PROSPERITY BANCSHARES INC
Form 10-Q
August 07, 2015
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q
(Mark One)
QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

FOR THE QUARTERLY PERIOD ENDED JUNE 30, 2015

OR

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

FOR THE TRANSITION PERIOD FROM TO

COMMISSION FILE NUMBER: 001-35388
PROSPERITY BANCSHARES, INC. ${ }^{\circledR}$
(Exact name of registrant as specified in its charter)

| TEXAS | 74-2331986 |
| :--- | :--- |
| (State or other jurisdiction | (I.R.S. Employer |
|  |  |
| of incorporation or organization) | Identification No.) |

## Prosperity Bank Plaza

## 4295 San Felipe

Houston, Texas 77027
(Address of principal executive offices, including zip code)
(713) 693-9300
(Registrant's telephone number, including area code)

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

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

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

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

Accelerated Filer
Smaller Reporting Company

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

As of August 3, 2015, there were 70,041,790 outstanding shares of the registrant's Common Stock, par value $\$ 1.00$ per share.

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## PROSPERITY BANCSHARES, INC. ${ }^{\circledR}$ AND SUBSIDIARIES

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## PART I-FINANCIAL INFORMATION

## ITEM 1. INTERIM CONSOLIDATED FINANCIAL STATEMENTS

## PROSPERITY BANCSHARES, INC. ${ }^{\circledR}$ AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

## (UNAUDITED)

|  | June 30, <br> 2015 <br> (Dollars in th except par v | December <br> 31, <br> 2014 <br> housands, <br> alue) |
| :---: | :---: | :---: |
| ASSETS |  |  |
| Cash and due from banks | \$353,047 | \$677,285 |
| Federal funds sold | 1,451 | 569 |
| Total cash and cash equivalents | 354,498 | 677,854 |
| Available for sale securities, at fair value | 123,229 | 145,399 |
| Held to maturity securities, at cost (fair value of $\$ 9,592,825$ and $\$ 8,948,692$, respectively) | 9,574,850 | 8,900,377 |
| Total securities | 9,698,079 | 9,045,776 |
| Loans held for sale | 10,482 | 8,602 |
| Loans held for investment | 9,103,853 | 9,235,581 |
| Total loans | 9,114,335 | 9,244,183 |
| Less: allowance for credit losses | (80,972 | (80,762 |
| Loans, net | 9,033,363 | 9,163,421 |
| Accrued interest receivable | 51,303 | 51,941 |
| Goodwill | 1,881,955 | 1,874,191 |
| Core deposit intangibles, net | 54,068 | 58,947 |
| Bank premises and equipment, net | 275,347 | 281,549 |
| Other real estate owned | 2,806 | 3,237 |
| Bank owned life insurance (BOLI) | 232,963 | 230,095 |
| Federal Home Loan Bank of Dallas stock | 58,132 | 15,432 |
| Other assets | 43,773 | 105,290 |
| TOTAL ASSETS | \$21,686,287 | \$21,507,733 |

Deposits:

| Noninterest-bearing | $\$ 5,040,628$ | $\$ 4,936,420$ |
| :--- | :--- | :--- |
| Interest-bearing | $11,961,036$ | $12,756,738$ |
| Total deposits | $17,001,664$ | $17,693,158$ |
| Other borrowings | 886,741 | 8,724 |
| Securities sold under repurchase agreements | 334,189 | 315,523 |
| Junior subordinated debentures | - | 167,531 |
| Accrued interest payable | 2,115 | 3,190 |
| Other liabilities | 104,293 | 74,781 |
| Total liabilities | $18,329,002$ | $18,262,907$ |

## COMMITMENTS AND CONTINGENCIES

SHAREHOLDERS' EQUITY:
Preferred stock, $\$ 1$ par value; 20,000,000 shares authorized; none issued or outstanding
Common stock, $\$ 1$ par value; 200,000,000 shares authorized; 70,076,778 and
69,816,653 shares issued at June 30, 2015 and December 31, 2014,
respectively; 70,039,690 and 69,779,565 shares outstanding at June 30, 2015 and
December 31, 2014, respectively
Capital surplus
Retained earnings
Accumulated other comprehensive income-net unrealized gain on available for sale
securities, net of tax of $\$ 1,629$ and $\$ 2,008$, respectively
Less treasury stock, at cost, 37,088 shares (607 ) (607)
Total shareholders' equity
3,357,285 3,244,826
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY

See notes to interim consolidated financial statements.

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## PROSPERITY BANCSHARES, INC. ${ }^{\circledR}$ AND SUBSIDIARIES

## CONSOLIDATED STATEMENTS OF INCOME

(UNAUDITED)

INTEREST INCOME:
Loans, including fees
Securities
Federal funds sold
Total interest income

| Three Ended |  | Six Mo | hs Ended |
| :---: | :---: | :---: | :---: |
| June 30 |  | June 30, |  |
| 2015 | 2014 | 2015 | 2014 |
| (Dollar data) |  | , except | er share |


| $\$ 119,404$ | $\$ 138,655$ | $\$ 244,282$ | $\$ 245,799$ |
| :--- | :--- | :--- | :--- |
| 48,530 | 47,670 | 97,092 | 94,726 |
| 47 | 178 | 212 | 226 |
| 167,981 | 186,503 | 341,586 | 340,751 |

INTEREST EXPENSE:

| Deposits | 9,169 | 10,918 | 18,746 | 20,305 |
| :--- | :--- | :--- | :--- | :--- |
| Other borrowings | 365 | 189 | 494 | 347 |
| Securities sold under repurchase agreements | 208 | 254 | 411 | 491 |
| Junior subordinated debentures | - | 1,087 | 791 | 1,862 |
| Total interest expense | 9,742 | 12,448 | 20,442 | 23,005 |
|  |  |  |  |  |
| NET INTEREST INCOME | 158,239 | 174,055 | 321,144 | 317,746 |
| PROVISION FOR CREDIT LOSSES | 500 | 6,325 | 1,750 | 6,925 |
| NET INTEREST INCOME AFTER PROVISION FOR CREDIT | 157,739 | 167,730 | 319,394 | 310,821 |
| LOSSES |  |  |  |  |
| NONINTEREST INCOME: | 8,310 | 9,099 | 16,228 | 17,969 |
| Nonsufficient funds (NSF) fees | 6,003 | 6,030 | 11,641 | 11,182 |
| Credit card, debit card and ATM card income | 4,189 | 4,325 | 8,368 | 7,934 |
| Service charges on deposit accounts | 2,047 | 2,044 | 4,056 | 3,844 |
| Trust income | 1,513 | 1,208 | 2,661 | 1,801 |
| Mortgage income | 1,541 | 1,401 | 2,950 | 2,670 |
| Brokerage income | 270 | 1,301 | 1,649 | 4,611 |
| Net gain on sale of assets | 6,424 | 7,189 | 11,165 | 11,250 |
| Other | 30,297 | 32,597 | 58,718 | 61,261 |
| Total noninterest income |  |  |  |  |
| NONINTEREST EXPENSE: | 47,819 | 54,126 | 97,785 | 97,534 |
| Salaries and employee benefits | 5,812 | 5,996 | 11,776 | 11,335 |
| Net occupancy and equipment | 4,045 | 4,009 | 7,862 | 7,193 |
| Credit and debit card, data processing and software amortization | 4,253 | 3,886 | 8,607 | 6,612 |
| Regulatory assessments and FDIC insurance | 2,390 | 2,630 | 4,879 | 4,675 |

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| Depreciation | 3,420 | 3,522 | 6,336 | 6,723 |
| :--- | :--- | :--- | :--- | :--- |
| Communications | 2,835 | 2,919 | 5,644 | 5,656 |
| Other real estate expense | 129 | 188 | 261 | 584 |
| Other | 9,032 | 10,016 | 16,047 | 18,074 |
| Total noninterest expense | 79,735 | 87,292 | 159,197 | 158,386 |
| INCOME BEFORE INCOME TAXES | 108,301 | 113,035 | 218,915 | 213,696 |
| PROVISION FOR INCOME TAXES | 36,369 | 37,529 | 73,342 | 71,053 |
| NET INCOME | $\$ 71,932$ | $\$ 75,506$ | $\$ 145,573$ | $\$ 142,643$ |

EARNINGS PER SHARE:
$\begin{array}{lllll}\text { Basic } & \$ 1.03 & \$ 1.08 & \$ 2.08 & \$ 2.10\end{array}$
Diluted
\$1.03 \$1.08 \$2.08 \$2.10

See notes to interim consolidated financial statements.

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## PROSPERITY BANCSHARES, INC. ${ }^{\circledR}$ AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(UNAUDITED)

Net income

| Three Months Ended | Six Months Ended |  |
| :---: | :---: | :---: |
| June 30, | June |  |
| 20152014 | 2015 | 2014 |
| (Dollars in thousands) |  |  |

Other comprehensive loss, before tax:
Securities available for sale:
Change in unrealized gain during period
Total other comprehensive loss
Deferred tax benefit related to other comprehensive loss
Other comprehensive loss, net of tax
Comprehensive income
\$71,932 \$75,506 \$145,573 \$142,643
$\left.\begin{array}{lllllll}(640 & ) & (317 & ) & (1,082 & ) & (806\end{array}\right)$

See notes to interim consolidated financial statements.

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## PROSPERITY BANCSHARES, INC. ${ }^{\circledR}$ AND SUBSIDIARIES

## CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

(UNAUDITED)

BALANCE AT
DECEMBER 31, 2013
Net income
Other comprehensive loss
Common stock issued in connection with the
exercise of stock options and restricted stock awards Common stock issued in connection with the acquisition of $\mathrm{F} \& \mathrm{M}$
Bancorporation Inc.
Stock based compensation expense
Cash dividends declared,
$\$ 0.4800$ per share
BALANCE AT JUNE 30, 2014

BALANCE AT
DECEMBER 31, 2014
Net income
Other comprehensive loss
Common stock issued in connection with the issuance of restricted stock awards
Stock based compensation expense
Cash dividends declared,
$\$ 0.5450$ per share
BALANCE AT JUNE 30, 2015

| Common Stock |  | Capital <br> Surplus | Retained <br> Earnings <br> share data) |  | ed <br> nsiTTreasur | Total |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Shares <br> (In thousand | Amount ds, except |  |  | Income | Stock | Equity |
| 66,085,179 | \$66,085 | \$1,798,862 | \$917,595 | \$ 4,883 | \$ (607 | ) $\$ 2,786,818$ |
|  |  |  | 142,643 | (524 | ) | $\begin{aligned} & 142,643 \\ & (524 \quad) \end{aligned}$ |
| 398,384 | 399 | 2,016 |  |  |  | 2,415 |
| 3,298,022 | 3,298 | 214,866 |  |  |  | 218,164 |
|  |  | 3,709 |  |  |  | 3,709 |
|  |  |  | (32,631 ) |  |  | (32,631 ) |
| 69,781,585 | \$69,782 | \$2,019,453 | \$1,027,607 | \$ 4,359 | \$ (607 | ) \$3,120,594 |
| 69,816,653 | \$69,817 | \$2,025,235 | \$1,146,652 | \$ 3,729 | \$ (607 | ) \$3,244,826 |
|  |  |  | 145,573 | (703 | ) | $\left.\begin{array}{l} 145,573 \\ (703 \end{array}\right)$ |
| 260,125 | 260 | (193 |  |  |  | 67 |
|  |  | 5,690 |  |  |  | 5,690 |
|  |  |  | (38,168 ) |  |  | (38,168 ) |
| 70,076,778 | \$70,077 | \$2,030,732 | \$1,254,057 | \$ 3,026 | \$ (607 ) | ) \$3,357,285 |

See notes to interim consolidated financial statements.

