014.

(2) Of the total PCI loans, \$34.1 million were classified as substandard at September 30, 2014. None were classified as doubtful or loss.

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The following table presents risk grades and classified loans by class of loan at December 31, 2013. Impaired loans include loans in risk grades 7, 8 and 9.

	<b>Construction and Land Development and other land loans (Dollars in thousands)</b>	<b>Agriculture and Agriculture Real Estate (includes Farmland)</b>	<b>1-4 Family (includes Home Equity) (1)</b>	<b>Commercial Real Estate (includes Multi- Family Residential)</b>	<b>Commercial and Industrial</b>	<b>Consumer and Other</b>	<b>Total</b>
Grade 1	\$-	\$ 5,225	\$-	\$ -	\$ 50,131	\$ 31,362	\$86,718
Grade 2	-	-	-	-	-	-	-
Grade 3	858,712	520,921	2,113,698	2,697,664	1,202,604	181,406	7,575,005
Grade 4	-	-	-	-	-	-	-
Grade 5	1,141	3,427	6,337	10,798	17,179	146	39,028
Grade 6	1,616	1,043	4,504	14,316	2,423	134	24,036
Grade 7	277	35	3,093	4,103	1,214	110	8,832
Grade 8	-	-	10	-	-	-	10
Grade 9	-	-	-	-	-	-	-
PCI Loans (2)	3,765	607	4,078	26,916	6,226	-	41,592
Total	\$865,511	\$ 531,258	\$2,131,720	\$ 2,753,797	\$ 1,279,777	\$ 213,158	\$7,775,221

(1) Includes \$2.2 million of residential mortgage loans held for sale at December 31, 2013.

(2) Of the total PCI loans, \$17.6 million were classified as substandard at December 31, 2013. None were classified as doubtful or loss.

*Allowance for Credit Losses.* The allowance for credit losses is a valuation allowance 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 probable 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 certain impaired loans, 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 in accordance with ASC Topic 450, "*Contingencies*."

Based on a review of these factors for each loan type, the Company applies an estimated percentage to the outstanding balance of each loan type, excluding any 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, 2014, the allowance for credit losses totaled \$77.6 million or 0.83% of total loans, including acquired loans with discounts. At December 31, 2013, the allowance totaled \$67.3 million or 0.87% of total loans, including loans with discounts.

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The following table details activity in the allowance for loan losses by portfolio segment for the three and nine months ended September 30, 2014 and 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 Land Development and Other Land Loans	Agriculture Real Estate (includes Farmland)	1-4 Family (includes Home Equity)	Commercial Real Estate (includes Multi-Family Residential)	Commercial and Industrial	Consumer and Other	Total
(Dollars in thousands)							
<b>Allowance for credit losses:</b>							
<b>Three Months Ended</b>							
Balance June 30, 2014	\$ 14,993	\$ 1,448	\$ 18,905	\$ 23,679	\$ 10,957	\$ 3,284	\$ 73,266
Provision for credit losses	1,063	(25 )	854	1,096	269	1,743	5,000
Charge-offs	-	(12 )	(128 )	-	(188 )	(2,112 )	(2,440 )
Recoveries	28	65	58	6	171	1,459	1,787
Net charge-offs	28	53	(70 )	6	(17 )	(653 )	(653 )
Balance September 30, 2014	\$ 16,084	\$ 1,476	\$ 19,689	\$ 24,781	\$ 11,209	\$ 4,374	\$ 77,613
<b>Nine Months Ended</b>							
Balance January 1, 2014	\$ 14,353	\$ 1,229	\$ 17,046	\$ 24,835	\$ 8,167	\$ 1,652	\$ 67,282
Provision for credit losses	1,801	(730 )	3,250	4	3,076	4,524	11,925
Charge-offs	(155 )	(27 )	(790 )	(127 )	(390 )	(4,037 )	(5,526 )
Recoveries	85	1,004	183	69	356	2,235	3,932
Net charge-offs	(70 )	977	(607 )	(58 )	(34 )	(1,802 )	(1,594 )

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Balance September 30, 2014	\$ 16,084	\$ 1,476	\$ 19,689	\$ 24,781	\$ 11,209	\$ 4,374	\$ 77,613
<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



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The following table details the amount of the allowance for loan losses allocated to each portfolio segment as of September 30, 2014, December 31, 2013 and September 30, 2013, detailed on the basis of the impairment methodology used by the Company.

	Construction Land Development and Other Land Loans (Dollars in thousands)	Agriculture and Real Estate (includes Farmland)	1-4 Family (includes Home Equity)	Commercial Real Estate (includes Multi-Family Residential)	Commercial and Industrial	Consumer and Other	Total
<b>Allowance for credit losses related to:</b>							
<b>September 30, 2014</b>							
Individually evaluated for impairment	\$-	\$ 28	\$ 168	\$ 267	\$ 3,850	\$ 166	\$4,479
Collectively evaluated for impairment	16,084	1,448	19,081	24,514	7,359	4,208	72,694
PCI loans	-	-	440	-	-	-	440
Total allowance for credit losses	\$16,084	\$ 1,476	\$ 19,689	\$ 24,781	\$ 11,209	\$ 4,374	\$77,613
<b>December 31, 2013</b>							
Individually evaluated for impairment	\$-	\$ 18	\$ 890	\$ 445	\$ 1,029	\$ 77	\$2,459
Collectively evaluated for impairment	14,353	1,211	16,156	24,390	7,138	1,575	64,823
PCI loans	-	-	-	-	-	-	-
Total allowance for credit losses	\$14,353	\$ 1,229	\$ 17,046	\$ 24,835	\$ 8,167	\$ 1,652	\$67,282
<b>September 30, 2013</b>							
	\$-	\$ 20	\$ 53	\$ 17	\$ 741	\$ 69	\$900

Individually evaluated for  
impairment

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

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The following table details the recorded investment in loans as of September 30, 2014, December 31, 2013 and September 30, 2013, excluding \$8.5 million, \$2.2 million and \$4.9 million, respectively, of residential mortgage loans held for sale, related to each balance in the allowance for loan losses by portfolio segment.

	<b>Construction and Land Development and Other Land Loans</b>	<b>Agriculture and Real Estate (includes Farmland)</b>	<b>1-4 Family (includes Home Equity)</b>	<b>Commercial Real Estate (includes Multi-Family Residential)</b>	<b>Commercial and Industrial</b>	<b>Consumer and Other</b>	<b>Total</b>
<b>(Dollars in thousands)</b>							
<b>Recorded investment in loans:</b>							
<b>September 30, 2014</b>							
Individually evaluated for impairment	\$469	\$ 50	\$1,689	\$ 1,734	\$ 13,302	\$9,017	\$26,261
Collectively evaluated for impairment	1,037,907	534,054	2,462,225	3,059,845	2,017,536	151,229	9,262,796
PCI loans	2,924	568	7,553	29,511	30,751	-	71,307
Total loans evaluated for impairment	\$1,041,300	\$ 534,672	\$2,471,467	\$ 3,091,090	\$ 2,061,589	\$ 160,246	\$9,360,364
<b>December 31, 2013</b>							
Individually evaluated for impairment	\$277	\$ 35	\$3,103	\$ 4,103	\$ 1,214	\$ 110	\$8,842
Collectively evaluated for impairment	861,469	530,616	2,122,329	2,722,778	1,272,337	213,048	7,722,577
PCI loans	3,765	607	4,078	26,916	6,226	-	41,592
Total loans evaluated for impairment	\$865,511	\$ 531,258	\$2,129,510	\$ 2,753,797	\$ 1,279,777	\$ 213,158	\$7,773,011
<b>September 30, 2013</b>							

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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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*Troubled Debt Restructurings.* The restructuring of a loan is considered a “troubled debt restructuring” if both (i) the borrower is experiencing financial difficulties and (ii) the creditor has granted a concession. Concessions may include interest rate reductions or below market interest rates, principal forgiveness, restructuring amortization schedules and other actions intended to minimize potential losses. Effective July 1, 2011, the Company adopted the provisions of ASU No. 2011-02, “*Receivables (Topic 310)-A Creditor’s Determination of Whether a Restructuring Is a Troubled Debt Restructuring.*” As such, the Company reassessed all loan modifications occurring since January 1, 2011 for identification as troubled debt restructurings. The following table presents information regarding the recorded balance of loans modified in a troubled debt restructuring during the nine months ended September 30, 2014 and 2013:

	Nine Months Ended September 30, 2014			September 30, 2013		
	Pre- Modification Outstanding	Post- Modification Outstanding	Number of Recorded Investment	Pre- Modification Outstanding	Post- Modification Outstanding	Number of Recorded Investment
			(Dollars in thousands)			
<b>Troubled Debt Restructurings</b>						
Construction, land development and other land loans	- \$ -	\$ -	-	- \$ -	\$ -	-
Agriculture and agriculture real estate	-	-	-	-	-	-
1-4 Family (includes home equity)	-	-	-	-	-	-
Commercial real estate (commercial mortgage and multi-family)	1 35	35	-	-	-	-
Commercial and industrial	1 16	15	-	-	-	-
Consumer and other	-	-	-	-	-	-
Total	2 \$ 51	\$ 50	-	- \$ -	\$ -	-

As of September 30, 2014, there have been no defaults on any loans that were modified as troubled debt restructurings during the preceding nine months. Default is determined at 90 or more days past due. The modifications primarily related to extending the amortization periods of the loans, which includes loans modified during bankruptcy. The Company did not grant principal reductions on any restructured loans. For the nine months ended September 30, 2014, the Company added \$51 thousand in new troubled debt restructurings of which \$50 thousand was still outstanding on September 30, 2014. The remaining restructured loans from prior periods are performing and accruing loans. These

modifications did not have a material impact on the Company's determination of the allowance for credit losses.

