

PROSPERITY BANCSHARES INC
Form 10-K
March 01, 2007
Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

(Mark One)

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15 (D) OF THE SECURITIES EXCHANGE ACT OF 1934

For The Fiscal Year Ended December 31, 2006
OR

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

For the transition period from _____ to _____
Commission File Number 0-25051

PROSPERITY BANCSHARES, INC.[®]

(Exact name of registrant as specified in its charter)

TEXAS
(State or other jurisdiction of
incorporation or organization)

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

Edgar Filing: PROSPERITY BANCSHARES INC - Form 10-K

PROSPERITY BANK PLAZA

4295 SAN FELIPE

HOUSTON, TEXAS
(Address of principal executive offices)

77027
(Zip Code)

Registrant's Telephone Number, Including Area Code: (713) 693-9300

Securities registered pursuant to Section 12(b) of the Act:

Common Stock, par value

\$1.00 per share

Securities registered pursuant to Section 12(g) of the Act: None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15 (d) of the Act. Yes No

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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of the Form 10-K or any amendment of this Form 10-K.

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

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

The aggregate market value of the shares of Common Stock held by non-affiliates as of June 30, 2006, based on the closing price of the Common Stock on the Nasdaq National Market System on June 30, 2006 was approximately \$885.3 million.

As of February 28, 2007, the number of outstanding shares of Common Stock was 43,667,909.

Documents Incorporated by Reference:

Portions of the Company's Proxy Statement relating to the 2007 Annual Meeting of Shareholders, which will be filed within 120 days after December 31, 2006, are incorporated by reference into Part III, Items 10-14 of this Form 10-K.

Table of Contents

PROSPERITY BANCSHARES, INC.®

2006 ANNUAL REPORT ON FORM 10-K

TABLE OF CONTENTS

PART I

<u>Item 1.</u>	Business	3
	<u>General</u>	3
	<u>2006 Acquisition</u>	4
	<u>Acquisition of Texas United Bancshares, Inc.</u>	4
	<u>Available Information</u>	5
	<u>Officers and Associates</u>	5
	<u>Banking Activities</u>	5
	<u>Business Strategies</u>	6
	<u>Competition</u>	7
	<u>Supervision and Regulation</u>	7
<u>Item 1A.</u>	Risk Factors	15
<u>Item 1B.</u>	Unresolved Staff Comments	19
<u>Item 2.</u>	Properties	20
<u>Item 3.</u>	Legal Proceedings	21
<u>Item 4.</u>	Submission of Matters to a Vote of Security Holders	21

PART II

<u>Item 5.</u>	Market for Registrant's Common Equity, Related Shareholder Matters and Issuer Purchases of Equity Securities	21
<u>Item 6.</u>	Selected Consolidated Financial Data	25
<u>Item 7.</u>	Management's Discussion and Analysis of Financial Condition and Results of Operations	27
	<u>Overview</u>	28
	<u>Acquisition of Texas United Bancshares, Inc.</u>	29
	<u>Critical Accounting Policies</u>	29
	<u>Results of Operations</u>	30
	<u>Financial Condition</u>	37
<u>Item 7A.</u>	Quantitative and Qualitative Disclosures about Market Risk	54
<u>Item 8.</u>	Financial Statements and Supplementary Data	55
<u>Item 9.</u>	Changes In and Disagreements with Accountants on Accounting and Financial Disclosure	56
<u>Item 9A.</u>	Controls and Procedures	56
<u>Item 9B.</u>	Other Information	59

PART III

<u>Item 10.</u>	Directors, Executive Officers and Corporate Governance	59
<u>Item 11.</u>	Executive Compensation	59
<u>Item 12.</u>	Security Ownership of Certain Beneficial Owners and Management and Related Shareholder Matters	59
<u>Item 13.</u>	Certain Relationships, Related Transactions and Director Independence	59
<u>Item 14.</u>	Principal Accountant Fees and Services	59

PART IV

<u>Item 15.</u>	Exhibits, Financial Statement Schedules	60
<u>Signatures</u>		63

Table of Contents

PART I

ITEM 1. BUSINESS

General

Prosperity Bancshares, Inc.[®], a Texas corporation (the "Company"), was formed in 1983 as a vehicle to acquire the former Allied Bank in Edna, Texas which was chartered in 1949 as The First National Bank of Edna. The Company is a registered financial holding company that derives substantially all of its revenues and income from the operation of its bank subsidiary, Prosperity Bank[®] ("Prosperity Bank" or the "Bank"). The Bank provides a broad line of financial products and services to small and medium-sized businesses and consumers. As of December 31, 2006, the Bank operated eighty-eight (88) full-service banking locations; with thirty-eight (38) in the Greater Houston Consolidated Metropolitan Statistical Area ("CMSA"), seventeen (17) in fifteen contiguous counties situated south and southwest of Houston and extending into South Texas, five (5) in the Austin, Texas area, fifteen (15) in the Corpus Christi, Texas area, two (2) in East Texas and eleven (11) in the Dallas/Fort Worth, Texas area. The Greater Houston CMSA includes Austin, Brazoria, Chambers, Fort Bend, Galveston, Harris, Liberty, Montgomery, San Jacinto and Waller counties. 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.prosperitybanktx.com.

The Company's market consists of the communities served by its banking centers. The diverse nature of the economies in each local market served by the Company provides the Company with a varied customer base and allows the Company to spread its lending risk throughout a number of different industries including farming, ranching, petrochemicals, manufacturing, tourism, recreation and professional service firms and their principals. The Company's market areas outside of Houston, Dallas, Corpus Christi and Austin are dominated by either small community banks or branches of large regional banks. Management believes that the Company, as one of the few mid-sized financial institutions that combines responsive community banking with the sophistication of a regional bank holding company, has a competitive advantage in its market areas and excellent growth opportunities through acquisitions, new banking center locations and additional business development.

Operating under a community banking philosophy, the Company seeks to develop broad customer relationships based on service and convenience while maintaining its conservative approach to lending and strong asset quality. The Company has grown through a combination of internal growth, the acquisition of community banks, branches of banks and the opening of new banking centers. Utilizing a low cost of funds and employing stringent cost controls, the Company has been profitable in every full year of its existence, including the period of adverse economic conditions in Texas in the late 1980s. From 1988 to 1992, as a sound and profitable institution, the Company took advantage of this economic downturn and acquired the deposits and certain assets of failed banks in West Columbia, El Campo and Cuero, Texas and two failed banks in Houston, which diversified the Company's franchise and increased its core deposits. The Company opened a full-service banking center in Victoria, Texas in 1993 and the following year established a banking center in Bay City, Texas. The Company expanded its Bay City presence in 1996 with the acquisition of an additional branch location from Norwest Bank Texas (now Wells Fargo), and in 1997, the Company acquired the Angleton, Texas branch of Wells Fargo Bank. In 1998, the Company enhanced its West Columbia Banking Center with the purchase of a commercial bank branch located in West Columbia and acquired Union State Bank in East Bernard, Texas.

Table of Contents

From December 31, 1998 through December 31, 2006, the Company grew through internal growth and the completion of the following acquisitions:

Acquired Entity	Acquired Bank	Completion Date	Number of
			Banking Centers Added ⁽¹⁾
South Texas Bancshares, Inc.	Commercial State Bank	1999	3
Compass Bank (5 branches)	N/A	2000	4
Commercial Bancshares, Inc.	Heritage Bank	2001	12
Texas Guaranty Bank, N.A.	Same	2002	3
The First State Bank of Needville	Same	2002	(2)
Paradigm Bancorporation, Inc.	Paradigm Bank Texas	2002	8
Southwest Bank Holding Company	Bank of the Southwest	2002	2
First National Bank of Bay City	Same	2002	(2)
Abrams Centre Bancshares, Inc.	Abrams Centre National Bank	2003	1
Dallas Bancshares, Inc.	BankDallas	2003	1
MainBancorp, Inc.	mainbank, n.a.	2003	4
First State Bank of North Texas	Same	2003	3
Liberty Bancshares, Inc.	Liberty Bank, S.S.B.	2004	4
Village Bank and Trust, s.s.b	Same	2004	1
First Capital Bankers, Inc.	FirstCapital Bank, s.s.b.	2005	25
Grapeland Bancshares, Inc.	First State Bank of Grapeland	2005	2
SNB Bancshares, Inc	Southern National Bank of Texas	2006	6 ⁽³⁾

- (1) The number of banking centers added does not include any locations of the acquired entity that were closed and consolidated into existing banking centers of the Company upon consummation of the transaction or closed after consummation of the transaction
- (2) The only banking center of the acquired entity was closed and consolidated into an existing banking center of the Company.
- (3) Includes one banking center under construction at the time of consummation.

2006 Acquisition

On April 1, 2006, the Company completed its acquisition of SNB Bancshares, Inc., Sugar Land, Texas (SNB). Under the terms of the merger agreement, SNB was merged into the Company and subsequently, SNB's wholly owned subsidiary, Southern National Bank of Texas, was merged into Prosperity Bank® (Prosperity Bank® or the Bank). The Company issued approximately 4.448 million shares of its common stock and \$93.3 million in cash for all of the issued and outstanding capital stock of SNB. In addition, options to acquire 761,950 shares of SNB common stock were converted into options to acquire 467,578 shares of Company common stock. All remaining options to acquire SNB common stock were cancelled and redeemed for cash prior to the merger. In connection with the merger, the Company assumed \$30.9 million in junior subordinated debentures issued to three subsidiary trusts. SNB was publicly traded and operated five (5) banking offices in Fort Bend County, Houston and Katy, Texas and two (2) stand alone motor banks in Houston, Texas. At the time of acquisition, SNB had an additional banking office under construction in Katy, Texas, which became a full-service banking center of the Company upon completion in July 2006. As of December 31, 2005, SNB had, on a consolidated basis, total assets of \$1.025 billion, loans (including loans held for sale) of \$652.8 million, deposits of \$892.0 million and shareholders' equity of \$82.5 million.

Acquisition of Texas United Bancshares, Inc.

On January 31, 2007, the Company completed its acquisition of Texas United Bancshares, Inc., La Grange, Texas (TXUI). Under the terms of the merger agreement, TXUI was merged into the Company and subsequently each of TXUI's wholly owned subsidiary banks, State Bank, GNB Financial, n.a., Gateway

Table of Contents

National Bank and Northwest Bank, was merged into the Bank. The Company issued approximately 10.770 million shares of its common stock for all of the issued and outstanding capital stock of TXUI. In addition, options to acquire 179,956 shares of TXUI common stock were converted into options to acquire 179,956 shares of Company common stock. In connection with the acquisition, the Company assumed \$44.8 million in junior subordinated debentures issued to five subsidiary trusts. TXUI was publicly traded and operated forty-one (41) banking offices in Texas. As of December 31, 2006, TXUI had, on a consolidated basis, total assets of \$1.806 billion, loans (including loans held for sale) of \$1.212 billion, deposits of \$1.362 billion and shareholders' equity of \$161.9 million.

Available Information

The Company's website address is www.prosperitybanktx.com. The Company makes available free of charge on or through its website its annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and all amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended, as soon as reasonably practicable after such material is electronically filed with or furnished to the Securities and Exchange Commission. Information contained on the Company's website is not incorporated by reference into this annual report on Form 10-K and is not part of this or any other report.

Officers and Associates

The Company's directors and officers are important to the Company's success and play a key role in the Company's business development efforts by actively participating in civic and public service activities in the communities served by the Company.

The Company has invested heavily in its officers and associates by recruiting talented officers in its market areas and providing them with economic incentive in the form of stock-based compensation and bonuses based on cross-selling performance. The senior management team has substantial experience in the Houston, Dallas, Austin and Corpus Christi markets and the surrounding communities in which the Company has a presence. Each banking center location is administered by a local president or manager with knowledge of the community and lending expertise in the specific industries found in the community. The Company entrusts its banking center Presidents and Managers with authority and flexibility within general parameters with respect to product pricing and decision making in order to avoid the bureaucratic structure of larger banks. The Company operates each banking center as a separate profit center, maintaining separate data with respect to each banking center's 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's local banking centers have no 1-800 telephone numbers. Each banking center has its own listed local business telephone number, which enables a customer to be served by a local banker with decision making authority.

As of December 31, 2006, the Company and the Bank had 908 full-time equivalent associates, 344 of whom were officers of the Bank. The Company provides medical and hospitalization insurance to its full-time associates. The Company considers its relations with associates to be excellent. Neither the Company nor the Bank is a party to any collective bargaining agreement.

Banking Activities

The Company, through the Bank, offers a variety of traditional loan and deposit products to its customers, which consist primarily of consumers and small and medium-sized businesses. The Bank tailors its products to the specific needs of customers in a given market. At December 31, 2006, the Bank maintained approximately 192,000 separate deposit accounts and 22,000 separate loan accounts and 22.4% of the Bank's total deposits were noninterest-bearing demand deposits. For the year ended December 31, 2006, the Company's average cost of funds was 2.56% and the Company's average cost of deposits (excluding all borrowings) was 2.35%.

Table of Contents

The Company has been an active mortgage lender, with commercial mortgage and 1-4 family residential loans comprising 54.2% of the Company's total loans as of December 31, 2006. The Company also offers loans for automobiles and other consumer durables, home equity loans, debit cards, internet banking and other cash management services and automated telephone banking. By offering certificates of deposit, checking with interest accounts, savings accounts and overdraft protection at competitive rates, the Company gives its depositors a full range of traditional deposit products.

The businesses targeted by the Company in its lending efforts are primarily those that require loans in the \$100,000 to \$8.0 million range. The Company offers these businesses a broad array of loan products including term loans, lines of credit and loans for working capital, business expansion and the purchase of equipment and machinery, interim construction loans for builders and owner-occupied commercial real estate loans.

Business Strategies

The Company's main objective is to increase deposits and loans internally, as well as through additional expansion opportunities, while maintaining efficiency, individualized customer service and maximizing profitability. To achieve this objective, the Company has employed the following strategic goals:

Continue Community Banking Emphasis. The Company intends to continue operating as a community banking organization focused on meeting the specific needs of consumers and small and medium-sized businesses in its market areas. The Company will continue to provide a high degree of responsiveness combined with a wide variety of banking products and services. The Company staffs its banking centers with experienced bankers with lending expertise in the specific industries found in the community, giving them authority to make certain pricing and credit decisions, thereby attempting to avoid the bureaucratic structure of larger banks.

Expand Market Share Through Internal Growth and a Disciplined Acquisition Strategy. The Company intends to continue seeking opportunities, both inside and outside its existing markets, to expand either by acquiring existing banks or branches of banks or by establishing new banking centers. All of the Company's acquisitions have been accretive to earnings within 12 months after acquisition date and generally have supplied the Company with relatively low-cost deposits which have been used to fund the Company's lending and investing activities. However, the Company makes no guarantee that future acquisitions, if any, will be accretive to earnings within any particular time period. Factors used by the Company to evaluate expansion opportunities include the similarity in management and operating philosophies, whether the acquisition will be accretive to earnings and enhance shareholder value, the ability to achieve economies of scale to improve the efficiency ratio and the opportunity to enhance the Company's market presence.

Increase Loan Volume and Diversify Loan Portfolio. While maintaining its conservative approach to lending, the Company has emphasized both new and existing loan products, focusing on growing its construction, commercial mortgage and commercial loan portfolios. During the two-year period from December 31, 2004 to December 31, 2006, the Company's construction loans grew from \$109.6 million to \$433.2 million, or 295.3%, and represented 10.6% and 19.9% of the total portfolio, respectively. The Company's commercial and industrial loans grew from \$144.4 million to \$281.0 million, or 94.5%, and represented 13.9% and 12.9% of the total portfolio, respectively. Commercial mortgages increased from \$369.2 million to \$803.1 million, or 117.6%, and represented 35.6% and 36.9% of the total portfolio, respectively, for the same period. In addition, the Company targets professional service firms including legal and medical practices for both loans secured by owner-occupied premises and personal loans to their principals.

Continue Strict Focus on Efficiency. The Company plans to maintain its stringent cost control practices and policies. The Company has invested significantly in the infrastructure required to centralize many of its critical operations, such as data processing and loan processing. For its banking centers, which the Company operates as independent profit centers, the Company supplies complete support in the areas of loan review, internal audit, compliance and training. Management believes that this centralized infrastructure can accommodate additional growth while enabling the Company to minimize operational costs through certain economies of scale.

Table of Contents

Enhance Cross-Selling. The Company recognizes that its customer base provides significant opportunities to cross-sell various products and it seeks to develop broader customer relationships by identifying cross-selling opportunities. The Company uses incentives and friendly competition to encourage cross-selling efforts and increase cross-selling results among its associates. Officers and associates have access to each customer's existing and related account relationships and are better able to inform customers of additional products when customers visit or call the various banking centers or use their drive-in facilities. In addition, the Company includes product information in monthly statements and other mailings.

Maintain Strong Asset Quality. The Company intends to maintain the strong asset quality that has been representative of its historical loan portfolio. As the Company diversifies and increases its lending activities, it may face higher risks of nonpayment and increased risks in the event of economic downturns. The Company intends, however, to continue to employ the strict underwriting guidelines and comprehensive loan review process that has contributed to its low incidence of nonperforming assets and its minimal charge-offs in relation to its size.

Competition

The banking business is highly competitive, and the profitability of the Company depends principally on its ability to compete in its market areas. The Company competes with other commercial banks, savings banks, savings and loan associations, credit unions, finance companies, mutual funds, insurance companies, brokerage and investment banking firms, asset-based nonbank lenders and certain other nonfinancial entities, including retail stores which may maintain their own credit programs and certain governmental organizations which may offer more favorable financing than the Company. The Company believes it has been able to compete effectively with other financial institutions by emphasizing customer service, technology and responsive decision-making with respect to loans; by establishing long-term customer relationships and building customer loyalty; and by providing products and services designed to address the specific needs of its customers.

Supervision and Regulation

The supervision and regulation of bank holding companies and their subsidiaries is intended primarily for the protection of depositors, the deposit insurance funds of the Federal Deposit Insurance Corporation (FDIC) and the banking system as a whole, and not for the protection of the bank holding company shareholders or creditors. The banking agencies have broad enforcement power over bank holding companies and banks including the power to impose substantial fines and other penalties for violations of laws and regulations.

The following description summarizes some of the laws to which the Company and the Bank are subject. References in this annual report on Form 10-K to applicable statutes and regulations are brief summaries thereof, do not purport to be complete, and are qualified in their entirety by reference to such statutes and regulations.

The Company

The Company is a financial holding company pursuant to the Gramm-Leach-Bliley Act and a bank holding company registered under the Bank Holding Company Act of 1956, as amended (BHCA). Accordingly, the Company is subject to supervision, regulation and examination by the Board of Governors of the Federal Reserve System (Federal Reserve Board). The Gramm-Leach-Bliley Act, the BHCA and other federal laws subject financial and bank holding companies to particular restrictions on the types of activities in which they may engage, and to a range of supervisory requirements and activities, including regulatory enforcement actions for violations of laws and regulations.

Regulatory Restrictions on Dividends; Source of Strength. It is the policy of the Federal Reserve Board that bank holding companies should pay cash dividends on common stock only out of income available over the past year and only if prospective earnings retention is consistent with the organization's expected future needs and

Table of Contents

financial condition. The policy provides that bank holding companies should not maintain a level of cash dividends that undermines the bank holding company's ability to serve as a source of strength to its banking subsidiaries.

Under Federal Reserve Board policy, a bank holding company is expected to act as a source of financial strength to each of its banking subsidiaries and commit resources to their support. Such support may be required at times when, absent this Federal Reserve Board policy, a holding company may not be inclined to provide it. As discussed below, a bank holding company, in certain circumstances, could be required to guarantee the capital plan of an undercapitalized banking subsidiary.

In the event of a bank holding company's bankruptcy under Chapter 11 of the U.S. Bankruptcy Code, the trustee will be deemed to have assumed and is required to cure immediately any deficit under any commitment by the debtor holding company to any of the federal banking agencies to maintain the capital of an insured depository institution. Any claim for breach of such obligation will generally have priority over most other unsecured claims.

Scope of Permissible Activities. Under the BHCA, bank holding companies generally may not acquire a direct or indirect interest in or control of more than 5% of the voting shares of any company that is not a bank or bank holding company or from engaging in activities other than those of banking, managing or controlling banks or furnishing services to or performing services for its subsidiaries, except that it may engage in, directly or indirectly, certain activities that the Federal Reserve Board determined to be closely related to banking or managing and controlling banks as to be a proper incident thereto. In approving acquisitions or the addition of activities, the Federal Reserve considers whether the acquisition or the additional activities can reasonably be expected to produce benefits to the public, such as greater convenience, increased competition, or gains in efficiency, that outweigh such possible adverse effects as undue concentration of resources decreased or unfair competition, conflicts of interest or unsound banking practices.

Notwithstanding the foregoing, the Gramm-Leach-Bliley Act, effective March 11, 2000, eliminated the barriers to affiliations among banks, securities firms, insurance companies and other financial service providers and permits bank holding companies to become financial holding companies and thereby affiliate with securities firms and insurance companies and engage in other activities that are financial in nature. The Gramm-Leach-Bliley Act defines "financial in nature" to include securities underwriting, dealing and market making; sponsoring mutual funds and investment companies; insurance underwriting and agency; merchant banking activities; and activities that the Federal Reserve Board has determined to be closely related to banking. No regulatory approval will be required for a financial holding company to acquire a company, other than a bank or savings association, engaged in activities that are financial in nature or incidental to activities that are financial in nature, as determined by the Federal Reserve Board.