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## PROSPERITY BANCSHARES, INC. ${ }^{\circledR}$ AND SUBSIDIARIES

## CONSOLIDATED STATEMENTS OF CASH FLOWS

## (UNAUDITED)

| Redemption of junior subordinated debentures | $(167,531$ | - |  |
| :--- | :---: | :---: | :---: |
| Proceeds from stock option exercises | 67 | 2,415 |  |
| Payments of cash dividends | $(38,168$ | $)$ | $(32,631$ |
| Net cash provided by (used in) financing activities | 197 | $(92,849$ | $)$ |
| NET (DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS | $(323,356$ | $)$ | 132,093 |
| CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD | 677,854 | 381,390 |  |
| CASH AND CASH EQUIVALENTS, END OF PERIOD | $\$ 354,498$ | $\$ 513,483$ |  |
| NONCASH ACTIVITIES: |  |  |  |
| Stock issued in connection with the F\&M Bancorporation Inc. acquisition | $\$-$ | $\$ 218,164$ |  |
| Acquisition of real estate through foreclosure of collateral | 1,166 | 4,401 |  |
|  |  |  |  |
| SUPPLEMENTAL INFORMATION: | $\$ 42,580$ | $\$ 50,843$ |  |
| Income taxes paid | 21,517 | 24,153 |  |

See notes to interim consolidated financial statements.

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# PROSPERITY BANCSHARES, INC. ${ }^{\circledR}$ AND SUBSIDIARIES 

## NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS

JUNE 30, 2015
(UNAUDITED)

## 1. BASIS OF PRESENTATION

The interim consolidated financial statements include the accounts of Prosperity Bancshares, Inc. ${ }^{\circledR}$ ("Bancshares") and its wholly-owned subsidiary, Prosperity Bank ${ }^{\circledR}$ (the "Bank", collectively referred to as the "Company"). All intercompany transactions and balances have been eliminated.

The accompanying unaudited interim consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles ("GAAP") for interim financial information and with the rules and regulations of the Securities and Exchange Commission. Accordingly, they do not include all of the information and footnotes required by U.S. GAAP for complete financial statements. In the opinion of management, the statements reflect all adjustments necessary for a fair presentation of the financial position, results of operations and cash flows of the Company on a consolidated basis, and all such adjustments are of a normal recurring nature. These financial statements and the notes thereto should be read in conjunction with the Company's Annual Report on Form 10-K for the year ended December 31, 2014. Operating results for the six-month period ended June 30, 2015 are not necessarily indicative of the results that may be expected for the year ending December 31, 2015 or any other period.

## 2. INCOME PER COMMON SHARE

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

| Three Months Ended June 30,2015 |  |  |  | Six Months Ended June 30,2015 |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  |  |  |  |  |  |  |  |
|  | Per |  | Per |  | Per |  | Per |
|  | Share |  | Share |  | Share |  | Share |
| Amount | Amount | Amount | Amount | Amount | Amount | Amount | Amount |

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| Net income | \$71,932 |  | \$75,506 |  | \$ 145,573 |  | \$ 142,643 |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Basic: |  |  |  |  |  |  |  |  |
| Weighted average shares outstanding | 70,037 | \$ 1.03 | 69,667 | \$ 1.08 | 70,035 | \$ 2.08 | 67,936 | \$ 2.10 |
| Diluted: |  |  |  |  |  |  |  |  |
| Add incremental shares for: |  |  |  |  |  |  |  |  |
| Effect of dilutive securities options | 16 |  | 61 |  | 19 |  | 78 |  |
| Total | 70,053 | \$ 1.03 | 69,728 | \$ 1.08 | 70,054 | \$ 2.08 | 68,014 | \$ 2.10 |

There were no stock options exercisable during the three and six months ended June 30, 2015 or 2014 that would have had an anti-dilutive effect on the above computation.

## 3. NEW ACCOUNTING STANDARDS

## Accounting Standards Updates ("ASU")

ASU 2015-01, "Income Statement - Extraordinary and Unusual Items (Subtopic 225-20) - Simplifying Income Statement Presentation by Eliminating the Concept of Extraordinary Items." ASU 2015-01 eliminates from U.S. GAAP the concept of extraordinary items, which, among other things, required an entity to segregate extraordinary items considered to be unusual and infrequent from the results of ordinary operations and show the item separately in the income statement, net of tax, after income from continuing operations. ASU 2015-01 is effective for the Company beginning January 1, 2016, though early adoption is permitted. ASU 2015-01 is not expected to have a significant impact on the Company's financial statements.

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# PROSPERITY BANCSHARES, INC. ${ }^{\circledR}$ AND SUBSIDIARIES 

# NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS 

JUNE 30, 2015

## (UNAUDITED)


#### Abstract

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


ASU 2014-11 "Transfers and Servicing (Topic 860) - Repurchase-to-Maturity Transactions, Repurchase Financings, and Disclosure." ASU 2014-11 changes the accounting for repurchase-to-maturity transactions to secured borrowing accounting. It also requires separate accounting for a transfer of a financial asset executed contemporaneously with a repurchase agreement with the same counterparty, which will result in secured borrowing accounting and disclosure for the repurchase agreement. ASU 2014-11 became effective for the Company on January 1, 2015 and did not have a significant impact on the Company's financial statements.

ASU 2014-09 "Revenue from Contract with Customers (Topic 606)." ASU 2014-09 supersedes the revenue recognition requirements in Revenue Recognition (Topic 605), and most industry-specific guidance throughout the Industry Topics of the Codification. Additionally, ASU 2014-09 supersedes some cost guidance included in Revenue Recognition-Construction-Type and Production-Type Contracts (Subtopic 605-35). In addition, the existing requirements for the recognition of a gain or loss on the transfer of nonfinancial assets that are not in a contract with a customer are amended to be consistent with the guidance on recognition and measurement. The core principle of ASU 2014-09 is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. ASU 2014-09 is effective for the Company beginning January 1, 2018, with retrospective application to each prior reporting period presented. The Company is currently evaluating the requirements of ASU 2014-09, but it is not expected to have a significant impact on the Company's financial statements.

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

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PROSPERITY BANCSHARES, INC. ${ }^{\circledR}$ AND SUBSIDIARIES

## NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS

JUNE 30, 2015
(UNAUDITED)

## 4. SECURITIES

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

## Available for Sale

| States and political subdivisions | $\$ 9,207$ | $\$ 65$ | $\$-$ | $\$ 9,272$ |  |
| :--- | :---: | :---: | :---: | :---: | :---: |
| Collateralized mortgage obligations | 29,824 | 103 | $(10$ | $)$ | 29,917 |
| Mortgage-backed securities | 66,955 | 4,380 | $(12$ | $)$ | 71,323 |
| Other securities | 12,588 | 160 | $(31$ | $)$ | 12,717 |
| Total | $\$ 118,574$ | $\$ 4,708$ | $\$(53$ | $)$ |  |

Held to Maturity
U.S. Treasury securities and obligations of U.S. Government agencies
States and political subdivisions
Collateralized mortgage obligations
Mortgage-backed securities
Total
June 30, 2015
Gross Gross
Amortized Unrealized Unrealized Fair Cost Gains Losses Value (Dollars in thousands)

[^0]December 31, 2014
Gross Gross
Amortized Unrealized Unrealized Fair Cost Gains Losses Value (Dollars in thousands)

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| States and political subdivisions | $\$ 14,402$ | $\$ 183$ | $\$-$ | $\$ 14,585$ |  |
| :--- | :---: | :---: | :---: | :---: | :---: |
| Collateralized mortgage obligations | 33,519 | 91 | $(37$ | $)$ | 33,573 |
| Mortgage-backed securities | 79,153 | 5,344 | $(14$ | $)$ | 84,483 |
| Other securities | 12,588 | 201 | $(31$ | 12,758 |  |
| Total | $\$ 139,662$ | $\$ 5,819$ | $\$(82$ | $\$ 145,399$ |  |

## Held to Maturity

U.S. Treasury securities and obligations of U.S. Government agencies
States and political subdivisions
Collateralized mortgage obligations
Mortgage-backed securities
Total

| $\$ 52,353$ | $\$ 360$ | $\$(74$ | $) \$ 52,639$ |
| :---: | :--- | :---: | :--- |
| 404,356 | 6,147 | $(1,422$ | $)$ |
| 19,585 | 215 | $(8$ | $)$ |
| $8,424,081$ |  |  |  |
| 8,083 | 96,650 | $(53,553$ | $)$ |
| $8,900,377$ | $\$ 103,372$ | $\$(55,057$ | $)$ |
| $\$ 8,948,692$ |  |  |  |

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# PROSPERITY BANCSHARES, INC. ${ }^{\circledR}$ AND SUBSIDIARIES 

## NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS

JUNE 30, 2015

## (UNAUDITED)

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

In determining OTTI, management considers many factors, including: (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, (3) whether the market decline was affected by macroeconomic conditions, and (4) whether the entity has the intent to sell the debt security or more likely than not will be required to sell the debt security before its anticipated recovery. The assessment of whether an other-than-temporary decline exists involves a high degree of subjectivity and judgment and is based on the information available to management at a point in time.

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

As of June 30, 2015, management does not have the intent to sell any of its securities and believes that it is more likely than not that the Company will not have to sell any such securities before a recovery of cost. The unrealized losses are largely due to increases in market interest rates over the yields available at the time the underlying securities

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were purchased. The fair value is expected to recover as the securities approach their maturity date or repricing date or if market yields for such investments decline. Management does not believe any of the securities are impaired due to reasons of credit quality. Accordingly, as of June 30, 2015, management believes any impairment in the Company's securities is temporary and no impairment loss has been realized in the Company's consolidated statements of income.

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Securities with unrealized losses, segregated by length of time, that have been in a continuous loss position were as follows:

## Available for Sale

$\left.\begin{array}{llllllrl}\text { Collateralized mortgage obligations } & \$- & \$- & \$ 5,298 & \$(10 & ) & \$ 5,298 & \$(10 \\ \text { Mortgage-backed securities } & 155 & - & 2,692 & (12 & ) & 2,847 & (12\end{array}\right)$

## Held to Maturity

U.S. Treasury securities and
$\left.\begin{array}{lllllllll}\begin{array}{l}\text { obligations of U.S. Government } \\ \text { agencies }\end{array} & \$ 500 & \$(1) & ) & \$- & \$- & \$ 500 & \$(1) & \\ \text { States and political subdivisions } & 45,734 & (245 & ) & 53,902 & (1,074 & ) & 99,636 & (1,319\end{array}\right)$

## Available for Sale

Collateralized mortgage obligations
$\left.\begin{array}{llllllll}\text { Mortgage-backed securities } & 358 & - & 2,837 & (14 & ) & 3,195 & (14 \\ \text { Other securities } & 1,706 & (31 & ) & - & - & 1,706 & (31\end{array}\right)$

Total $\$ 8,739 \quad \$(67 \quad) \$ 2,882 \quad \$(15 \quad) \$ 11,621 \quad \$(82 \quad)$

## Held to Maturity

U.S. Treasury securities and
$\left.\begin{array}{lllllllll}\begin{array}{l}\text { obligations of U.S. Government } \\ \text { agencies }\end{array} & \$ 17,098 & \$(74 & ) \\ \text { States and political subdivisions } & 45,680 & (425 & ) & 44,760 & (997 & ) & 90,440 & (1,422\end{array}\right)$

At June 30, 2015 and December 31, 2014, there were 487 securities and 501 securities, respectively, in an unrealized loss position for more than 12 months.

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The amortized cost and fair value of investment securities at June 30, 2015, by contractual maturity, are shown below. Actual maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations at any time with or without call or prepayment penalties.

|  | Held to Maturity |  | Available for Sale AmortizedFair |  |
| :---: | :---: | :---: | :---: | :---: |
|  | Amortized | Fair |  |  |
|  | Cost | Value | Cost | Value |
|  | (Dollars in thousands) |  |  |  |
| Due in one year or less | \$35,523 | \$35,597 | \$12,688 | \$12,818 |
| Due after one year through five years | 185,036 | 186,467 | 4,618 | 4,644 |
| Due after five years through ten years | 162,059 | 165,223 | 3,859 | 3,894 |
| Due after ten years | 57,674 | 57,991 | 630 | 633 |
| Subtotal | 440,292 | 445,278 | 21,795 | 21,989 |
| Mortgage-backed securities and collateralized mortgage obligations | 9,134,558 | 9,147,547 | 96,779 | 101,240 |
| Total | \$9,574,850 | \$9,592,825 | \$118,574 | \$ 123,229 |

The Company recorded no gain or loss on sale of securities for the three and six months ended June 30, 2015 and 2014. As of June 30, 2015, the Company did not own any non-agency collateralized mortgage obligations.