## 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 residential mortgage 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. ASC Topic 820 "*Fair Value Measurements and Disclosures*" 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 hierarchy is as follows:

### *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.



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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.

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

**As of September 30, 2014**

	<b>Level 1</b>	<b>Level 2</b>	<b>Level 3</b>	<b>Total</b>
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**(Dollars in thousands)**

**Assets:****Available for sale securities:**

States and political subdivisions	\$-	\$15,704	\$ -	\$15,704
Collateralized mortgage obligations	-	35,749	-	35,749
Mortgage-backed securities	-	91,296	-	91,296
Other securities	12,467	-	-	12,467
Total	\$12,467	\$142,749	\$ -	\$155,216
Non-hedging interest rate swap	\$-	\$184	\$ -	\$184

**Liabilities:**

Non-hedging interest rate swap	\$-	\$(184 )	\$ -	\$(184 )
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**As of December 31, 2013**

	<b>Level 1</b>	<b>Level 2</b>	<b>Level 3</b>	<b>Total</b>
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**(Dollars in thousands)**

**Assets:****Available for sale securities:**

States and political subdivisions	\$-	\$29,375	\$ -	\$29,375
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Collateralized mortgage obligations	-	489	-	489
Mortgage-backed securities	-	115,137	-	115,137
Other securities	12,477	-	-	12,477
Total	\$12,477	\$145,001	\$ -	\$157,478
Non-hedging interest rate swap	\$-	\$38	\$ -	\$38

**Liabilities:**

Non-hedging interest rate swap	\$-	\$(38 )	\$ -	\$(38 )
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Certain assets and 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). These instruments include other real estate owned, repossessed assets, held to maturity debt securities, loans held for sale, and impaired loans. For the three and nine months ended September 30, 2014, the Company had additions to other real estate owned of \$1.5 million and \$5.9 million, respectively, of which \$982 thousand and \$3.8 million were outstanding as of September 30, 2014. For the nine months ended September 30, 2014, the Company had additions to impaired loans of \$25.5 million, of which \$24.7 million were outstanding as of September 30, 2014. The remaining assets and liabilities measured at fair value on a nonrecurring basis that were recorded in 2014 and remained outstanding at September 30, 2014 were not significant.

ASC Topic 825, “*Financial Instruments*” requires that the Company disclose estimated fair values for its financial instruments. The following table presents carrying and fair value information of financial instruments as of the dates indicated:

	<b>As of September 30, 2014</b>				
	<b>Carrying Amount</b>	<b>Estimated Fair Value Level 1</b>	<b>Level 2</b>	<b>Level 3</b>	<b>Total</b>
	<b>(Dollars in thousands)</b>				
<b>Assets</b>					
Cash and due from banks	\$330,952	\$330,952	\$-	\$-	\$330,952
Federal funds sold	484	484	-	-	484
Held to maturity securities	8,690,693	-	8,671,934	-	8,671,934
Loans held for sale	8,524	-	8,524	-	8,524
Loans held for investment, net of allowance	9,282,751	-	-	9,297,297	9,297,297
<b>Liabilities</b>					
<b>Deposits:</b>					
Noninterest-bearing	\$4,968,867	\$-	\$4,968,867	\$-	\$4,968,867
Interest-bearing	12,045,160	-	12,058,694	-	12,058,694
Other borrowings	289,972	-	291,260	-	291,260
Securities sold under repurchase agreements	358,053	-	349,076	-	349,076
Junior subordinated debentures	167,531	-	160,994	-	160,994

	<b>As of December 31, 2013</b>				<b>Total</b>
	<b>Carrying Amount</b>	<b>Estimated Fair Value</b>		<b>Level 3</b>	
		<b>Level 1</b>	<b>Level 2</b>		
<b>(Dollars in thousands)</b>					
<b>Assets</b>					
Cash and due from banks	\$380,990	\$380,990	\$-	\$-	\$380,990
Federal funds sold	400	400	-	-	400
Held to maturity securities	8,066,970	-	7,987,342	-	7,987,342
Loans held for sale	2,210	2,210	-	-	2,210
Loans held for investment, net of allowance	7,705,729	-	-	7,749,786	7,749,786
<b>Liabilities</b>					
<b>Deposits:</b>					
Noninterest-bearing	\$4,108,835	\$-	\$4,108,835	\$-	\$4,108,835
Interest-bearing	11,182,436	-	11,196,241	-	11,196,241
Other borrowings	10,689	-	12,014	-	12,014
Securities sold under repurchase agreements	364,357	-	364,477	-	364,477
Junior subordinated debentures	124,231	-	119,325	-	119,325

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

**NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS**

**SEPTEMBER 30, 2014**

**(UNAUDITED)**

The following is a description of the fair value estimates, methods and assumptions that are used by the Company in estimating the fair values of financial instruments.

**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.

**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 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 2.

**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.

**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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**(UNAUDITED)**

**Derivative financial instruments**—The fair value of the underlying non-hedging derivative contracts offset each other and are measured utilizing Level 2 inputs.

**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 Company's off-balance sheet commitments including letters of credit, which totaled \$2.2 billion at September 30, 2014, 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, 2014. 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 the nine months ended September 30, 2014 and the year ended December 31, 2013 were as follows:

	<b>Goodwill</b>	<b>Core Deposit Intangibles</b>
	<b>(Dollars in thousands)</b>	
Balance as of December 31, 2012	\$1,217,162	\$ 26,159
Less:		
Amortization	-	(6,145 )
Add:		
Measurement period adjustments	(1,225 )	2,110
Acquisition of East Texas Financial Services, Inc.	15,007	-
Acquisition of Coppermark Bancshares, Inc.	117,544	1,514
Acquisition of FVNB Corp.	323,032	18,411
Balance as of December 31, 2013	1,671,520	42,049
Less:		
Amortization	-	(7,273 )
Add:		
Measurement period adjustments	5,839	(302 )
Acquisition of F&M Bancorporation Inc.	214,896	-
Balance as of September 30, 2014	\$1,892,255	\$ 34,474

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**(UNAUDITED)**

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, 2014, 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 2014 and 2013 may be subject to adjustment.

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 \$2.6 million and \$1.5 million for the three months ended September 30, 2014 and 2013, respectively, and \$7.3 million and \$4.6 million for the nine months ended September 30, 2014 and 2013, respectively. The estimated aggregate future amortization expense for CDI remaining as of September 30, 2014 is as follows (dollars in thousands):

Remaining 2014	\$321
2015	6,549
2016	5,798
2017	3,843
2018	3,134
Thereafter	14,829
Total	\$34,474

**8. STOCK BASED COMPENSATION**



At September 30, 2014, 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.

During 2012, the Company's Board of Directors adopted the Prosperity Bancshares, Inc. 2012 Stock Incentive Plan (the "2012 Plan"), which 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, 2014, no options or other awards have been granted under the 2012 Plan.

The Company received \$920 thousand and \$1.2 million in cash from the exercise of stock options during the three month periods ended September 30, 2014 and 2013, respectively, and \$3.3 million and \$3.0 million during the nine month periods ended September 30, 2014 and 2013, 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, 2014 and 2013.

As of September 30, 2014, there was \$23.3 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 2.53 years.

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The following table summarizes the Company's contractual obligations and other commitments to make future payments as of September 30, 2014 (other than deposit obligations and securities sold under repurchase agreements). 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, 2014 are summarized below. Payments for junior subordinated debentures include interest of \$82.3 million that will be paid over the future periods. The future interest payments were calculated using the current rate in effect at September 30, 2014. The current principal balance of the junior subordinated debentures at September 30, 2014 was \$167.5 million. Payments for FHLB borrowings include interest of \$1.9 million that will be paid over the future periods. Payments related to leases are based on actual payments specified in underlying contracts.

	<b>1 year or less</b>	<b>More than 1 year but less than 3 years</b>	<b>3 years or more but less than 5 years</b>	<b>5 years or more</b>	<b>Total</b>
	<b>(Dollars in thousands)</b>				
Junior subordinated debentures	\$1,043	\$8,348	\$8,347	\$232,054	\$249,792
Federal Home Loan Bank notes payable	280,443	3,456	5,665	2,337	291,901
Operating leases	1,871	12,162	6,262	9,474	29,769
Total	\$283,357	\$23,966	\$20,274	\$243,865	\$571,462

*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 expiring by periods as of September 30, 2014 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
	<b>(Dollars in thousands)</b>				
Standby letters of credit	\$27,574	\$76,749	\$646	\$449	\$105,418
Commitments to extend credit	360,381	1,153,517	132,128	457,662	2,103,688
Total	\$387,955	\$1,230,266	\$132,774	\$458,111	\$2,209,106

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

	<b>Three Months Ended September 30,</b>			<b>2013</b>		
	<b>Before</b>	<b>Tax</b>	<b>Net of</b>	<b>Before</b>	<b>Tax</b>	<b>Net of</b>
	<b>Tax</b>	<b>Benefit</b>	<b>Tax</b>	<b>Tax</b>	<b>Benefit</b>	<b>Tax</b>
	<b>Amount</b>		<b>Amount</b>	<b>Amount</b>		<b>Amount</b>
	<b>(Dollars in thousands)</b>					
Other comprehensive loss:						
Securities available for sale:						
Change in unrealized gain during period	\$ (951)	\$ 333	\$ (618 )	\$ (1,136)	\$ 398	\$ (738 )
Total securities available for sale	(951)	333	(618 )	(1,136)	398	(738 )
Total other comprehensive loss	\$ (951)	\$ 333	\$ (618 )	\$ (1,136)	\$ 398	\$ (738 )