Under the Gramm-Leach-Bliley Act, a bank holding company may become a financial holding company by filing a declaration with the Federal Reserve Board if each of its subsidiary banks is well capitalized under the Federal Deposit Insurance Corporation Improvement Act prompt corrective action provisions, is well managed, and has at least a satisfactory rating under the Community Reinvestment Act of 1977. The Company became a financial holding company on April 18, 2000.

While the Federal Reserve Board is the "umbrella" regulator for financial holding companies and has the power to examine banking organizations engaged in new activities, regulation and supervision of activities which are financial in nature or determined to be incidental to such financial activities will be handled along functional lines. Accordingly, activities of subsidiaries of a financial holding company will be regulated by the agency or authorities with the most experience regulating that activity as it is conducted in a financial holding company.

Safe and Sound Banking Practices. Bank holding companies are not permitted to engage in unsafe and unsound banking practices. The Federal Reserve Board's Regulation Y, for example, generally requires a holding

Table of Contents

company to give the Federal Reserve Board prior notice of any redemption or repurchase of its own equity securities, if the consideration to be paid, together with the consideration paid for any repurchases or redemptions in the preceding year, is equal to 10% or more of the company's consolidated net worth. The Federal Reserve Board may oppose the transaction if it believes that the transaction would constitute an unsafe or unsound practice or would violate any law or regulation. Depending upon the circumstances, the Federal Reserve Board could take the position that paying a dividend would constitute an unsafe or unsound banking practice.

The Federal Reserve Board has broad authority to prohibit activities of bank holding companies and their nonbanking subsidiaries which represent unsafe and unsound banking practices or which constitute violations of laws or regulations, and can assess civil money penalties for certain activities conducted on a knowing and reckless basis, if those activities caused a substantial loss to a depository institution. The penalties can be as high as \$1.0 million for each day the activity continues.

Anti-Tying Restrictions. Bank holding companies and their affiliates are prohibited from tying the provision of certain services, such as extensions of credit, to other services offered by a holding company or its affiliates.

Capital Adequacy Requirements. The Federal Reserve Board has adopted a system using risk-based capital guidelines to evaluate the capital adequacy of bank holding companies. Under the guidelines, specific categories of assets are assigned different risk weights, based generally on the perceived credit risk of the asset. These risk weights are multiplied by corresponding asset balances to determine a risk-weighted asset base. The guidelines require a minimum ratio of total capital to total tangible risk-weighted assets of 8.0% (of which at least 4.0% is required to consist of Tier 1 capital elements). Total capital is the sum of Tier 1 and Tier 2 capital. As of December 31, 2006, the Company's ratio of Tier 1 capital to total tangible risk-weighted assets was 13.52% and its ratio of total capital to total tangible risk-weighted assets was 14.55%. Tangible risk-weighted assets are calculated as total risk-weighted assets less intangible assets such as goodwill and core deposit intangibles.

In addition to the risk-based capital guidelines, the Federal Reserve Board uses a leverage ratio as an additional tool to evaluate the capital adequacy of bank holding companies. The leverage ratio is a company's Tier 1 capital divided by its average total tangible consolidated assets. Certain highly rated bank holding companies may maintain a minimum leverage ratio of 3.0%, but other bank holding companies are required to maintain a leverage ratio of 4.0%. As of December 31, 2006, the Company's leverage ratio was 7.76%.

The federal banking agencies' risk-based and leverage ratios are minimum supervisory ratios generally applicable to banking organizations that meet certain specified criteria, assuming that they have the highest regulatory rating. Banking organizations not meeting these criteria are expected to operate with capital positions well above the minimum ratios. The federal bank regulatory agencies may set capital requirements for a particular banking organization that are higher than the minimum ratios when circumstances warrant. Federal Reserve Board guidelines also provide that banking organizations experiencing internal growth or making acquisitions will be expected to maintain strong capital positions substantially above the minimum supervisory levels, without significant reliance on intangible assets.

Imposition of Liability for Undercapitalized Subsidiaries. Bank regulators are required to take prompt corrective action to resolve problems associated with insured depository institutions whose capital declines below certain levels. In the event an institution becomes undercapitalized, it must submit a capital restoration plan. The capital restoration plan will not be accepted by the regulators unless each company having control of the undercapitalized institution guarantees the subsidiary's compliance with the capital restoration plan up to a certain specified amount. Any such guarantee from a depository institution's holding company is entitled to a priority of payment in bankruptcy.

The aggregate liability of the holding company of an undercapitalized bank is limited to the lesser of 5% of the institution's assets at the time it became undercapitalized or the amount necessary to cause the institution to be adequately capitalized. The bank regulators have greater power in situations where an institution becomes

Table of Contents

significantly or critically undercapitalized or fails to submit a capital restoration plan. For example, a bank holding company controlling such an institution can be required to obtain prior Federal Reserve Board approval of proposed dividends, or might be required to consent to a consolidation or to divest the troubled institution or other affiliates.

Acquisitions by Bank Holding Companies. The BHCA requires every bank holding company to obtain the prior approval of the Federal Reserve Board before it may acquire all or substantially all of the assets of any bank, or ownership or control of any voting shares of any bank, if after such acquisition it would own or control, directly or indirectly, more than 5% of the voting shares of such bank. In approving bank acquisitions by bank holding companies, the Federal Reserve Board is required to consider the financial and managerial resources and future prospects of the bank holding company and the banks concerned, the convenience and needs of the communities to be served, and various competitive factors.

Control Acquisitions. The Change in Bank Control Act prohibits a person or group of persons from acquiring control of a bank holding company unless the Federal Reserve Board has been notified and has not objected to the transaction. Under a rebuttable presumption established by the Federal Reserve Board, the acquisition of 10% or more of a class of voting stock of a bank holding company with a class of securities registered under Section 12 of the Exchange Act, such as the Company, would, under the circumstances set forth in the presumption, constitute acquisition of control of the Company.

In addition, any entity is required to obtain the approval of the Federal Reserve Board under the BHCA before acquiring 25% (5% in the case of an acquirer that is a bank holding company) or more of the outstanding Common Stock of the Company, or otherwise obtaining control or a controlling influence over the Company.

The Bank

The Bank is a Texas-chartered banking association, the deposits of which are insured by the Deposit Insurance Fund (DIF) of the FDIC. The Bank is not a member of the Federal Reserve System; therefore, the Bank is subject to supervision and regulation by the FDIC and the Texas Banking Department. Such supervision and regulation subject the Bank to special restrictions, requirements, potential enforcement actions and periodic examination by the FDIC and the Texas Banking Department. Because the Federal Reserve Board regulates the bank holding company parent of the Bank, the Federal Reserve Board also has supervisory authority which directly affects the Bank.

Equivalence to National Bank Powers. The Texas Constitution, as amended in 1986, provides that a Texas-chartered bank has the same rights and privileges that are or may be granted to national banks domiciled in Texas. To the extent that the Texas laws and regulations may have allowed state-chartered banks to engage in a broader range of activities than national banks, the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) has operated to limit this authority. FDICIA provides that no state bank or subsidiary thereof may engage as principal in any activity not permitted for national banks, unless the institution complies with applicable capital requirements and the FDIC determines that the activity poses no significant risk to the insurance fund. In general, statutory restrictions on the activities of banks are aimed at protecting the safety and soundness of depository institutions.

Financial Modernization. Under the Gramm-Leach-Bliley Act, a national bank may establish a financial subsidiary and engage, subject to limitations on investment, in activities that are financial in nature, other than insurance underwriting as principal, insurance company portfolio investment, real estate development, real estate investment and annuity issuance. To do so, a bank must be well capitalized, well managed and have a CRA rating of satisfactory or better. Subsidiary banks of a financial holding company or national banks with financial subsidiaries must remain well capitalized and well managed in order to continue to engage in activities that are financial in nature without regulatory actions or restrictions, which could include divestiture of the financial in nature subsidiary or subsidiaries. In addition, a financial holding company or a bank may not acquire a company

Table of Contents

that is engaged in activities that are financial in nature unless each of the subsidiary banks of the financial holding company or the bank has a CRA rating of satisfactory or better.

Although the powers of state chartered banks are not specifically addressed in the Gramm-Leach-Bliley Act, Texas-chartered banks such as the Bank, will have the same if not greater powers as national banks through the parity provision contained in the Texas Constitution.

Branching. Texas law provides that a Texas-chartered bank can establish a branch anywhere in Texas provided that the branch is approved in advance by the Texas Banking Department. The branch must also be approved by the FDIC, which considers a number of factors, including financial history, capital adequacy, earnings prospects, character of management, needs of the community and consistency with corporate powers.

Restrictions on Transactions with Affiliates and Insiders. Transactions between the Bank and its nonbanking affiliates, including the Company, are subject to Section 23A of the Federal Reserve Act. In general, Section 23A imposes limits on the amount of such transactions, and also requires certain levels of collateral for loans to affiliated parties. It also limits the amount of advances to third parties which are collateralized by the securities or obligations of the Company or its subsidiaries.

Affiliate transactions are also subject to Section 23B of the Federal Reserve Act which generally requires that certain transactions between the Bank and its affiliates be on terms substantially the same, or at least as favorable to the Bank, as those prevailing at the time for comparable transactions with or involving other nonaffiliated persons. The Federal Reserve has also issued Regulation W which codifies prior regulations under Sections 23A and 23B of the Federal Reserve Act and interpretive guidance with respect to affiliate transactions.

The restrictions on loans to directors, executive officers, principal shareholders and their related interests (collectively referred to herein as insiders) contained in the Federal Reserve Act and Regulation O apply to all insured institutions and their subsidiaries and holding companies. These restrictions include limits on loans to one borrower and conditions that must be met before such a loan can be made. There is also an aggregate limitation on all loans to insiders and their related interests. These loans cannot exceed the institution's total unimpaired capital and surplus, and the FDIC may determine that a lesser amount is appropriate. Insiders are subject to enforcement actions for knowingly accepting loans in violation of applicable restrictions.

Restrictions on Distribution of Subsidiary Bank Dividends and Assets. Dividends paid by the Bank have provided a substantial part of the Company's operating funds and for the foreseeable future it is anticipated that dividends paid by the Bank to the Company will continue to be the Company's principal source of operating funds. Capital adequacy requirements serve to limit the amount of dividends that may be paid by the Bank. Under federal law, the Bank cannot pay a dividend if, after paying the dividend, the Bank will be undercapitalized. The FDIC may declare a dividend payment to be unsafe and unsound even though the Bank would continue to meet its capital requirements after the dividend. Because the Company is a legal entity separate and distinct from its subsidiaries, its right to participate in the distribution of assets of any subsidiary upon the subsidiary's liquidation or reorganization will be subject to the prior claims of the subsidiary's creditors. In the event of a liquidation or other resolution of an insured depository institution, the claims of depositors and other general or subordinated creditors are entitled to a priority of payment over the claims of holders of any obligation of the institution to its shareholders, including any depository institution holding company (such as the Company) or any shareholder or creditor thereof.

Examinations. The FDIC periodically examines and evaluates insured banks. Based on such an evaluation, the FDIC may revalue the assets of the institution and require that it establish specific reserves to compensate for the difference between the FDIC-determined value and the book value of such assets. The Texas Banking Department also conducts examinations of state banks but may accept the results of a federal examination in lieu of conducting an independent examination. In addition, the FDIC and Texas Banking Department may elect to conduct a joint examination.

Table of Contents

Audit Reports. Insured institutions with total assets of \$500 million or more must submit annual audit reports prepared by independent auditors to federal and state regulators. In some instances, the audit report of the institution's holding company can be used to satisfy this requirement. Auditors must receive examination reports, supervisory agreements and reports of enforcement actions. In addition, financial statements prepared in accordance with generally accepted accounting principles, management's certifications concerning responsibility for the financial statements, internal controls and compliance with legal requirements designated by the FDIC, and an attestation by the auditor regarding the statements of management relating to the internal controls must be submitted. For institutions with total assets of more than \$3 billion, independent auditors may be required to review quarterly financial statements. FDICIA requires that independent audit committees be formed, consisting of outside directors only. The committees of such institutions must include members with experience in banking or financial management, must have access to outside counsel, and must not include representatives of large customers.

Capital Adequacy Requirements. The FDIC has adopted regulations establishing minimum requirements for the capital adequacy of insured institutions. The FDIC may establish higher minimum requirements if, for example, a bank has previously received special attention or has a high susceptibility to interest rate risk.

The FDIC's risk-based capital guidelines generally require state banks to have a minimum ratio of Tier 1 capital to total tangible risk-weighted assets of 4.0% and a ratio of total capital to total tangible risk-weighted assets of 8.0%. The capital categories have the same definitions for the Bank as for the Company. As of December 31, 2006, the Bank's ratio of Tier 1 capital to total tangible risk-weighted assets was 13.28% and its ratio of total capital to total tangible risk-weighted assets was 14.31%.

The FDIC's leverage guidelines require state banks to maintain Tier 1 capital of no less than 4.0% of average total tangible assets, except in the case of certain highly rated banks for which the requirement is 3.0% of average total assets. The Texas Banking Department has issued a policy which generally requires state chartered banks to maintain a leverage ratio (defined in accordance with federal capital guidelines) of 5.0%. As of December 31, 2006, the Bank's ratio of Tier 1 capital to average total assets (leverage ratio) was 7.61%.

Corrective Measures for Capital Deficiencies. The federal banking regulators are required to take prompt corrective action with respect to capital-deficient institutions. Agency regulations define, for each capital category, the levels at which institutions are well-capitalized, adequately capitalized, under capitalized, significantly under capitalized and critically under capitalized. A well-capitalized bank has a total risk-based capital ratio of 10.0% or higher; a Tier 1 risk-based capital ratio of 6.0% or higher; a leverage ratio of 5.0% or higher; and is not subject to any written agreement, order or directive requiring it to maintain a specific capital level for any capital measure. An adequately capitalized bank has a total risk-based capital ratio of 8.0% or higher; a Tier 1 risk-based capital ratio of 4.0% or higher; a leverage ratio of 4.0% or higher (3.0% or higher if the bank was rated a composite 1 in its most recent examination report and is not experiencing significant growth); and does not meet the criteria for a well capitalized bank. A bank is under capitalized if it fails to meet any one of the ratios required to be adequately capitalized. The Bank is classified as well-capitalized for purposes of the FDIC's prompt corrective action regulations.

In addition to requiring undercapitalized institutions to submit a capital restoration plan, agency regulations contain broad restrictions on certain activities of undercapitalized institutions including asset growth, acquisitions, branch establishment and expansion into new lines of business. With certain exceptions, an insured depository institution is prohibited from making capital distributions, including dividends, and is prohibited from paying management fees to control persons if the institution would be undercapitalized after any such distribution or payment.

As an institution's capital decreases, the FDIC's enforcement powers become more severe. A significantly undercapitalized institution is subject to mandated capital raising activities, restrictions on interest rates paid and transactions with affiliates, removal of management and other restrictions. The FDIC has only very limited

Table of Contents

discretion in dealing with a critically undercapitalized institution and is virtually required to appoint a receiver or conservator.

Banks with risk-based capital and leverage ratios below the required minimums may also be subject to certain administrative actions, including the termination of deposit insurance upon notice and hearing, or a temporary suspension of insurance without a hearing in the event the institution has no tangible capital.

Deposit Insurance Assessments. The Bank's deposits are insured by the FDIC through the DIF to the extent provided by law and the Bank must pay assessments to the FDIC for such deposit insurance protection. The FDIC has implemented a risk-based assessment system under which FDIC-insured depository institutions pay annual premiums at rates based on their risk classification. A bank's risk classification is based on its capital levels and the level of supervisory concern the Bank poses to the regulators. Institutions assigned to higher risk classifications (that is, institutions that pose a greater risk of loss to their respective deposit insurance funds) pay assessments of higher rates than institutions that pose a lower risk. A decrease in the Bank's capital ratios or the occurrence of events that have an adverse effect on the Bank's asset quality, management, earnings or liquidity could result in a substantial increase in deposit insurance premiums paid by the Bank, which would adversely affect the Bank's earnings. In addition, the FDIC can impose special assessments in certain instances. The current range of DIF assessments is between 0% and 0.27% of deposits.

The Federal Deposit Insurance Reform Act of 2005 (*Deposit Reform Act*) among other things, consolidates the Bank Insurance Fund and Savings Association Insurance Fund into the DIF, establishes a range for reserves levels for the DIF of 1.15% to 1.50% and creates a mechanism for raising the ceiling on deposit insurance coverage to reflect future inflation. The FDIC has adopted final regulations with respect to the *Deposit Reform Act* effective as of January 1, 2007. Under the new regulations, the FDIC will evaluate each institution's risk based on three primary sources of information: supervisory ratings for all insured institutions, financial ratios for most institutions, and long-term debt issuer ratings for large institutions that have them. In connection with the adoption of the new regulations, the FDIC set the assessment rates that took effect on January 1, 2007. The FDIC also set the designated reserve ratio for the DIF at 1.25% of estimated insured deposits.

Brokered Deposit Restrictions. Adequately capitalized institutions cannot accept, renew or roll over brokered deposits except with a waiver from the FDIC, and are subject to restrictions on the interest rates that can be paid on such deposits. Undercapitalized institutions may not accept, renew, or roll over brokered deposits.

Cross-Guarantee Provisions. The Financial Institutions Reform, Recovery and Enforcement Act of 1989 (*FIRREA*) contains a cross-guarantee provision which generally makes commonly controlled insured depository institutions liable to the FDIC for any losses incurred in connection with the failure of a commonly controlled depository institution.

Community Reinvestment Act. The Community Reinvestment Act (*CRA*) and the regulations issued thereunder are intended to encourage banks to help meet the credit needs of their service area, including low and moderate income neighborhoods, consistent with the safe and sound operations of the banks. These regulations also provide for regulatory assessment of a bank's record in meeting the needs of its service area when considering applications to establish branches, merger applications and applications to acquire the assets and assume the liabilities of another bank. *FIRREA* requires federal banking agencies to make public a rating of a bank's performance under the *CRA*. In the case of a bank holding company, the *CRA* performance record of the banks involved in the transaction are reviewed in connection with the filing of an application to acquire ownership or control of shares or assets of a bank or to merge with any other bank holding company. An unsatisfactory record can substantially delay or block the transaction.

Consumer Laws and Regulations. In addition to the laws and regulations discussed herein, the Bank is also subject to certain consumer laws and regulations that are designed to protect consumers in transactions with

Table of Contents

banks. While the list set forth herein is not exhaustive, these laws and regulations include the Truth in Lending Act, the Truth in Savings Act, the Electronic Funds Transfer Act, the Expedited Funds Availability Act, the Equal Credit Opportunity Act, and the Fair Housing Act, among others. These laws and regulations mandate certain disclosure requirements and regulate the manner in which financial institutions must deal with customers when taking deposits or making loans to such customers. The Bank must comply with the applicable provisions of these consumer protection laws and regulations as part of their ongoing customer relations.

The USA PATRIOT Act of 2001. The Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (USA PATRIOT Act) was enacted in October 2001. The USA PATRIOT Act is intended to strengthen U.S. law enforcement s and the intelligence communities ability to work cohesively to combat terrorism on a variety of fronts. The potential impact of the USA PATRIOT Act on financial institutions of all kinds is significant and wide ranging. The USA PATRIOT Act contains sweeping anti-money laundering and financial transparency laws and requires various regulations, including: (i) due diligence requirements for financial institutions that administer, maintain, or manage private bank accounts or correspondent accounts for non-U.S. persons; (ii) standards for verifying customer identification at account opening; (iii) rules to promote cooperation among financial institutions, regulators and law enforcement entities in identifying parties that may be involved in terrorism or money laundering; (iv) reports by nonfinancial trades and business filed with the Treasury Department s Financial Crimes Enforcement Network for transactions exceeding \$10,000; and (v) filing of suspicious activities reports involving securities by brokers and dealers if they believe a customer may be violating U.S. laws and regulations.

Privacy. In addition to expanding the activities in which banks and bank holding companies may engage, the Gramm-Leach-Bliley Act also imposed new requirements on financial institutions with respect to customer privacy. The Gramm-Leach-Bliley Act generally prohibits disclosure of customer information to non-affiliated third parties unless the customer has been given the opportunity to object and has not objected to such disclosure. Financial institutions are further required to disclose their privacy policies to customers annually. Financial institutions, however, will be required to comply with state law if it is more protective of customer privacy than the Gramm-Leach-Bliley Act.

Legislative Initiatives

From time to time, various legislative and regulatory initiatives are introduced in Congress and State Legislatures. Such initiatives may change banking statutes and the operating environment of the Company and its banking subsidiaries in substantial and unpredictable ways. The Company cannot determine the ultimate effect that any potential legislation, if enacted, or implementing regulations with respect thereto, would have, upon the financial condition or results of operations of the Company or its subsidiaries. A change in statutes, regulations or regulatory policies applicable to the Company or any of its subsidiaries could have a material effect on the financial condition, results of operations or business of the Company and its subsidiaries.

Enforcement Powers of Federal and State Banking Agencies

The federal banking agencies have broad enforcement powers, including the power to terminate deposit insurance, impose substantial fines and other civil and criminal penalties, and appoint a conservator or receiver. Failure to comply with applicable laws, regulations, and supervisory agreements could subject the Company or the Bank and their subsidiaries, as well as officers, directors, and other institution-affiliated parties of these organizations, to administrative sanctions and potentially substantial civil money penalties. In addition to the grounds discussed above under The Bank Corrective Measures for Capital Deficiencies, the appropriate federal banking agency may appoint the FDIC as conservator or receiver for a banking institution (or the FDIC may appoint itself, under certain circumstances) if any one or more of a number of circumstances exist, including, without limitation, the fact that the banking institution is undercapitalized and has no reasonable prospect of becoming adequately capitalized; fails to become adequately capitalized when required to do so; fails to submit a timely and acceptable capital restoration plan; or materially fails to implement an accepted capital

Table of Contents

restoration plan. The Texas Department of Banking also has broad enforcement powers over the Bank, including the power to impose orders, remove officers and directors, impose fines and appoint supervisors and conservators.