At June 30, 2015 and December 31, 2014, the Company did not own securities of any one issuer (other than the U.S. government and its agencies) for which aggregate adjusted cost exceeded $10 \%$ of the consolidated shareholders' equity at such respective dates.

Securities with an amortized cost of $\$ 4.88$ billion and $\$ 5.08$ billion and a fair value of $\$ 4.89$ billion and $\$ 5.10$ billion at June 30, 2015 and December 31, 2014, respectively, were pledged to collateralize public deposits and for other purposes required or permitted by law.

# PROSPERITY BANCSHARES, INC. ${ }^{\circledR}$ AND SUBSIDIARIES 

## NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS

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## 5. LOANS AND ALLOWANCE FOR CREDIT LOSSES

The loan portfolio consists of various types of loans made principally to borrowers located within the states of Texas and Oklahoma and is categorized by major type as follows:
$\left.\begin{array}{lll} & \text { June 30, } & \begin{array}{l}\text { December } \\ \text { 31, }\end{array} \\ & \begin{array}{l}\mathbf{2 0 1 5} \\ \text { (Dollars in }\end{array} & \mathbf{2 0 1 4} \\ \text { Residential mortgage loans held for sale } & \$ 10,482 & \$ 8,602\end{array}\right)$
(i) Commercial and Industrial Loans. In nearly all cases, the Company's commercial loans are made in the Company's market areas and are underwritten on the basis of the borrower's ability to service the debt from income. As a general practice, the Company takes as collateral a lien on any available real estate, equipment or other assets owned by the borrower and obtains a personal guaranty of the borrower or principal. Working capital loans are primarily collateralized by short-term assets whereas term loans are primarily collateralized by long-term assets. In general, commercial loans involve more credit risk than residential mortgage loans and commercial mortgage loans and, therefore, usually yield a higher return. The increased risk in commercial loans is due to the type of collateral securing these loans as well as 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,

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commercial loans require thorough underwriting and more active servicing than other types of loans.
(ii) Commercial Real Estate. The Company makes commercial real estate loans collateralized by owner-occupied and nonowner-occupied real estate to finance the purchase of real estate. The Company's commercial real estate loans are collateralized by first liens on real estate, typically have variable interest rates (or five year or less fixed rates) and amortize over a 15 to 20 year period. Payments on loans secured by nonowner-occupied properties are often dependent on the successful operation or management of the properties. Accordingly, repayment of these loans may be subject to adverse conditions in the real estate market or the economy to a greater extent than other types of loans. The Company seeks to minimize these risks in a variety of ways, including giving careful consideration to the property's operating history, future operating projections, current and projected occupancy, location and physical condition in connection with underwriting these loans. The underwriting analysis also includes credit verification, analysis of global cash flow, appraisals and a review of the financial condition of the borrower. At June 30, 2015, approximately $47.5 \%$ of the outstanding principal balance of the Company's commercial real estate loans were secured by owner-occupied properties.

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## PROSPERITY BANCSHARES, INC. ${ }^{\circledR}$ AND SUBSIDIARIES

## NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS

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(iii) 1-4 Family Residential Loans. The Company's lending activities also include the origination of 1-4 family residential mortgage loans (including home equity loans) collateralized by owner-occupied residential properties located in the Company's market areas. The Company offers a variety of mortgage loan portfolio products which generally are amortized over five to 25 years. Loans collateralized by 1-4 family residential real estate generally have been originated in amounts of no more than $89 \%$ of appraised value or have mortgage insurance. The Company requires mortgage title insurance and hazard insurance. The Company retains these portfolio loans for its own account rather than selling them into the secondary market. By doing so, the Company incurs interest rate risk as well as the risks associated with nonpayments on such loans. The Company's Home Loan Center offers a variety of mortgage loan products which are generally amortized over 30 years, including FHA and VA loans. The Company sells the loans originated by the Home Loan Center into the secondary market.
(iv) Construction, Land Development and Other Land Loans. The Company makes loans to finance the construction of residential and, to a lesser extent, nonresidential properties. Construction loans generally are collateralized by first liens on real estate and have floating interest rates. The Company conducts periodic inspections, either directly or through an agent, prior to approval of periodic draws on these loans. Underwriting guidelines similar to those described above are also used in the Company's construction lending activities. Construction loans involve additional risks attributable to the fact that loan funds are advanced upon the security of a project under construction, and the project is of uncertain value prior to its completion. Because of uncertainties inherent in estimating construction costs, the market value of the completed project and the effects of governmental regulation on real property, it can be difficult to accurately evaluate the total funds required to complete a project and the related loan to value ratio. As a result of these uncertainties, construction lending often involves the disbursement of substantial funds with repayment dependent, in part, on the success of the ultimate project rather than the ability of a borrower or guarantor to repay the loan. If the Company is forced to foreclose on a project prior to completion, there is no assurance that the Company will be able to recover all of the unpaid portion of the loan. In addition, the Company may be required to fund additional amounts to complete a project and may have to hold the property for an indeterminate period of time. While the Company has underwriting procedures designed to identify what it believes to be acceptable levels of risks in construction lending, no assurance can be given that these procedures will prevent losses from the risks described above.
(v) Agriculture Loans. The Company provides agriculture loans for short-term crop production, including rice, cotton, milo and corn, farm equipment financing and agriculture real estate financing. The Company evaluates agriculture borrowers primarily based on their historical profitability, level of experience in their particular agriculture industry, overall financial capacity and the availability of secondary collateral to withstand economic and natural variations
common to the industry. Because agriculture loans present a higher level of risk associated with events caused by nature, the Company routinely makes on-site visits and inspections in order to identify and monitor such risks.
(vi) Consumer Loans. Consumer loans made by the Company include direct "A"-credit automobile loans, recreational vehicle loans, boat loans, home improvement loans, personal loans (collateralized and uncollateralized), credit cards and deposit account collateralized loans. The terms of these loans typically range from 12 to 180 months and vary based upon the nature of collateral and size of loan. Generally, consumer loans entail greater risk than do real estate secured loans, particularly in the case of consumer loans that are unsecured or collateralized by rapidly depreciating assets such as automobiles. In such cases, any repossessed collateral for a defaulted consumer loan may not provide an adequate source of repayment for the outstanding loan balance. The remaining deficiency often does not warrant further substantial collection efforts against the borrower beyond obtaining a deficiency judgment. In addition, consumer loan collections are dependent on the borrower's continuing financial stability, and thus are more likely to be adversely affected by job loss, divorce, illness or personal bankruptcy. Furthermore, the application of various federal and state laws may limit the amount which can be recovered on such loans.

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

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Concentrations of Credit. Most of the Company's lending activity occurs within the states of Texas and Oklahoma. The majority of the Company's loan portfolio consists of commercial real estate, 1-4 family residential loans, and commercial and industrial loans. As of June 30, 2015 and December 31, 2014, there were no concentrations of loans related to any single industry in excess of $10 \%$ of total loans.

Foreign Loans. The Company has U.S. dollar-denominated loans and commitments to borrowers in Mexico. The outstanding balance of these loans and the unfunded amounts available under these commitments was not significant at June 30, 2015 or December 31, 2014.

Related Party Loans. As of June 30, 2015 and December 31, 2014, loans outstanding to directors, officers and their affiliates totaled $\$ 4.0$ million and $\$ 4.9$ million, respectively. All transactions entered into between the Company and such related parties are done in the ordinary course of business and made on the same terms and conditions as similar transactions with unaffiliated persons.

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

|  | June $\quad$ December |  |
| :--- | :--- | :--- |
|  | $\mathbf{3 0 ,}$ | $\mathbf{3 1 ,}$ |
|  | $\mathbf{2 0 1 5}$ | $\mathbf{2 0 1 4}$ |
|  | (Dollars in |  |
|  | thousands) |  |
|  | $\$ 4,940$ | $\$ 6,187$ |
| Beginning balance on January 1 | 174 | 4,913 |
| New loans | $(1,161)$ | $(6,160$ |$)$

Nonperforming Assets and Nonaccrual and Past Due Loans. The Company has several procedures in place to assist it in maintaining the overall quality of its loan portfolio. The Company has established underwriting guidelines to be

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followed by its officers and the Company also monitors its delinquency levels for any negative or adverse trends. There can be no assurance, however, that the Company's loan portfolio will not become subject to increasing pressures from deteriorating borrower credit due to general economic conditions.

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

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

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An aging analysis of past due loans, segregated by category of loan, is presented below:

June 30, 2015
Loans Past Due and Still
Accruing
90 or Total
More Past
$\begin{array}{lll}\text { 30-89 } & \text { Days } & \begin{array}{l}\text { Due } \\ \text { Days }\end{array}\end{array} \begin{aligned} & \text { Loans }\end{aligned} \quad$ Loans Loans
(Dollars in thousands)
Construction, land development and other land loans
Agriculture and agriculture real estate (includes farmland)
$1-4$ family (includes home equity) (1)
Commercial real estate (includes multi-family residential)
Commercial and industrial
Consumer and other
Total

| $\$ 2,896$ | $\$ 153$ | $\$ 3,049$ | $\$ 421$ | $\$ 1,064,586$ | $\$ 1,068,056$ |
| :---: | :---: | :---: | :---: | :---: | :---: |
| 728 | - | 728 | 605 | 599,412 | 600,745 |
| 2,456 | - | 2,456 | 2,987 | $2,557,209$ | $2,562,652$ |
| 5,640 | - | 5,640 | 7,536 | $2,945,063$ | $2,958,239$ |
| 16,615 | - | 16,615 | 20,164 | $1,617,738$ | $1,654,517$ |
| 302 | - | 302 | 274 | 269,550 | 270,126 |
| $\$ 28,637$ | $\$ 153$ | $\$ 28,790$ | $\$ 31,987$ | $\$ 9,053,558$ | $\$ 9,114,335$ |

December 31, 2014
Loans Past Due and Still
Accruing
90 or Total More Past

Nonaccrual Current
Total

|  | 90 or <br> More | Total <br> Past | Nonaccrual | Current | Total |
| :---: | :---: | :---: | :---: | :---: | :---: |
| 30-89 <br> Days <br> (Dolla | Days <br> in thou | Due Loans ands) | Loans | Loans | Loans |
| \$7,667 | \$- | \$7,667 | \$ 526 | \$ 1,018,282 | \$1,026,475 |
| 2,995 | 377 | 3,372 | 96 | 548,178 | 551,646 |

Construction, land development and other land loans
Agriculture and agriculture real estate (includes farmland)

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| 1-4 family (includes home equity) (1) | 2,261 | 82 | 2,343 | 3,570 | $2,516,268$ | $2,522,181$ |
| :--- | :--- | :--- | :--- | :--- | :--- | :--- |
| Commercial real estate (includes multi-family | 12,679 | 65 | 12,744 | 6,340 | $3,011,256$ | $3,030,340$ |
| residential) | 18,305 | 869 | 19,174 | 20,537 | $1,766,556$ | $1,806,267$ |
| Commercial and industrial | 612 | 800 | 1,412 | 353 | 305,509 | 307,274 |
| Consumer and other | $\$ 44,519$ | $\$ 2,193$ | $\$ 46,712$ | $\$ 31,422$ | $\$ 9,166,049$ | $\$ 9,244,183$ |

[^1]
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The following table presents information regarding nonperforming assets as of the dates indicated:

Nonaccrual loans (1)
Accruing loans 90 or more days past due
Total nonperforming loans
Repossessed assets
Other real estate
Total nonperforming assets
June $\quad$ December
30, $\quad$ 31,
2015 2014
(Dollars in
thousands)

Nonperforming assets to total loans and other real estate

| $\$ 31,987$ | $\$ 31,422$ |
| :---: | :--- |
| 153 | 2,193 |
| 32,140 | 33,615 |
| 173 | 67 |
| 2,806 | 3,237 |
| $\$ 35,119$ | $\$ 36,919$ |

$0.39 \quad \% \quad 0.40 \quad \%$

[^2]The Company had $\$ 35.1$ million in nonperforming assets at June 30, 2015 compared with $\$ 36.9$ million at December 31,2014 , of which $\$ 30.3$ million and $\$ 30.7$ million, respectively, were originated by acquired banks. These results are reflective of the Company's conservative lending approach.

If interest on nonaccrual loans had been accrued under the original loan terms, approximately $\$ 1.6$ million and $\$ 483$ thousand would have been recorded as income for the six months ended June 30, 2015 and 2014, respectively.