	<b>Nine Months Ended September 30,</b>			<b>2013</b>		
	<b>Before</b>	<b>Tax</b>	<b>Net of</b>	<b>Before</b>	<b>Tax</b>	<b>Net of</b>
	<b>Tax</b>	<b>Benefit</b>	<b>Tax</b>	<b>Tax</b>	<b>Benefit</b>	<b>Tax</b>
	<b>Amount</b>		<b>Amount</b>	<b>Amount</b>		<b>Amount</b>
	<b>(Dollars in thousands)</b>					
Other comprehensive loss:						
Securities available for sale:						
Change in unrealized gain during period	\$ (1,757)	\$ 615	\$ (1,142 )	\$ (5,237)	\$ 1,833	\$ (3,404 )
Total securities available for sale	(1,757)	615	(1,142 )	(5,237)	1,833	(3,404 )
Total other comprehensive loss	\$ (1,757)	\$ 615	\$ (1,142 )	\$ (5,237)	\$ 1,833	\$ (3,404 )

Activity in accumulated other comprehensive income associated with securities available for sale, net of tax, was as follows:

	<b>Accumulated Other Comprehensive Income (Dollars in thousands)</b>	
Balance at January 1, 2014	\$ 4,883	
Other comprehensive loss	(1,142	)
Balance at September 30, 2014	\$ 3,741	
Balance at January 1, 2013	\$ 8,986	
Other comprehensive loss	(3,404	)
Balance at September 30, 2013	\$ 5,582	

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On November 1, 2013, the Company acquired FVNB Corp. and assumed the following derivative contracts relating to loans made to certain commercial customers. The interest rate derivative contracts outstanding at September 30, 2014 are presented in the following table:

	<b>Current</b>			<b>Fixed</b>	<b>Variable Rate</b>
	<b>Notional</b>	<b>Estimated</b>		<b>Pay</b>	
	<b>Amount</b>	<b>Fair</b>	<b>Maturity Date</b>	<b>Rate</b>	<b>Received</b>
		<b>Value</b>			
(Dollars in thousands)					
Commercial Loan Interest Rate Swap	\$4,282	\$ 87	August 1, 2020	4.30%	1-Month USD - LIBOR BBA+2.50
Commercial Loan Interest Rate Swap	1,601	49	August 15, 2020	5.49%	1-Month USD - LIBOR BBA+3.00
Commercial Loan Interest Rate Swap	1,463	48	August 15, 2020	4.30%	1-Month USD - LIBOR BBA+2.50
Commercial Loan Interest Rate Swap	1,847	-	May 1, 2022	5.60%	1-Month USD - LIBOR BBA+3.50
	\$9,193	\$ 184			



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In these transactions, the Company has made a loan to a borrower at a variable rate of interest which the borrower pays directly to the Company. The Company also enters into an interest rate swap with a customer to accommodate the customer's desired terms while at the same time entering into an identical offsetting interest rate swap with another financial institution, thus fully eliminating any interest rate risk to the Company. In connection with each swap transaction, the Company agrees to pay interest to the borrowing customer on a notional amount at a variable interest rate and receive interest from the customer on the same notional amount at a fixed interest rate. At the same time, the Company agrees to pay another financial institution the same fixed interest rate on the same notional amount and receive the same variable interest rate on the same notional amount. The transaction allows the Company's customer to effectively convert a variable-rate loan to a fixed-rate loan. Because the Company acts solely as an intermediary for its customer, changes in the fair value of the underlying derivative contracts offset each other and do not materially impact the Company's results of operations. Derivative assets of \$184 thousand and derivative liabilities of \$184 thousand are recorded in other assets and other liabilities, respectively. The notional amounts and estimated fair values of interest rate derivative contracts outstanding at September 30, 2014 are presented in the following table:

	<b>Current Notional Amount</b>	<b>Estimated Fair Value</b>
	(Dollars in thousands)	
<b>Financial Institution Counterparties:</b>		
Swaps - liabilities	\$9,193	\$ (184 )
<b>Bank Customer Counterparties:</b>		
Swaps - assets	\$9,193	\$ 184

Credit risk arises from the possible inability of counterparties to meet the terms of their contracts. The Company's exposure is limited to the replacement value of the contracts rather than the notional, principal or contract amounts. Credit risk is minimized through credit approvals, limits, counterparty collateral and monitoring procedures. The Company's derivative assets and liabilities include certain contractual features in which the Company requires the counterparties to provide collateral in the form of cash and securities to offset changes in the fair value of the derivatives. When necessary, the Company posts collateral primarily in the form of cash to offset changes in fair value of the derivatives, including changes in fair value due to the Company's credit risk. As of September 30, 2014 and December 31, 2013, the balance of collateral posted by the Company for derivatives was \$260 thousand.

**12. ACQUISITIONS**

Acquisition of F&M Bancorporation Inc. – On April 1, 2014, the Company completed the acquisition of F&M Bancorporation Inc. ("FMBC") and its wholly-owned subsidiary The F&M Bank & Trust Company ("F&M") headquartered in Tulsa, Oklahoma. F&M operated 13 banking offices: 9 in Tulsa, Oklahoma and surrounding areas; 3



in Dallas, Texas; and 1 loan production office in Oklahoma City, Oklahoma. The Company acquired FMBC to further expand its Oklahoma and Dallas, Texas area markets. The acquisition was not considered significant to the Company's financial statements and therefore pro forma financial data and related disclosures are not included.

The Company acquired loans and deposits with fair values of \$1.60 billion and \$2.27 billion, respectively, at acquisition date. Under the terms of the agreement, the Company issued 3,298,022 shares of Company common stock plus \$34.2 million in cash for all outstanding shares of FMBC capital stock for total merger consideration of \$252.4 million based on the Company's closing stock price of \$66.15. As of September 30, 2014, the Company recognized \$214.9 million in goodwill. Goodwill recognized 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. As of September 30, 2014, management had not completed the core deposit intangibles assessment for this acquisition. For the nine months ended September 30, 2014, the Company incurred approximately \$2.5 million of pre-tax merger related expenses related to this acquisition.

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

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**(UNAUDITED)**

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. The Company acquired FVNB to expand its Central and South Texas markets. The acquisition was not considered significant to the Company’s financial statements and therefore pro forma financial data and related disclosures are not included.

The Company acquired loans and deposits with fair values of \$1.58 billion and \$2.25 billion, respectively, at acquisition date. 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. As of September 30, 2014, the Company recognized \$328.7 million in goodwill. Goodwill recognized 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 \$18.4 million of core deposit intangibles. For the nine months ended September 30, 2014, the Company incurred approximately \$604 thousand of pre-tax merger related expenses in connection with 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.

The Company acquired loans and deposits with fair values of \$800.2 million and \$1.12 billion, respectively, at acquisition date. 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. As of September 30, 2014, the Company recognized goodwill of \$117.7 million, after recording a \$109 thousand measurement period

adjustment during the first quarter of 2014. Additionally, the Company recognized \$1.5 million of core deposit intangibles.

*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 3 locations in Tyler, Texas and 1 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.

The Company acquired loans and deposits with fair values of \$122.1 million and \$112.4 million, respectively, at acquisition date. 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 goodwill of \$15.0 million.

## **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;



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

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

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

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

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

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

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

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

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

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

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

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

government intervention in the U.S. financial system;

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

• poor performance by external vendors;

• the failure of analytical and forecasting models used by the Company to estimate probable credit losses and to measure the fair value of financial instruments;

• additional risks from new lines of businesses or new products and services;

• claims or litigation related to intellectual property or fiduciary responsibilities;

• potential risk of environmental liability associated with lending activities;

• the potential payment of interest on demand deposit accounts in order to effectively compete for clients;

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

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

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

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Management's Discussion and Analysis of Financial Condition and Results of Operations analyzes the major elements of the Company's interim consolidated financial statements and accompanying notes. This section should be read in conjunction with the Company's interim consolidated financial statements and accompanying notes included elsewhere in this report and with the consolidated financial statements and accompanying notes and other detailed information appearing in the Company's Annual Report on Form 10-K for the year ended December 31, 2013.

Included in this discussion and analysis are descriptions of the composition, performance, and credit quality of the Company's loan portfolio. The Company has two general categories of loans in its portfolio. Loans originated by Prosperity Bank and made pursuant to the Company's loan policy and procedures in effect at the time the loan was made are referred to as "legacy loans." "Acquired loans" refer to all loans acquired in a business combination. Those acquired loans that are renewed or substantially modified after the date of the business combination, which therefore causes them to become subject to the Company's allowance for credit losses methodology, are referred to as "acquired legacy loans." Modifications are reviewed for determination of troubled debt restructuring status independently of this process. Acquired loans with a fair value discount or premium at the date of the business combination that remained at the reporting date are referred to as "fair-valued acquired loans." All fair-valued acquired loans are further categorized into "Non-PCI loans" and "PCI loans" (purchased credit impaired loans). Acquired loans with evidence of credit quality deterioration at acquisition for which it is probable that the Company would not be able to collect all contractual amounts due are PCI loans.

**OVERVIEW**

The Company, a Texas corporation, was formed in 1983 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 ("Prosperity Bank®" or the "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®. The Bank provides a wide array of financial products and services to small and medium-sized businesses and consumers. As of September 30, 2014, the Bank operated 245 full-service banking locations; with 62 in the Houston area, including The Woodlands; 30 in the South Texas area including Corpus Christi and Victoria; 36 in the Dallas/Fort Worth area; 22 in the East Texas area; 30 in the Central Texas area including Austin and San Antonio; 34 in the West Texas area including Lubbock, Midland-Odessa and Abilene; 16 in the Bryan/College Station area, 6 in the Central Oklahoma area and 9 in the Tulsa, 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.