Effect on Economic Environment

The policies of regulatory authorities, including the monetary policy of the Federal Reserve Board, have a significant effect on the operating results of bank holding companies and their subsidiaries. Among the means available to the Federal Reserve Board to affect the money supply are open market operations in U.S. government securities, changes in the discount rate on member bank borrowings, and changes in reserve requirements against member bank deposits. These means are used in varying combinations to influence overall growth and distribution of bank loans, investments and deposits, and their use may affect interest rates charged on loans or paid for deposits.

Federal Reserve Board monetary policies have materially affected the operating results of commercial banks in the past and are expected to continue to do so in the future. The nature of future monetary policies and the effect of such policies on the business and earnings of the Company and its subsidiaries cannot be predicted.

ITEM 1A. RISK FACTORS

An investment in the Company's Common Stock involves risks. The following is a description of the material risks and uncertainties that the Company believes affect its business and an investment in the Common Stock. Additional risks and uncertainties that the Company is unaware of, or that it currently deems immaterial, also may become important factors that affect the Company and its business. If any of the risks described in this annual report on Form 10-K were to occur, the Company's financial condition and results of operations could be materially and adversely affected. If this were to happen, the value of the Common Stock could decline significantly and you could lose all or part of your investment.

Risks Associated with the Company's Business

If the Company is not able to continue its historical levels of growth, it may not be able to maintain its historical earnings trends.

To achieve its past levels of growth, the Company has initiated internal growth programs and completed a number of acquisitions. The Company may not be able to sustain its historical rate of growth or may not be able to grow at all. In addition, the Company may not be able to obtain the financing necessary to fund additional growth and may not be able to find suitable candidates for acquisition. Various factors, such as economic conditions and competition, may impede or prohibit the opening of new banking centers. Further, the Company may be unable to attract and retain experienced bankers, which could adversely affect its internal growth. If the Company is not able to continue its historical levels of growth, it may not be able to maintain its historical earnings trends.

If the Company is unable to manage its growth effectively, its operations could be negatively affected.

Companies that experience rapid growth face various risks and difficulties, including:

finding suitable markets for expansion;

finding suitable candidates for acquisition;

attracting funding to support additional growth;

maintaining asset quality;

attracting and retaining qualified management; and

maintaining adequate regulatory capital.

Table of Contents

In addition, in order to manage its growth and maintain adequate information and reporting systems within its organization, the Company must identify, hire and retain additional qualified employees, particularly in the accounting and operational areas of its business.

If the Company does not manage its growth effectively, its business, financial condition, results of operations and future prospects could be negatively affected, and the Company may not be able to continue to implement its business strategy and successfully conduct its operations.

If the Company is unable to identify and acquire other financial institutions and successfully integrate its acquired businesses, its business and earnings may be negatively affected.

The market for acquisitions remains highly competitive, and the Company may be unable to find acquisition candidates in the future that fit its acquisition and growth strategy. To the extent that the Company is unable to find suitable acquisition candidates, an important component of its growth strategy may be lost.

Acquisitions of financial institutions involve operational risks and uncertainties and acquired companies may have unforeseen liabilities, exposure to asset quality problems, key employee and customer retention problems and other problems that could negatively affect the Company's organization. The Company may not be able to complete future acquisitions and, if completed, the Company may not be able to successfully integrate the operations, management, products and services of the entities that it acquires and eliminate redundancies. The integration process could result in the loss of key employees or disruption of the combined entity's ongoing business or inconsistencies in standards, controls, procedures and policies that adversely affect the Company's ability to maintain relationships with customers and employees or achieve the anticipated benefits of the transaction. The integration process may also require significant time and attention from the Company's management that they would otherwise direct at servicing existing business and developing new business. The Company's failure to successfully integrate the entities it acquires into its existing operations may increase its operating costs significantly and adversely affect its business and earnings.

The Company's business is subject to interest rate risk and fluctuations in interest rates may adversely affect its earnings and capital levels.

The majority of the Company's assets are monetary in nature and, as a result, the Company is subject to significant risk from changes in interest rates. Changes in interest rates can impact the Company's net interest income as well as the valuation of its assets and liabilities. The Company's earnings and cash flows are significantly dependent on its net interest income. Net interest income is the difference between the interest income earned on loans, investment securities and other interest-earning assets and the interest expense paid on deposits, borrowings and other interest-bearing liabilities. Therefore, any change in general market interest rates, such as a change in the monetary policy of the Federal Reserve Board or otherwise, can have a significant effect on the Company's net interest income. The Company's assets and liabilities may react differently to changes in overall market rates or conditions because there may be mismatches between the repricing or maturity characteristics of the assets and liabilities.

The Company's profitability depends significantly on local economic conditions.

The Company's success depends primarily on the general economic conditions of the geographic markets in which it operates. Unlike larger banks that are more geographically diversified, the Company provides banking and financial services to customers primarily in the central, north central, south central and southeast areas of Texas. The local economic conditions in these areas have a significant impact on the Company's commercial, real estate and construction loans, the ability of its borrowers to repay their loans and the value of the collateral securing these loans. A significant decline in general economic conditions, caused by inflation, recession, acts of terrorism, outbreak of hostilities or other international or domestic calamities, unemployment or other factors could impact these local economic conditions and negatively affect the Company's financial results.

Table of Contents

The Company's allowance for credit losses may not be sufficient to cover actual credit losses, which could adversely affect its earnings.

As a lender, the Company is exposed to the risk that its loan customers may not repay their loans according to the terms of these loans and the collateral securing the payment of these loans may be insufficient to fully compensate the Company for the outstanding balance of the loan plus the costs to dispose of the collateral. The Company may experience significant loan losses which could have a material adverse effect on its operating results and financial condition. Management makes various assumptions and judgments about the collectibility of the Company's loan portfolio, including the diversification by industry of its commercial loan portfolio, the amount of nonperforming loans and related collateral, the volume, growth and composition of its loan portfolio, the effects on the loan portfolio of current economic indicators and their probable impact on borrowers and the evaluation of its loan portfolio through its internal loan review process and other relevant factors.

The Company maintains an allowance for credit losses in an attempt to cover credit losses inherent in its loan portfolio. Additional credit losses will likely occur in the future and may occur at a rate greater than the Company has experienced to date. In determining the size of the allowance, the Company relies on an analysis of its loan portfolio, its experience and its evaluation of general economic conditions. If the Company's assumptions prove to be incorrect, its current allowance may not be sufficient and adjustments may be necessary to allow for different economic conditions or adverse developments in its loan portfolio. Material additions to the allowance would materially decrease net income.

In addition, federal and state regulators periodically review the Company's allowance for credit losses and may require the Company to increase its provision for credit losses or recognize further charge-offs, based on judgments different than those of the Company's management. Any increase in the Company's allowance for credit losses or charge-offs as required by these regulatory agencies could have a material adverse effect on the Company's operating results and financial condition.

The Company's small to medium-sized business target market may have fewer financial resources to weather a downturn in the economy.

The Company targets its business development and marketing strategy primarily to serve the banking and financial services needs of small to medium-sized businesses. These small to medium-sized businesses generally have fewer financial resources in terms of capital or borrowing capacity than larger entities. If general economic conditions negatively impact the southeast Texas area or the other markets in which the Company operates, the Company's results of operations and financial condition may be negatively affected.

An interruption in or breach in security of the Company's information systems may result in a loss of customer business.

The Company relies heavily on communications and information systems to conduct its business. Any failure, interruption or breach in security of these systems could result in failures or disruptions in the Company's customer relationship management, general ledger, deposits, servicing or loan origination systems. Although the Company has policies and procedures designed to prevent or minimize the effect of a failure, interruption or breach in security of its communications or information systems, there can be no assurance that any such failures, interruptions or security breaches will not occur, or if they do occur, that they will be adequately addressed by the Company. The occurrence of any such failures, interruptions or security breaches could result in a loss of customer business and have a negative effect on the Company's results of operations and financial condition.

The business of the Company is dependent on technology and the Company's inability to invest in technological improvements may adversely affect its results of operations and financial condition.

The financial services industry is undergoing rapid technological changes with frequent introductions of new technology driven products and services. In addition to better serving customers, the effective use of technology increases efficiency and enables financial institutions to reduce costs. The Company's future success

Table of Contents

depends in part upon its ability to address the needs of its customers by using technology to provide products and services that will satisfy customer demands for convenience as well as create additional efficiencies in its operations. Many of the Company's competitors have substantially greater resources to invest in technological improvements. The Company may not be able to effectively implement new technology driven products and services or be successful in marketing these products and services to its customers, which may negatively affect the Company's results of operations and financial condition.

The Company operates in a highly regulated environment and, as a result, is subject to extensive regulation and supervision that could adversely affect its financial performance, and the Company may be adversely affected by changes in federal, state and local laws and regulations.

The Company is subject to extensive regulation, supervision and examination by federal and state banking authorities. Any change in applicable regulations or federal or state legislation could have a substantial impact on the Company, its subsidiary bank, and their respective operations. Additional legislation and regulations may be enacted or adopted in the future that could significantly affect the Company's powers, authority and operations, or the powers, authority and operations of the Bank, which could have a material adverse effect on the Company's financial condition and results of operations. Further, regulators have significant discretion and power to prevent or remedy unsafe or unsound practices or violations of laws by banks and bank holding companies in the performance of their supervisory and enforcement duties. The exercise of this regulatory discretion and power may have a negative impact on the Company.

Risks Associated with the Company's Common Stock

The Company's corporate organizational documents and the provisions of Texas law to which it is subject may delay or prevent a change in control of the Company that you may favor.

The Company's amended and restated articles of incorporation and amended and restated bylaws contain various provisions which may delay, discourage or prevent an attempted acquisition or change of control of the Company. These provisions include:

a board of directors classified into three classes of directors with the directors, of each class having staggered, three year terms;

a provision that any special meeting of the Company's shareholders may be called only by the chairman of the board and chief executive officer, the president, a majority of the board of directors or the holders of at least 50% of the Company's shares entitled to vote at the meeting;

a provision establishing certain advance notice procedures for nomination of candidates for election as directors and for shareholder proposals to be considered at an annual or special meeting of shareholders; and

a provision that denies shareholders the right to amend the Company's bylaws.

The Company's articles of incorporation provide for noncumulative voting for directors and authorize the board of directors to issue shares of its preferred stock without shareholder approval and upon such terms as the board of directors may determine. The issuance of the Company's preferred stock could have the effect of making it more difficult for a third party to acquire, or of discouraging a third party from acquiring, a controlling interest in the Company. In addition, certain provisions of Texas law, including a provision which restricts certain business combinations between a Texas corporation and certain affiliated shareholders, may delay, discourage or prevent an attempted acquisition or change in control of the Company.

Table of Contents

The holders of the Company's junior subordinated debentures have rights that are senior to those of the Company's shareholders.

As of December 31, 2006, the Company had \$100.5 million in junior subordinated debentures outstanding that were issued to the Company's subsidiary trusts. The subsidiary trusts purchased the junior subordinated debentures from the Company using the proceeds from the sale of trust preferred securities to third party investors. Payments of the principal and interest on the trust preferred securities are conditionally guaranteed by the Company to the extent not paid or made by each trust, provided the trust has funds available for such obligations.

The junior subordinated debentures are senior to the Company's shares of Common Stock. As a result, the Company must make payments on the junior subordinated debentures (and the related trust preferred securities) before any dividends can be paid on its Common Stock and, in the event of the Company's bankruptcy, dissolution or liquidation, the holders of the debentures must be satisfied before any distributions can be made to the holders of the Common Stock. The Company has the right to defer distributions on the junior subordinated debentures (and the related trust preferred securities) for up to five years, during which time no dividends may be paid to holders of the Company's Common Stock.

ITEM 1B. UNRESOLVED STAFF COMMENTS

None.

Table of Contents**ITEM 2. PROPERTIES**

As of December 31, 2006, the Company conducted business at 88 full-service banking centers. The Company's headquarters are located at Prosperity Bank Plaza, 4295 San Felipe, in the Galleria area in Houston, Texas. The Company owns all of the buildings in which its banking centers are located other than those listed below. The expiration dates of the leases for the banking centers listed below do not include renewal periods at the Company's option which may be available.

Banking Center	Expiration Date of Lease
Houston CMSA ⁽¹⁾ :	
Bellaire	October 2007
City West	January 2009
Downtown	October 2012
Fairfield	May 2008
Galveston	November 2010
Gladebrook	October 2010
Heights	January 2008
Holcombe	July 2009
Medical Center	March 2010
Post Oak	June 2007
Pecan Grove	October 2015
River Oaks	December 2009
Southwest Medical	October 2010
Waugh Drive	February 2011
Westheimer	May 2011
South Texas Area:	
Gonzales	November 2007
Dallas, Texas Area:	
Abrams Centre	December 2008
Preston Road	September 2013
Corpus Christi, Texas Area:	
Airline	August 2008
Aransas Pass	March 2011
Carmel	January 2009
Port Aransas	February 2009
Waterstreet	November 2015
Woodlawn	April 2007
Austin, Texas Area:	
Congress	August 2014
Congress Drive-thru	* (2)
Oak Hill	May 2010
East Texas Area:	
None	

(1) The Houston CMSA includes Austin, Brazoria, Chambers, Fort Bend, Galveston, Harris, Liberty, Montgomery, San Jacinto and Waller counties.

(2) Month to month lease.

Table of Contents

The following table sets forth specific information regarding the banking centers located in each of the Company's geographical market areas at December 31, 2006:

Geographical Area	Number of Banking Centers	Deposits at December 31, 2006 (Dollars in thousands)
Houston CMSA	38	\$ 1,834,757
South Texas area	17	932,024
Dallas, Texas area	11	372,602
Corpus Christi, Texas area	15	329,967
Austin, Texas area	5	210,615
East Texas area	2	45,713
Total	88	\$ 3,725,678

ITEM 3. LEGAL PROCEEDINGS

Neither the Company nor the Bank is currently a party to any material legal proceeding.

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

A special meeting of the Company's shareholders was held on December 13, 2006. The record date for the special meeting was October 27, 2006, at which date the Company had 32,791,785 shares of common stock outstanding. At the special meeting, the shareholders of the Company considered and acted on a proposal to approve the Agreement and Plan of Reorganization, dated as of July 18, 2006, as amended, by and between the Company and Texas United Bancshares, Inc. pursuant to which Texas United will merge with and into the Company, all on and subject to the terms and conditions contained therein. A total of 24,014,255 shares voted in favor of the proposal, 2,478 shares voted against the proposal and 387,482 shares abstained.

PART II.**ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED SHAREHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES****Common Stock Market Prices**

The Company's Common is listed on the Nasdaq Global Select Market under the symbol PRSP. As of February 28, 2007, there were 43,667,909 shares outstanding and 2,303 shareholders of record. The number of beneficial owners is unknown to the Company at this time.

The following table presents the high and low intra-day sales prices for the Common Stock as reported by Nasdaq during the two years ended December 31, 2006:

2006	High	Low
Fourth Quarter	\$ 35.38	\$ 32.54
Third Quarter	36.16	31.64
Second Quarter	33.90	29.65
First Quarter	30.54	28.50
2005	High	Low
Fourth Quarter	\$ 32.12	\$ 27.97
Third Quarter	31.45	28.14
Second Quarter	28.97	25.05
First Quarter	29.32	25.50

Table of Contents**Dividends**

Holders of Common Stock are entitled to receive dividends when, as and if declared by the Company's Board of Directors out of funds legally available therefor. While the Company has declared dividends on its Common Stock since 1994, and paid quarterly dividends aggregating \$0.4125 per share in 2006 and \$0.3475 per share in 2005, there is no assurance that the Company will continue to pay dividends in the future. Future dividends on the Common Stock will depend upon the Company's earnings and financial condition, liquidity and capital requirements, the general economic and regulatory climate, the Company's ability to service any equity or debt obligations senior to the Common Stock and other factors deemed relevant by the board of directors of the Company.

As a holding company, the Company is ultimately dependent upon its subsidiaries to provide funding for its operating expenses, debt service and dividends. Various banking laws applicable to the Bank limit the payment of dividends and other distributions by the Bank to the Company, and may therefore limit the Company's ability to pay dividends on its Common Stock. If required payments on the Company's outstanding junior subordinated debentures held by its unconsolidated subsidiary trusts are not made or suspended, the Company will be prohibited from paying dividends on its Common Stock. Regulatory authorities could impose administratively stricter limitations on the ability of the Bank to pay dividends to the Company if such limits were deemed appropriate to preserve certain capital adequacy requirements.

The cash dividends declared per share by quarter (and paid on the first business day of the subsequent quarter) for the Company's last two fiscal years were as follows:

	2006	2005
Fourth quarter	\$ 0.1125	\$ 0.1000
Third quarter	0.1000	0.0825
Second quarter	0.1000	0.0825
First quarter	0.1000	0.0825

Recent Sales of Unregistered Securities

None.

Table of Contents**Securities Authorized for Issuance under Equity Compensation Plans**

As of December 31, 2006, the Company had outstanding stock options granted under three stock option plans, all of which were approved by the Company's shareholders. As of such date, the Company also had outstanding stock options granted under stock option plans that it assumed in connection with various acquisition transactions. The following table provides information as of December 31, 2006 regarding the Company's equity compensation plans under which the Company's equity securities are authorized for issuance:

Plan category	Number of securities		
	Number of securities to be issued upon exercise of outstanding options, warrants and rights	Weighted-average exercise price of outstanding options	remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a))
	(a)	(b)	(c)
Equity compensation plans approved by security holders	1,142,084 ⁽¹⁾	\$ 21.68	1,206,483
Equity compensation plans not approved by security holders			
Total	1,142,084	\$ 21.68	1,206,483

(1) Includes (a) 4,240 shares which may be issued upon exercise of options outstanding assumed by the Company in connection with the acquisition of Paradigm Bancorporation, Inc. at a weighted average exercise price of \$11.50, (b) 31,127 shares which may be issued upon exercise of options outstanding assumed by the Company in connection with the acquisition of MainBancorp, Inc. at a weighted average exercise price of \$16.26, (c) 136,645 shares which may be issued upon exercise of options outstanding assumed by the Company in connection with the acquisition of First Capital Bankers, Inc. at a weighted average exercise price of \$18.47 and (d) 75,172 shares which may be issued upon exercise of options outstanding assumed by the Company in connection with the acquisition of SNB Bancshares, Inc. at a weighted average exercise price of \$8.12.

Issuer Purchases of Equity Securities

None.

Table of Contents**Performance Graph**

The following Performance Graph compares the cumulative total shareholder return on the Company's Common Stock for the period beginning at the close of trading on December 31, 2001 to December 31, 2006, with the cumulative total return of the S&P 500 Total Return Index and the Nasdaq Bank Index for the same period. Dividend reinvestment has been assumed. The Performance Graph assumes \$100 invested on December 31, 2001 in the Company's Common Stock, the S&P 500 Total Return Index and the Nasdaq Bank Index. The historical stock price performance for the Company's Common Stock shown on the graph below is not necessarily indicative of future stock performance.

Composite of Cumulative Total Return

**Prosperity Bancshares, Inc., the S&P 500 Total Return Index
and the Nasdaq Bank Index**

	<i>Year Ending</i>					
	12/31/01	12/31/02	12/31/03	12/31/04	12/31/05	12/31/06
Prosperity Bancshares, Inc.	\$ 100.00	\$ 142.64	\$ 172.11	\$ 224.73	\$ 223.82	\$ 272.17
S & P 500	100.00	77.90	100.24	111.15	116.61	135.03
NASDAQ Bank	100.00	59.14	89.11	103.85	130.57	166.05

Copyright© 2007, Standard & Poor's, a division of The McGraw-Hill Companies, Inc. All rights reserved.

www.researchdatagroup.com/S&P.htm

Table of Contents**ITEM 6. SELECTED CONSOLIDATED FINANCIAL DATA**

The following selected consolidated financial data for, and as of the end of, each of the years in the five-year period ended December 31, 2006 are derived from and should be read in conjunction with the Company's consolidated financial statements and the notes thereto. All per share data for 2002 has been restated to give effect to the two-for-one stock split effective May 31, 2002.