Acquired Loans. Acquired loans were preliminarily recorded at fair value based on a discounted cash flow valuation methodology that considers, among other things, interest rates, projected default rates, loss given default, and recovery

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rates (no allowance for credit losses was carried over from acquisitions completed during 2014 or 2013). During the valuation process, the Company identified Purchased Credit-Impaired ("PCI") and Non-PCI loans in the acquired loan portfolios. Loans acquired with evidence of credit quality deterioration at acquisition for which it was probable that the Company would not be able to collect all contractual amounts due were accounted for as PCI. PCI loan identification considers the following factors: payment history and past due status, debt service coverage, loan grading, collateral values and other factors that may indicate deterioration of credit quality since origination. Non-PCI loan identification considers the following factors: account types, remaining terms, annual interest rates or coupons, current market rates, interest types, past delinquencies, timing of principal and interest payments, loan to value ratios, loss exposures and remaining balances. Accretion of purchased discounts on PCI loans will be based on estimated future cash flows, regardless of contractual maturities. Accretion of purchased discounts on Non-PCI loans will be recognized on a level-yield basis based on contractual maturity of individual loans.

PCI Loans. The carrying amount of PCI loans included in the consolidated balance sheet and the related outstanding balance as of the dates indicated are presented in the table below. The outstanding balance represents the total amount owed as of June 30, 2015 and December 31, 2014, including accrued but unpaid interest.

June December
30, 31,
20152014
(Dollars in
thousands)
PCI loans:
Outstanding balance $\$ 94,601 \quad \$ 129,412$
Less: discount $\quad 48,277 \quad 72,270$
Recorded investment \$46,324 \$57,142

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Changes in the accretable yield for acquired PCI loans as of the three and six months ended June 30, 2015 and 2014 were as follows:

|  | Three Months <br> Ended June 30, | Six Months Ended <br> June 30, |  |  |
| :--- | :--- | :--- | :--- | :--- |
|  | $\mathbf{2 0 1 5}$ $\mathbf{2 0 1 4}$ $\mathbf{2 0 1 5}$ $\mathbf{2 0 1 4}$ <br>     <br> (Dollars in thousands)    |  |  |  |
| Balance at beginning of period | $\$ 7,870$ | $\$ 8,470$ | $\$ 9,867$ | $\$ 9,855$ |
| Additions | - | 7,158 | - | 7,158 |
| Reclassifications from nonaccretable | 1,695 | 4,532 | 8,632 | 6,035 |
| Accretion | $(3,214)$ | $(5,471)$ | $(12,148)$ | $(8,359)$ |
| Balance at June 30 | $\$ 6,351$ | $\$ 14,689$ | $\$ 6,351$ | $\$ 14,689$ |

Income recognition on PCI loans is subject to the Company's ability to reasonably estimate both the timing and amount of future cash flows. PCI loans for which the Company is accruing interest income are not considered non-performing or impaired. The non-accretable difference represents contractual principal and interest the Company does not expect to collect.

Non-PCI Loans. The carrying amount of Non-PCI loans included in the consolidated balance sheet and the related outstanding balance as of the dates indicated are presented in the table below. The outstanding balance represents the total amount owed as of June 30, 2015 and 2014, including accrued but unpaid interest.

| June 30, $\quad$December <br> 31, |  |
| :--- | :--- |
| 2015 | 2014 |
| (Dollars in thousands) |  |
| $\$ 1,727,123$ | $\$ 2,186,111$ |

Less: discount 67,895 89,105
Recorded investment \$1,659,228 \$2,097,006

Changes in the discount accretion for Non-PCI loans for the three and six months ended June 30, 2015 and December 31, 2014 were as follows:

|  | Three Months <br> Ended June 30, |  |  |  |  |
| :--- | :--- | :--- | :--- | :--- | :--- | | Six Months Ended |
| :--- |
| June 30, |

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

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

| With no related allowance recorded: |  |  |  |  |
| :--- | :--- | :--- | :--- | :--- |
| Construction, land development and other land loans | $\$ 156$ | $\$ 159$ | $\$-$ | $\$ 204$ |
| Agriculture and agriculture real estate (includes farmland) | 545 | 551 | - | 276 |
| 1-4 family (includes home equity) | 1,858 | 2,005 | - | 1,857 |
| Commercial real estate (includes multi-family residential) | 5,560 | 5,606 | - | 5,350 |
| Commercial and industrial | 6,845 | 7,577 | - | 8,531 |
| Consumer and other | 62 | 62 | - | 4,103 |
| Total | 15,026 | 15,960 | - | 20,321 |
|  |  |  |  |  |
| With an allowance recorded: |  |  |  |  |
| Construction, land development and other land loans | 273 | 466 | 185 | 371 |
| Agriculture and agriculture real estate (includes farmland) | 11 | 19 | 11 | 33 |
| 1-4 family (includes home equity) | 1,093 | 1,136 | 243 | 1,281 |
| Commercial real estate (includes multi-family residential) | 1,847 | 3,442 | 743 | 1,752 |
| Commercial and industrial | 6,724 | 6,787 | 2,004 | 4,621 |
| Consumer and other | 205 | 243 | 87 | 238 |
| Total | 10,153 | 12,093 | 3,273 | 8,296 |
|  |  |  |  |  |
| Total: |  |  |  |  |
| Construction, land development and other land loans | 429 | 625 | 185 | 575 |
| Agriculture and agriculture real estate (includes farmland) | 556 | 570 | 11 | 309 |
| 1-4 family (includes home equity) | 2,951 | 3,141 | 243 | 3,138 |
| Commercial real estate (includes multi-family residential) | 7,407 | 9,048 | 743 | 7,102 |
| Commercial and industrial | 13,569 | 14,364 | 2,004 | 13,152 |
| Consumer and other | 267 | 305 | 87 | 4,341 |

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$$
\$ 25,179 \quad \$ 28,053 \quad \$ 3,273 \quad \$ 28,617
$$

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With no related allowance recorded:

| Construction, land development and other land loans | $\$ 250$ | $\$ 256$ | $\$-$ | $\$ 264$ |
| :--- | :--- | :--- | :---: | :---: |
| Agriculture and agriculture real estate (includes farmland) | - | - | - | 7 |
| 1-4 family (includes home equity) | 1,710 | 1,831 | - | 1,147 |
| Commercial real estate (includes multi-family residential) | 5,093 | 5,126 | - | 3,792 |
| Commercial and industrial | 9,485 | 9,678 | - | 4,794 |
| Consumer and other | 8,144 | 8,161 | - | 4,080 |
| Total | 24,682 | 25,052 | - | 14,084 |

With an allowance recorded:

| Construction, land development and other land loans | 276 | 276 | 225 | 138 |
| :--- | :--- | :--- | :--- | :--- |
| Agriculture and agriculture real estate (includes farmland) | 46 | 55 | 24 | 34 |
| 1-4 family (includes home equity) | 1,426 | 1,473 | 418 | 1,973 |
| Commercial real estate (includes multi-family residential) | 62 | 63 | 24 | 838 |
| Commercial and industrial | 2,454 | 4,182 | 1,597 | 1,783 |
| Consumer and other | 234 | 251 | 205 | 164 |
| Total | 4,498 | 6,300 | 2,493 | 4,930 |
|  |  |  |  |  |
| Total: |  |  |  |  |
| Construction, land development and other land loans | 526 | 532 | 225 | 402 |
| Agriculture and agriculture real estate (includes farmland) | 46 | 55 | 24 | 41 |
| 1-4 family (includes home equity) | 3,136 | 3,304 | 418 | 3,120 |
| Commercial real estate (includes multi-family residential) | 5,155 | 5,189 | 24 | 4,630 |
| Commercial and industrial | 11,939 | 13,860 | 1,597 | 6,577 |
| Consumer and other | 8,378 | 8,412 | 205 | 4,244 |
|  | $\$ 29,180$ | $\$ 31,352$ | $\$ 2,493$ | $\$ 19,014$ |

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

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

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

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# PROSPERITY BANCSHARES, INC. ${ }^{\circledR}$ AND SUBSIDIARIES 

## NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS

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

Grade 4 - Credits in this category are considered to be of acceptable credit quality with moderately greater credit risk than Grade 3 and receiving closer monitoring. Loans in this category have sources of repayment that remain sufficient to preclude a larger than normal probability of default and secondary sources are likewise currently of sufficient quantity, quality, and liquidity to protect the Company against loss of principal and interest. These borrowers have specific risk factors, but the overall strength of the credit is acceptable based on other mitigating credit and/or collateral factors and can repay the debt in the normal course of business.

Grade 5 - Credits in this category constitute an undue and unwarranted credit risk; however the factors do not rise to a level of substandard. These credits have potential weaknesses and/or declining trends that, if not corrected, could expose the Bank to risk at a future date. These loans are monitored on the Bank's internally-generated watch list and evaluated on a quarterly basis.

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

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

Grade 8 - Credits in this category include "doubtful" loans in accordance with regulatory guidance. Such loans are no longer accruing interest and factors indicate a loss is imminent. These loans are also deemed "impaired." While a
specific reserve may be in place while the loan and collateral is being evaluated, these loans are typically charged down to an amount the Bank estimates is collectible.

Grade 9 - Credits in this category are deemed a "loss" in accordance with regulatory guidelines and have been charged off or charged down. The Bank may continue collection efforts and may have partial recovery in the future.

The following table presents risk grades and PCI loans by category of loan at June 30, 2015. Impaired loans include loans in risk grades 7, 8 and 9 .

| Construction, <br> and <br> Agriculture <br> Real | 1-4 Family |
| :--- | :--- | :--- | :--- | :--- | :--- | :--- | Ceal Estate

(1) Includes $\$ 10.5$ million of residential mortgage loans held for sale at June 30, 2015.
(2) Of the total PCI loans, $\$ 26.6$ million were classifed as substandard at June 30, 2015.

## PROSPERITY BANCSHARES, INC. ${ }^{\circledR}$ AND SUBSIDIARIES

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The following table presents risk grades and PCI loans by category of loan at December 31, 2014. Impaired loans include loans in risk grades 7, 8 and 9 .

|  | $\begin{aligned} & \text { Construction } \begin{array}{c} \text { Agriculture } \\ \text { Agd } \end{array} \\ & \hline \end{aligned}$ |  |  | Commercial |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  | Land | Agriculture Real | 1-4 Family | Real Estate |  |  |  |
|  | Developmen and | Estate (includes | (includes | (includes Multi- | Commercial | Consumer and |  |
|  | Other <br> Land <br> Loans <br> (Dollars in | Farmland) thousands) | Home <br> Equity) (1) | Family Residential) | and <br> Industrial | Other | Total |
| Grade 1 | \$- | \$ 13,507 | \$- | \$ - | \$ 61,697 | \$41,240 | \$ 116,444 |
| Grade 2 | - | - | - | - | - | - | - |
| Grade 3 | 1,022,002 | 528,400 | 2,503,679 | 2,965,455 | 1,698,558 | 257,588 | 8,975,682 |
| Grade 4 | - | - | - | - | - | - | - |
| Grade 5 | 497 | 4,265 | 1,174 | 10,424 | 3,266 | 18 | 19,644 |
| Grade 6 | 2,308 | 4,921 | 8,266 | 25,839 | 4,707 | 50 | 46,091 |
| Grade 7 | 526 | 46 | 3,136 | 5,155 | 11,834 | 8,378 | 29,075 |
| Grade 8 | - | - | - | - | 105 | - | 105 |
| Grade 9 | - | - | - | - | - | - | - |
| PCI Loans (2) | 1,142 | 507 | 5,926 | 23,467 | 26,100 | - | 57,142 |
| Total | \$ 1,026,475 | \$ 551,646 | \$2,522,181 | \$ 3,030,340 | \$ 1,806,267 | \$ 307,274 | \$9,244,183 |

(1) Includes $\$ 8.6$ million of residential mortgage loans held for sale at December 31, 2014.
(2) Of the total PCI loans, $\$ 32.0$ million were classifed as substandard at December 31, 2014.