The Company generates the majority of its revenues from interest income on loans, service charges on customer accounts and income from investments 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. The Company has recognized increased net interest income due primarily to an increase in the volume of interest-earning assets.

Three principal components of the Company's growth strategy are internal growth, stringent cost control practices and acquisitions, including strategic merger 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 2013, the Company completed the acquisitions of East Texas Financial Services Inc., Coppermark Bancshares, Inc. and FVNB Corp. During 2014, the Company completed the acquisition of F&M Bancorporation Inc.

Total assets were \$21.12 billion at September 30, 2014 compared with \$18.64 billion at December 31, 2013, an increase of \$2.48 billion or 13.3%. Total loans were \$9.37 billion at September 30, 2014 compared with \$7.78 billion at December 31, 2013, an increase of \$1.59 billion or 20.5%. Total deposits were \$17.01 billion at September 30, 2014 compared with \$15.29 billion at December 31, 2013, an increase of \$1.72 billion or 11.3%. Total shareholders' equity was \$3.18 billion at September 30, 2014 compared with \$2.79 billion at December 31, 2013, an increase of \$396.1 million or 14.2%.

### ***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, 2013. The Company believes that of its significant accounting policies, the following may involve a higher degree of judgment and complexity:



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*Allowance for Credit Losses* — The allowance for credit losses is established through charges to earnings in the form of a provision for credit losses. The determination of the allowance for credit losses has two components, the allowance for legacy credit losses, which includes the allowance for acquired legacy loans, and the allowance for acquired credit losses for fair-valued acquired loans. The allowance for acquired credit losses is calculated as described under the heading “Accounting for Acquired Loans and the Allowance for Acquired Credit Losses” below. 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 portfolio, 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. In making its evaluation, management considers factors such as historical loan loss experience, the amount of nonperforming assets and related collateral, the volume, growth and composition of the portfolio, current economic conditions that may affect the borrower’s ability to pay and the value of collateral, the evaluation of the 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. For further discussion of the methodology used in the determination of the allowance for credit losses, refer to the “Financial Condition – Allowance for Credit Losses” section below.

*Accounting for Acquired Loans and the Allowance for Acquired Credit Losses* — The Company accounts for its acquisitions using the acquisition method of accounting. Accordingly, the assets, including loans, and liabilities of the acquired entity were recorded at their fair values at the acquisition date. No allowance for credit losses related to the acquired loans is recorded on the acquisition date, as the fair value of the acquired loans incorporates assumptions regarding credit risk. These fair value estimates associated with acquired loans, and based on a discounted cash flow model, include estimates related to market interest rates and undiscounted projections of future cash flows that incorporate expectations of prepayments and the amount and timing of principal, interest and other cash flows, as well as any shortfalls thereof.

At period-end after acquisition, the fair-valued acquired loans from each acquisition are reassessed to determine whether an addition to the allowance for credit losses is appropriate due to further credit quality deterioration. For further discussion of the methodology used in the determination of the allowance for credit losses for fair-valued acquired loans, see “Financial Condition – Allowance for Credit Losses” section below.

*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.

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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 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, 2014. 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, 2014, management does not believe any of its goodwill is impaired as of September 30, 2014 because the fair value of the Company's equity substantially exceeded its carrying value. While the Company believes no impairment existed at September 30, 2014, 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 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 at book value, on a consolidated basis, total assets of \$165.0 million, total loans of \$129.3 million and total deposits of \$112.3 million.

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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 at book value, on a consolidated basis, total assets of \$1.25 billion, total loans of \$847.6 million and total deposits of \$1.11 billion.

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. As of September 30, 2013, FVNB reported at book value, on a consolidated basis, total assets of \$2.47 billion, total loans of \$1.65 billion and total deposits of \$2.20 billion.

Acquisition of F&M Bancorporation Inc. – On April 1, 2014, the Company completed the acquisition of F&M Bancorporation Inc. (“FMBC”) and its wholly-owned subsidiary The F&M Bank & Trust Company (“F&M”) headquartered in Tulsa, Oklahoma. F&M operated 13 banking offices: 9 in Tulsa, Oklahoma and surrounding areas; 3 in Dallas, Texas and 1 loan production office in Oklahoma City, Oklahoma. As of March 31, 2014, FMBC reported at book value, on a consolidated basis, total assets of \$2.41 billion, total loans of \$1.74 billion and total deposits of \$2.27 billion.

**RESULTS OF OPERATIONS**

Net income available to common shareholders was \$76.6 million (\$1.10 per common share on a diluted basis) for the quarter ended September 30, 2014 compared with \$55.3 million (\$0.91 per common share on a diluted basis) for the quarter ended September 30, 2013, an increase in net income of \$21.3 million or 38.5%. The Company posted annualized returns on average common equity of 9.69% and 9.31%, annualized returns on average assets of 1.45% and 1.37% and efficiency ratios of 41.55% and 41.59% for the quarters ended September 30, 2014 and 2013, 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, 2014, net income available to common shareholders was \$219.2 million (\$3.19 per common share on a diluted basis) compared with \$158.4 million (\$2.67 per common share on a diluted basis) for the same period in 2013, an increase in net income of \$60.8 million or 38.4%. The Company posted annualized returns on average common equity of 9.67% and 9.29%, annualized returns on average assets of 1.44% and 1.33% and efficiency ratios of 42.17% and 42.16% for the nine months ended September 30, 2014 and 2013, 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 \$175.7 million for the quarter ended September 30, 2014 compared with \$126.5 million for the quarter ended September 30, 2013, an increase of \$49.1 million or 38.8%. The increase in net interest income was primarily due to the acquisition of F&M and an increase in average interest-earning assets of \$4.10 billion or 28.8%, for the quarter ended September 30, 2014 compared with the quarter ended September 30, 2013, and a decrease in the average rate paid on interest-bearing liabilities of 1 basis point from 0.37% for the quarter ended September 30, 2013 compared with 0.36% for the quarter ended September 30, 2014. Interest income on loans was \$140.5 million for the quarter ended September 30, 2014, an increase of \$46.3 million or 49.1%, compared with the third quarter of 2013 due in part to an increase in average loans outstanding of \$3.21 billion or 52.0%. Additionally, during the third quarters of 2014 and 2013, interest income on loans benefitted from purchase accounting loan discount accretion of \$28.5 million and \$16.4 million, respectively, which partially offset the decrease in interest rates on the loan portfolio. As of September 30, 2014, the Company had \$194.9 million of total outstanding discounts on acquired loans, of which \$116.7 million was accretable at September 30, 2014. Interest income on securities was \$46.9 million during the third quarter of 2014, an increase of \$4.9 million or 11.8%, compared with the third quarter of 2013 due, in part, to an increase in average securities of \$821.1 million or 10.2%. Interest income on securities was also impacted by \$1.5 million of securities amortization purchase accounting adjustments during the third quarter of 2014. Average interest-bearing liabilities increased \$2.47 billion for the quarter ended September 30, 2014 compared with the same period in 2013. The net interest margin on a tax equivalent basis increased 26 basis points from 3.59% for the quarter ended September 30, 2013 to 3.85% for the quarter ended September 30, 2014. The impact of the purchase accounting adjustments on the tax equivalent net interest margin was an increase of 59 basis points for the quarter ended September 30, 2014.

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Net interest income before the provision for credit losses increased \$140.0 million or 39.6%, to \$493.4 million for the nine months ended September 30, 2014 compared with \$353.4 million for the same period in 2013. During the nine months ended September 30, 2014 and 2013, interest income on loans benefitted from purchase accounting loan discount accretion of \$67.3 million and \$42.7 million, respectively. 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 \$3.90 billion for the nine months ended September 30, 2014 compared with the same period in 2013. The net interest margin on a tax equivalent basis increased to 3.77% for the nine months ended September 30, 2014 compared with 3.48% for the same period in 2013. The impact of purchase accounting adjustments on the tax equivalent net interest margin was an increase of 47 basis points.

The following table presents, for the periods indicated, the total dollar amount of average balances, interest income from average interest-earning assets and the resultant yields, as well as the interest expense on average interest-bearing liabilities, expressed in both dollars and rates. 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.

	<b>Three Months Ended September 30,</b>					
	<b>2014</b>			<b>2013</b>		
	<b>Average</b>	<b>Interest</b>		<b>Average</b>	<b>Interest</b>	<b>Average</b>
	<b>Outstanding</b>	<b>Earned/</b>	<b>Average</b>	<b>Outstanding</b>	<b>Earned/</b>	<b>Yield/Rate</b>
	<b>Balance</b>	<b>Interest</b>	<b>Yield/Rate</b>	<b>Balance</b>	<b>Interest</b>	<b>Yield/Rate</b>
	<b>(Dollars in thousands)</b>	<b>Paid</b>	<b>(4)</b>		<b>Paid</b>	<b>(4)</b>
<b>Assets</b>						
Interest-Earning Assets:						
Loans	\$9,381,248	\$140,521	5.94%	\$6,173,394	\$94,236	6.06%
Investment securities	8,836,309	46,910	2.11%	8,015,221	41,961	2.08%
Federal funds sold and other earning assets	95,378	35	0.15%	27,451	16	0.22%
Total interest-earning assets	18,312,935	\$187,466	4.06%	14,216,066	\$136,213	3.80%
Allowance for credit losses	(73,977 )			(56,765 )		
Noninterest-earning assets	2,881,762			2,034,968		
Total assets	\$21,120,720			\$16,194,269		
<b>Liabilities and Shareholders' Equity</b>						
Interest-Bearing Liabilities:						
Interest-bearing demand deposits	\$3,399,655	\$2,089	0.24%	\$2,400,555	\$1,708	0.28%
Savings and money market deposits	5,502,326	3,400	0.25%	4,233,911	2,911	0.27%
Certificates and other time deposits	3,235,185	4,751	0.58%	2,489,848	3,695	0.59%
Securities sold under repurchase agreements	389,726	245	0.25%	455,276	317	0.28%

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Junior subordinated debentures	167,531	1,099	2.60%	85,055	439	2.05%
Other borrowings	215,222	225	0.42%	772,083	610	0.31%
Total interest-bearing liabilities	12,909,645	11,809	0.36%	10,436,728	9,680	0.37%
Noninterest-Bearing Liabilities:						
Noninterest-bearing demand deposits	4,939,388			3,308,158		
Other liabilities	109,287			73,571		
Total liabilities	17,958,320			13,818,457		
Shareholders' equity	3,162,400			2,375,812		
Total liabilities and shareholders' equity	\$21,120,720			\$16,194,269		
Net interest rate spread			3.70%			3.43%
Net interest income and margin (1) (2)		\$175,657	3.81%		\$126,533	3.53%
Net interest income and margin (tax equivalent) (3)		\$177,654	3.85%		\$128,561	3.59%

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(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.