	2006 ⁽¹⁾	As of and for the Years Ended December 31,			2002
		2005	2004	2003	
		(Dollars in thousands, except per share data)			
Income Statement Data:					
Interest income	\$ 231,739	\$ 162,123	\$ 111,756	\$ 90,845	\$ 80,742
Interest expense	93,594	51,226	29,789	26,346	28,101
Net interest income	138,145	110,897	81,967	64,499	52,641
Provision for credit losses	504	480	880	483	1,010
Net interest income after provision for credit losses	137,641	110,417	81,087	64,016	51,631
Noninterest income	33,982	30,021	23,071	16,966	11,594
Noninterest expense	77,669	68,957	51,707	42,021	32,349
Income before taxes	93,954	71,481	52,451	38,961	30,876
Provision for income taxes	32,229	23,621	17,744	12,413	9,555
Net income	\$ 61,725	\$ 47,860	\$ 34,707	\$ 26,548	\$ 21,321
Per Share Data^{(2):}					
Basic earnings per share	\$ 1.96	\$ 1.79	\$ 1.61	\$ 1.38	\$ 1.25
Diluted earnings per share	1.94	1.77	1.59	1.36	1.22
Book value per share	20.26	16.69	12.32	10.49	8.19
Cash dividends declared.	0.41	0.35	0.31	0.25	0.22
Dividend payout ratio	21.10%	20.11%	19.22%	18.29%	18.13%
Weighted average shares outstanding (basic) (in thousands).	31,491	26,706	21,534	19,225	17,122
Weighted average shares outstanding (diluted) (in thousands).	31,893	27,024	21,804	19,536	17,442
Shares outstanding at end of period (in thousands).	32,793	27,821	22,381	20,930	18,896
Balance Sheet Data (at period end):					
Total assets	\$ 4,586,769	\$ 3,585,982	\$ 2,697,228	\$ 2,400,487	\$ 1,823,286
Securities	1,590,303	1,572,602	1,302,792	1,376,880	950,317
Loans	2,176,507	1,542,125	1,035,513	770,053	679,559
Allowance for credit losses	23,990	17,203	13,105	10,345	9,580
Total goodwill and intangibles	447,371	284,425	164,672	124,755	72,410
Total deposits	3,725,678	2,920,318	2,317,076	2,083,748	1,586,611
Borrowings and notes payable.	73,633	102,389	38,174	30,936	37,939
Total shareholders' equity	664,411	464,717	275,647	219,588	154,739
Junior subordinated debentures	100,519 ⁽³⁾	75,775	47,424	59,804	34,030
Average Balance Sheet Data:					
Total assets	\$ 4,283,795	\$ 3,361,617	\$ 2,543,088	\$ 2,006,869	\$ 1,470,758
Securities	1,612,221	1,471,067	1,383,790	1,108,153	818,362
Loans	2,037,379	1,435,376	871,736	697,235	524,885
Allowance for credit losses	22,476	16,334	11,454	9,525	7,350
Total goodwill and intangibles	406,920	253,703	139,405	81,485	38,531
Total deposits	3,449,100	2,791,813	2,189,695	1,749,045	1,300,884

Edgar Filing: PROSPERITY BANCSHARES INC - Form 10-K

Total shareholders' equity	602,712	413,864	243,274	170,167	114,234
Junior subordinated debentures	92,271	69,869	59,288	39,400	29,648

(Table continued on next page)

Table of Contents

	2006 ⁽¹⁾	As of and for the Years Ended December 31, 2005 2004 2003			2002
	(Dollars in thousands, except per share data)				
Performance Ratios:					
Return on average assets	1.44%	1.42%	1.36%	1.32%	1.45%
Return on average equity	10.24	11.56	14.27	15.60	18.66
Net interest margin (tax equivalent)	3.80	3.81	3.63	3.64	4.00
Efficiency ratio ⁽⁴⁾	45.29	48.93	49.45	51.82	50.39
Asset Quality Ratios⁽⁵⁾:					
Nonperforming assets to total loans and other real estate.	0.05%	0.09%	0.17%	0.13%	0.38%
Net charge-offs to average loans	0.04	0.03	0.06	0.23	0.08
Allowance for credit losses to total loans.	1.10	1.12	1.27	1.34	1.41
Allowance for credit losses to nonperforming loans ⁽⁶⁾	2,530.6	1,505.1	949.6	1,519.1	408.53
Capital Ratios⁽⁵⁾:					
Leverage ratio	7.76%	7.83%	6.30%	7.10%	6.56%
Average shareholders' equity to average total assets	14.07	12.31	9.57	8.48	7.77
Tier 1 risk-based capital ratio.	13.52	15.34	13.56	15.82	14.10
Total risk-based capital ratio	14.55	16.37	14.67	16.90	15.30

(1) The Company completed the acquisition of SNB Bancshares, Inc. on April 1, 2006.

(2) Adjusted for a two-for-one stock split effective May 31, 2002.

(3) Consists of \$15.5 million of junior subordinated debentures of Prosperity Statutory Trust II due July 31, 2031, \$12.9 million of junior subordinated debentures of Prosperity Statutory Trust III due September 17, 2033, \$12.9 million of junior subordinated debentures of Prosperity Statutory Trust IV due December 30, 2033, \$20.6 million of junior subordinated debentures of First Capital Statutory Trust I due March 26, 2032 (assumed by the Company on March 1, 2005), \$7.7 million of junior subordinated debentures of First Capital Statutory Trust II due September 26, 2032 (assumed by the Company on March 1, 2005), \$10.3 million of junior subordinated debentures of SNB Statutory Trust II due March 26, 2033 (assumed by the Company on April 1, 2006), \$10.3 million of junior subordinated debentures of SNB Capital Trust III due March 27, 2033 (assumed by the Company on April 1, 2006) and \$10.3 million of junior subordinated debentures of SNB Capital Trust IV due September 25, 2033 (assumed by the Company on April 1, 2006).

(4) Calculated by dividing total noninterest expense, excluding credit loss provisions, by net interest income plus noninterest income, excluding net gains and losses on the sale of securities and on the sale of assets. Additionally, taxes are not part of this calculation.

(5) At period end, except for net charge-offs to average loans and average shareholders' equity to average total assets, which is for periods ended at such dates.

(6) Nonperforming loans consist of nonaccrual loans, loans contractually past due 90 days or more, restructured loans and any other loan management deems to be nonperforming.

Table of Contents

ITEM 7. 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 annual report on Form 10-K that are not statements of historical fact constitute forward-looking statements made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. These 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, but are not limited to:

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

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

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

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

the timing, impact and other uncertainties of 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;

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 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;

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;

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;

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. Therefore, the

Table of Contents

Company cautions you not to place undue reliance on its forward-looking statements. The forward-looking statements are made as of the date the statement is made. The Company undertakes no obligation to publicly update or otherwise revise any forward-looking statements, whether as a result of new information, future events or otherwise.

Management's Discussion and Analysis of Financial Condition and Results of Operations analyzes the major elements of the Company's balance sheets and statements of income. This section should be read in conjunction with the Company's consolidated financial statements and accompanying notes and other detailed information appearing elsewhere in this Annual Report on Form 10-K.

For the Years Ended December 31, 2006, 2005 and 2004

Overview

The Company generates the majority of its revenues from interest income on loans, service charges on customer accounts and income from investment in securities. The revenues are partially offset by interest expense paid on deposits and other borrowings and non-interest expenses such as administrative and occupancy expenses. Net interest income is the difference between interest income on earning assets such as loans and securities and interest expense on liabilities such as deposits and borrowings which are used to fund those assets. Net interest income is the Company's largest source of revenue, representing 52.0% of total revenue during 2006. 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 strategic merger transactions. The Company focuses on continual internal growth. Each banking center is operated as a separate profit center, maintaining separate data with respect to its net interest income, efficiency ratio, deposit growth, loan growth and overall profitability. Banking center presidents and managers are accountable for performance in these areas and compensated accordingly. The Company also focuses on maintaining stringent cost control practices and policies. The Company has invested significantly in the infrastructure required to centralize many of its critical operations, such as data processing and loan processing. Management believes that this centralized infrastructure can accommodate substantial additional growth while enabling the Company to minimize operational costs through certain economies of scale. The Company also intends to continue to seek expansion opportunities. During 2004, seven banking centers were acquired in the Austin, Texas area, two of which was subsequently closed and consolidated into existing banking centers of the Company. The acquisitions of both Liberty Bancshares, Inc. (the Liberty acquisition) and Village Bank and Trust s.s.b. (the Village acquisition) were completed on August 1, 2004. During 2005, twenty-seven (27) banking centers were acquired in the acquisition of First Capital Bankers, Inc. (the First Capital acquisition) on March 1, 2005, two of which was subsequently closed and consolidated into existing banking centers of the Company. Two (2) additional banking centers were acquired in the acquisition of Grapeland Bancshares, Inc. (the Grapeland acquisition) on December 1, 2005. On April 1, 2006, the Company acquired SNB Bancshares, Inc. (the SNB Bancshares acquisition) which added five (5) banking centers. At the time of acquisition, SNB had an additional banking office under construction in Katy, Texas, which became a full-service banking center of the Company upon completion in July 2006.

Net income was \$61.7 million, \$47.9 million and \$34.7 million for the years ended December 31, 2006, 2005 and 2004, respectively, and diluted earnings per share were \$1.94, \$1.77 and \$1.59, respectively, for these same periods. Earnings growth during both 2006 and 2005 resulted principally from an increase in loan volume and acquisitions, including the First Capital acquisition in March 2005 and the SNB acquisition in April 2006. Earnings growth during 2004 also resulted principally from an increase in loan volume and acquisitions, including the Liberty and Village acquisitions. The Company posted returns on average assets of 1.44%, 1.42%

Table of Contents

and 1.36% and returns on average equity of 10.24%, 11.56% and 14.27% for the years ended December 31, 2006, 2005 and 2004, respectively. The Company's efficiency ratio was 45.29% in 2006, 48.93% in 2005 and 49.45% in 2004. The efficiency ratio is calculated by dividing total noninterest expense (excluding credit loss provisions) by net interest income plus noninterest income (excluding net gains and losses on the sale of securities and on the sale of assets). Additionally, taxes are not part of this calculation.

Total assets at December 31, 2006 and 2005 were \$4.587 billion and \$3.586 billion, respectively. Total deposits at December 31, 2006 and 2005 were \$3.726 billion and \$2.920 billion, respectively. Total loans were \$2.177 billion at December 31, 2006, an increase of \$634.4 million or 41.14% compared with \$1.542 billion at December 31, 2005. At December 31, 2006, the Company had \$948,000 in nonperforming loans and its allowance for credit losses was \$24.0 million. Shareholders' equity was \$664.4 million and \$464.7 million at December 31, 2006 and 2005, respectively.

Acquisition of Texas United Bancshares, Inc.

On January 31, 2007, the Company completed its acquisition of Texas United Bancshares, Inc., La Grange, Texas (TXUI). Under the terms of the merger agreement, TXUI was merged into the Company and subsequently, each of TXUI's wholly owned subsidiary banks, State Bank, GNB Financial, n.a., Gateway National Bank and Northwest Bank, was merged with the Bank. The Company issued approximately 10.770 million shares of its common stock for all of the issued and outstanding capital stock of TXUI. In addition, options to acquire 179,956 shares of TXUI common stock were converted into options to acquire 179,956 shares of Company common stock. In connection with the merger, the Company assumed \$44.8 million in junior subordinated debentures issued to five subsidiary trusts. TXUI was publicly traded and operated forty-three (43) banking offices in Texas. As of December 31, 2006, TXUI had, on a consolidated basis, total assets of \$1.806 billion, loans of \$1.212 billion, deposits of \$1.362 billion and shareholders' equity of \$161.9 million.

Critical Accounting Policies

The Company's significant accounting policies are integral to understanding the results reported. The Company's accounting policies are described in detail in Note 1 to the consolidated financial statements. The Company believes that of its significant accounting policies, the following may involve a higher degree of judgment and complexity:

Allowance for Credit Losses The allowance for credit losses is a reserve established through charges to earnings in the form of a provision for credit losses. Management has established an allowance for credit losses which it believes is adequate for estimated losses in the Company's loan portfolio. Based on an evaluation of the loan portfolio, management presents a monthly review of the allowance for credit losses to the Bank's Board of Directors, indicating any change in the allowance since the last review and any recommendations as to adjustments in the allowance. In making its evaluation, management considers factors such as historical loan loss experience, industry diversification of the Company's commercial loan portfolio, the amount of nonperforming assets and related collateral, the volume, growth and composition of the Company's loan portfolio, current economic changes that may affect the borrower's ability to pay and the value of collateral, the evaluation of the Company's loan portfolio through its internal loan review process and other relevant factors. Portions of the allowance may be allocated for specific credits; however, the entire allowance is available for any credit that, in management's judgment, should be charged off. Charge-offs occur when loans are deemed to be uncollectible. The allowance for credit losses includes allowance allocations calculated in accordance with Statement of Financial Accounting Standards (SFAS) No. 114, Accounting by Creditors for Impairment of a Loan, as amended by SFAS 118, and allowance allocations determined in accordance with SFAS No. 5, Accounting for Contingencies.

Goodwill and Intangible Assets Goodwill and intangible assets that have indefinite useful lives are subject to an annual impairment test at least annually and more frequently if circumstances indicate their value may not be recoverable. Goodwill is tested for impairment using a two-step process that begins with an estimation of the

Table of Contents

fair value of each of the Company's reporting units compared with its carrying value. If the carrying amount exceeds the fair value of a reporting unit, a second step test is completed comparing the implied fair value of the reporting unit's goodwill to its carrying value to measure the amount of impairment. Intangible assets that are not amortized will be tested for impairment at least annually by comparing the fair values of those assets to their carrying values. 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 eight 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, 2006, management does not believe any of its goodwill is impaired as of December 31, 2006. While the Company believes no impairment existed at December 31, 2006 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 adopted the provisions of SFAS No. 123R *Share-Based Payment (Revised 2004)*, on January 1, 2006 and its adoption did not have a material impact on the Company's financial statements. The Company had previously adopted SFAS No. 123 on January 1, 2003. Among other things, SFAS No. 123R eliminates the ability to account for stock-based compensation using the intrinsic value based method of accounting and requires that such transactions be recognized as compensation expense in the income statement based on their fair values on the date of the grant. SFAS No. 123R requires that management make assumptions including stock price volatility and employee turnover that are utilized to measure compensation expense. The fair value of stock options granted is estimated at the date of grant using the Black-Scholes option-pricing model. This model requires the input of highly subjective assumptions.

Valuation of Securities The Company's available for sale securities portfolio is reported at fair value. When the fair value of a security is below its amortized cost, and depending on the length of time the condition exists and the extent the fair 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 the financial condition and near-term prospects of the issuer, as well as the value of any security we may have in the investment. Often, the information available to conduct these assessments is limited and rapidly changing, making estimates of fair value subject to judgment. If actual information or conditions are different than estimated, the extent of the impairment of the security may be different than previously estimated, which could have a material effect on the Company's results of operations and financial condition.

Results of Operations*Net Interest Income*

The Company's operating results depend primarily on its net interest income, which is the difference between interest income on interest-earning assets, including securities and loans, and interest expense incurred on interest-bearing liabilities, including deposits and other borrowed funds. Interest rate fluctuations, as well as changes in the amount and type of earning assets and liabilities, combine to affect 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.

2006 versus 2005. Net interest income before the provision for credit losses for the year ended December 31, 2006 was \$138.1 million compared with \$110.9 million for the year ended December 31, 2005, an increase of \$27.2 million or 24.6%. The improvement in net interest income for 2006 was principally due to a \$732.8 million or 24.8% increase in average interest-earning assets to \$3.682 billion at December 31, 2006 from \$2.949 billion at December 31 2005. The increase in average interest-earning assets was primarily due to the

Table of Contents

SNB acquisition. The improvement in net interest income for 2006 was also partially due to an increase in the yield on interest-earning assets. The rate paid on interest-bearing liabilities increased 105 basis points from 2.21% for the year ended December 31, 2005 to 3.26% for the year ended December 31, 2006 and total yield on interest-earning assets increased 79 basis points from 5.50% at December 31, 2005 to 6.29% at December 31, 2006. At December 31, 2006, period end demand deposits represented an important component of funding sources and was 22.4% of total period end deposits compared with 23.1% at December 31, 2005.

Net interest margin on a tax equivalent basis, defined as net interest income divided by average interest-earning assets, for 2006 was 3.80%, down 1 basis point from 3.81% in 2005

2005 versus 2004. Net interest income before the provision for credit losses for the year ended December 31, 2005 was \$110.9 million compared with \$82.0 million for the year ended December 31, 2004, an increase of \$28.9 million or 35.3%. The improvement in net interest income for 2005 was principally due to a \$647.7 million or 28.1% increase in average interest-earning assets to \$2.949 billion at December 31, 2005 from \$2.302 billion at December 31 2004. The increase in average interest-earning assets was primarily due to the First Capital acquisition. The improvement in net interest income for 2005 was also partially due to an increase in the yield on interest-earning assets that was greater than the increase in the rate paid on interest-bearing liabilities. Total cost of interest-bearing liabilities increased 57 basis points from 1.64% for the year ended December 31, 2004 to 2.21% for the year ended December 31, 2005, while total yield on interest-earning assets increased 64 basis points from 4.86% at December 31, 2004 to 5.50% at December 31, 2005. At December 31, 2005, period end demand deposits represented an important component of funding sources and was 23.1% of total period end deposits compared with 22.4% at December 31, 2004.

Net interest margin on a tax equivalent basis for 2005 was 3.81%, up 18 basis points from 3.63% in 2004. The increase in the net interest margin was primarily attributable to an increase in interest-earning assets.

Table of Contents

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 both in 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.

	Years Ended December 31,								
	2006			2005			2004		
	Average	Interest	Average	Average	Interest	Average	Average	Interest	Average
	Outstanding	Earned/	Yield/	Outstanding	Earned/	Yield/	Outstanding	Earned/	Yield/
Balance	Paid	Rate	Balance	Paid	Rate	Balance	Paid	Rate	
(Dollars in thousands)									
Assets									
Interest-earning assets:									
Loans held for investment	\$ 2,037,379	\$ 157,426	7.73%	\$ 1,435,376	\$ 99,958	6.96%	\$ 871,736	\$ 55,779	6.40%
Securities ⁽¹⁾	1,612,221	72,632	4.51	1,471,067	60,866	4.14	1,383,790	55,241	3.99
Federal funds sold and other temporary investments	32,522	1,681	5.17	42,859	1,299	3.03	46,121	736	1.60
Total interest-earning assets.	3,682,122	231,739	6.29%	2,949,302	162,123	5.50%	2,301,647	111,756	4.86%
Less allowance for credit losses	(22,476)			(16,334)			(11,454)		
Total interest-earning assets, net of allowance.	3,659,646			2,932,968			2,290,193		
Noninterest-earning assets	624,149			428,649			252,895		
Total assets	\$ 4,283,795			\$ 3,361,617			\$ 2,543,088		
Liabilities and shareholders equity									
Interest-bearing liabilities:									
Interest-bearing demand deposits	\$ 602,946	\$ 11,440	1.90%	\$ 477,199	\$ 4,666	0.98%	\$ 485,557	\$ 5,027	1.04%
Savings and money market accounts.	897,667	23,539	2.62	696,237	10,683	1.53	495,330	4,002	0.81
Certificates of deposit.	1,165,056	45,963	3.95	1,009,147	28,294	2.80	735,095	15,557	2.12
Junior subordinated debentures	92,271	7,592	8.23	69,869	4,895	7.00	59,288	4,046	6.82
Securities sold under repurchase agreements	45,488	1,820	4.00	29,850	768	2.57	19,522	232	1.19
Other borrowings	64,052	3,240	5.06	40,794	1,920	4.71	20,597	925	4.49
Total interest-bearing liabilities	2,867,480	93,594	3.26%	2,323,096	51,226	2.21%	1,815,389	29,789	1.64%
Noninterest-bearing liabilities:									
Noninterest-bearing demand deposits	783,431			609,230			473,713		
Other liabilities.	30,172			15,427			10,712		
Total liabilities.	3,681,083			2,947,753			2,299,814		
Shareholders equity	602,712			413,864			243,274		
Total liabilities and shareholders equity.	\$ 4,283,795			\$ 3,361,617			\$ 2,543,088		
Net interest rate spread			3.03%			3.29%			3.21%
Net interest income and margin ⁽²⁾		\$ 138,145	3.75%		\$ 110,897	3.76%		\$ 81,967	3.56%
Net interest income and margin (tax-equivalent basis) ⁽³⁾		\$ 139,961	3.80%		\$ 112,262	3.81%		\$ 83,631	3.63%

-
- (1) Yield is based on amortized cost and does not include any component of unrealized gains or losses.
 - (2) The net interest margin is equal to net interest income divided by average interest-earning assets.
 - (3) In order to make pretax income and resultant yields on tax-exempt investments and loans comparable to those on taxable investments and loans, a tax-equivalent adjustment has been computed using a federal income tax rate of 35% for the years ended December 31, 2006, 2005 and 2004 and other applicable effective tax rates.

Table of Contents

The following table presents information regarding the dollar amount of changes in interest income and interest expense for the major components of interest-earning assets and interest-bearing liabilities and distinguishes between the increase (decrease) related to higher outstanding balances and the 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.

	Years Ended December 31,					
	2006 vs. 2005			2005 vs. 2004		
	Increase			Increase		
	(Decrease)			(Decrease)		
	Due to Change in		Total	Due to Change in		Total
	Volume	Rate		Volume	Rate	
(Dollars in thousands)						
Interest-earning assets:						
Loans held for investment	\$ 41,923	\$ 15,545	\$ 57,468	\$ 36,065	\$ 8,114	\$ 44,179
Securities	5,840	5,926	11,766	3,484	2,141	5,625
Federal funds sold and other temporary investments	(313)	695	382	(52)	615	563
Total increase in interest income	47,450	22,166	69,616	39,497	10,870	50,367
Interest-bearing liabilities:						
Interest-bearing demand deposits	1,230	5,544	6,774	(87)	(274)	(361)
Savings and money market accounts.	3,091	9,765	12,856	1,623	5,058	6,681
Certificates of deposit	4,371	13,298	17,669	5,800	6,937	12,737
Junior subordinated debentures	1,569	1,128	2,697	722	127	849
Securities sold under repurchase agreements	402	650	1,052	123	413	536
Other borrowings	1,095	225	1,320	907	88	995
Total increase in interest expense	11,758	30,610	42,368	9,088	12,349	21,437
Increase (decrease) in net interest income	\$ 35,692	\$ (8,444)	\$ 27,248	\$ 30,409	\$ (1,479)	\$ 28,930

Provision for Credit Losses

The Company's provision for credit losses is established through charges to income in the form of the provision in order to bring the Company's allowance for credit losses to a level deemed appropriate by management based on the factors discussed under Financial Condition Allowance for Credit Losses. The allowance for credit losses at December 31, 2006 was \$24.0 million, representing 1.10% of outstanding loans. The provision for credit losses for the year ended December 31, 2006 was \$504,000 compared with \$480,000 for the year ended December 31, 2005. Net charge-offs for the year ended December 31, 2006 were \$771,000 compared with \$410,000 in net charge-offs for the year ended December 31, 2005. The provision for credit losses for the year ended December 31, 2005 was \$480,000 compared with \$880,000 for the year ended December 31, 2004. In 2004, an additional \$400,000 provision for credit losses was made in anticipation of increased charge-offs related to loans acquired in merger transactions that year. Net charge-offs for the year ended December 31, 2004 were \$485,000.