Allowance for Credit Losses. The allowance for credit losses is a valuation established through charges to earnings in the form of a provision for credit losses. Management has established an allowance for credit losses which it believes is adequate for estimated losses in the Company's loan portfolio. The amount of the allowance for credit losses is affected by the following: (1) charge-offs of loans that occur when loans are deemed uncollectible and decrease the

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allowance, (2) recoveries on loans previously charged off that increase the allowance and (3) provisions for credit losses charged to earnings that increase the allowance. Based on an evaluation of the loan portfolio and consideration of the factors listed below, management presents a quarterly review of the allowance for credit losses to the Bank's Board of Directors, indicating any change in the allowance since the last review and any recommendations as to adjustments in the allowance. Although management believes it uses the best information available to make determinations with respect to the allowance for credit losses, future adjustments may be necessary if economic conditions or the borrower's performance differ from the assumptions used in making the initial determinations.

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

In setting the specific valuation allowance, the Company follows a loan review program to evaluate the credit risk in the total loan portfolio and assigns risk grades to each loan. Through this loan review process, the Company maintains an internal list of impaired loans which, along with the delinquency list of loans, helps management assess the overall quality of the loan portfolio and the adequacy of the allowance for credit losses. All loans that have been identified as impaired are reviewed on a quarterly basis in order to determine whether a specific reserve is required. For certain impaired loans, the Company allocates a specific loan loss reserve primarily based on the value of the collateral securing the impaired loan in accordance with ASC Topic 310-10, "Receivables." The specific reserves are determined on an individual loan basis. Loans for which specific reserves are provided are excluded from the general valuation allowance described below.

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In connection with this review of the loan portfolio, the Company considers risk elements attributable to particular loan types or categories in assessing the quality of individual loans. Some of the risk elements include:
for 1-4 family residential mortgage loans, the borrower's ability to repay the loan, including a consideration of the debt to income ratio and employment and income stability, the loan to value ratio, and the age, condition and marketability of collateral;
for commercial real estate loans and multifamily residential loans, the debt service coverage ratio (income from the property in excess of operating expenses compared to loan payment requirements), operating results of the owner in the case of owner-occupied properties, the loan to value ratio, the age and condition of the collateral and the volatility of income, property value and future operating results typical of properties of that type;
for construction, land development and other land loans, the perceived feasibility of the project including the ability to sell developed lots or improvements constructed for resale or the ability to lease property constructed for lease, the quality and nature of contracts for presale or prelease, if any, experience and ability of the developer and loan to value ratio;
for commercial and industrial loans, the operating results of the commercial, industrial or professional enterprise, the borrower's business, professional and financial ability and expertise, the specific risks and volatility of income and operating results typical for businesses in that category and the value, nature and marketability of collateral;
for agricultural real estate loans, the experience and financial capability of the borrower, projected debt service coverage of the operations of the borrower and loan to value ratio; and
for non-real estate agricultural loans, the operating results, experience and financial capability of the borrower, historical and expected market conditions and the value, nature and marketability of collateral.

In determining the amount of the general valuation allowance, management considers factors such as historical loan loss experience, concentration risk of specific loan types, the volume, growth and composition of the Company's loan

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portfolio, current economic conditions that may affect the borrower's ability to pay and the value of collateral, the evaluation of the Company's loan portfolio through its internal loan review process, general economic conditions and other qualitative risk factors both internal and external to the Company and other relevant factors in accordance with ASC Topic 450, "Contingencies." Based on a review of these factors for each loan type, the Company applies an estimated percentage to the outstanding balance of each loan type, excluding any loan that has a specific reserve allocated to it. The Company uses this information to establish the amount of the general valuation allowance.

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

At June 30, 2015, the allowance for credit losses totaled $\$ 81.0$ million or $0.89 \%$ of total loans, including acquired loans with discounts. At December 31, 2014, the allowance for credit losses totaled $\$ 80.8$ million or $0.87 \%$ of total loans, including acquired loans with discounts.

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The following table details activity in the allowance for credit losses by category of loan for the three and six months ended June 30, 2015 and 2014. Allocation of a portion of the allowance to one category of loans does not preclude its availability to absorb losses in other categories.

| Agriculture |  |  |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: |
| Constructionl |  | Commercial |  |  |  |
| Land Agriculture | 1-4 <br> Family | Real Estate |  |  |  |
| DevelopmRieal Estate | (includes | (includes | Commercial |  |  |
| and (includes | Home | Multi-Family | and | Consumer |  |
| Land $\quad$ Farmland) Loans (Dollars in thousands) | Equity) | Residential) | Industrial | and Other | Total |

## Allowance for credit

 losses:Three Months Ended

| Balance March 31, 2015 | \$16,858 | \$ 3,277 | \$ 16,778 |  | 12,538 |  | \$ 30,084 |  | \$ 1,428 |  | \$80,963 |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Provision for credit losses | 49 | 429 | (173 | ) | 578 |  | (907 | ) | 524 |  | 500 |
| Charge-offs | - | - | (31 | ) | (136 | ) | (98 | ) | (744 | ) | (1,009) |
| Recoveries | 2 | 65 | 19 |  | 22 |  | 126 |  | 284 |  | 518 |
| Net charge-offs | 2 | 65 | (12 | ) | (114 | ) | 28 |  | (460 |  | (491 |

Balance June 30, $2015 \quad \$ 16,909 \quad \$ 3,771 \quad \$ 16,593 \quad \$ 13,002 \quad \$ 29,205 \quad \$ 1,492 \quad \$ 80,972$
Six Months Ended


Balance June 30, $2015 \quad \$ 16,909 \quad \$ 3,771 \quad \$ 16,593 \quad \$ 13,002 \quad \$ 29,205 \quad \$ 1,492 \quad \$ 80,972$

| Allowance for credit |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Three Months Ended |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Balance March 31, 2014 | \$13,600 |  | \$ 1,356 |  | \$ 18,718 |  |  | 23,371 |  | \$ 8,653 |  | \$ 1,398 |  | \$67,096 |
| Provision for credit losses | 1,508 |  | (751 | ) | 593 |  |  | 313 |  | 2,240 |  | 2,422 |  | 6,325 |
| Charge-offs | (153 |  |  | ) | (523 | ) |  | (26 | , |  |  | (879 | ) | (1,641) |
| Recoveries | 38 |  | 844 |  | 117 |  |  | 21 |  | 123 |  | 343 |  | 1,486 |
| Net charge-offs | (115 |  | 843 |  | (406 | ) |  | (5 | ) |  |  | (536 |  | (155 ) |
| Balance June 30, 2014 | \$14,993 |  | \$ 1,448 |  | \$ 18,905 |  |  | 23,679 |  | \$ 10,957 |  | \$ 3,284 |  | \$73,266 |
| Six Months Ended |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Balance January 1, 2014 | \$14,353 |  | \$ 1,229 |  | \$ 17,046 |  |  | 24,835 |  | \$ 8,167 |  | \$ 1,652 |  | \$67,282 |
| Provision for credit losses | 738 |  | (705 | ) | 2,396 |  |  | (1,091 | ) | 2,807 |  | 2,780 |  | 6,925 |
| Charge-offs | (155 |  |  | ) | (662 | ) |  | (128 | ) | (202 |  | (1,924 | ) | $(3,086)$ |
| Recoveries | 57 |  | 939 |  | 125 |  |  | 63 |  | 185 |  | 776 |  | 2,145 |
| Net charge-offs | (98 |  | 924 |  | (537 | ) |  | (65 | ) |  |  | (1,148 | ) | (941 ) |
| Balance June 30, 2014 | \$14,993 |  | \$ 1,448 |  | \$ 18,905 |  |  | 23,679 |  | \$ 10,957 |  | \$ 3,284 |  | \$73,266 |
| 25 |  |  |  |  |  |  |  |  |  |  |  |  |  |  |

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The following table details the amount of the allowance for credit losses allocated to each category of loan as of June 30, 2015, December 31, 2014 and June 30, 2014, detailed on the basis of the impairment methodology used by the Company.

| Constructionl, |  | Commercial |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: |
| Land Agriculture | 1-4 <br> Family | Real Estate |  |  |  |
| Real Development Estate | (includes | (includes | Commerci |  |  |
| $\begin{aligned} & \text { and } \quad \text { (includes } \\ & \text { Other } \end{aligned}$ | Home | Multi-Fami | and | Consumer |  |
| Land Farmland) Loans (Dollars in thousands) | Equity) | Residential) | Industrial | and Other | Total |

Allowance for credit losses related to:
June 30, 2015

| Individually evaluated for <br> impairment | $\$ 185$ | $\$ 11$ | $\$ 243$ | $\$ 743$ | $\$ 2,004$ | $\$ 87$ | $\$ 3,273$ |
| :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- |
| Collectively evaluated for <br> impairment | 16,724 | 3,760 | 16,350 | 12,259 | 27,038 | 1,405 | 77,536 |
| PCI loans | - | - | - | - | 163 | - | 163 |
| Total allowance for credit losses | $\$ 16,909$ | $\$ 3,771$ | $\$ 16,593$ | $\$ 13,002$ | $\$ 29,205$ | $\$ 1,492$ | $\$ 80,972$ |

December 31, 2014

| Individually evaluated for impairment | \$225 | \$ 24 | \$418 | \$ 24 | \$ 1,597 | \$ 205 | \$2,493 |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Collectively evaluated for impairment | 15,600 | 3,698 | 15,959 | 12,720 | 28,405 | 1,887 | 78,269 |
| PCI loans | - | - | - | - | - | - | - |
| Total allowance for credit losses | \$15,825 | \$ 3,722 | \$ 16,377 | \$ 12,744 | \$ 30,002 | \$ 2,092 | \$80,762 |
| June 30, 2014 |  |  |  |  |  |  |  |

Individually evaluated for impairment

| Collectively evaluated for | 14,993 | 1,395 | 18,656 | 23,632 | 8,070 | 3,192 | 69,938 |
| :--- | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| impairment | - | - | - | - | - | - | - |
| PCI loans |  |  |  |  |  |  |  |
| Total allowance for credit losses | $\$ 14,993$ | $\$ 1,448$ | $\$ 18,905$ | $\$ 23,679$ | $\$ 10,957$ | $\$ 3,284$ | $\$ 73,266$ |

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The following table details the recorded investment in loans as of June 30, 2015, December 31, 2014 and June 30, 2014, excluding $\$ 10.5$ million, $\$ 8.6$ million and $\$ 8.4$ million, respectively, of residential mortgage loans held for sale, related to each balance in the allowance for credit losses by category of loan.

| Agriculture |  |  |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: |
| Constructiomnd |  | Commercial |  |  |  |
| Land Agriculture | 1-4 Family | Real Estate |  |  |  |
| Developmen Real | (includes | (includes | Commercial |  |  |
| and Other (includes | Home | Multi-Family |  | Consumer |  |
| Land Farmland) | Equity) | Residential) | Industrial | and Other | Total |
| (Dollars in thousands) |  |  |  |  |  |

## Recorded investment

 in loans:June 30, 2015

| Individually evaluated <br> for impairment | $\$ 429$ | $\$ 556$ | $\$ 2,951$ | $\$ 7,407$ | $\$ 13,569$ | $\$ 267$ | $\$ 25,179$ |
| :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- |
| Collectively evaluated <br> for impairment | $1,066,061$ | 599,689 | $2,543,494$ | $2,930,343$ | $1,622,904$ | 269,859 | $9,032,350$ |
| PCI loans | 1,566 | 500 | 5,725 | 20,489 | 18,044 | - | 46,324 |
| Total loans evaluated <br> for impairment | $\$ 1,068,056$ | $\$ 600,745$ | $\$ 2,552,170$ | $\$ 2,958,239$ | $\$ 1,654,517$ | $\$ 270,126$ | $\$ 9,103,853$ |

December 31, 2014

| Individually evaluated <br> for impairment | $\$ 526$ | $\$ 46$ | $\$ 3,136$ | $\$ 5,155$ | $\$ 11,939$ | $\$ 8,378$ | $\$ 29,180$ |
| :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- |
| Collectively evaluated <br> for impairment | $1,024,807$ | 551,093 | $2,504,517$ | $3,001,718$ | $1,768,228$ | 298,896 | $9,149,259$ |
| PCI loans | 1,142 | 507 | 5,926 | 23,467 | 26,100 | - | 57,142 |
| Total loans evaluated <br> for impairment | $\$ 1,026,475$ | $\$ 551,646$ | $\$ 2,513,579$ | $\$ 3,030,340$ | $\$ 1,806,267$ | $\$ 307,274$ | $\$ 9,235,581$ |
| June 30, 2014 | $\$ 315$ | $\$ 75$ | $\$ 1,180$ | $\$ 937$ | $\$ 10,094$ | $\$ 127$ | $\$ 12,728$ |