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, 2014 and 2013.



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	Nine Months Ended September 30, 2014			2013		
	Average Outstanding Balance (Dollars in thousands)	Interest Earned/ Interest Paid	Average Yield/Rate (4)	Average Outstanding Balance	Interest Earned/ Interest Paid	Average Yield/Rate (4)
<b>Assets</b>						
Interest-Earning Assets:						
Loans	\$8,874,414	\$386,320	5.82%	\$5,853,924	\$265,542	6.06%
Investment securities	8,685,212	141,636	2.18%	7,912,599	117,893	1.99%
Federal funds sold and other earning assets	143,770	261	0.24%	32,426	111	0.46%
Total interest-earning assets	17,703,396	\$528,217	3.99%	13,798,949	\$383,546	3.72%
Allowance for credit losses	(71,287 )			(55,933 )		
Noninterest-earning assets	2,791,827			2,000,425		
Total assets	\$20,423,936			\$15,743,441		
<b>Liabilities and Shareholders' Equity</b>						
Interest-Bearing Liabilities:						
Interest-bearing demand deposits	\$3,506,932	\$6,493	0.25%	\$2,545,983	\$6,018	0.32%
Savings and money market deposits	5,326,783	10,105	0.25%	4,096,889	8,912	0.29%
Certificates and other time deposits	3,145,435	13,947	0.59%	2,468,518	11,244	0.61%
Securities sold under repurchase agreements	373,542	737	0.26%	458,441	921	0.27%
Junior subordinated debentures	150,692	2,961	2.63%	85,055	1,273	2.00%
Other borrowings	136,618	571	0.56%	558,594	1,821	0.44%
Total interest-bearing liabilities	12,640,002	34,814	0.37%	10,213,480	30,189	0.40%
Noninterest-Bearing Liabilities:						
Noninterest-bearing demand deposits	4,567,397			3,182,349		
Other liabilities	185,838			68,721		
Total liabilities	17,393,237			13,464,550		
Shareholders' equity	3,030,699			2,278,891		
Total liabilities and shareholders' equity	\$20,423,936			\$15,743,441		
Net interest rate spread			3.62%			3.32%
Net interest income and margin (1) (2)		\$493,403	3.73%		\$353,357	3.42%
Net interest income and margin (tax equivalent) (3)		\$499,535	3.77%		\$359,573	3.48%

(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.

- In order to make pretax income and resultant yields on tax-exempt investments and loans comparable to those on
- (3) 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, 2014 and 2013.

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The following table presents information regarding the dollar amount of changes in interest income and interest expense for the periods indicated for each major component of interest-earning assets and interest-bearing liabilities and distinguishes between the changes attributable to changes in volume and changes in interest rates. For purposes of this table, changes attributable to both rate and volume which cannot be segregated have been allocated to rate.

	<b>Three Months Ended September 30, 2014 vs. 2013 Increase (Decrease) Due to Change in Volume Rate Total (Dollars in thousands)</b>			<b>Nine Months Ended September 30, 2014 vs. 2013 Increase (Decrease) Due to Change in Volume Rate Total</b>		
Interest-Earning assets:						
Loans (1)	\$48,967	\$(2,682)	\$46,285	\$137,014	\$(16,236)	\$120,778
Investment securities (1)	4,298	651	4,949	11,511	12,232	23,743
Federal funds sold and other earning assets	37	(18 )	19	381	(231 )	150
Total increase (decrease) in interest income	53,302	(2,049)	51,253	148,906	(4,235 )	144,671
Interest-Bearing liabilities:						
Interest-bearing demand deposits	711	(330 )	381	2,271	(1,796 )	475
Savings and money market deposits	872	(383 )	489	2,675	(1,482 )	1,193
Certificates and other time deposits (1)	1,106	(50 )	1,056	3,083	(380 )	2,703
Securities sold under repurchase agreements	(46 )	(26 )	(72 )	(171 )	(13 )	(184 )
Junior subordinated debentures	426	234	660	982	706	1,688
Other borrowings	(440 )	55	(385 )	(1,376 )	126	(1,250 )
Total increase (decrease) in interest expense	2,629	(500 )	2,129	7,464	(2,839 )	4,625
Increase (decrease) in net interest income	\$50,673	\$(1,549)	\$49,124	\$141,442	\$(1,396 )	\$140,046

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(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 \$5.0 million provision for credit losses for the quarter ended September 30, 2014 and a \$4.0 million provision for the quarter ended September 30, 2013. Net charge-offs were \$653 thousand for the quarter ended September 30, 2014 compared with net charge-offs of \$288 thousand for the quarter ended September 30, 2013. The Company made an \$11.9 million provision for credit losses for the nine months ended September 30, 2014 and a \$9.4 million provision for the nine months ended September 30, 2013. Net charge-offs were \$1.6 million for the nine months ended September 30, 2014 compared with \$2.0 million for the nine months ended September 30, 2013. See "Allowance for Credit Losses" for more information.

#### *Noninterest Income*

The Company's primary sources of recurring noninterest income are NSF fees, credit, debit, and ATM card income and service charges on deposit accounts. Noninterest income does not include loan origination fees which are recognized over the life of the related loan as an adjustment to yield using the interest method. Noninterest income totaled \$30.2 million for the three months ended September 30, 2014 compared with \$21.6 million for the same period in 2013, an increase of \$8.6 million or 39.9%. This increase was primarily due to an increase in NSF fees, credit, debit, and ATM card income, and service charges as a result of the additional accounts acquired from F&M and FVNB. Additionally, trust and brokerage income increased as a result of the additional accounts acquired through the acquisition of FVNB in 2013. While debit card income increased due to higher volume related to acquisitions, income was negatively impacted by the Durbin Amendment beginning in July of 2013. As a result of this legislation, the Federal Reserve imposed limits on the amount of interchange, or swipe, fees that can be collected for financial institutions that have assets of \$10 billion or more. 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 \$92.8 million for the nine months ended September 30, 2014 compared with \$70.3 million for the same period in 2013, an increase of \$22.5 million or 32.0%. This increase was primarily due to the effects of the additional accounts acquired in the acquisitions of FVNB and F&M completed in 2013 and 2014. In addition, gain on the sale of assets increased \$4.7 million during the nine months ended September 30, 2014 compared with the same period in 2013, primarily due to a \$2.2 million gain that was recorded during the first quarter of 2014 on the sale of the agent bank credit card and agent bank merchant processing business of Bankers Credit Card Services, Inc., a subsidiary acquired as part of the acquisition of Coppermark.



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

	Three Months Ended		Nine Months Ended	
	September 30, 2014    2013		September 30, 2014    2013	
	(Dollars in thousands)			
Nonsufficient funds (NSF) fees	\$9,734	\$8,649	\$27,703	\$25,504
Credit card, debit card and ATM card income	5,921	4,307	17,103	17,801
Service charges on deposit accounts	4,255	3,169	12,189	9,404
Trust income	2,099	901	5,943	2,814
Mortgage income	1,414	931	3,215	3,489
Brokerage income	1,743	233	4,413	798
Bank owned life insurance income	1,404	916	3,797	2,624
Net gain (loss) on sale of assets	23	126	4,634	(53 )
Net (loss) gain on sale of other real estate	(30 )	(864 )	1,314	(732 )
Other	3,598	3,186	12,455	8,620
Total noninterest income	\$30,161	\$21,554	\$92,766	\$70,269

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Noninterest expense totaled \$85.5 million for the quarter ended September 30, 2014 compared with \$61.5 million for the quarter ended September 30, 2013, an increase of \$24.0 million or 39.0%. Noninterest expense totaled \$245.2 million for the nine months ended September 30, 2014 compared with \$178.6 million for the nine months ended September 30, 2013, an increase of \$66.6 million or 37.3%. Both increases were primarily due to the increases in salaries and employee benefits and general and administrative expenses related to the recent acquisitions. The Company also incurred one-time pre-tax merger related expenses of \$338 thousand and \$3.1 million for the three months and nine months ended September 30, 2014, respectively. The merger related expenses are reflected on the Company's income statement for the applicable periods and are reported primarily in the categories of salaries and benefits, data processing and professional fees.