Noninterest Income

The Company's primary sources of recurring noninterest income are service charges on deposit accounts and other banking service related fees. 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. Banking related service fees include check cashing fees, official check fees, safe deposit box rent and currency handling fees. For the year ended December 31, 2006, noninterest income totaled \$34.0 million, an increase of \$4.0 million or

Table of Contents

13.2% compared with \$30.0 million in 2005. The increase was primarily due to an increase in insufficient funds charges and customer service charges which resulted from an increase in the number of accounts due to the First Capital acquisition completed in March 2005, the Grapeland acquisition in December 2005 and the SNB acquisition in April 2006. As of December 31, 2006, these three acquisitions added approximately 45,000 deposit accounts and over 16,000 debit cards. Noninterest income for 2005 was \$30.0 million, an increase of \$7.0 million or 30.1% compared with \$23.1 million in 2004, resulting largely from an increase in service charges due to the additional deposit accounts from the Liberty and Village acquisitions completed in August 2004 and the First Capital acquisition in March 2005.

Brokered mortgage income increased \$144,000 to \$839,000 for the year ended December 31, 2006 compared with \$695,000 for the year ended December 31, 2005. The increase was primarily due to additional mortgage loan originations resulting from the mortgage division of SNB acquired in April 2006 and the mortgage division of First Capital that was acquired in March 2005.

Income from leased assets increased \$180,000 from \$895,000 for the year ended December 31, 2005 to \$1.1 million for the year ended December 31, 2006. The expiration dates of the leased assets range from 2009 to 2011 and the related depreciation expense for the leased assets was \$756,000 and \$630,000 for the years ended December 31, 2006 and 2005, respectively. Income from Bank Owned Life Insurance (BOLI) increased \$103,000 from \$397,000 for the year ended December 31, 2005 to \$500,000 for the year ended December 31, 2006. Both leased assets and bank owned life insurance were acquired in the First Capital acquisition.

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

	Years Ended December 31,		
	2006	2005	2004
	(Dollars in thousands)		
Service charges on deposit accounts.	\$ 27,379	\$ 24,985	\$ 20,215
Banking related service fees	1,358	1,133	1,002
Brokered mortgage income	839	695	383
Trust and investment income	208	274	214
Income from leased assets	1,075	895	
Bank Owned Life Insurance income (BOLI)	500	397	
Gains on sales of assets (net)	622 ⁽¹⁾	72	315 ⁽²⁾
Net (loss) gain on sale of securities		(79)	78
Gain on held for sale loans		173	74
Other noninterest income	2,001	1,476	790
Total noninterest income.	\$ 33,982	\$ 30,021	\$ 23,071

(1) Includes gains on the sale of real estate in Beeville, Palacios, Red Oak and Victoria.

(2) Includes gains on the sale of TIB-The Independent BankersBank stock acquired in various acquisitions and a gain on the sale of real property acquired in the Paradigm acquisition.

Noninterest Expense

For the year ended December 31, 2006, noninterest expense totaled \$77.7 million, an increase of \$8.7 million or 12.6% compared with \$69.0 million for the same period in 2005. This increase was principally due to increases in salaries and employee benefits, net occupancy, depreciation costs, ad valorem and franchise taxes and core deposit intangibles amortization primarily as a result of the SNB acquisition. For the year ended December 31, 2005, noninterest expense totaled \$69.0 million, an increase of \$17.3 million or 33.4% compared with \$51.7 million for the same period in 2004. The increase was primarily attributable to the additional general operating costs associated with the acquisitions completed in 2005 and the full year effect of the acquisitions completed in 2004. These items and other changes in the various components of noninterest expense are discussed in more detail below.

Table of Contents

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

	Years Ended December 31,		
	2006	2005	2004
	(Dollars in thousands)		
Salaries and employee benefits	\$ 41,298	\$ 36,672	\$ 27,861
Non-staff expenses:			
Net occupancy expense	7,884	6,663	4,814
Depreciation expense	5,048	4,462	2,843
Data processing	3,612	2,837	2,036
Regulatory assessments and FDIC insurance	716	548	524
Ad valorem and franchise taxes.	2,246	1,594	1,154
Core deposit intangibles amortization	4,869	3,912	1,781
Communications expense ⁽¹⁾	4,339	3,782	2,929
Other	7,657	8,487	7,765
Total noninterest expense⁽²⁾	\$ 77,669	\$ 68,957	\$ 51,707

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

(2) Total noninterest expense includes \$850,000, \$751,000 and \$141,000 in 2006, 2005 and 2004 respectively, in stock-based compensation expense.

Salaries and Employee Benefits. Salaries and employee benefits increased \$4.6 million to \$41.3 million at December 31, 2006 compared with \$36.7 million at December 31, 2005 primarily due to increased staff added with the SNB acquisition in April 2006. The number of associates employed by the Company increased from 859 at December 31, 2005 to 908 at December 31, 2006. Salaries and employee benefits increased \$8.8 million from \$27.9 million at December 31, 2004 to \$36.7 million at December 31, 2005 primarily due to increased staff added with the Liberty and Village acquisitions in August 2004 and the First Capital acquisition in March 2005. The number of associates employed by the Company increased from 653 at December 31, 2004 to 859 at December 31, 2005. In accordance with the Company's adoption of SFAS 123R, total noninterest expense for the year ended December 31, 2006 includes \$850,000 in stock-based compensation expense compared with \$751,000 and \$141,000 recorded for the years ended December 31, 2005 and 2004, respectively.

Net Occupancy, Depreciation Expenses and Ad Valorem and Franchise Taxes. Net occupancy expense increased \$1.2 million or 18.33% to \$7.9 million for the year ended December 31, 2006 compared with \$6.7 million for the year ended December 31, 2005. Depreciation expense increased \$600,000 to \$5.0 million compared with \$4.5 million for the same periods and ad valorem and franchise taxes increased \$652,000 or 40.9% to \$2.2 million. These increases were primarily attributable to the addition of five (5) banking centers and the completion of construction of one banking center, all acquired in 2006. Net occupancy expense increased \$1.8 million or 38.4% to \$6.7 million for the year ended December 31, 2005 compared with \$4.8 million for the year ended December 31, 2004. Depreciation expense increased \$1.6 million to \$4.5 million compared with \$2.8 million for the same periods and ad valorem and franchise taxes increased \$440,000 or 38.1% to \$1.6 million. These increases were primarily attributable to the addition of thirty-two (32) banking centers acquired in 2004 and 2005.

Communications Expense. Communications expense includes telephone, data circuits, postage and courier expenses. Communications expense increased \$557,000 or 14.7% from \$3.8 million for the year December 31, 2005 to \$4.3 million for the same period in 2006. The increase was primarily associated with the addition of six banking centers in 2006. Communications expense was \$3.8 million for the year ended December 31, 2005 compared with \$2.9 million for the same period in 2004, an increase of \$853,000 or 29.1%. The increase was primarily attributable to the addition of thirty-two (32) banking centers in 2004 and 2005.

Table of Contents

Core Deposit Intangibles Amortization. Core deposit intangibles amortization increased \$1.0 million or 24.5% from \$3.9 million for the year December 31, 2005 to \$4.9 million for the same period in 2006. The increase was associated with the addition of \$5.7 million in core deposit intangible assets related to the SNB acquisition. Core deposit intangibles amortization was \$3.9 million for the year ended December 31, 2005 compared with \$1.8 million for the same period in 2004, an increase of \$2.1 million or 119.7%. The increase was attributable to the addition of \$21.4 million in core deposit intangible assets related to the acquisitions made in 2004 and 2005. Core deposit intangibles are being amortized on an accelerated basis over an eight year life.

Other Noninterest Expense. Other operating expenses decreased \$830,000 or 9.8% from \$8.5 million at December 31, 2005 to \$7.7 million for the year ended December 31, 2006. The decrease was primarily attributable to a decrease in advertising expense which is a component of other expenses. Other operating expenses of \$8.5 million for the year ended December 31, 2005 represented an increase of \$721,000 or 9.3% compared with \$7.8 million in 2004. The increase was primarily attributable to advertising expense and additional operating expenses related to the First Capital acquisition in 2005.

Efficiency Ratio. The efficiency ratio is a supplemental financial measure utilized in management's internal evaluation of the Company and is not defined under generally accepted accounting principles. The efficiency ratio is calculated by dividing total noninterest expense, excluding credit loss provisions, by net interest income plus noninterest income, excluding net gains and losses on the sale of securities and on the sale of assets. Taxes are not part of this calculation. An increase in the efficiency ratio indicates that more resources are being utilized to generate the same volume of income, while a decrease would indicate a more efficient allocation of resources. The Company's efficiency ratio was 45.29% at December 31, 2006, a decrease from 48.93% at December 31, 2005. The decrease reflects the Company's continued success in controlling operating expenses and the cost savings achieved with the SNB acquisition in 2006. The Company's efficiency ratio was 49.45% at December 31, 2004.

Income Taxes

The amount of federal income tax expense is influenced by the amount of taxable income, the amount of tax-exempt income, the amount of nondeductible interest expense and the amount of other nondeductible expenses. For the year ended December 31, 2006, income tax expense was \$32.2 million compared with \$23.6 million for the year ended December 31, 2005 and \$17.7 million for the year ended December 31, 2004. The increases were primarily attributable to higher pretax net earnings which resulted from an increase in net interest income for the year ended December 31, 2006 compared with the same period in 2005 and 2004. The effective tax rate for the years ended December 31, 2006, 2005 and 2004 was 34.3%, 33.0% and 33.8%, respectively. The effective income tax rates differed from the U.S. statutory rate of 35% during the comparable periods primarily due to the effect of tax-exempt income from loans and securities.

Impact of Inflation

The Company's consolidated financial statements and related notes included in this annual report on Form 10-K have been prepared in accordance with generally accepted accounting principles. These require the measurement of financial position and operating results in terms of historical dollars, without considering changes in the relative purchasing power of money over time due to inflation.

Unlike many industrial companies, substantially all of the Company's assets and liabilities are monetary in nature. As a result, interest rates have a more significant impact on the Company's performance than the effects of general levels of inflation. Interest rates may not necessarily move in the same direction or in the same magnitude as the prices of goods and services. However, other expenses do reflect general levels of inflation.

Table of Contents**Financial Condition***Loan Portfolio*

At December 31, 2006, total loans were \$2.177 billion, an increase of \$634.4 million or 41.1% compared with \$1.542 billion at December 31, 2005. The growth in loans was primarily attributable to the combined effect of internal growth and the SNB acquisition. At December 31, 2006, total loans at the banking centers acquired in 2006 totaled \$519.3 million. At December 31, 2006, total loans were 58.4% of deposits and 47.5% of total assets. At December 31, 2005, total loans were 52.8% of deposits and 43.0% of total assets. Loans increased 48.9% during 2005 from \$1.036 billion at December 31, 2004 to \$1.542 billion at December 31, 2005. The growth in loans was primarily attributable to internal growth and the First Capital and Grapeland acquisitions.

The following table summarizes the Company's loan portfolio by type of loan as of the dates indicated:

	2006		2005		December 31, 2004		2003		2002	
	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent
	(Dollars in thousands)									
Commercial and industrial	\$ 280,957	12.9%	\$ 222,773	14.4%	\$ 144,432	13.9%	\$ 93,989	12.2%	\$ 93,797	13.8%
Real estate:										
Construction and land development	433,178	19.9	206,653	13.4	109,591	10.6	36,470	4.7	52,377	7.7
1-4 family residential	376,996	17.3	313,184	20.3	260,453	25.2	237,055	30.8	206,586	30.4
Home equity	63,427	2.9	58,729	3.8	34,453	3.3	27,943	3.6	23,249	3.4
Commercial mortgages	803,145	36.9	566,356	36.7	369,151	35.6	260,882	33.9	183,970	27.1
Farmland	30,925	1.4	30,920	2.0	22,240	2.1	15,247	2.0	11,887	1.7
Multifamily residential	77,980	3.6	32,039	2.1	18,187	1.9	20,679	2.7	15,502	2.3
Agriculture	26,504	1.2	25,429	1.6	21,906	2.1	20,693	2.7	24,683	3.6
Consumer (net of unearned discount).	66,675	3.1	65,183	4.3	52,854	5.1	54,821	7.1	64,488	9.6
Other	16,720	0.8	20,859	1.4	2,246	0.2	2,274	0.3	3,020	0.4
Total loans.	\$ 2,176,507	100.0%	\$ 1,542,125	100.0%	\$ 1,035,513	100.0%	\$ 770,053	100.0%	\$ 679,559	100.0%

The Company is focused on growing its construction and land development, commercial mortgage and commercial and industrial loan portfolios. The Company's construction and land development loans grew from \$206.7 million at December 31, 2005 to \$433.2 million at December 31, 2006, an increase of \$226.5 million or 109.6%. The Company's commercial mortgages grew from \$566.4 million at December 31, 2005 to \$803.1 million at December 31, 2006, an increase of \$236.8 million or 41.8%. The Company's commercial and industrial loans grew from \$222.8 million at December 31, 2005 to \$281.0 million at December 31, 2006, an increase of \$58.2 million or 26.1%. The Company offers a variety of commercial lending products including term loans and lines of credit. The Company offers a broad range of short to medium-term commercial loans, primarily collateralized, to businesses for working capital (including inventory and receivables), business expansion (including acquisitions of real estate and improvements) and the purchase of equipment and machinery. Historically, the Company has originated loans for its own account and has not securitized its loans. The purpose of a particular loan generally determines its structure. All loans in the 1-4 family residential category were originated by the Company.

All loans over \$500,000 and below \$1.0 million are evaluated and acted upon on a daily basis by two of the Company's regional loan concurrence officers. All loans over \$1.0 million and below \$2.5 million are evaluated and acted upon on a daily basis by two of the Company's six company-wide loan concurrence officers. All loans above \$2.5 million are evaluated and acted upon by an officers' loan committee, which meets weekly. In addition to the officers' loan committee evaluation, loans from \$15.0 million to \$25.0 million are evaluated and acted upon by the directors' loan committee, which consists of three directors of the bank and meets as necessary. Loans over \$25.0 million are evaluated and acted upon by the Bank's board of directors either at a regularly scheduled monthly board meeting or by teleconference or written consent.

Table of Contents

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.

Commercial Mortgages. The Company makes commercial mortgage loans collateralized by real estate to finance the purchase of real estate. The Company's commercial mortgage loans are collateralized by first liens on real estate, typically have variable interest rates and amortize over a ten to 15 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, appraisals and a review of the financial condition of the borrower.

1-4 Family Residential Loans. A significant portion of the Company's lending activity has consisted of the origination of 1-4 family residential mortgage loans collateralized by owner-occupied properties located in the Company's market areas. The Company offers a variety of mortgage loan products which generally are amortized over five to 25 years. Loans collateralized by 1-4 family residential real estate generally have been originated in amounts of no more than 90% of appraised value or have mortgage insurance. The Company requires mortgage title insurance and hazard insurance. The Company has elected to keep all 1-4 family residential loans for its own account rather than selling such loans into the secondary market. By doing so, the Company is able to realize a higher yield on these loans; however, the Company also incurs interest rate risk as well as the risks associated with nonpayments on such loans.

Construction Loans. The Company makes loans to finance the construction of residential and, to a limited 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.

Table of Contents

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 monitor and identify such risks.

Consumer Loans. Consumer loans made by the Company include direct A -credit automobile loans, recreational vehicle loans, boat loans, home improvement loans, home equity loans, personal loans (collateralized and uncollateralized) and deposit account collateralized loans. The terms of these loans typically range from 12 to 120 months and vary based upon the nature of collateral and size of loan. Consumer loans entail greater risk than do residential mortgage 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 contractual maturity ranges of the commercial and industrial, construction and land development, 1-4 family residential, home equity and commercial mortgage portfolios and the amount of such loans with predetermined interest rates and floating rates in each maturity range as of December 31, 2006 are summarized in the following table:

	December 31, 2006			Total
	One Year or Less	After One Through Five Years	After Five Years	
	(Dollars in thousands)			
1-4 family residential and home equity	\$ 13,967	\$ 54,686	\$ 371,770	\$ 440,423
Commercial and industrial	131,820	112,830	36,307	280,957
Commercial mortgages	50,791	247,230	505,124	803,145
Construction and land development	198,390	96,680	138,108	433,178
Total	\$ 394,968	\$ 511,426	\$ 1,051,309	\$ 1,957,703
Loans with a predetermined interest rate.	\$ 100,417	\$ 275,222	\$ 398,438	\$ 774,077
Loans with a floating interest rate.	294,551	236,204	652,871	1,183,626
Total	\$ 394,968	\$ 511,426	\$ 1,051,309	\$ 1,957,703

Nonperforming Assets

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 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 write-downs or appropriate additions to the allowance for credit losses.

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

Table of Contents

collection and the underlying collateral fully supports the carrying value of the loan. The Company generally charges off such loans before attaining nonaccrual status.

The Company's conservative lending approach has resulted in strong asset quality. The Company had \$1.1 million in nonperforming assets at December 31, 2006 compared with \$1.4 million at December 31, 2005 and \$1.7 million at December 31, 2004. Interest foregone on nonaccrual loans for the years ended December 31, 2006, 2005 and 2004 was \$30,000, \$35,000 and \$54,000, respectively.

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

	2006	2005	December 31, 2004 (Dollars in thousands)	2003	2002
Nonaccrual loans.	\$ 181	\$ 355	\$ 297	\$ 2	\$ 1,125
Restructured loans.					
Other nonperforming loans					1,100
Accruing loans 90 or more days past due	767	788	1,083	679	120
Total nonperforming loans	948	1,143	1,380	681	2,345
Reposessed assets	32	26		40	46
Other real estate	140	239	341	246	219
Total nonperforming assets	\$ 1,120	\$ 1,408	\$ 1,721	\$ 967	\$ 2,610
Nonperforming assets to total loans and other real estate	0.05%	0.09%	0.17%	0.13%	0.38%
Nonperforming assets to average earning assets	0.03%	0.05%	0.07%	0.05%	0.19%

Allowance for Credit Losses

The following table presents, as of and for the periods indicated, an analysis of the allowance for credit losses and other related data:

	2006	2005	Years Ended December 31, 2004 (Dollars in thousands)	2003	2002
Average loans outstanding	\$ 2,037,379	\$ 1,435,376	\$ 871,736	\$ 697,235	\$ 524,885
Gross loans outstanding at end of period.	\$ 2,176,507	\$ 1,542,125	\$ 1,035,513	\$ 770,053	\$ 679,559
Allowance for credit losses at beginning of period	\$ 17,203	\$ 13,105	\$ 10,345	\$ 9,580	\$ 5,985
Balance acquired with acquisitions	7,054	4,028	2,365	1,900	2,981
Provision for credit losses	504	480	880	483	1,010
Charge-offs:					
Commercial and industrial	(353)	(410)	(139)	(810)	(356)
Real estate and agriculture	(128)	(242)	(613)	(960)	(231)
Consumer.	(696)	(240)	(198)	(471)	(180)
Recoveries:					
Commercial and industrial	95	188	239	159	111
Real estate and agriculture	59	184	65	198	175
Consumer.	252	110	161	266	85
Net charge-offs	(771)	(410)	(485)	(1,618)	(396)
Allowance for credit losses at end of period.	\$ 23,990	\$ 17,203	\$ 13,105	\$ 10,345	\$ 9,580

Edgar Filing: PROSPERITY BANCSHARES INC - Form 10-K

Ratio of allowance to end of period loans	1.10%	1.12%	1.27%	1.34%	1.41%
Ratio of net charge-offs to average loans	0.04	0.03	0.06	0.23	0.08
Ratio of allowance to end of period nonperforming loans	2,530.6	1,505.1	949.6	1,519.1	408.5

40

Table of Contents

The allowance for credit losses is a valuation established through charges to earnings in the form of a provision for credit losses. Management has established an allowance for credit losses which it believes is adequate for estimated losses in the Company's loan portfolio. Based on an evaluation of the loan 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, industry diversification of the Company's commercial loan portfolio, the amount of nonperforming assets and related collateral, the volume, growth and composition of the Company's loan portfolio, current economic changes that may affect the borrower's ability to pay and the value of collateral, the evaluation of the Company's loan portfolio through its internal loan review process and other relevant factors. Charge-offs occur when loans are deemed to be uncollectible.

The Company considers risk elements attributable to particular loan types or categories in assessing the quality of individual loans. Some of the risk elements include:

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

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

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

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 ability to lease property constructed for lease, the quality and nature of contracts for presale or preleasing, 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; and

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

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

The Company follows a loan review program to evaluate the credit risk in the loan portfolio. Through the 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. For each impaired loan, the Company allocates a specific loan loss reserve primarily based on the value of the collateral securing the impaired loan in accordance with Statement of Financial Accounting Standards (SFAS) No. 114, Accounting by Creditors for Impairment of a Loan, as amended.