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Individually evaluated for impairment

| Collectively evaluated | $1,001,378$ | 541,703 | $2,403,165$ | $2,996,361$ | $2,098,292$ | 167,044 | $9,207,943$ |
| :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- |
| for impairment | 3,406 | 582 | 8,807 | 30,647 | 35,641 | - | 79,083 |
| PCI loans | $\$ 1,005,099$ | $\$ 542,360$ | $\$ 2,413,152$ | $\$ 3,027,945$ | $\$ 2,144,027$ | $\$ 167,171$ | $\$ 9,299,754$ |

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Troubled Debt Restructurings. The restructuring of a loan is considered a "troubled debt restructuring" if both (1) the borrower is experiencing financial difficulties and (2) the creditor has granted a concession. Concessions may include interest rate reductions or below market interest rates, principal forgiveness, restructuring amortization schedules and other actions intended to minimize potential losses. Per ASU No. 2011-02, "Receivables (Topic 310)-A Creditor's Determination of Whether a Restructuring Is a Troubled Debt Restructuring," the Company reassesses all loan modifications to identify whether the restructuring constitutes a troubled debt restructuring. The following table presents information regarding the recorded investment of loans modified in a troubled debt restructuring during the six months ended June 30, 2015 and 2014:

## Troubled Debt Restructurings

Construction, land development and other land loans
Agriculture and agriculture real estate (includes farmland)
1-4 Family (includes home equity)
Commercial real estate (includes multi-family residential)
Commercial and industrial
Consumer and other
Total

| Six Months Ended |  |  |  |
| :---: | :---: | :---: | :---: |
| June 30, |  |  |  |
| 2015 |  | 2014 |  |
| Pre- | Post- | Pre- | Post- |
| Modification | Modification | Modification | ation |
| Outstanding | Outstanding | Outstanding | Outstanding |
| Number of Recorded | Recorded | Number <br> of Recorded | Recorded |
| Loahsvestment | Investment sands) | Loahsvestment | Investment |


| - | $\$$ | - | $\$$ | - | - | - | $\$$ |
| :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- |
| - | - |  | - | - | - |  | - |
| - | - |  | - | - | - |  | - |
| - | - |  | - | 1 | 35 |  | 35 |
| - | - |  | - | 1 | 16 |  | 15 |
| 1 | 10 |  | 9 | - | - |  | - |
| 1 | $\$$ | 10 | $\$$ | 9 | 2 | $\$$ | 51 |

As of June 30, 2015, there have been no defaults on any loans that were modified as troubled debt restructurings during the preceding six months. Default is determined at 90 or more days past due. The modifications primarily related to extending the amortization periods of the loans, which includes loans modified during bankruptcy. The Company did not grant principal reductions on any restructured loans. At June 30, 2015 and 2014, the Company had

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$\$ 661$ thousand and $\$ 1.3$ million, respectively, in outstanding troubled debt restructurings. For the six months ended June 30, 2015, the Company added one loan totaling $\$ 10$ thousand as a new troubled debt restructuring, of which $\$ 9$ thousand was still outstanding at June 30, 2015. These modifications did not have a material impact on the Company's determination of the allowance for credit losses.

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## 6. FAIR VALUE

The Company uses fair value measurements to record fair value adjustments to certain assets and to determine fair value disclosures. Fair values represent the estimated price that would be received from selling an asset or paid to transfer a liability, otherwise known as an "exit price." Securities available for sale are recorded at fair value on a recurring basis. Additionally, from time to time, the Company may be required to record at fair value other assets on a nonrecurring basis such as certain loans including residential mortgage loans held for sale, goodwill and other intangible assets and other real estate owned. These nonrecurring fair value adjustments typically involve application of lower-of-cost-or-market accounting or write downs of individual assets. ASC Topic 820 "Fair Value Measurements and Disclosures" establishes a fair value hierarchy for valuation inputs that gives the highest priority to quoted prices in active markets for identical assets or liabilities and the lowest priority to unobservable inputs. The fair value hierarchy is as follows:

## Fair Value Hierarchy

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

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

Level 2-Other significant observable inputs (including quoted prices in active markets for similar assets or liabilities) or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities.

Level 3-Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities.

The fair value of an asset or liability is the price that would be received to sell that asset or paid to transfer that liability in an orderly transaction occurring in the principal market (or most advantageous market in the absence of a principal market) for such asset or liability. In estimating fair value, the Company utilizes valuation techniques that are consistent with the market approach, the income approach and/or the cost approach. Such valuation techniques are consistently applied. Inputs to valuation techniques include the assumptions that market participants would use in pricing an asset or liability.

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

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

As of June 30, 2015

| Level 1 | Level 2 | Level | Total |
| :--- | :--- | :--- | :--- |
| (Dollars in thousands) |  |  |  |

## Assets:

Available for sale securities:
States and political subdivisions \$- \$9,272 \$ - \$9,272
Collateralized mortgage obligations - 29,917 - 29,917
Mortgage-backed securities - 71,323 - 71,323
Other securities
12,717 - $\quad 12,717$
Total $\$ 12,717$ \$110,512 \$ - \$123,229
Non-hedging interest rate swap \$- \$368 \$ - \$368

## Liabilities:

Non-hedging interest rate swap $\$$ - $\$(368 \quad) \$-\$(368)$

## As of December 31, 2014

Level 1 Level $23^{\text {Level }}$ Total
(Dollars in thousands)

## Assets:

## Available for sale securities:

| States and political subdivisions | $\$-$ | $\$ 14,585$ | $\$$ | - | $\$ 14,585$ |
| :--- | :--- | ---: | :--- | :--- | ---: |
| Collateralized mortgage obligations | - | 33,573 |  | - | 33,573 |
| Mortgage-backed securities | - | 84,483 | - | 84,483 |  |
| Other securities | 12,758 | - | - | 12,758 |  |

Total
Non-hedging interest rate swap
Liabilities:
Non-hedging interest rate swap $\$-\quad \$(303) \$-\$(303)$

# PROSPERITY BANCSHARES, INC. ${ }^{\circledR}$ AND SUBSIDIARIES 

## NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS

JUNE 30, 2015
(UNAUDITED)

Certain assets and liabilities are measured at fair value on a nonrecurring basis; that is, the instruments are not measured at fair value on an ongoing basis but are subject to fair value adjustments in certain circumstances (for example, when there is evidence of impairment). These instruments include other real estate owned, held to maturity debt securities, loans held for sale, and impaired loans. For the three and six months ended June 30, 2015, the Company had additions to other real estate owned of $\$ 183$ thousand and $\$ 1.2$ million, respectively, of which $\$ 183$ thousand and $\$ 763$ thousand, respectively, were outstanding as of June 30, 2015. For the three and six months ended June 30, 2015, the Company had additions to impaired loans of $\$ 6.5$ million and $\$ 8.0$ million, respectively, of which $\$ 6.5$ million and $\$ 7.7$ million, respectively, were still outstanding as of June 30,2015 . The remaining assets and liabilities measured at fair value on a nonrecurring basis that were recorded in 2015 and remained outstanding at June 30, 2015 were not significant.

The following table presents carrying and fair value information of financial instruments as of the dates indicated:

As of June 30, 2015
Carrying Estimated Fair Value
Amount Level 1 Level 2 Level 3 Total (Dollars in thousands)
Assets

| Cash and due from banks | $\$ 353,047$ | $\$ 353,047$ | $\$-$ | $\$-$ | $\$ 353,047$ |
| :--- | :--- | :--- | :--- | :--- | :--- |
| Federal funds sold | 1,451 | 1,451 | - | - | 1,451 |
| Held to maturity securities | $9,574,850$ | - | $9,592,825$ | - | $9,592,825$ |
| Loans held for sale | 10,482 | - | 10,482 | - | 10,482 |
| Loans held for investment, net of allowance | $9,022,881$ | - | - | $9,068,305$ | $9,068,305$ |
| Other real estate owned | 2,806 | - | 2,806 | - | 2,806 |
|  |  |  |  |  |  |
| Liabilities |  |  |  |  |  |
| Deposits: |  |  |  |  |  |
| Noninterest-bearing | $\$ 5,040,628$ | $\$-$ | $\$ 5,040,628$ | $\$-$ | $\$ 5,040,628$ |
| Interest-bearing | $11,961,036$ | - | $11,969,183$ | - | $11,969,183$ |
| Other borrowings | 886,741 | - | 887,556 | - | 887,556 |
| Securities sold under repurchase agreements | 334,189 | - | 334,207 | - | 334,207 |
| Junior subordinated debentures | - | - | - | - | - |

As of December 31, 2014
Carrying Estimated Fair Value
Amount Level 1 Level 2 Level 3 Total (Dollars in thousands)
Assets

| Cash and due from banks | $\$ 677,285$ | $\$ 677,285$ | $\$-$ | $\$-$ | $\$ 677,285$ |
| :--- | :--- | :--- | :--- | :--- | :--- |
| Federal funds sold | 569 | 569 | - | - | 569 |
| Held to maturity securities | $8,900,377$ | - | $8,948,692$ | - | $8,948,692$ |
| Loans held for sale | 8,602 | - | 8,602 | - | 8,602 |
| Loans held for investment, net of allowance | $9,154,819$ | - | - | $9,192,231$ | $9,192,231$ |
| Other real estate owned | 3,237 | - | 3,237 | - | 3,237 |

Liabilities
Deposits:

| Noninterest-bearing | $\$ 4,936,420$ | $\$-$ | $\$ 4,936,420$ | $\$-$ | $\$ 4,936,420$ |
| :--- | :--- | :--- | :--- | :--- | :--- |
| Interest-bearing | $12,756,738$ | - | $12,767,961$ | - | $12,767,961$ |
| Other borrowings | 8,724 | - | 10,000 | - | 10,000 |
| Securities sold under repurchase agreements | 315,523 | - | 315,543 | - | 315,543 |
| Junior subordinated debentures | 167,531 | - | 159,740 | - | 159,740 |

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# PROSPERITY BANCSHARES, INC. ${ }^{\circledR}$ AND SUBSIDIARIES 

## NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS

JUNE 30, 2015
(UNAUDITED)

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

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

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

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

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

Loans held for sale - Loans held for sale are carried at the lower of cost or estimated fair value. Fair value for consumer mortgages held for sale is based on commitments on hand from investors or prevailing market prices. As such, the Company classifies loans subjected to nonrecurring fair value adjustments as Level 2.

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

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

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

Deposits-The fair value of demand deposits, savings accounts and certain money market deposits is the amount payable on demand at the reporting date. The fair value of fixed-maturity certificates of deposit is estimated using the rates currently offered for deposits of similar remaining maturities. Deposits fair value measurements utilize Level 2 inputs.

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

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

# PROSPERITY BANCSHARES, INC. ${ }^{\circledR}$ AND SUBSIDIARIES 

## NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS

JUNE 30, 2015
(UNAUDITED)

Junior subordinated debentures-The fair value of the junior subordinated debentures was calculated using the quoted market prices, if available. If quoted market prices are not available, fair value is estimated using quoted market prices for similar subordinated debentures. Junior subordinated debentures fair value measurements utilize Level 2 inputs.

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

Off-balance sheet financial instruments-The fair value of commitments to extend credit and standby letters of credit is estimated using the fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreement and the present creditworthiness of the counterparties. The Company has reviewed the unfunded portion of commitments to extend credit as well as standby and other letters of credit, and has determined that the fair value of such financial instruments is not material. The Company classifies the estimated fair value of credit-related financial instruments as Level 3.

The fair value estimates presented herein are based on pertinent information available to management at June 30, 2015. Although management is not aware of any factors that would significantly affect the estimated fair value amounts, such amounts have not been comprehensively revalued for purposes of these financial statements since those dates and, therefore, current estimates of fair value may differ significantly from the amounts presented herein.