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

	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>September 30, 2014</b>	<b>2013</b>	<b>September 30, 2014</b>	<b>2013</b>
	<b>(Dollars in thousands)</b>			
Salaries and employee benefits (1)	\$52,179	\$37,135	\$149,713	\$107,861
Non-staff expenses:				
Net occupancy and equipment	6,801	5,094	18,136	14,041
Debit card, data processing and software amortization	4,044	2,756	11,237	8,575
Regulatory assessments and FDIC insurance	4,051	2,516	10,663	7,490
Core deposit intangibles amortization	2,598	1,455	7,273	4,551
Depreciation	3,516	2,679	10,239	7,521
Communications (2)	2,960	2,397	8,616	7,003
Other real estate expense	72	75	656	535
Professional fees	1,331	1,150	4,057	3,081
Printing and supplies	663	606	1,800	1,627
Other	7,295	5,674	22,850	16,319
Total noninterest expense	\$85,510	\$61,537	\$245,240	\$178,604

Includes stock based compensation expense of \$2.3 million and \$1.0 million for the three months ended (1) September 30, 2014 and 2013, respectively, and \$5.9 million and \$3.1 million for the nine months ended September 30, 2014 and 2013, respectively.

(2) Communications expense includes telephone, data circuits, postage, and courier expenses.

*Income Taxes*

Income tax expense increased \$11.5 million or 42.2%, to \$38.7 million for the quarter ended September 30, 2014 compared with \$27.2 million for the same period in 2013. For the nine months ended September 30, 2014, income tax expense totaled \$109.8 million, an increase of \$32.6 million or 42.2%, compared with \$77.2 million for the same period in 2013. The increases were primarily attributable to higher pretax net earnings for the three and nine months ended September 30, 2014 compared with the same periods in 2013. The Company's effective tax rate for the three months ended September 30, 2014 and 2013 was 33.6% and 33.0%, respectively. The Company's effective tax rate for the nine months ended September 30, 2014 and 2013 was 33.4% and 32.8%, respectively.



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## FINANCIAL CONDITION

*Loan Portfolio*

Total loans were \$9.37 billion at September 30, 2014, an increase of \$1.59 billion or 20.5%, compared with \$7.78 billion at December 31, 2013. Loan growth was impacted by the acquisition of FMBC on April 1, 2014. As of March 31, 2014, FMBC reported, on a consolidated basis, total loans of \$1.74 billion. Average outstanding loans at September 30, 2014 represented 51.2% of average earning assets for the quarter ended September 30, 2014.

The following tables summarize the Company's legacy and acquired loan portfolios broken out into legacy loans, acquired legacy loans, Non-PCI loans and PCI loans, as of the dates indicated:

	<b>September 30, 2014</b>				
		<b>Acquired Loans</b>			
	<b>Legacy Loans</b>	<b>Legacy Loans</b>	<b>Non-PCI Loans</b>	<b>PCI Loans</b>	<b>Total Loans</b>
Residential mortgage loans held for sale	\$8,524	\$-	\$-	\$-	\$8,524
Commercial and industrial	906,699	580,285	543,854	30,751	2,061,589
Real estate:					
Construction, land development and other land loans	759,569	126,447	152,360	2,924	1,041,300
1-4 family residential (including home equity)	1,781,644	93,799	588,471	7,553	2,471,467
Commercial real estate (including multi-family residential)	1,833,712	251,167	976,699	29,512	3,091,090
Farmland	231,312	15,418	101,450	460	348,640
Agriculture	100,405	65,608	19,912	107	186,032
Consumer and other (net of unearned discount)	61,772	13,448	85,026	-	160,246
Total loans held for investment	5,675,113	1,146,172	2,467,772	71,307	9,360,364
Total	\$5,683,637	\$1,146,172	\$2,467,772	\$71,307	\$9,368,888

	<b>December 31, 2013</b>				
		<b>Acquired Loans</b>			
	<b>Legacy Loans</b>	<b>Legacy Loans</b>	<b>Non-PCI Loans</b>	<b>PCI Loans</b>	<b>Total Loans</b>
Residential mortgage loans held for sale	\$2,210	\$-	\$-	\$-	\$2,210

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Commercial and industrial	693,540	216,530	363,481	6,226	1,279,777
Real estate:					
Construction, land development and other land loans	602,535	80,011	179,202	3,763	865,511
1-4 family residential (including home equity)	1,519,143	53,455	552,834	4,078	2,129,510
Commercial real estate (including multi-family residential)	1,648,670	124,291	953,918	26,918	2,753,797
Farmland	193,757	11,873	126,515	503	332,648
Agriculture	60,514	36,503	101,489	104	198,610
Consumer and other (net of unearned discount)	99,339	16,291	97,528	-	213,158
Total loans held for investment	4,817,498	538,954	2,374,967	41,592	7,773,011
Total	\$4,819,708	\$538,954	\$2,374,967	\$41,592	\$7,775,221

*Nonperforming Assets*

Nonperforming assets include loans on nonaccrual status, accruing loans 90 days past due or more, and real estate which has been acquired through foreclosure and is awaiting disposition. Nonperforming assets do not include PCI loans unless the timing and amount of projected cashflows can no longer be reasonably estimated. PCI loans become subject to the Company's allowance for credit losses methodology when a deterioration in projected cashflows is identified.

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.

Nonperforming assets increased \$27.6 million or 122.5%, to \$50.1 million at September 30, 2014 compared with \$22.5 million at December 31, 2013, of which \$42.9 million and \$8.6 million were attributable to acquired loans, respectfully. The ratio of nonperforming assets to loans and other real estate was 0.53% at September 30, 2014 compared with 0.29% at December 31, 2013.

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The following tables present information regarding nonperforming assets differentiated among legacy loans, acquired legacy loans, Non-PCI loans and PCI loans, as of the dates indicated:

**September 30, 2014**

	<b>Acquired Loans</b>				
	<b>Acquired</b>				
	<b>Legacy Loans</b>	<b>Legacy Loans</b>	<b>Non-PCI Loans</b>	<b>PCI Loans</b>	<b>Total Loans</b>
	<b>(Dollars in thousands)</b>				
Nonaccrual loans	\$4,201	\$2,863	\$ 10,047	\$9,693	\$26,804
Accruing loans 90 or more days past due	78	15,276	1	2,398	17,753
Total nonperforming loans	4,279	18,139	10,048	12,091	44,557
Reposessed assets	6	-	15	-	21
Other real estate	2,923	-	1,610	971	5,504
Total nonperforming assets	\$7,208	\$18,139	\$ 11,673	\$13,062	\$50,082

Nonperforming assets to total loans and other real estate by category	0.13	%	1.58	%	0.47	%	18.07	%	0.53	%
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**December 31, 2013**

	<b>Acquired Loans</b>				
	<b>Acquired</b>				
	<b>Legacy Loans</b>	<b>Legacy Loans</b>	<b>Non-PCI Loans</b>	<b>PCI Loans</b>	<b>Total Loans</b>
	<b>(Dollars in thousands)</b>				
Nonaccrual loans	\$5,386	\$2,992	\$ 890	\$962	\$10,230
Accruing loans 90 or more days past due	1,408	1,716	1,385	439	4,948
Total nonperforming loans	6,794	4,708	2,275	1,401	15,178
Reposessed assets	17	-	10	-	27
Other real estate	7,071	-	228	-	7,299
Total nonperforming assets	\$13,882	\$4,708	\$ 2,513	\$1,401	\$22,504

Nonperforming assets to total loans and other real estate by category	0.29	%	0.87	%	0.11	%	3.37	%	0.29	%
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Nonperforming assets were 0.53% of total loans and other real estate at September 30, 2014. Nonperforming assets were 0.97% of total fair-valued acquired loans and other real estate at September 30, 2014. Nonperforming assets were 1.58% of total acquired legacy loans and other real estate at September 30, 2014 and 0.13% of total legacy loans and other real estate at September 30, 2014. The allowance for credit losses as a percentage of total nonperforming loans was 174.2% at September 30, 2014 and 443.3% at December 31, 2013. The increase in nonperforming assets in

each acquired loan category during this period is primarily due to the acquisition of F&M.

*Allowance for Credit Losses*

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. Management has established an allowance for credit losses which it believes is adequate for estimated losses in the Company's loan portfolio. 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, 2014, the allowance for credit losses amounted to \$77.6 million or 0.83%, of total loans compared with \$67.3 million or 0.87%, of total loans at December 31, 2013.

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The following table presents information regarding the allowance for credit losses as of and for the period indicated:

	<b>As of and for the Nine Months Ended September 30, 2014                  2013 (Dollars in thousands)</b>			
Average loans outstanding	\$8,874,414		\$5,853,924	
Gross loans outstanding at end of period	\$9,368,888		\$6,182,589	
Allowance for credit losses at beginning of period	\$67,282		\$52,564	
Provision for credit losses	11,925		9,375	
Charge-offs:				
Commercial and industrial	(390	)	(592	)
Real estate and agriculture	(1,099	)	(1,382	)
Consumer and other	(4,037	)	(2,100	)
Recoveries:				
Commercial and industrial	356		275	
Real estate and agriculture	1,341		903	
Consumer and other	2,235		870	
Net charge-offs	(1,594	)	(2,026	)
Allowance for credit losses at end of period	\$77,613		\$59,913	
Ratio of allowance to end of period loans	0.83	%	0.97	%
Ratio of net charge-offs to average loans (annualized)	0.02	%	0.05	%
Ratio of allowance to end of period nonperforming loans	174.2	%	1144.0	%

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The following table presents, as of and for the periods indicated, information regarding the allowance for credit losses differentiated between legacy loans and acquired loans. The charge-offs and recoveries with respect to the acquired loans shown below are primarily from acquired legacy loans. Reported net charge-offs may include those from Non-PCI loans and PCI loans, but only if the total charge-off required is greater than the remaining discount.