Table of Contents

Federal and state bank regulators also require that a bank maintain an allowance that is sufficient to absorb an estimated amount of unidentified potential losses to the portfolio based on management's perception of economic conditions, loan portfolio growth, historical charge-off experience and exposure concentrations. This unallocated allowance is also established based on the Company's historical charge-off experience and existing general economic and business conditions affecting the key lending areas of the Company, credit quality trends, collateral values, loan volume, concentrations and seasoning of the loan portfolio and factors associated with the Company's acquisitions. The Company then charges to operations a provision for credit losses to maintain the allowance for credit losses at an adequate level determined by the foregoing methodology.

At December 31, 2006, the allowance for credit losses totaled \$24.0 million, or 1.10% of total loans. At December 31, 2005, the allowance aggregated \$17.2 million or 1.12% of total loans and at December 31, 2004, the allowance was \$13.1 million, or 1.27% of total loans.

The following tables describe the allocation of the allowance for credit losses among various categories of loans and certain other information as of the dates indicated. 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.

	2006		December 31,		2005	
	Percent of		Percent of		Percent of	
	Loans to		Loans to		Loans to	
	Amount	Total Loans	Amount	Total Loans	Amount	Total Loans
	(Dollars in thousands)					
Balance of allowance for credit losses applicable to:						
Commercial and industrial	\$ 3,660	12.9%	\$ 636	14.4%		
Real estate	18,140	82.0	923	78.4		
Agriculture	131	1.2	28	1.6		
Consumer and other.	732	3.9	53	5.6		
Unallocated ⁽¹⁾	1,327		15,563			
Total allowance for credit losses.	\$ 23,990	100.0%	\$ 17,203	100.0%		

(1) In 2006, the Company revised its allowance methodology to provide for more specific allocation of its reserves. The revised methodology did not have a material impact on the Company's determination of the overall allowance for credit losses.

	2004		December 31,		2002	
	Percent of		Percent of		Percent of	
	Loans to		Loans to		Loans to	
	Amount	Total Loans	Amount	Total Loans	Amount	Total Loans
	(Dollars in thousands)					
Balance of allowance for credit losses applicable to:						
Commercial and industrial	\$ 274	13.9%	\$ 253	12.2%	\$ 559	13.8%
Real estate	503	78.7	957	77.7	397	72.6
Agriculture	12	2.1	35	2.7	42	3.6
Consumer and other.	26	5.3	34	7.4	71	10.0
Unallocated	12,290		9,066		8,781	
Total allowance for credit losses.	\$ 13,105	100.0%	\$ 10,345	100.0%	\$ 9,850	100.0%

Edgar Filing: PROSPERITY BANCSHARES INC - Form 10-K

The Company believes that the allowance for credit losses at December 31, 2006 is adequate to cover losses inherent in the portfolio as of such date. There can be no assurance, however, that the Company will not sustain losses in future periods, which could be substantial in relation to the size of the allowance at December 31, 2006.

Table of Contents

Securities

The Company uses its securities portfolio as a source of income, as a source of liquidity for cash requirements and to manage interest rate risk. At December 31, 2006, investment securities totaled \$1.590 billion, an increase of \$17.7 million or 1.1% compared with \$1.573 billion at December 31, 2005. The increase in securities was primarily due to the SNB acquisition. Securities increased to \$1.573 billion at December 31, 2005 from \$1.303 billion at December 31, 2004, an increase of \$269.8 million or 20.7%. At December 31, 2006, securities represented 34.7% of total assets compared with 43.9% of total assets at December 31, 2005.

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

	2006	2005	December 31, 2004	2003	2002
	(Dollars in thousands)				
U.S. Treasury securities and obligations of U.S. government agencies.	\$ 402,328	\$ 296,349	\$ 30,726	\$ 48,762	\$ 97,098
70% non-taxable preferred stock	24,000	24,000	24,000	44,015	44,029
States and political subdivisions	44,378	31,250	37,698	45,738	50,994
Corporate debt securities	6,218	8,550	10,491	15,619	25,338
Collateralized mortgage obligations	276,629	222,615	238,994	178,487	168,282
Mortgage-backed securities	829,195	987,088	957,354	1,032,861	552,515
Qualified Zone Academy Bond (QZAB)	8,000	8,000	8,000	8,000	8,000
Other	4,093	814	296	283	
Total	\$ 1,594,841	\$ 1,578,666	\$ 1,307,559	\$ 1,373,765	\$ 946,256

The following table summarizes the contractual maturity of securities and their weighted average yields as of December 31, 2006. Available-for-sale securities are shown at fair value and held-to-maturity securities are shown at amortized cost. Other securities are included in the corporate debt securities category. For purposes of the table below, tax-exempt states and political subdivisions are calculated on a tax equivalent basis. The QZAB bond is not calculated on a tax equivalent basis and it generates a tax credit of 7.18%, which is included in gross income.

	December 31, 2006									
	After One Year				After Five Years					
	but		but		but		but			
	Within One		Within Five		Within Ten		After Ten			
	Year	Year	Year	Year	Year	Year	Year	Year	Total	Total
	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield
(Dollars in thousands)										
U.S. Treasury securities and obligations of U.S. government agencies	\$ 206,975	4.51%	\$ 170,083	5.17%	\$	%	\$ 24,476	5.75%	\$ 401,534	4.87%
70% non-taxable preferred stock							20,205	6.01	20,205	6.01
States and political subdivisions.	3,388	6.06	7,117	5.87	8,348	7.16	26,129	6.82	44,982	6.68
Corporate debt securities and other	7,100	6.67	248	4.70	2,991	7.62			10,339	6.90
Collateralized mortgage obligations.	5		2,790	4.83	94,422	4.99	179,388	4.56	276,605	4.71
Mortgage-backed securities	343	5.00	54,388	4.42	466,887	4.36	307,020	5.23	828,638	4.68
Qualified Zone Academy Bond (QZAB)			8,000	2.00					8,000	2.00
Total	\$ 217,811	4.61%	\$ 242,626	5.01%	\$ 572,648	4.52%	\$ 557,218	5.14%	\$ 1,590,303	4.81%

Table of Contents

The contractual maturity of mortgage-backed securities and collateralized mortgage obligations is not a reliable indicator of their expected life because borrowers have the right to prepay their obligations at any time. Mortgage-backed securities monthly pay downs cause the average lives of the securities to be much different than their stated lives. The weighted average life of the Company's complete portfolio is 3.2 years with an effective duration of 2.5 years at December 31, 2006. The 70% non-taxable preferred stock includes investments in Federal National Mortgage Association (Fannie Mae) and Federal Home Loan Mortgage Corporation (Freddie Mac) preferred stock.

At December 31, 2006 and 2005, 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.

At the date of purchase, the Company is required to classify debt and equity securities into one of three categories: held-to-maturity, trading or available-for-sale. At each reporting date, the appropriateness of the classification is reassessed. Investments in debt securities are classified as held-to-maturity and measured at amortized cost in the financial statements only if management has the positive intent and ability to hold those securities to maturity. Securities that are bought and held principally for the purpose of selling them in the near term are classified as trading and measured at fair value in the financial statements with unrealized gains and losses included in earnings. Investments not classified as either held-to-maturity or trading are classified as available-for-sale and measured at fair value in the financial statements with unrealized gains and losses reported, net of tax, in a separate component of shareholders' equity until realized.

The average yield of the securities portfolio was 4.51% in 2006 compared with 4.14% in 2005 and 3.99% in 2004. The 37 basis point increase in 2006 was primarily due to the Company reinvesting funds at higher rates in 2006 compared to 2005. The overall growth in the securities portfolio over the comparable periods was primarily funded by deposit growth and securities acquired in acquisitions.

The following table summarizes the carrying value by classification of securities as of the dates shown:

	2006	2005	December 31, 2004	2003	2002
			(Dollars in thousands)		
Available-for-sale	\$ 434,331	\$ 410,361	\$ 177,683	\$ 263,648	\$ 309,219
Held-to-maturity	1,155,972	1,162,241	1,125,109	1,113,232	641,098
Total	\$ 1,590,303	\$ 1,572,602	\$ 1,302,792	\$ 1,376,880	\$ 950,317

Table of Contents

The following tables present the amortized cost and fair value of securities classified as available-for-sale at December 31, 2006, 2005 and 2004:

	December 31, 2006				December 31, 2005			
	Amortized	Gross		Fair	Amortized	Gross		Fair
		Cost	Unrealized Gains			Unrealized Losses	Cost	
		(Dollars in thousands)		Value		(Dollars in thousands)		Value
U.S. Treasury securities and obligations of U.S. government agencies.	\$ 290,629	\$	\$ 794	\$ 289,835	\$ 231,399	\$ 430	\$ 1,752	\$ 230,077
70% non-taxable preferred stock	24,000		3,795	20,205	24,000		5,334	18,666
States and political subdivisions.	14,098	604		14,702	14,102	1,005		15,107
Collateralized mortgage obligations	5,352	12	36	5,328	8,096	45	34	8,107
Mortgage-backed securities	90,986	172	729	90,429	130,014	277	701	129,590
Qualified Zone Academy Bond (QZAB)	8,000			8,000	8,000			8,000
Other	5,804	28		5,832	814			814
Total.	\$ 438,869	\$ 816	\$ 5,354	\$ 434,331	\$ 416,425	\$ 1,757	\$ 7,821	\$ 410,361

	December 31, 2004			
	Amortized	Gross		Fair
		Cost	Unrealized Gains	
		(Dollars in thousands)		Value
U.S. Treasury securities and obligations of U.S. government agencies.	\$ 10,579	\$ 2	\$ 69	\$ 10,512
70% non-taxable preferred stock	24,000		6,150	17,850
States and political subdivisions	14,382	1,366		15,748
Collateralized mortgage obligations	13,143	76	35	13,184
Mortgage-backed securities.	112,050	545	502	112,093
Qualified Zone Academy Bond (QZAB)	8,000			8,000
Other	296			296
Total.	\$ 182,450	\$ 1,989	\$ 6,756	\$ 177,683

Table of Contents

The following tables present the amortized cost and fair value of securities classified as held-to-maturity at December 31, 2006, 2005 and 2004:

	December 31, 2006				December 31, 2005			
	Amortized	Unrealized	Unrealized	Fair	Amortized	Unrealized	Unrealized	Fair
	Cost	Gains	Losses	Value	Cost	Gains	Losses	Value
	(Dollars in thousands)				(Dollars in thousands)			
U.S. Treasury securities and obligations of U.S. government agencies.	\$ 111,699	\$ 405	\$ 588	\$ 111,516	\$ 64,950	\$ 409	\$ 564	\$ 64,795
States and political subdivisions	30,280	255	53	30,482	17,148	173	31	17,290
Corporate debt securities	4,507	6	10	4,503	8,550	108	3	8,655
Collateralized mortgage obligations.	271,277	337	5,260	266,354	214,519	313	5,805	209,027
Mortgage-backed securities	738,209	616	20,584	718,241	857,074	721	21,868	835,927
Total	\$ 1,155,972	\$ 1,619	\$ 26,495	\$ 1,131,096	\$ 1,162,241	\$ 1,724	\$ 28,271	\$ 1,135,694

	December 31, 2004			
	Amortized	Unrealized	Unrealized	Fair
	Cost	Gains	Losses	Value
	(Dollars in thousands)			
U.S. Treasury securities and obligations of U.S. government agencies.	\$ 20,147	\$ 661	\$ 6	\$ 20,802
States and political subdivisions	23,317	510	15	23,812
Corporate debt securities	10,491	301		10,792
Collateralized mortgage obligations	225,851	97	802	225,146
Mortgage-backed securities.	845,303	3,559	4,914	843,948
Total	\$ 1,125,109	\$ 5,128	\$ 5,737	\$ 1,124,500

Management believes that the unrealized losses in the Company's securities portfolio at December 31, 2006 were primarily due to interest rate increases. Because the decline in market value is attributable to changes in interest rates and not credit quality, and because the Company has the ability and intent to hold such securities until a recovery of fair value, which may be at maturity, the Company does not consider such securities to be other-than-temporarily impaired at December 31, 2006.

Mortgage-backed securities are securities that have been developed by pooling a number of real estate mortgages and which are principally issued by federal agencies such as Government National Mortgage Association (Ginnie Mae), Fannie Mae and Freddie Mac. These securities are deemed to have high credit ratings, and minimum regular monthly cash flows of principal and interest are guaranteed by the issuing agencies.

Unlike U.S. Treasury and U.S. government agency securities, which have a lump sum payment at maturity, mortgage-backed securities provide cash flows from regular principal and interest payments and principal prepayments throughout the lives of the securities. Mortgage-backed securities which are purchased at a premium will generally suffer decreasing net yields as interest rates drop because home owners tend to refinance their mortgages. Thus, the premium paid must be amortized over a shorter period. Therefore, these securities purchased at a discount will obtain higher net yields in a decreasing interest rate environment. As interest rates rise, the opposite will generally be true. During a period of increasing interest rates, fixed rate mortgage-backed securities do not tend to experience heavy prepayments of principal and consequently, the average life of this security will not be shortened. If interest rates begin to fall, prepayments will increase. At December 31, 2006,

Table of Contents

37.1% of the mortgage-backed securities held by the Company had contractual final maturities of more than ten years with a weighted average life of 3.58 years.

Collateralized mortgage obligations (CMOs) are bonds that are backed by pools of mortgages. The pools can be Ginnie Mae, Fannie Mae or Freddie Mac pools or they can be private-label pools. CMOs are designed so that the mortgage collateral will generate a cash flow sufficient to provide for the timely repayment of the bonds. The mortgage collateral pool can be structured to accommodate various desired bond repayment schedules, provided that the collateral cash flow is adequate to meet scheduled bond payments. This is accomplished by dividing the bonds into classes to which payments on the underlying mortgage pools are allocated in different order. The bond s cash flow, for example can be dedicated to one class of bondholders at a time, thereby increasing call protection to bondholders. In private-label CMOs, losses on underlying mortgages are directed to the most junior of all classes and then to the classes above in order of increasing seniority, which means that the senior classes have enough credit protection to be given the highest credit rating by the rating agencies.

Deposits

The Company s lending and investment activities are primarily funded by deposits. The Company offers a variety of deposit accounts having a wide range of interest rates and terms including demand, savings, money market and time accounts. The Company relies primarily on competitive pricing policies and customer service to attract and retain these deposits. The Company does not have or accept any brokered deposits.

Total deposits at December 31, 2006 were \$3.726 billion, an increase of \$805.4 million or 27.6% compared with \$2.920 billion at December 31, 2005. The increase was primarily attributable to the SNB acquisition in 2006. As of December 31, 2006, the banking centers acquired in 2006 had approximately \$728.5 million in total deposits. Noninterest-bearing deposits were \$835.9 million at December 31, 2006, an increase of \$161.5 million or 23.9% compared with \$674.4 million at December 31, 2005. Noninterest-bearing deposits at December 31, 2005 were \$674.4 million compared with \$518.4 million at December 31, 2004. Interest-bearing deposits at December 31, 2006 were \$2.89 billion, up \$643.9 million or 28.7% compared with \$2.25 billion at December 31, 2005. Interest-bearing deposits at December 31, 2005 of \$2.25 billion represented a \$447.2 million or 24.9% increase compared with \$1.80 billion at December 31, 2004. Total deposits at December 31, 2004 were \$2.317 billion. There were no major concentrations of deposits at December 31, 2006, 2005 or 2004.

The daily average balances and weighted average rates paid on deposits for each of the years ended December 31, 2006, 2005 and 2004 are presented below:

	Years Ended December 31,					
	2006		2005		2004	
	Amount	Rate	Amount	Rate	Amount	Rate
	(Dollars in thousands)					
Interest-bearing checking	\$ 602,946	1.90%	\$ 477,199	0.98%	\$ 485,557	1.04%
Regular savings	164,963	1.11	150,577	0.83	110,801	0.59
Money market savings	732,704	2.96	545,660	1.73	384,529	0.87
Time deposits	1,165,056	3.95	1,009,147	2.80	735,095	2.12
Total interest-bearing deposits	2,665,669	3.04	2,182,583	2.00	1,715,982	1.43
Noninterest-bearing deposits	783,431		609,230		473,713	
Total deposits	\$ 3,449,100	2.35%	\$ 2,791,813	1.56%	\$ 2,189,695	1.12%

The Company s ratio of average noninterest-bearing deposits to average total deposits for the years ended December 31, 2006, 2005, and 2004 was 22.7%, 21.8%, and 21.6%, respectively.

Table of Contents

The following table sets forth the amount of the Company's certificates of deposit that are \$100,000 or greater by time remaining until maturity:

	December 31, 2006 (Dollars in thousands)
Three months or less	\$ 198,330
Over three through six months.	132,795
Over six through 12 months	142,893
Over 12 months	100,275
Total	\$ 574,293

Other Borrowings

The Company utilizes borrowings to supplement deposits to fund its lending and investment activities. Borrowings consist of funds from the Federal Home Loan Bank (FHLB) and correspondent banks. FHLB advances are considered short-term, overnight borrowings. At December 31, 2006, the Company had \$26.4 million in FHLB borrowings all of which consisted of long-term FHLB notes payable compared with \$55.4 million in FHLB borrowings at December 31, 2005, of which \$38.4 million were long-term FHLB notes payable and \$17.0 million were overnight advances. The \$29.0 million decrease was primarily attributable to the payoff of the FHLB advances of \$17.0 million and normal pay downs on the remaining notes. The weighted average interest rate paid on the FHLB advances at period end was 5.4%. The maturity dates on the FHLB notes payable range from the years 2007 to 2028 and have interest rates ranging from 3.32% to 6.48%. The highest outstanding balance of FHLB advances during 2006 was \$116.0 million compared with \$39.0 million during 2005. The Company had no federal funds purchased at December 31, 2006 or 2005.

At December 31, 2006, the Company had \$47.2 million in securities sold under repurchase agreements compared with \$47.0 million at December 31, 2005, an increase of \$240,000 or 0.5%. The increase was primarily attributable to normal customer activity.

At December 31, 2006 and 2005, the Company had outstanding \$100.5 million and \$75.8 million, respectively, in junior subordinated debentures issued to the Company's unconsolidated subsidiary trusts. The increase of \$24.7 million was due to the Company's assumption of \$30.9 million in junior subordinated debentures issued by SNB to its three subsidiary trusts, partially offset by the redemption of \$6.2 million in junior subordinated debentures issued to Paradigm Capital Trust II on February 28, 2006.

A summary of pertinent information related to the Company's eight issues of junior subordinated debentures outstanding at December 31, 2006 is set forth in the table below:

Description	Issuance Date	Trust Preferred Securities Outstanding	Interest Rate⁽¹⁾	Junior Subordinated Debt Owed to Trusts	Maturity Date⁽²⁾
Prosperity Statutory Trust II	July 31, 2001	\$ 15,000,000	3-month LIBOR + 3.58%, not to exceed 12.50%	\$ 15,464,000	July 31, 2031
Prosperity Statutory Trust III	Aug. 15, 2003	12,500,000	6.50% ⁽³⁾	12,887,000	Sept. 17, 2033
Prosperity Statutory Trust IV	Dec. 30, 2003	12,500,000	6.50% ⁽⁴⁾	12,887,000	Dec. 30, 2033
First Capital Statutory Trust I ⁽⁵⁾	Mar. 26, 2002	20,000,000	3-month LIBOR + 3.60%	20,619,000	Mar. 26, 2032

Edgar Filing: PROSPERITY BANCSHARES INC - Form 10-K

First Capital Statutory Trust II ⁽⁵⁾	Sept. 26, 2002	7,500,000	3-month LIBOR	7,732,000	Sept. 26, 2032
			+ 3.40%		
SNB Statutory Trust II ⁽⁶⁾	Mar. 26, 2003	10,000,000	3-month LIBOR	10,310,000	Mar. 26, 2033
			+ 3.15%		
SNB Capital Trust III ⁽⁶⁾	Mar. 27, 2003	10,000,000	3-month LIBOR	10,310,000	Mar. 27, 2033
			+ 3.15%		
SNB Capital Trust IV ⁽⁶⁾	Sept. 25, 2003	10,000,000	3-month LIBOR	10,310,000	Sept. 25, 2033
			+ 3.00%		

Table of Contents

- (1) The 3-month LIBOR in effect as of December 31, 2006 was 5.36%.
- (2) The debentures are callable five years from issuance date.
- (3) The debentures bear a fixed interest rate until September 17, 2008, when the rate begins to float on a quarterly basis based on the three-month LIBOR plus 3.00%.
- (4) The debentures bear a fixed interest rate until December 30, 2008, when the rate begins to float on a quarterly basis based on the three-month LIBOR plus 2.85%.
- (5) Assumed in connection with the First Capital acquisition on March 1, 2005.
- (6) Assumed in connection with the SNB acquisition on April 1, 2006.

Each of the trusts is a capital or statutory business trust organized for the sole purpose of issuing trust securities and investing the proceeds in the Company's junior subordinated debentures. The preferred trust securities of each trust represent preferred beneficial interests in the assets of the respective trusts and are subject to mandatory redemption upon payment of the junior subordinated debentures held by the trust. The common securities of each trust are wholly-owned by the Company. Each trust's ability to pay amounts due on the trust preferred securities is solely dependent upon the Company making payment on the related junior subordinated debentures. The debentures, which are the only assets of each trust, are subordinate and junior in right of payment to all of the Company's present and future senior indebtedness. The Company has fully and unconditionally guaranteed each trust's obligations under the trust securities issued by such trust to the extent not paid or made by each trust, provided such trust has funds available for such obligations.