## 7. GOODWILL AND CORE DEPOSIT INTANGIBLES

Changes in the carrying amount of the Company's goodwill and core deposit intangibles ("CDI") for the six months ended June 30, 2015 and the year ended December 31, 2014 were as follows:

Balance as of December 31, 2013
Less:
Amortization
Add:
Measurement period adjustments (302)
Acquisition of F\&M Bancorporation Inc.
Balance as of December 31, 2014
Less:
Amortization
Add:
Measurement period adjustments
Balance as of June 30, 2015

Core
Deposit
Goodwill Intangibles
(Dollars in thousands)
\$ 1,671,520 \$ 42,049

- $\quad(9,940)$

198,245 27,140
1,874,191 58,947

- $(4,879)$

7,764
\$1,881,955 \$ 54,068

Goodwill is recorded on the acquisition date of each entity. The Company may record subsequent adjustments to goodwill for amounts undeterminable at acquisition date, such as deferred taxes and real estate valuations, and therefore the goodwill amounts reflected in the table above may change accordingly. The Company initially records the total premium paid on acquisitions as goodwill. After finalizing the valuation, core deposit intangibles are identified and reclassified from goodwill to core deposit intangibles on the balance sheet. This reclassification has no effect on total assets, liabilities, shareholders' equity, net income or cash flows. Management performs an evaluation annually, and more frequently if a triggering event occurs, of whether any impairment of the goodwill and other intangibles has occurred. If any such impairment is determined, a write-down is recorded. As of June 30, 2015, there were no impairments recorded on goodwill and other intangibles.

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## PROSPERITY BANCSHARES, INC. ${ }^{\circledR}$ AND SUBSIDIARIES

## NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS

JUNE 30, 2015
(UNAUDITED)

The measurement period for the Company to determine the fair value of acquired identifiable assets and assumed liabilities will be at the end of the earlier of (1) twelve months from the date of acquisition or (2) as soon as the Company receives the information it was seeking about facts and circumstances that existed as of the date of acquisition.

Core deposit intangibles are being amortized on a non-pro rata basis over their estimated lives, which the Company believes is between 10 and 15 years. Amortization expense related to intangible assets totaled $\$ 2.4$ million and $\$ 2.6$ million for the three months ended June 30, 2015 and 2014, respectively, and $\$ 4.9$ million and $\$ 4.7$ million for the six months ended June 30, 2015 and 2014, respectively. The estimated aggregate future amortization expense for CDI remaining as of June 30, 2015 is as follows (dollars in thousands):

Remaining 2015 \$4,651
$2016 \quad 8,519$
2017 6,327
$2018 \quad$ 5,400
2019 4,546
Thereafter 24,625
Total \$54,068

## 8. STOCK BASED COMPENSATION

At June 30, 2015, the Company had three stock-based employee compensation plans. Two of the three plans adopted by the Company have expired and therefore no additional awards may be issued under those plans.

During 1998, the Company's Board of Directors and shareholders approved the Prosperity Bancshares, Inc. 1998 Stock Incentive Plan (the "1998 Plan") which authorized the issuance of up to 920,000 (after two-for-one stock split) shares of the common stock of Bancshares under both non-qualified and incentive stock options to employees and non-qualified stock options to directors who are not employees. The 1998 Plan also provided for the granting of restricted stock

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awards, stock appreciation rights, phantom stock awards and performance awards on substantially similar terms. The 1998 Plan has expired and therefore no additional options may be issued from the 1998 Plan.

During 2004, the Company's Board of Directors adopted the Prosperity Bancshares, Inc. 2004 Stock Incentive Plan (the "2004 Plan") which was approved by the Company's shareholders and authorized the issuance of up to $1,250,000$ shares of common stock upon the exercise of options granted under the 2004 Plan or upon the grant or exercise, as the case may be, of other awards granted under the 2004 Plan. The 2004 Plan provided for the granting of incentive and nonqualified stock options to employees and nonqualified stock options to directors who were not employees. The 2004 Plan also provided for the granting of shares of restricted stock, stock appreciation rights, phantom stock awards and performance awards on substantially similar terms. The 2004 Plan has expired and therefore no additional shares may be issued from the 2004 Plan.

During 2012, the Company's Board of Directors and shareholders adopted the Prosperity Bancshares, Inc. 2012 Stock Incentive Plan (the " 2012 Plan"), which authorizes the issuance of up to $1,250,000$ shares of common stock upon the exercise of options granted under the 2012 Plan or pursuant to the grant or exercise, as the case may be, of other awards granted under the 2012 Plan, including restricted stock, stock appreciation rights, phantom stock awards and performance awards. A total of 300,943 shares have been granted under the 2012 Plan as of June 30, 2015.

The Company received $\$ 67$ thousand and $\$ 576$ thousand from the exercise of stock options for the three month periods ended June 30, 2015 and 2014, respectively, and $\$ 67$ thousand and $\$ 2.4$ million during the six month periods ended June 30, 2015 and 2014, respectively. There was no tax benefit realized from option exercises of the share-based payment arrangements during the three and six month periods ended June 30, 2015 and 2014.

As of June 30, 2015, there was $\$ 26.3$ million of total unrecognized compensation expense related to stock-based compensation arrangements. That cost is expected to be recognized over a weighted average period of 2.19 years.

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PROSPERITY BANCSHARES, INC. ${ }^{\circledR}$ AND SUBSIDIARIES

## NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS

JUNE 30, 2015
(UNAUDITED)

## 9. CONTRACTUAL OBLIGATIONS AND OFF-BALANCE SHEET ITEMS

## Contractual Obligations

The following table summarizes the Company's contractual obligations and other commitments to make future payments as of June 30, 2015 (other than deposit obligations and securities sold under repurchase agreements). The Company's future cash payments associated with its contractual obligations pursuant to its FHLB borrowings and operating leases as of June 30, 2015 are summarized below. Payments for FHLB borrowings include interest of $\$ 1.2$ million that will be paid over the future periods. Payments related to leases are based on actual payments specified in underlying contracts.

|  | $\begin{array}{l}\text { More } \\ \text { than 1 }\end{array}$ |  |  |  |  |
| :--- | :--- | :--- | :--- | :--- | :--- |
|  | $\begin{array}{l}\text { 3 } \\ \text { years } \\ \text { or }\end{array}$ |  |  |  |  |
| more |  |  |  |  |  |$)$

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

The Company's commitments associated with outstanding standby letters of credit and commitments to extend credit expiring by periods as of June 30, 2015 are summarized below. Since commitments associated with letters of credit and commitments to extend credit may expire unused, the amounts shown do not necessarily reflect the actual future cash funding requirements.

|  | 1 year or less (Dollars in | More <br> than 1 <br> year but <br> less <br> than 3 <br> years <br> thousands) | 3 years or more but less than 5 years | 5 years or more | Total |
| :---: | :---: | :---: | :---: | :---: | :---: |
| Standby letters of credit | \$84,099 | \$16,570 | \$1,136 | \$- | \$ 101,805 |
| Commitments to extend credit | 1,082,493 | 309,405 | 40,698 | 429,991 | 1,862,587 |
| Total | \$1,166,592 | \$325,975 | \$41,834 | \$429,991 | \$1,964,392 |

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PROSPERITY BANCSHARES, INC. ${ }^{\circledR}$ AND SUBSIDIARIES

## NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS

JUNE 30, 2015
(UNAUDITED)

## 10. OTHER COMPREHENSIVE (LOSS) INCOME

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

Three Months Ended June 30,
20152014


Other comprehensive loss:
Securities available for sale:
Change in unrealized gain during period
Total securities available for sale (640) $224 \quad(416$ ) (317) $111 \quad$ (206 )
Total other comprehensive loss \$(640) \$ 224 \$ (416 ) \$(317) \$ 111 \$ (206 )

Other comprehensive loss:
Securities available for sale:
Change in unrealized gain during period
Total securities available for sale
Total other comprehensive loss
$\left.\begin{array}{rrrlrrr}\$(1,082) & \$ 379 & \$(703 & ) & \$(806) & \$ 282 & \$(524 \\ (1,082) & 379 & \$(703 & ) & (806) & 282 & (524\end{array}\right)$

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

SecuritieAccumulated<br>Availabl@ther<br>for Comprehensive<br>Sale Income<br>(Dollars in thousands)

Balance at January 1, 2015 \$3,729 \$ 3,729
Other comprehensive loss (703) (703)
Balance at June 30, 2015 \$3,026 \$ 3,026
Balance at January 1, 2014 \$4,883 \$ 4,883
Other comprehensive loss (524) (524)
Balance at June 30, 2014 \$4,359 \$ 4,359

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# PROSPERITY BANCSHARES, INC. ${ }^{\circledR}$ AND SUBSIDIARIES 

## NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS

JUNE 30, 2015

## (UNAUDITED)

## 11. ACQUISITIONS

Acquisition of F\&M Bancorporation Inc. - On April 1, 2014, the Company completed the acquisition of F\&M Bancorporation Inc. ("FMBC") and its wholly-owned subsidiary The F\&M Bank \& Trust Company (collectively, "F\&M") headquartered in Tulsa, Oklahoma. F\&M operated 13 banking locations: 9 in Tulsa, Oklahoma and surrounding areas; 3 in Dallas, Texas; and 1 (a loan production office) in Oklahoma City, Oklahoma. The Company acquired FMBC to further expand its Oklahoma and Dallas, Texas area markets. The acquisition was not considered significant to the Company's financial statements and therefore pro forma financial data and related disclosures are not included.

The Company acquired loans and deposits with fair values of $\$ 1.60$ billion and $\$ 2.27$ billion, respectively, at acquisition date. Under the terms of the definitive agreement, the Company issued 3,298,022 shares of Company common stock plus $\$ 34.2$ million in cash for all outstanding shares of FMBC capital stock for total merger consideration of $\$ 252.4$ million based on the Company's closing stock price of $\$ 66.15$. During 2014, the Company recognized goodwill of $\$ 198.2$ million. As of June 30, 2015, total goodwill related to the F\&M acquisition was $\$ 206.0$ million, after recording a $\$ 7.8$ million measurement period adjustment during the first quarter 2015. Goodwill is calculated as the excess of both the consideration exchanged and liabilities assumed as compared to the fair value of identifiable assets acquired, none of which is expected to be deductible for tax purposes. Additionally, the Company recognized $\$ 27.1$ million of core deposit intangibles related to this acquisition.

## 12. SUBSEQUENT EVENTS

Pending Acquisition of Tradition Bancshares, Inc. - On August 6, 2015, the Company announced the signing of a definitive merger agreement to acquire Tradition Bancshares, Inc. ("Tradition") and its wholly-owned subsidiary Tradition Bank headquartered in Houston, Texas. Tradition Bank operates seven (7) banking offices in the Houston, Texas area, including its main office in Bellaire, three (3) banking centers in Katy and one (1) banking center in The Woodlands. Under the terms of the definitive agreement, the Company will issue approximately 679,679 shares of Company common stock plus $\$ 39.0$ million in cash for all outstanding shares of Tradition capital stock, subject to certain conditions and potential adjustments. The transaction is subject to customary closing conditions, including the receipt of customary regulatory approvals and approval by Tradition's shareholders.