	As of and for the Nine Months Ended September 30, 2014					
	Legacy Loans		Acquired Loans		Total	
	(Dollars in thousands)					
Average loans outstanding	\$5,310,877		\$3,563,537		\$8,874,414	
Gross loans outstanding at end of period	\$5,683,637		\$3,685,251		\$9,368,888	
Allowance for credit losses at beginning of period	\$60,115		\$7,167		\$67,282	
Provision for credit losses	3,346		8,579		11,925	
Charge-offs:						
Commercial and industrial	(147	)	(243	)	(390	)
Real estate and agriculture	(410	)	(689	)	(1,099	)
Consumer and other	(3,953	)	(84	)	(4,037	)
Recoveries:						
Commercial and industrial	313		43		356	
Real estate and agriculture	1,337		4		1,341	
Consumer and other	2,226		9		2,235	
Net charge-offs	(634	)	(960	)	(1,594	)
Allowance for credit losses at end of period	\$62,827		\$14,786		\$77,613	
Ratio of allowance to end of period loans	1.11	%	0.40	%	0.83	%
Ratio of net charge-offs to average loans (annualized)	0.02	%	0.04	%	0.02	%
Ratio of allowance to end of period nonperforming loans	1468.3	%	36.7	%	174.2	%

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 total loan portfolio and assigns risk grades to each loan. 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 certain impaired loans, the Company allocates a specific loan loss reserve primarily based on the value of the collateral securing the impaired loan. The specific reserves are determined on an individual loan basis. Loans for which specific reserves are provided are excluded from the general valuation allowance described below.

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

In determining the allowance for credit losses, management considers the type of loan (legacy or acquired) and the credit quality of the loan. The Company delineates between legacy loans and acquired legacy loans, which are accounted for under the contractual yield method, and fair-valued acquired loans consisting of Non-PCI loans and PCI loans, which are accounted for as purchased loans.

Loans acquired in business combinations are initially recorded at fair value, which includes an estimate of credit losses expected to be realized over the remaining lives of the loans, and therefore no corresponding allowance for loan losses is recorded for these loans at acquisition. When a fair-valued acquired loan is renewed at its maturity date, the loan is re-categorized as an acquired legacy loan. When a fair-valued acquired loan is modified after acquisition, the loan is independently evaluated subsequent to the modification decision to determine whether a substantial modification requires that the loan be re-categorized as an acquired legacy loan. The determination is based on a discounted cash-flow analysis. Generally, when a change in discounted cash-flow of greater than ten percent is identified, the fair-valued acquired loan becomes categorized as an acquired legacy loan. If and when a fair-valued acquired loan becomes an acquired legacy loan, the acquired legacy loan is evaluated at the time of renewal or modification in accordance with the Company's allowance for credit losses methodology described above.

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Non-PCI loans which were not subsequently impaired are considered non-impaired and are evaluated as part of the general valuation allowance. Non-PCI loans that have not become impaired subsequent to acquisition are segregated into a pool for each acquisition for allowance calculation purposes. For each pool, the Company estimates a hypothetical allowance for credit losses also referred to as an “indicated reserve” that is calculated in accordance with GAAP requirements. The Company uses the acquired bank’s past loss history adjusted for qualitative factors to establish the indicated reserve. The indicated reserve for each pool of Non-PCI loans is compared to the remaining discount for the respective pool to test for credit quality deterioration and the possible need for a loan loss provision. To the extent the remaining discount of the pool is greater than the indicated reserve, no additional allowance is necessary. In the event that the remaining discount of the pool is less than the indicated reserve, the difference results in an increase to the allowance recorded through a provision for loan losses.

Non-PCI loans that have deteriorated to an impaired status subsequent to acquisition are evaluated for a specific reserve which, when identified, is added to the allowance for credit losses.

PCI loans are individually monitored on a quarterly basis to assess for deterioration subsequent to acquisition and are only subject to the Company’s allowance methodology when a deterioration in projected cash flows is identified. In the event that a deterioration in cash flows is identified, an additional provision for credit losses is made. PCI loans were recorded at their acquisition date fair values, which were based on expected cash flows and included estimates of expected future credit losses. The Company’s estimates of loan fair values at the acquisition date may be adjusted for a period of up to one year as the Company continues to evaluate its estimate of expected future cash flows at the acquisition date. If the Company determines that losses arose after the acquisition date, the additional losses will be reflected as a provision for credit losses. An allowance for credit losses is not calculated for PCI loans that have not experienced deterioration subsequent to the acquisition date. See “Critical Accounting Policies” for more information.

The Company further disaggregates its allowance for credit losses to distinguish between the portion of the allowance attributed to legacy loans and the portion of the allowance attributed to acquired loans. The following table shows the allocation of the allowance for credit losses among various categories of loans disaggregated between legacy loans, acquired legacy loans, Non-PCI loans and PCI loans. The allocation is made for analytical purposes and is not necessarily indicative of the categories in which future losses may occur. The total allowance is available to absorb losses from any loan category, regardless of whether allocated to a legacy loan or an acquired loan.

September 30, 2014					Percent of Loans to Total Loans
Acquired Loans					
Legacy Loans	Acquired Legacy Loans	Non-PCI Loans	PCI Loans	Total Allowance	



**(Dollars in thousands)**

Balance of allowance for credit losses applicable to:							
Commercial and industrial	\$4,169	\$4,792	\$ 2,248	\$ -	\$ 11,209	22.0	%
Real estate	53,384	6,518	212	440	60,554	70.6	%
Agriculture and agriculture real estate	1,160	311	5	-	1,476	5.7	%
Consumer and other	4,115	73	186	-	4,374	1.7	%
Total allowance for credit losses	\$62,828	\$11,694	\$ 2,651	\$ 440	\$ 77,613	100.0	%

**December 31, 2013****Acquired Loans**

	Legacy Loans (Dollars in thousands)	Acquired Legacy Loans	Non-PCI Loans	PCI Loans	Total Allowance	Percent of Loans to Total Loans	
Balance of allowance for credit losses applicable to:							
Commercial and industrial	\$6,139	\$1,831	\$ 197	\$ -	\$ 8,167	16.5	%
Real estate	51,235	4,889	110	-	56,234	73.9	%
Agriculture and agriculture real estate	1,174	55	-	-	1,229	6.8	%
Consumer and other	1,567	71	14	-	1,652	2.8	%
Total allowance for credit losses	\$60,115	\$6,846	\$ 321	\$ -	\$ 67,282	100.0	%

The carrying cost of securities totaled \$8.85 billion at September 30, 2014 compared with \$8.22 billion at December 31, 2013, an increase of \$621.5 million or 7.6%. At September 30, 2014, securities represented 41.9% of total assets compared with 44.1% of total assets at December 31, 2013.

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

	September 30, 2014			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
	(Dollars in thousands)			
Available for Sale				
States and political subdivisions	\$15,410	\$ 294	\$ -	\$15,704
Collateralized mortgage obligations	35,688	100	(39 )	35,749
Mortgage-backed securities	85,774	5,538	(16 )	91,296
Other securities	12,588	-	(121 )	12,467
Total	\$149,460	\$ 5,932	\$(176 )	\$155,216
Held to Maturity				
U.S. Treasury securities and obligations of U.S. Government sponsored entities	\$58,559	\$ 218	\$(136 )	\$58,641
States and political subdivisions	406,437	5,547	(1,657 )	410,327
Corporate debt securities	-	-	-	-
Collateralized mortgage obligations	27,306	357	(32 )	27,631
Mortgage-backed securities	8,198,391	82,239	(105,295 )	8,175,335
Total	\$8,690,693	\$ 88,361	\$(107,120 )	\$8,671,934
December 31, 2013				
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
	(Dollars in thousands)			
Available for Sale				
States and political subdivisions	\$28,578	\$ 797	\$ -	\$29,375
Collateralized mortgage obligations	483	7	(1 )	489
Mortgage-backed securities	108,316	6,843	(22 )	115,137
Other securities	12,589	14	(126 )	12,477
Total	\$149,966	\$ 7,661	\$(149 )	\$157,478
Held to Maturity				
U.S. Treasury securities and obligations of U.S. Government sponsored entities	\$62,931	\$ 46	\$(935 )	\$62,042
States and political subdivisions	439,235	4,317	(2,207 )	441,345
Corporate debt securities	513	5	-	518
Collateralized mortgage obligations	50,034	1,017	(58 )	50,993
Mortgage-backed securities	7,514,257	84,166	(165,979 )	7,432,444

Total	\$8,066,970	\$ 89,551	\$(169,179 )	\$7,987,342
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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. 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, 2014, 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, 2014, management believes any impairment in the Company's securities is temporary, and therefore no impairment loss has been realized in the Company's consolidated statements of income.

### *Deposits*

Total deposits were \$17.01 billion at September 30, 2014 compared with \$15.29 billion at December 31, 2013, an increase of \$1.72 billion or 11.3%. At September 30, 2014, noninterest-bearing deposits totaled \$4.97 billion compared with \$4.11 billion at December 31, 2013, an increase of \$860.0 million or 20.9%. Interest-bearing deposits totaled \$12.05 billion at September 30, 2014 compared with \$11.18 billion, an increase of \$862.7 million or 7.7%.

Average deposits for the nine months ended were \$16.55 billion as of September 30, 2014 an increase of \$4.25 billion or 34.6%, compared with \$12.29 billion as of September 30, 2013. Deposit growth was impacted by the acquisitions of FVNB and F&M. Deposits for these acquisitions totaled \$2.25 billion and \$2.27 billion, respectively, at acquisition date. The ratio of average interest-bearing deposits to total average deposits was 72.4% during the nine months of 2014 compared with 74.1% during the first nine months of 2013.