Under the provisions of each issue of the debentures, the Company has the right to defer payment of interest on the debentures at any time, or from time to time, for periods not exceeding five years. If interest payments on either issue of the debentures are deferred, the distributions on the applicable trust preferred securities and common securities will also be deferred.

Interest Rate Sensitivity and Market Risk

The Company's asset liability and funds management policy provides management with the necessary guidelines for effective funds management, and the Company has established a measurement system for monitoring its net interest rate sensitivity position. The Company manages its sensitivity position within established guidelines.

As a financial institution, the Company's primary component of market risk is interest rate volatility. Fluctuations in interest rates will ultimately impact both the level of income and expense recorded on most of the Company's assets and liabilities, and the market value of all interest-earning assets and interest-bearing liabilities, other than those which have a short term to maturity. Interest rate risk is the potential of economic losses due to future interest rate changes. These economic losses can be reflected as a loss of future net interest income and/or a loss of current fair market values. The objective is to measure the effect on net interest income and to adjust the balance sheet to minimize the inherent risk while at the same time maximizing income.

The Company manages its exposure to interest rates by structuring its balance sheet in the ordinary course of business. The Company does not enter into instruments such as leveraged derivatives, interest rate swaps, financial options, financial future contracts or forward delivery contracts for the purpose of reducing interest rate risk. Based upon the nature of the Company's operations, the Company is not subject to foreign exchange or commodity price risk. The Company does not own any trading assets.

The Company's exposure to interest rate risk is managed by the Asset Liability Committee (ALCO), which is composed of senior officers of the Company, in accordance with policies approved by the Company's Board of Directors. The ALCO formulates strategies based on appropriate levels of interest rate risk. In determining the appropriate level of interest rate risk, the ALCO considers the impact on earnings and capital of the current outlook on interest rates, potential changes in interest rates, regional economies, liquidity, business strategies and other factors. The ALCO meets regularly to review, among other things, the sensitivity of assets

Table of Contents

and liabilities to interest rate changes, the book and market values of assets and liabilities, unrealized gains and losses, purchase and sale activities, commitments to originate loans and the maturities of investments and borrowings. Additionally, the ALCO reviews liquidity, cash flow flexibility, maturities of deposits and consumer and commercial deposit activity. Management uses two methodologies to manage interest rate risk: (1) an analysis of relationships between interest-earning assets and interest-bearing liabilities; and (2) an interest rate shock simulation model. The Company has traditionally managed its business to reduce its overall exposure to changes in interest rates.

An interest rate sensitive asset or liability is one that, within a defined time period, either matures or experiences an interest rate change in line with general market interest rates. The management of interest rate risk is performed by analyzing the maturity and repricing relationships between interest-earning assets and interest-bearing liabilities at specific points in time (GAP) and by analyzing the effects of interest rate changes on net interest income over specific periods of time by projecting the performance of the mix of assets and liabilities in varied interest rate environments. Interest rate sensitivity reflects the potential effect on net interest income of a movement in interest rates. A company is considered to be asset sensitive, or having a positive GAP, when the amount of its interest-earning assets maturing or repricing within a given period exceeds the amount of its interest-bearing liabilities also maturing or repricing within that time period. Conversely, a company is considered to be liability sensitive, or having a negative GAP, when the amount of its interest-bearing liabilities maturing or repricing within a given period exceeds the amount of its interest-earning assets also maturing or repricing within that time period. During a period of rising interest rates, a negative GAP would tend to affect net interest income adversely, while a positive GAP would tend to result in an increase in net interest income. During a period of falling interest rates, a negative GAP would tend to result in an increase in net interest income, while a positive GAP would tend to affect net interest income adversely.

The following table sets forth the Company's interest rate sensitivity analysis at December 31, 2006:

	Volumes Subject to Repricing Within				Total
	0-30	31-180	181-365	Greater than	
	days	days	days	one year	
	(Dollars in thousands)				
Interest-earning assets:					
Securities (excluding unrealized loss of \$4.5 million)	\$ 110,410	\$ 195,835	\$ 221,583	\$ 1,067,013	\$ 1,594,841
Loans held for investment	769,377	172,355	151,299	1,083,476	2,176,507
Federal funds sold and other temporary investments	153,643	100	297		154,040
Total interest-earning assets	\$ 1,033,430	\$ 368,290	\$ 373,179	\$ 2,150,489	\$ 3,925,388
Interest-bearing liabilities:					
Demand, money market and savings deposits	\$ 1,731,149	\$	\$	\$	\$ 1,731,149
Certificates of deposit and other time deposits.	149,926	466,988	309,945	231,794	1,158,653
Junior subordinated debentures	74,939			25,580	100,519
Securities sold under repurchase agreements	47,225				47,225
Other borrowings		380	5,449	20,579	26,408
Total interest-bearing liabilities	\$ 2,003,239	\$ 467,368	\$ 315,394	\$ 277,953	\$ 3,063,954
Period GAP	\$ (969,809)	\$ (99,078)	\$ 57,785	\$ 1,872,536	\$ 861,434
Cumulative GAP	\$ (969,809)	\$ (1,068,887)	\$ (1,011,102)	\$ 861,434	
Period GAP to total assets	(21.14)%	(2.16)%	1.26%	40.82%	
Cumulative GAP to total assets	(21.14)%	(23.30)%	(22.04)%	18.78%	

Table of Contents

While the GAP position is a useful tool in measuring interest rate risk and contributes toward effective asset and liability management, it is difficult to predict the effect of changing interest rates solely on that measure, without accounting for alterations in the maturity or repricing characteristics of the balance sheet that occur during changes in market interest rates. For example, the GAP position reflects only the prepayment assumptions pertaining to the current rate environment. Assets tend to prepay more rapidly during periods of declining interest rates than during periods of rising interest rates. Because of this and other risk factors not contemplated by the GAP position, an institution could have a matched GAP position in the current rate environment and still have its net interest income exposed to increased rate risk. Additionally, the Company had \$835.9 million in noninterest-bearing deposits at December 31, 2006 which are not reflected in the table above and are not directly impacted by interest rate changes.

In addition to GAP analysis, the Company uses an interest rate risk simulation model and shock analysis to test the interest rate sensitivity of net interest income and the balance sheet, respectively. Contractual maturities and repricing opportunities of loans are incorporated in the model as are prepayment assumptions, maturity data and call options within the investment portfolio. Assumptions based on past experience are incorporated into the model for nonmaturity deposit accounts. The Company's simulation analysis as of December 31, 2006 estimates a percentage of change in these metrics from the stable rate base scenario versus alternative scenarios of rising and falling market interest rates by instantaneously shocking a static balance sheet. The following table summarizes the simulated change in net interest income over a 12-month horizon in the event of an immediate change in interest rates:

Change in Interest	Increase (Decrease)
Rates (Basis Points)	in Net Interest Income
+200	4.2%
+100.	3.2%
Base	0.0%
-100	2.1%
-200	(0.4)%

The results are primarily due to behavior of demand, money market and savings deposits during such rate fluctuations. The Company has found that historically, interest rates on these deposits change more slowly than changes in the discount and federal funds rates. This assumption is incorporated into the simulation model and is generally not fully reflected in a GAP analysis.

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. During the three years ended December 31, 2006, the Company's liquidity needs have primarily been met by growth in core deposits and the issuance of junior subordinated debentures, as previously discussed. 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, have generally created an adequate liquidity position.

Asset liquidity is provided by cash and assets which are readily marketable or which will mature in the near future. As of December 31, 2006, the Company had cash and cash equivalents of \$269.7 million compared with \$97.4 million at December 31, 2005. The increase was mainly due to an increase in federal funds sold of \$147.8 million and an increase in cash and due from banks of \$24.6 million.

Table of Contents*Contractual Obligations*

The following table summarizes the Company's contractual obligations and other commitments to make future payments as of December 31, 2006 (other than deposit obligations). The Company's future cash payments associated with its contractual obligations pursuant to its junior subordinated debentures, FHLB notes payable and operating leases as of December 31, 2006 are summarized below. Payments for FHLB notes payable does not include interest of \$6.6 million that will be paid over the future periods. Payments related to leases are based on actual payments specified in underlying contracts.

	Payments due in:				Total
	More than 1 year but less 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	
	(Dollars in thousands)				
Junior subordinated debentures	\$	\$	\$	\$ 100,519	\$ 100,519
Federal Home Loan Bank notes payable	7,620	1,496	10,555	6,737	26,408
Operating leases	2,885	4,231	2,404	2,269	11,789
Total.	\$ 10,505	\$ 5,727	\$ 12,959	\$ 109,525	\$ 138,716

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 period as of December 31, 2006 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:

	Payments due in:				Total
	More than 1 year but less 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	
	(Dollars in thousands)				
Standby letters of credit	\$ 8,257	\$ 1,439	\$	\$	\$ 9,696
Commitments to extend credit	343,613	68,971	7,699	89,493	509,776
Total.	\$ 351,870	\$ 70,410	\$ 7,699	\$ 89,493	\$ 519,472

Standby Letters of Credit. Standby letters of credit are written conditional commitments issued by the Company to guarantee the performance of a customer to a third party. In the event the customer does not perform in accordance with the terms of the agreement with the third party, the Company would be required to fund the commitment. The maximum potential amount of future payments the Company could be required to make is represented by the contractual amount of the commitment. If the commitment is funded, the Company would be entitled to seek recovery from the customer. The Company's policies generally require that standby letter of credit arrangements contain security and debt covenants similar to those contained in loan agreements.

Edgar Filing: PROSPERITY BANCSHARES INC - Form 10-K

Commitments to Extend Credit. The Company enters into contractual commitments to extend credit, normally with fixed expiration dates or termination clauses, at specified rates and for specific purposes. Substantially all of the Company's commitments to extend credit are contingent upon customers maintaining specific credit standards at the time of loan funding. The Company minimizes its exposure to loss under these commitments by subjecting them to credit approval and monitoring procedures. Management assesses the credit risk associated with certain commitments to extend credit in determining the level of the allowance for credit losses.

Table of Contents

Capital Resources

Capital management consists of providing equity to support the Company's current and future operations. The Company is subject to capital adequacy requirements imposed by the Federal Reserve Board and the Bank is subject to capital adequacy requirements imposed by the FDIC. Both the Federal Reserve Board and the FDIC have adopted risk-based capital requirements for assessing bank holding company and bank capital adequacy. These standards define capital and establish minimum capital requirements in relation to assets and off-balance sheet exposure, adjusted for credit risk. The risk-based capital standards currently in effect are designed to make regulatory capital requirements more sensitive to differences in risk profiles among bank holding companies and banks, to account for off-balance sheet exposure and to minimize disincentives for holding liquid assets. Assets and off-balance sheet items are assigned to broad risk categories, each with appropriate relative risk weights. The resulting capital ratios represent capital as a percentage of total risk-weighted assets and off-balance sheet items.

The risk-based capital standards issued by the Federal Reserve Board require all bank holding companies to have Tier 1 capital of at least 4.0% and total risk-based capital (Tier 1 and Tier 2) of at least 8.0% of total risk-weighted tangible assets. Tier 1 capital generally includes common shareholders' equity and qualifying perpetual preferred stock together with related surpluses and retained earnings, less deductions for goodwill and various other intangibles. Tier 2 capital may consist of a limited amount of intermediate-term preferred stock, a limited amount of term subordinated debt, certain hybrid capital instruments and other debt securities, perpetual preferred stock not qualifying as Tier 1 capital, and a limited amount of the general valuation allowance for loan losses. The sum of Tier 1 capital and Tier 2 capital is total risk-based capital.

The Federal Reserve Board has also adopted guidelines which supplement the risk-based capital guidelines with a minimum ratio of Tier 1 capital to average total consolidated tangible assets, or leverage ratio, of 3.0% for institutions with well diversified risk, including no undue interest rate exposure; excellent asset quality; high liquidity; good earnings; and that are generally considered to be strong banking organizations, rated composite 1 under applicable federal guidelines, and that are not experiencing or anticipating significant growth. Other banking organizations are required to maintain a leverage ratio of at least 4.0%. These rules further provide that banking organizations experiencing internal growth or making acquisitions will be expected to maintain capital positions substantially above the minimum supervisory levels and comparable to peer group averages, without significant reliance on intangible assets.

Pursuant to FDICIA, each federal banking agency revised its risk-based capital standards to ensure that those standards take adequate account of interest rate risk, concentration of credit risk and the risks of nontraditional activities, as well as reflect the actual performance and expected risk of loss on multifamily mortgages. The Bank is subject to capital adequacy guidelines of the FDIC that are substantially similar to the Federal Reserve Board's guidelines. Also pursuant to FDICIA, the FDIC has promulgated regulations setting the levels at which an insured institution such as the Bank would be considered well-capitalized, adequately capitalized, undercapitalized, significantly undercapitalized and critically undercapitalized. Under the FDIC's regulations, the Bank is classified well-capitalized for purposes of prompt corrective action.

Total shareholders' equity increased to \$664.4 million at December 31, 2006 compared with \$464.7 million at December 31, 2005, an increase of \$199.7 million or 43.0%. This increase was primarily the result of net income of \$61.7 million and an of \$141.4 million in common stock issued in connection with the SNB acquisition, partially offset by dividends paid on the Common Stock of \$13.0 million. During 2005, shareholders' equity increased by \$189.1 million or 68.6% compared with \$275.6 million at December 31, 2004, primarily due to net income of \$47.9 million and \$149.6 million in common stock issued in connection with the First Capital and Grapeland acquisitions, partially offset by dividends paid on the Common Stock of \$9.6 million.

Table of Contents

The following table provides a comparison of the Company's and the Bank's leverage and risk-weighted capital ratios as of December 31, 2006 to the minimum and well-capitalized regulatory standards:

	To Be Categorized as		
	Minimum Required	Well-Capitalized Under Prompt	Actual Ratio at
	for Capital	Corrective Action	
Adequacy Purposes	Provisions	December 31, 2006	
The Company			
Leverage ratio.	3.00% ⁽¹⁾	N/A	7.76%
Tier 1 risk-based capital ratio	4.00	N/A	13.52
Total risk-based capital ratio.	8.00	N/A	14.55
The Bank			
Leverage ratio.	3.00% ⁽²⁾	5.00%	7.61%
Tier 1 risk-based capital ratio	4.00	6.00	13.28
Total risk-based capital ratio.	8.00	10.00	14.31

(1) The Federal Reserve Board may require the Company to maintain a leverage ratio above the required minimum.

(2) The FDIC may require the Bank to maintain a leverage ratio above the required minimum.

The trust preferred securities issued by the Company's subsidiary trusts are currently included in the Company's Tier 1 capital for regulatory purposes. On March 1, 2005, the Federal Reserve Board adopted final rules that continue to allow trust preferred securities to be included in Tier 1 capital, subject to stricter quantitative and qualitative limits. Currently, trust preferred securities and qualifying perpetual preferred stock are limited in the aggregate to no more than 25% of a bank holding company's core capital elements. The new rule amends the existing limit by providing that restricted core capital elements (including trust preferred securities and qualifying perpetual preferred stock) can be no more than 25% of core capital, net of goodwill and associated deferred tax liability. Because the 25% limit currently is calculated without deducting goodwill, the final rule reduces the amount of trust preferred securities that the Company can include in Tier 1 capital. The amount of such excess trust preferred securities are includable in Tier 2 capital. The new quantitative limits will be fully effective March 31, 2009.

Assuming these final rules were effective at December 31, 2006, approximately \$73.3 million of trust preferred securities would count as Tier 1 capital. The excess amount of trust preferred securities may be included in Tier 2 capital. Assuming these final rules were effective at December 31, 2006, the Company's consolidated capital ratios would have been:

Pro forma Consolidated Risk Based Capital Ratios:	
Total capital (to risk weighted assets)	14.55%
Tier 1 capital (to risk weighted assets)	12.49%
Leverage	7.16%

Each of the trusts issuing the trust preferred securities holds junior subordinated debentures the Company issued with a 30-year maturity. The final rules provide that in the last five years before the junior subordinated debentures mature, the associated trust preferred securities will be excluded from Tier 1 capital and included in Tier 2 capital. In addition, the trust preferred securities during this five-year period would be amortized out of Tier 2 capital by one-fifth each year and excluded from Tier 2 capital completely during the year prior to maturity of the debentures.

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

For information regarding the market risk of the Company's financial instruments, see Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operation Financial Condition Interest Rate Sensitivity and Market Risk. The Company's principal market risk exposure is to changes in interest rates.

Table of Contents**ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA**

The financial statements, the report thereon, the notes thereto and supplementary data commence at page 65 of this Annual Report on Form 10-K.

The following table presents certain unaudited quarterly financial information concerning the Company's results of operations for each of the two years indicated below. The information should be read in conjunction with the historical consolidated financial statements of the Company and the notes thereto appearing elsewhere in this Annual Report on Form 10-K.

CONSOLIDATED QUARTERLY FINANCIAL DATA OF THE COMPANY

	Quarter Ended 2006			
	December 31	September 30	June 30	March 31
	(Dollars in thousands, except per share data)			
	(unaudited)			
Interest income	\$ 62,893	\$ 62,150	\$ 61,012	\$ 45,684
Interest expense	26,487	26,183	24,430	16,494
Net interest income	36,406	35,967	36,582	29,190
Provision for credit losses	144	120	120	120
Net interest income after provision	36,262	35,847	36,462	29,070
Noninterest income	8,241	8,918	9,156	7,667
Noninterest expense	19,192	19,829	21,399	17,249
Income before income taxes	25,311	24,936	24,219	19,488
Provision for income taxes	8,709	8,572	8,324	6,624
Net income	\$ 16,602	\$ 16,364	\$ 15,895	\$ 12,864
Earnings per share ⁽¹⁾ :				
Basic	\$ 0.51	\$ 0.50	\$ 0.49	\$ 0.46
Diluted	\$ 0.50	\$ 0.49	\$ 0.48	\$ 0.46

	Quarter Ended 2005			
	December 31	September 30	June 30	March 31
	(Dollars in thousands, except per share data)			
	(unaudited)			
Interest income	\$ 44,277	\$ 42,707	\$ 41,106	\$ 34,033
Interest expense	15,256	13,787	12,627	9,556
Net interest income	29,021	28,920	28,479	24,477
Provision for credit losses	120	120	120	120
Net interest income after provision	28,901	28,800	28,359	24,357
Noninterest income	7,515	8,092	7,881	6,533
Noninterest expense	17,241	18,070	17,812	15,834
Income before income taxes	19,175	18,822	18,428	15,056
Provision for income taxes	6,548	6,351	6,220	4,502

Edgar Filing: PROSPERITY BANCSHARES INC - Form 10-K

Net income	\$ 12,627	\$ 12,471	\$ 12,208	\$ 10,554
Earnings per share⁽¹⁾:				
Basic	\$ 0.46	\$ 0.45	\$ 0.44	\$ 0.44
Diluted	\$ 0.45	\$ 0.45	\$ 0.44	\$ 0.43

(1) Earnings per share are computed independently for each of the quarters presented and therefore may not total earnings per share for the year.

Table of Contents

ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

None.

ITEM 9A. CONTROLS AND PROCEDURES

Evaluation of disclosure controls and procedures. As of the end of the period covered by this report, the Company carried out an evaluation, under the supervision and with the participation of its management, including its Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of its disclosure controls and procedures. In designing and evaluating the disclosure controls and procedures, management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and management was required to apply judgment in evaluating its controls and procedures. Based on this evaluation, the Company's Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934 (the Exchange Act)) were effective as of the end of the period covered by this report.

Changes in internal control over financial reporting. There were no changes in the Company's internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) that occurred during the quarter ended December 31, 2006, that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

Table of Contents

MANAGEMENT'S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

The management of the Company is responsible for establishing and maintaining adequate internal control over financial reporting. The Company's internal control over financial reporting is a process designed under the supervision of the Company's Chief Executive Officer and Chief Financial Officer to provide reasonable assurance regarding the reliability of financial reporting and the preparation of the Company's financial statements for external purposes in accordance with generally accepted accounting principles.

As of December 31, 2006, management assessed the effectiveness of the Company's internal control over financial reporting based on the criteria for effective internal control over financial reporting established in Internal Control--Integrated Framework, issued by the Committee of Sponsoring Organizations (COSO) of the Treadway Commission. This assessment included controls over the preparation of the schedules equivalent to the basic financial statements in accordance with the instructions for the Consolidated Financial Statements for Bank Holding Companies (Form FR Y-9C) to meet the reporting requirements of Section 112 of the Federal Deposit Insurance Corporation Improvement Act. Based on the assessment, management determined that the Company maintained effective internal control over financial reporting as of December 31, 2006, based on those criteria.

Deloitte & Touche LLP the independent registered public accounting firm that audited the consolidated financial statements of the Company included in this Annual Report on Form 10-K, has issued an attestation report on management's assessment of the effectiveness of the Company's internal control over financial reporting as of December 31, 2006. The report is included in this Item under the heading Report of Independent Registered Public Accounting Firm.

Compliance with Designated Laws and Regulations

Management is also responsible for ensuring compliance with the federal laws and regulations concerning loans to insiders and the federal and state laws and regulations concerning dividend restrictions, both of which are designated by the Federal Deposit Insurance Corporation (FDIC) as safety and soundness laws and regulations.

Management assessed its compliance with the designated safety and soundness laws and regulations and has maintained records of its determinations and assessments as required by the FDIC. Based on this assessment, management believes that the Company has complied, in all material respects, with the designated safety and soundness laws and regulations for the year ended December 31, 2006.

Table of Contents

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Shareholders of

Prosperity Bancshares, Inc.