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

	<b>Nine Months Ended September 30,</b>			<b>2013</b>		
	<b>Average</b>	<b>Average</b>		<b>Average</b>	<b>Average</b>	
	<b>Balance</b>	<b>Rate</b>		<b>Balance</b>	<b>Rate</b>	
	<b>(Dollars in thousands)</b>					
Interest-bearing demand deposits	\$3,506,932	0.25	%	\$2,545,983	0.32	%
Regular savings	1,664,601	0.20	%	1,359,020	0.21	%
Money market savings	3,662,182	0.28	%	2,737,869	0.33	%
Certificates and other time deposits	3,145,435	0.59	%	2,468,518	0.61	%
Total interest-bearing deposits	11,979,150	0.34	%	9,111,390	0.38	%
Noninterest-bearing deposits	4,567,397			3,182,349		
Total deposits	\$16,546,547	0.25	%	\$12,293,739	0.28	%

Table Of Contents*Other Borrowings*

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

	<b>September 30, 2014</b>	<b>December 31, 2013</b>
	<b>(Dollars in thousands)</b>	
FHLB advances	\$280,000	\$ -
FHLB long-term notes payable	9,972	10,689
Total other borrowings	289,972	10,689
Securities sold under repurchase agreements	358,053	364,357
Total	\$648,025	\$ 375,046

*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 are used to manage liquidity as needed. Maturing advances are replaced by drawing on available cash, making additional borrowings or through increased customer deposits. At September 30, 2014, the Company had total funds of \$5.75 billion available under this agreement, of which \$290.0 million was outstanding. Short-term overnight FHLB advances of \$280 million were outstanding at September 30, 2014, at a weighted average rate of 0.16%. Long-term notes payable were \$10.0 million at September 30, 2014, with a weighted average rate of 5.32%. The maturity dates on the FHLB notes payable range from the years 2014 to 2028 and have interest rates ranging from 4.23% to 6.10%.

*Securities sold under repurchase agreements*— At September 30, 2014, the Company had \$358.1 million in securities sold under repurchase agreements compared with \$364.4 million at December 31, 2013, a decrease of \$6.3 million or 1.7%. Repurchase agreements with banking customers are generally settled on the following business day. Approximately \$21.9 million of the repurchase agreements outstanding at September 30, 2014 have maturity dates ranging from 3 to 24 months. All securities sold under agreements to repurchase are collateralized by certain pledged securities.

*Junior Subordinated Debentures*

At September 30, 2014, the Company had outstanding \$167.5 million in junior subordinated debentures issued to the Company's unconsolidated subsidiary trusts compared with \$124.2 million at December 31, 2013. On April 1, 2014, the Company acquired FMBC and assumed the obligations related to the junior subordinated debentures issued to F&M Bancorporation Statutory Trust I, F&M Bancorporation Statutory Trust II and F&M Bancorporation Statutory Trust III.



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A summary of pertinent information related to the Company's twelve issues of junior subordinated debentures outstanding at September 30, 2014 is set forth in the table below:

Description (Dollars in thousands)	Issuance Date	Trust Preferred Securities	Interest Rate (1)	Junior Subordinated Debt Owed	Maturity Date (2)
		Outstanding		to Trusts	
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
FVNB Capital Trust II	June 14, 2005	18,000	3 month LIBOR + 1.68%	18,557	June 15, 2035
FVNB Capital Trust III	June 23, 2006	20,000	3 month LIBOR + 1.60%	20,619	July 7, 2036
F&M Bancorporation Statutory Trust I	March 26, 2003	15,000	3 month LIBOR + 3.15%	15,464	March 26, 2033
F&M Bancorporation Statutory Trust II	March 17, 2004	12,000	3 month LIBOR + 2.79%	12,372	March 17, 2034
		15,000		15,464	

F&M Bancorporation Statutory Trust III	December 15, 2005	3 month LIBOR + 1.80%	December 15, 2035
			\$ 167,531

(1) The 3-month LIBOR in effect as of September 30, 2014 was 0.234%.

(2) All debentures are callable five years from issuance date.

### *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, 2014, the Company had outstanding \$2.10 billion in commitments to extend credit and \$105.4 million in commitments associated with outstanding standby letters of credit. Since commitments associated with letters of credit and commitments to extend credit may expire unused, the total outstanding may not necessarily reflect the actual future cash funding requirements.

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

Asset liquidity is provided by cash and assets which are readily marketable or which will mature in the near future. As of September 30, 2014, the Company had cash and cash equivalents of \$331.4 million compared with \$381.4 million at December 31, 2013, a decrease of \$50.0 million. The decrease was primarily due to the purchase of \$7.25 billion of securities, a decrease in securities sold under repurchase agreements of \$6.3 million, a net decrease in deposits of \$543.2 million, and dividends paid of \$49.4 million. This decrease was partially offset by proceeds from the maturities and repayments of securities of \$6.66 billion, a decrease in loans of \$75.2 million, net proceeds from short-term borrowings of \$280.0 million and net income of \$219.2 million.

Table Of Contents*Contractual Obligations*

The following table summarizes the Company's contractual obligations and other commitments to make future payments as of September 30, 2014 (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, 2014 are summarized below. Payments for junior subordinated debentures include interest of \$82.3 million that will be paid over the future periods. The future interest payments were calculated using the current rate in effect at September 30, 2014. The current principal balance of the junior subordinated debentures at September 30, 2014 was \$167.5 million. Payments for FHLB borrowings include interest of \$1.9 million that will be paid over the future periods. Payments related to leases are based on actual payments specified in underlying contracts.

	<b>1 year or less</b>	<b>More than 1 year but less than 3 years</b>	<b>3 years or more but less than 5 years</b>	<b>5 years or more</b>	<b>Total</b>
	<b>(Dollars in thousands)</b>				
Junior subordinated debentures	\$1,043	\$8,348	\$8,347	\$232,054	\$249,792
Federal Home Loan Bank notes payable	280,443	3,456	5,665	2,337	291,901
Operating leases	1,871	12,162	6,262	9,474	29,769
Total	\$283,357	\$23,966	\$20,274	\$243,865	\$571,462

*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, 2014 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
	<b>(Dollars in thousands)</b>				
Standby letters of credit	\$27,574	\$76,749	\$646	\$449	\$105,418
Commitments to extend credit	360,381	1,153,517	132,128	457,662	2,103,688
Total	\$387,955	\$1,230,266	\$132,774	\$458,111	\$2,209,106

### *Capital Resources*

Total shareholders' equity was \$3.18 billion at September 30, 2014 compared with \$2.79 billion at December 31, 2013, an increase of \$396.1 million or 14.2%. The increase was due primarily to net income of \$219.2 million, the issuance of common stock in connection with the acquisition of FMBC of \$218.2 million and the issuance of common stock in connection with the exercise of stock options and restricted stock awards of \$3.3 million, which was partially offset by dividends paid of \$49.3 million and stock based compensation expense of \$5.9 million for the nine months ended September 30, 2014.

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, 2014:

### **Consolidated Capital Ratios**

Total capital (to risk weighted assets)	13.90%
Tier 1 capital (to risk weighted assets)	13.18%
Tier 1 capital (to average assets)	7.40 %

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As of September 30, 2014, 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, 2014:

**Bank Capital Ratios**

Total capital (to risk weighted assets)	13.66	%
Tier 1 capital (to risk weighted assets)	12.94	%
Tier 1 capital (to average assets)	7.26	%

**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 Item 7 "Management's Discussion and Analysis of Financial Condition and Results of Operations-Interest Rate Sensitivity and Liquidity" in the Company's Annual Report on Form 10-K for the year ended December 31, 2013, filed on February 28, 2014, for further discussion.

**ITEM 4. CONTROLS AND PROCEDURES**

*Evaluation of disclosure controls and procedures.* As of the end of the period covered by this report, the Company carried out an evaluation, under the supervision and with the participation of its management, including its Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of its disclosure controls and procedures. In designing and evaluating the disclosure controls and procedures, management recognizes

that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and management was required to apply judgment in evaluating its controls and procedures. Based on this evaluation, the Company's Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, 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, 2014 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, 2013.

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

a. None.

b. None.

c. None.

**ITEM 3. DEFAULTS UPON SENIOR SECURITIES**

None.

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**ITEM 4. MINE SAFETY DISCLOSURES**

Not applicable.

**ITEM 5. OTHER INFORMATION**

None.

**ITEM 6. EXHIBITS**

**Exhibit**

**Description of Exhibit**

**Number**

- |        |   |
|--------|---|
| 3.1    | Amended and Restated Articles of Incorporation of Prosperity Bancshares, Inc. (incorporated herein by reference to Exhibit 3.1 to the Company's Registration Statement on Form S-1 (Registration No. 333-63267) (the "Registration Statement")) |
| 3.2    | Articles of Amendment to Amended and Restated Articles of Incorporation of Prosperity Bancshares, Inc. (incorporated herein by reference to Exhibit 3.2 to the Company's Quarterly Report on Form 10-Q for the quarter ended March 31, 2006)    |
| 3.3    | Amended and Restated Bylaws of Prosperity Bancshares, Inc. (incorporated herein by reference to Exhibit 3.1 to the Company's Current Report on Form 8-K filed on October 19, 2007)  |
| 4.1    | Form of certificate representing shares of the Company's common stock (incorporated by reference to Exhibit 4 to the Registration Statement)  |
| 10.1*  | Amended and Restated Employment Agreement dated October 20, 2014 by and between W.R. Collier and Prosperity Bank  |
| 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** |   |



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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: 11/07/14

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

Date: 11/07/14

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