Houston, Texas

We have audited management's assessment, included in the accompanying Management's Report on Internal Control over Financial Reporting, that Prosperity Bancshares, Inc. and subsidiaries (the Company) maintained effective internal control over financial reporting as of December 31, 2006, based on criteria established in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Because management's assessment and our audit were conducted to meet the reporting requirements of Section 112 of the Federal Deposit Insurance Corporation Improvement Act (FDICIA), management's assessment and our audit of the Company's internal control over financial reporting included controls over the preparation of the schedules equivalent to the basic financial statements in accordance with the instructions for the *Consolidated Financial Statements for Bank Holding Companies (Form FR Y-9C)*. The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing, and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinions.

A company's internal control over financial reporting is a process designed by, or under the supervision of, the company's principal executive and principal financial officers, or persons performing similar functions, and effected by the company's board of directors, management, and other personnel to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of the inherent limitations of internal control over financial reporting, including the possibility of collusion or improper management override of controls, material misstatements due to error or fraud may not be prevented or detected on a timely basis. Also, projections of any evaluation of the effectiveness of the internal control over financial reporting to future periods are subject to the risk that the controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, management's assessment that the Company maintained effective internal control over financial reporting as of December 31, 2006, is fairly stated, in all material respects, based on the criteria established in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Also, in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2006, based on the criteria established in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

Table of Contents

We have not examined and, accordingly, we do not express an opinion or any other form of assurance on management's statement referring to compliance with laws and regulations.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated financial statements as of and for the year ended December 31, 2006 of the Company and our report dated February 27, 2007, expressed an unqualified opinion on those financial statements.

Houston, Texas

February 27, 2007

ITEM 9B. OTHER INFORMATION

None.

PART III.

ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE

The information required by this Item is incorporated herein by reference to the information under the captions Election of Directors, Continuing Directors and Executive Officers, Section 16(a) Beneficial Ownership Reporting Compliance, Corporate Governance and Nominating Procedures Committees of the Board of Directors Audit Committee, Corporate Governance and Nominating Procedures Director Nomination Process and Corporate Governance and Nominating Procedures Code of Ethics in the Company's definitive Proxy Statement for its 2007 Annual Meeting of Shareholders (the 2007 Proxy Statement) to be filed with the Commission pursuant to Regulation 14A under the Exchange Act within 120 days of the Company's fiscal year end.

ITEM 11. EXECUTIVE COMPENSATION

The information required by this Item is incorporated herein by reference to the information under the captions Executive Compensation and Other Matters and Director Compensation in the 2007 Proxy Statement.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED SHAREHOLDER MATTERS

Certain information required by this Item 12 is included under Securities Authorized for Issuance under Equity Compensation Plans in Part II, Item 5 of this annual report on Form 10-K. The other information required by this Item is incorporated herein by reference to the information under the caption Beneficial Ownership of Common Stock by Management of the Company and Principal Shareholders in the 2007 Proxy Statement.

ITEM 13. CERTAIN RELATIONSHIPS, RELATED TRANSACTIONS AND DIRECTOR INDEPENDENCE

The information required by this Item is incorporated herein by reference to the information under the captions Corporate Governance and Nominating Procedures Director Independence and Interests of Management and Others in Certain Transactions in the 2007 Proxy Statement.

ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES

The information required by this Item is incorporated herein by reference to the information under the caption Fees and Services of Independent Registered Public Accounting Firm in the 2007 Proxy Statement.

Table of Contents

PART IV.

ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES

Consolidated Financial Statements and Schedules

Reference is made to the Consolidated Financial Statements, the report thereon and the notes thereto commencing at page 65 of this Annual Report on Form 10-K. Set forth below is a list of such Consolidated Financial Statements:

Report of Independent Registered Public Accounting Firm

Consolidated Balance Sheets as of December 31, 2006 and 2005

Consolidated Statements of Income for the Years Ended December 31, 2006, 2005 and 2004

Consolidated Statements of Changes in Shareholders' Equity for the Years Ended December 31, 2006, 2005 and 2004

Consolidated Statements of Cash Flows for the Years Ended December 31, 2006, 2005 and 2004

Notes to Consolidated Financial Statements

Financial Statement Schedules

All supplemental schedules are omitted as inapplicable or because the required information is included in the Consolidated Financial Statements or notes thereto.

Exhibits

Each exhibit marked with an asterisk is filed or furnished with this Annual Report on Form 10-K as noted below.

Exhibit Number⁽¹⁾	Description
3.1	Amended and Restated Articles of Incorporation of Prosperity (incorporated herein by reference to Exhibit 3.1 to the Company's Registration Statement on Form S-1 (Registration No. 333-63267))
3.2	Articles of Amendment to Amended and Restated Articles of Incorporation of the Company (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 (incorporated herein by reference to Exhibit 3.1 to the Company's Current Report on Form 8-K filed April 20, 2006)
4.1	Form of certificate representing shares of Prosperity common stock (incorporated herein by reference to Exhibit 4 to the Company's Registration Statement on Form S-1 (Registration No. 333-63267))
4.2	Indenture dated as of July 31, 2001 by and between Prosperity Bancshares, Inc., as Issuer, and State Street Bank and Trust Company of Connecticut, National Association, with respect to the Floating Rate Junior Subordinated Deferrable Interest Debentures of Prosperity Bancshares, Inc. (incorporated herein by reference to Exhibit 4.1 to the Company's Quarterly Report on Form 10-Q for the quarter ended September 30, 2001)
4.3	Amended and Restated Declaration of Trust of Prosperity Statutory Trust II dated as of July 31, 2001 (incorporated herein by reference to Exhibit 4.2 to the Company's Quarterly Report on Form 10-Q for the quarter ended September 30, 2001)

Table of Contents

Exhibit Number⁽¹⁾	Description
4.4	Guarantee Agreement dated as of July 31, 2001 by and between Prosperity Bancshares, Inc. and State Street Bank and Trust Company of Connecticut, National Association (incorporated herein by reference to Exhibit 4.3 to the Company's Quarterly Report on Form 10-Q for the quarter ended September 30, 2001)
10.1	Prosperity Bancshares, Inc. 1995 Stock Option Plan (incorporated herein by reference to Exhibit 10.1 to the Company's Registration Statement on Form S-1 (Registration No. 333-63267))
10.2	Prosperity Bancshares, Inc. 1998 Stock Incentive Plan (incorporated herein by reference to Exhibit 10.2 to the Company's Registration Statement on Form S-1 (Registration No. 333-63267))
10.3	Prosperity Bancshares, Inc. 2004 Stock Incentive Plan (incorporated herein by reference to Exhibit 10.3 to the Company's Registration Statement on Form S-4 (Registration No. 333-121767))
10.4	Amended and Restated Employment Agreement by and between Prosperity Bank and David Zalman (incorporated herein by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K filed January 24, 2005)
10.5	Amended and Restated Employment Agreement by and between Prosperity Bank and H. E. Timanus, Jr. (incorporated herein by reference to Exhibit 10.2 to the Company's Current Report on Form 8-K filed January 24, 2005)
10.6	Employment Agreement, dated as of August 10, 2006, by and among Prosperity Bancshares, Inc., Prosperity Bank and James D. Rollins III (incorporated herein by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K filed on August 15, 2006)
10.7	Employment Agreement, dated as of August 10, 2006, by and among Prosperity Bancshares, Inc., Prosperity Bank and David Hollaway (incorporated herein by reference to Exhibit 10.2 to the Company's Current Report on Form 8-K filed on August 15, 2006)
10.8	Non-Competition, Non-Solicitation and Confidentiality Agreement, dated as of January 31, 2007, by and between L. Don Stricklin, Texas United and Prosperity (incorporated herein by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K filed on February 2, 2007)
10.9	First Amendment to Employment and Non-Competition Agreement, dated as of September 19, 2006, by and between Prosperity Bank and Peter E. Fisher (incorporated herein by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K filed on September 21, 2006)
10.10	Employment and Non-Competition Agreement, dated as of September 1, 2002, by and between Prosperity Bank and Peter E. Fisher (incorporated herein by reference to Exhibit 10.2 to the Company's Current Report on Form 8-K filed on September 21, 2006)
10.11	Termination Agreement dated as of December 8, 2005 by and among Prosperity Bancshares, Inc., Prosperity Bank and D. Michael Hunter (incorporated herein by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K filed December 9, 2005)
10.12	Non-Competition Agreement dated as of December 8, 2005 by and among Prosperity Bancshares, Inc., Prosperity Bank and D. Michael Hunter (incorporated herein by reference to Exhibit 10.2 to the Company's Current Report on Form 8-K filed December 9, 2005)
10.13	Paradigm Bancorporation, Inc. 1999 Stock Incentive Plan (incorporated herein by reference to Exhibit 4.2 to the Company's Registration Statement on Form S-8 (Registration No. 333-100815))
10.14	MainBancorp, Inc. 1996 Employee Stock Option Plan (incorporated herein by reference to Exhibit 4.2 to the Company's Registration Statement on Form S-8 (Registration No. 333-110755))
10.15	Form of MainBancorp, Inc. Non-Qualified Stock Option Agreement (incorporated herein by reference to Exhibit 4.3 to the Company's Registration Statement on Form S-8 (Registration No. 333-110755))

Table of Contents

Exhibit Number ⁽¹⁾	Description
10.16	First Capital Bankers, Inc. 1996 Executive Stock Option Plan (incorporated herein by reference to Exhibit 10.11 to the Company's Annual Report on Form 10-K for the year ended December 31, 2004)
10.17	First Capital Bankers, Inc. Amended and Restated 1998 Stock Option Plan (incorporated herein by reference to Exhibit 10.12 to the Company's Annual Report on Form 10-K for the year ended December 31, 2004)
10.18	SNB Bancshares, Inc. 2002 Stock Option Plan, as amended and restated (incorporated herein by reference to Exhibit 4.2 to the Company's Registration Statement on Form S-8 (Registration No. 333-133214))
10.19	Texas United Bancshares, Inc. 1998 Incentive Stock Option Plan (incorporated herein by reference to Exhibit 4.2 to the Company's Registration Statement on Form S-8 (Registration No. 333-140425))
10.20	Texas United Bancshares, Inc. 2004 Stock Incentive Plan (incorporated herein by reference to Exhibit 4.3 to the Company's Registration Statement on Form S-8 (Registration No. 333-140425))
10.21	1998 Incentive Stock Option Plan for Gateway Holding Company, Inc. (incorporated herein by reference to Exhibit 4.4 to the Company's Registration Statement on Form S-8 (Registration No. 333-140425))
10.22	Stock Option Agreement dated July 1, 1998 by and between Texas United Bancshares, Inc. and L. Steve Stapp (incorporated herein by reference to Exhibit 4.5 to the Company's Registration Statement on Form S-8 (Registration No. 333-140425))
21.1*	Subsidiaries of Prosperity Bancshares, Inc.
23.1*	Consent of Deloitte & Touche LLP
31.1*	Certification of the Chief Executive Officer pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended.
31.2*	Certification of the Chief Financial Officer pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended.
32.1**	Certification of the Chief Executive Officer pursuant to 18 U.S.C. Section 1350, adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2**	Certification of the Chief Financial Officer pursuant to 18 U.S.C. Section 1350, adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

Management contract or compensatory plan or arrangement.

* Filed with this Annual Report on Form 10-K.

** Furnished with this Annual Report on Form 10-K.

(1) The Company has other long-term debt agreements that meet the exclusion set forth in Section 601(b)(4)(iii)(A) of Regulation S-K. The Company hereby agrees to furnish a copy of such agreements to the Commission upon request.

Table of Contents**SIGNATURES**

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, Prosperity Bancshares, Inc., has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

Date: March 1, 2007

PROSPERITY BANCSHARES, INC.®

By: /s/ DAVID ZALMAN
David Zalman

Chairman of the Board and Chief Executive Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, as amended, this report has been signed by the following persons on behalf of the registrant in the capacities and on the date indicated.

Signature	Positions	Date
/s/ DAVID ZALMAN David Zalman	Chairman of the Board and Chief Executive Officer (principal executive officer); Director	March 1, 2007
/s/ DAVID HOLLOWAY David Hollaway	Chief Financial Officer (principal financial officer and principal accounting officer)	March 1, 2007
/s/ JAMES A. BOULIGNY James A. Bouligny	Director	March 1, 2007
/s/ CHARLES A. DAVIS, JR. Charles A. Davis, Jr.	Director	March 1, 2007
/s/ WILLIAM H. FAGAN, M.D. William Fagan, M.D.	Director	March 1, 2007
/s/ NED S. HOLMES Ned S. Holmes	Director	March 1, 2007
/s/ D. MICHAEL HUNTER D. Michael Hunter	Director	March 1, 2007
/s/ S. REED MORIAN S. Reed Morian	Director	March 1, 2007

Edgar Filing: PROSPERITY BANCSHARES INC - Form 10-K

/s/ PERRY MUELLER, JR., D.D.S.

Director

March 1, 2007

Perry Mueller, Jr., D.D.S.

/s/ JAMES D. ROLLINS, III

Director

March 1, 2007

James D. Rollins, III

Table of Contents

Signature	Positions	Date
/s/ TRACY T. RUDOLPH Tracy T. Rudolph	Director	March 1, 2007
/s/ HARRISON STAFFORD II Harrison Stafford II	Director	March 1, 2007
/s/ ROBERT STEELHAMMER Robert Steelhammer	Director	March 1, 2007
/s/ L. DON STRICKLIN L. Don Stricklin	Director	March 1, 2007
/s/ H.E. TIMANUS, JR. H.E. Timanus, Jr.	Director	March 1, 2007

Table of Contents

TABLE OF CONTENTS TO CONSOLIDATED FINANCIAL STATEMENTS

	Page
<u>Prosperity Bancshares, Inc.®</u>	
<u>Report of Independent Registered Public Accounting Firm</u>	66
<u>Consolidated Balance Sheets as of December 31, 2006 and 2005</u>	67
<u>Consolidated Statements of Income for the Years Ended December 31, 2006, 2005 and 2004</u>	68
<u>Consolidated Statements of Changes in Shareholders' Equity for the Years Ended December 31, 2006, 2005 and 2004</u>	69
<u>Consolidated Statements of Cash Flows for the Years Ended December 31, 2006, 2005 and 2004</u>	70
<u>Notes to Consolidated Financial Statements</u>	71

Table of Contents

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Shareholders of

Prosperity Bancshares, Inc.

Houston, Texas

We have audited the accompanying consolidated balance sheets of Prosperity Bancshares Inc. and subsidiaries (the Company) as of December 31, 2006 and 2005, and the related consolidated statements of income, shareholders' equity, and cash flows for each of the three years in the period ended December 31, 2006. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of Prosperity Bancshares, Inc. and subsidiaries as of December 31, 2006 and 2005, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2006, in conformity with accounting principles generally accepted in the United State of America.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of the Company's internal control over financial reporting as of December 31, 2006, based on the criteria established in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated February 27, 2007, expressed an unqualified opinion on management's assessment of the effectiveness of the Company's internal control over financial reporting and an unqualified opinion on the effectiveness of the Company's internal control over financial reporting.

Houston, Texas

February 27, 2007

Table of Contents**PROSPERITY BANCSHARES, INC.® AND SUBSIDIARIES****CONSOLIDATED BALANCE SHEETS**

	December 31,	
	2006	2005
	(Dollars in thousands)	
ASSETS		
Cash and due from banks	\$ 116,078	\$ 91,518
Federal funds sold	153,643	5,846
Total cash and cash equivalents	269,721	97,364
Interest bearing deposits in financial institutions	397	297
Available for sale securities, at fair value	434,331	410,361
Held to maturity securities, at cost	1,155,972	1,162,241
Loans held for investment	2,176,507	1,542,125
Less allowance for credit losses	(23,990)	(17,203)
Loans, net	2,152,517	1,524,922
Accrued interest receivable	20,364	16,105
Goodwill	424,339	261,964
Core deposit intangibles, net of accumulated amortization of \$11.6 million and \$6.7 million, respectively	23,032	22,461
Bank premises and equipment, net	63,057	49,244
Other real estate owned	140	239
Bank Owned Life Insurance (BOLI), net	14,176	13,676
Leased assets	3,709	4,464
Other assets	25,014	22,644
TOTAL ASSETS	\$ 4,586,769	\$ 3,585,982
LIABILITIES AND SHAREHOLDERS EQUITY		
LIABILITIES:		
Deposits:		
Noninterest-bearing	\$ 835,876	\$ 674,407
Interest-bearing	2,889,802	2,245,911
Total deposits	3,725,678	2,920,318
Other borrowings	26,408	55,404
Securities sold under repurchase agreements	47,225	46,985
Accrued interest payable	8,451	6,546
Other liabilities	14,077	16,237
Junior subordinated debentures	100,519	75,775
Total liabilities	3,922,358	3,121,265
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; 32,829,873 and 27,857,887 shares issued at December 31, 2006 and 2005, respectively; 32,792,785 and 27,820,799 shares outstanding at December 31, 2006 and 2005, respectively	32,830	27,858
Capital surplus	425,557	280,525
Retained earnings	209,581	160,883
Accumulated other comprehensive loss net unrealized loss on available for sale securities, net of tax benefit of \$1,588 and \$2,122, respectively	(2,950)	(3,942)

Edgar Filing: PROSPERITY BANCSHARES INC - Form 10-K

Less treasury stock, at cost, 37,088 shares	(607)	(607)
Total shareholders' equity	664,411	464,717
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	\$ 4,586,769	\$ 3,585,982

See notes to consolidated financial statements.

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

	For the Years Ended		
	2006	December 31, 2005	2004
	(Dollars in thousands, except per share data)		
INTEREST INCOME:			
Loans, including fees	\$ 157,426	\$ 99,958	\$ 55,779
Securities:			
Taxable	69,896	59,066	52,771
Nontaxable	1,821	1,286	1,461
70% nontaxable preferred dividends	915	514	1,009
Federal funds sold	1,667	1,292	556
Deposits in financial institutions	14	7	180
Total interest income	231,739	162,123	111,756
INTEREST EXPENSE:			
Deposits	80,942	43,643	24,586
Junior subordinated debentures	7,592	4,895	4,046
Securities sold under repurchase agreements	1,820	768	232
Other borrowings	3,240	1,920	925
Total interest expense	93,594	51,226	29,789
NET INTEREST INCOME	138,145	110,897	81,967
PROVISION FOR CREDIT LOSSES	504	480	880
NET INTEREST INCOME AFTER PROVISION FOR CREDIT LOSSES	137,641	110,417	81,087
NONINTEREST INCOME:			
Service charges on deposit accounts	27,379	24,985	20,215
(Loss) gain on sale of securities, net	0	(79)	78
Other	6,603	5,115	2,778
Total noninterest income	33,982	30,021	23,071
NONINTEREST EXPENSE:			
Salaries and employee benefits	41,298	36,672	27,861
Net occupancy expense	7,884	6,663	4,814
Data processing	3,612	2,837	2,036
Core deposit intangibles amortization	4,869	3,912	1,781
Depreciation expense	5,048	4,462	2,843
Other	14,958	14,411	12,372
Total noninterest expense	77,669	68,957	51,707
INCOME BEFORE INCOME TAXES	93,954	71,481	52,451

Edgar Filing: PROSPERITY BANCSHARES INC - Form 10-K

PROVISION FOR INCOME TAXES	32,229	23,621	17,744
NET INCOME	\$ 61,725	\$ 47,860	\$ 34,707
EARNINGS PER SHARE:			
Basic	\$ 1.96	\$ 1.79	\$ 1.61
Diluted	\$ 1.94	\$ 1.77	\$ 1.59

See notes to consolidated financial statements.

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

	Common Stock		Accumulated			Treasury Stock	Total Shareholders Equity
	Shares	Amount	Capital Surplus (Dollars in thousands, except share data)	Retained Earnings	Other		
					Comprehensive		
					Income (loss)		
BALANCE AT JANUARY 1, 2004	20,966,706	20,967	102,594	94,610	2,024	(607)	219,588
Comprehensive income:							
Net income				34,707			34,707
Net change in unrealized loss on available for sale securities					(5,123)		(5,123)
Total comprehensive income							29,584
Issuance of common stock in connection with the exercise of stock options	206,231	206	840				1,046
Common stock issued in connection with the Liberty acquisition	1,245,191	1,245	30,713				31,958
Stock option compensation expense			141				141
Cash dividends declared, \$0.31 per share				(6,670)			(6,670)
BALANCE AT DECEMBER 31, 2004	22,418,128	22,418	134,288	122,647	(3,099)	(607)	275,647
Comprehensive Income:							
Net income				47,860			47,860
Net change in unrealized loss on available for sale securities					(894)		(894)
Add: Reclassification adjustment for net losses included in net income, net of tax benefit of \$28					51		51
Total comprehensive income							47,017
Issuance of common stock in connection with the exercise of stock options & restricted stock awards	128,015	128	1,089				1,217
Common stock issued in connection with the First Capital acquisition	5,078,856	5,079	137,439				142,518
Common stock issued in connection with the Grapeland acquisition	232,888	233	6,894				7,127
Stock option compensation expense			619				619
Cash dividends declared, \$0.35 per share				(9,624)			(9,624)
Other			196				196
BALANCE AT DECEMBER 31, 2005	27,857,887	\$ 27,858	\$ 280,525	\$ 160,883	\$ (3,942)	\$ (607)	\$ 464,717
Net income				61,725			61,725
Net change in unrealized loss on available for sale securities					992		992
Total comprehensive income							62,717
Issuance of common stock in connection with the exercise of stock options & restricted stock awards	523,761	524	7,268				