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

Special Cautionary Notice Regarding Forward-Looking Statements

Statements and financial discussion and analysis contained in this quarterly report on Form 10-Q that are not historical facts are forward-looking statements made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. Forward-looking statements are based on assumptions and involve a number of risks and uncertainties, many of which are beyond the Company's control. Many possible events or factors could affect the future financial results and performance of the Company and could cause such results or performance to differ materially from those expressed in the forward-looking statements. These possible events or factors include, but are not limited to:
changes in the strength of the United States economy in general and the strength of the local economies in which the Company conducts operations resulting in, among other things, a deterioration in credit quality or reduced demand for credit, including the result and effect on the Company's loan portfolio and allowance for credit losses;
changes in interest rates and market prices, which could reduce the Company's net interest margins, asset valuations and expense expectations;
ehanges 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 4o transact profitable business with the Company, including the ability of the Company's borrowers to repay their loans according to their terms or a change in the value of the related collateral;
increased competition for deposits and loans adversely affecting rates and terms;
the timing, impact and other uncertainties of any future acquisitions, including the Company's ability to identify suitable future acquisition candidates, the success or failure in the integration of their operations, and the ability to enter new markets successfully and capitalize on growth opportunities;
the possible impairment of goodwill associated with an acquisition and possible adverse short-term effects on the results of operations;

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increased credit risk in the Company's assets and increased operating risk caused by a material change in commercial, consumer and/or real estate loans as a percentage of the total loan portfolio;
the concentration of the Company's loan portfolio in loans collateralized by real estate;
the failure of assumptions underlying the establishment of and provisions made to the allowance for credit losses;

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changes in the availability of funds resulting in increased costs or reduced liquidity;
${ }_{\text {a }}^{\text {a deterioration or downgrade in the credit quality and credit agency ratings of the securities in the Company's }}$ securities portfolio;
increased asset levels and changes in the composition of assets and the resulting impact on the Company's capital levels and regulatory capital ratios;
the Company's ability to acquire, operate and maintain cost effective and efficient systems without incurring unexpectedly difficult or expensive but necessary technological changes;
the loss of senior management or operating personnel and the potential inability to hire qualified personnel at reasonable compensation levels;
government intervention in the U.S. financial system;
changes in statutes and government regulations or their interpretations applicable to financial holding companies and the Company's present and future banking and other subsidiaries, including changes in tax requirements and tax rates;
poor performance by external vendors;
the failure of analytical and forecasting models and tools used by the Company to estimate probable credit losses and to measure the fair value of financial instruments;
additional risks from new lines of businesses or new products and services;
claims or litigation related to intellectual property or fiduciary responsibilities;
*he failure of the Company's enterprise risk management framework to identify or address risks adequately;
${ }_{\text {a }}$ a failure in or breach of operational or security systems of the Company's infrastructure, or those of its third-party vendors and other service providers, including as a result of cyber attacks;
potential risk of environmental liability associated with lending activities;
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 Company cautions you not to place undue reliance on its forward-looking statements. The forward-looking statements speak only as of the date the statements are 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 interim consolidated financial statements and accompanying notes included elsewhere in this report and with the consolidated financial statements and accompanying notes and other detailed information appearing in the Company’s Annual Report on Form 10-K for the year ended December 31, 2014.

## OVERVIEW

Prosperity Bancshares, Inc., a Texas corporation, was formed in 1983 to acquire the former Allied First Bank in Edna, Texas, which was chartered in 1949 as The First National Bank of Edna and is now known as Prosperity Bank. 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 ${ }^{\circledR}$. The Bank provides a wide array of financial products and services to small and medium-sized businesses and consumers. As of June 30, 2015, the Bank operated 245 full-service banking locations; with 61 in the Houston area, including The Woodlands; 30 in the South Texas area including Corpus Christi and Victoria; 37 in the Dallas/Fort Worth area; 22 in the East Texas area; 30 in the Central Texas area including Austin and San Antonio; 34 in the West Texas area including Lubbock, Midland-Odessa and Abilene; 16 in the Bryan/College Station area, 6 in the Central Oklahoma area and 9 in the Tulsa, Oklahoma area. The Company's principal executive office is located at Prosperity Bank Plaza, 4295 San Felipe in Houston, Texas and its telephone number is (713) 693-9300. The Company's website address is www.prosperitybankusa.com. Information contained on the Company's website is not incorporated by reference into this quarterly report on Form 10-Q and is not part of this or any other report.

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

Three principal components of the Company's growth strategy are internal growth, stringent cost control practices and acquisitions, including strategic merger transactions. 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 centralized many of its critical operations, such as data processing and loan processing. Management believes that this centralized infrastructure can accommodate substantial additional growth while enabling the Company to minimize operational costs through certain economies of scale. The Company also intends to continue to seek expansion opportunities. During 2013, the Company completed three acquisitions including East Texas Financial Services Inc., Coppermark Bancshares, Inc. and FVNB Corp. During 2014, the Company completed the acquisition of F\&M Bancorporation Inc. and recently announced the pending acquisition of Tradition Bancshares, Inc.

Total assets were $\$ 21.69$ billion at June 30, 2015 compared with $\$ 21.51$ billion at December 31, 2014, an increase of $\$ 178.6$ million or $0.8 \%$. Total loans were $\$ 9.11$ billion at June 30, 2015 compared with $\$ 9.24$ billion at December 31, 2014, a decrease of $\$ 129.8$ million or $1.4 \%$. Total deposits were $\$ 17.00$ billion at June 30, 2015 compared with $\$ 17.69$ billion at December 31, 2014, a decrease of $\$ 691.5$ million or $3.9 \%$. Total shareholders' equity was $\$ 3.36$ billion at June 30, 2015 compared with $\$ 3.24$ billion at December 31, 2014, an increase of $\$ 112.5$ million or $3.5 \%$.

## CRITICAL ACCOUNTING POLICIES

The Company's significant accounting policies are integral to understanding the financial results reported. The Company's accounting policies are described in detail in Note 1 to the consolidated financial statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2014. The Company believes that of its significant accounting policies, the following may involve a higher degree of judgment and complexity:

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Allowance for Credit Losses - The allowance for credit losses is a valuation established through charges to earnings in the form of a provision for credit losses. The determination of the allowance for credit losses has two components, the allowance for legacy credit losses, which includes the allowance for acquired legacy loans, and the allowance for acquired credit losses for fair-valued acquired loans. The allowance for acquired credit losses is calculated as described under the heading "Accounting for Acquired Loans and the Allowance for Acquired Credit Losses" below. Management has established an allowance for credit losses which it believes is adequate for estimated losses in the Company's loan portfolio. Based on an evaluation of the portfolio, management presents a quarterly review of the allowance for credit losses to the Bank's Board of Directors, indicating any change in the allowance since the last review and any recommendations as to adjustments in the allowance. In making its evaluation, management considers factors such as historical loan loss experience, the amount of nonperforming assets and related collateral, the volume, growth and composition of the portfolio, current economic conditions that may affect the borrower's ability to pay and the value of collateral, the evaluation of the portfolio through its internal loan review process and other relevant factors. Portions of the allowance may be allocated for specific credits; however, the entire allowance is available for any credit that, in management's judgment, should be charged off. Charge-offs occur when loans are deemed to be uncollectible. For further discussion of the methodology used in the determination of the allowance for credit losses, refer to the "Financial Condition - Allowance for Credit Losses" section below.

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

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

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Goodwill and Intangible Assets-Goodwill and intangible assets that have indefinite useful lives are subject to an impairment test at least annually, or more often, if events or circumstances indicate that it is more likely than not that the fair value of the Company's reporting unit is below the carrying value of its equity. The Company has the option to first assess qualitative factors to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount as a basis for determining the need to perform step one of the annual test for goodwill impairment. An entity has an unconditional option to bypass the qualitative assessment for any reporting unit in any period and proceed directly to performing the first step of the goodwill impairment test. An entity may resume performing the qualitative assessment in any subsequent period.

If the Company bypasses the qualitative assessment, a two-step goodwill impairment test is performed. The two-step process begins with an estimation of the fair value of the Company's reporting unit compared with its carrying value. If the carrying amount exceeds the fair value of the reporting unit, a second test is completed comparing the implied fair value of the reporting unit's goodwill to its carrying value to measure the amount of impairment.

Estimating the fair value of the Company's reporting unit is a subjective process involving the use of estimates and judgments, particularly related to future cash flows of the reporting unit, discount rates (including market risk premiums) and market multiples. Material assumptions used in the valuation tools include the comparable public company price multiples used in the terminal value, future cash flows and the market risk premium component of the discount rate. The estimated fair values of the reporting unit is determined using a blend of two commonly used valuation techniques: the market approach and the income approach. The Company gives consideration to both valuation techniques, as either technique can be an indicator of value. For the market approach, valuations of the reporting unit were based on an analysis of relevant price multiples in market trades in companies with similar characteristics. For the income approach, estimated future cash flows (derived from internal forecasts and economic expectations) and terminal value (value at the end of the cash flow period, based on price multiples) were discounted. The discount rate was based on the imputed cost of equity capital.

The Company had no intangible assets with indefinite useful lives at June 30, 2015. Other identifiable intangible assets that are subject to amortization are being amortized on a non-pro rata basis over the years expected to be benefited, which the Company believes is between ten and fifteen years. These amortizable intangible assets are reviewed for impairment if circumstances indicate their value may not be recoverable based on a comparison of fair value to carrying value. Based on the Company's annual goodwill impairment test as of September 30, 2014, management does not believe any of its goodwill is impaired as of June 30, 2015 because the fair value of the Company's equity exceeded its carrying value. While the Company believes no impairment existed at June 30, 2015, under accounting standards applicable at that date, different conditions or assumptions, or changes in cash flows or profitability, if significantly negative or unfavorable, could have a material adverse effect on the outcome of the Company's impairment evaluation and financial condition or future results of operations.

Stock-Based Compensation-The Company accounts for stock-based employee compensation plans using the fair value-based method of accounting. The Company's results of operations reflect compensation expense for all

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

Other-Than-Temporarily Impaired Securities-When the fair value of a security is below its amortized cost, and depending on the length of time the condition exists and the extent the fair 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 (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, (3) whether the market decline was affected by macroeconomic conditions, and (4) whether the entity has the intent to sell the debt security or more likely than not will be required to sell the debt security before its anticipated recovery. Often, the information available to conduct these assessments is limited and rapidly changing, making estimates of fair value subject to judgment. If actual information or conditions are different than estimated, the extent of the impairment of the security may be different than previously estimated, which could have a material effect on the Company's results of operations and financial condition.

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

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## RECENT ACQUISITION

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

## SUBSEQUENT EVENTS

Pending Acquisition of Tradition Bancshares, Inc. - On August 6, 2015, the Company announced the signing of a definitive merger agreement to acquire Tradition Bancshares, Inc. ("Tradition") and its wholly-owned subsidiary Tradition Bank headquartered in Houston, Texas. Tradition Bank operates seven (7) banking offices in the Houston, Texas area, including its main office in Bellaire, three (3) banking centers in Katy and one (1) banking center in The Woodlands. As of June 30, 2015, Tradition, on a consolidated basis, reported total assets of $\$ 522.1$ million, total loans of $\$ 242.4$ million and total deposits of $\$ 463.8$ million. Under the terms of the definitive agreement, the Company will issue approximately 679,679 shares of Company common stock plus $\$ 39.0$ million in cash for all outstanding shares of Tradition capital stock, subject to certain conditions and potential adjustments. The transaction is subject to customary closing conditions, including the receipt of customary regulatory approvals and approval by Tradition's shareholders.

## RESULTS OF OPERATIONS

Net income available to common shareholders was $\$ 71.9$ million ( $\$ 1.03$ per common share on a diluted basis) for the quarter ended June 30, 2015 compared with $\$ 75.5$ million ( $\$ 1.08$ per common share on a diluted basis) for the quarter ended June 30, 2014, a decrease in net income of $\$ 3.6$ million or $4.7 \%$. The Company posted returns on average common equity of $8.61 \%$ and $9.75 \%$, returns on average assets of $1.33 \%$ and $1.42 \%$ and efficiency ratios of $42.35 \%$ and $42.90 \%$ for the quarters ended June 30, 2015 and 2014, respectively. The efficiency ratio is calculated by dividing total non-interest expense, excluding credit loss provisions, by net interest income plus non-interest income, excluding net gains and losses on the sale of securities and assets. Additionally, taxes are not part of this calculation.

For the six months ended June 30, 2015, net income available to common shareholders was $\$ 145.6$ million ( $\$ 2.08$ per common share on a diluted basis) compared with $\$ 142.6$ million ( $\$ 2.10$ per common share on a diluted basis) for the same period in 2014, an increase in net income of $\$ 2.9$ million or $2.1 \%$. The Company posted returns on average

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common equity of $8.80 \%$ and $9.72 \%$, returns on average assets of $1.35 \%$ and $1.43 \%$ and efficiency ratios of $42.09 \%$ and $42.51 \%$ for the six months ended June 30, 2015 and 2014, respectively.

## Net Interest Income

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

For the three months ended June 30, 2015

Net interest income before the provision for credit losses was $\$ 158.2$ million for the quarter ended June 30, 2015, a decrease of $\$ 15.8$ million or $9.1 \%$, compared with $\$ 174.1$ million for the same period in 2014. The decrease in net interest income was primarily due to a decrease in purchase accounting loan discount accretion of $\$ 11.8$ million from $\$ 25.4$ million for the quarter ended June 30, 2014 to $\$ 13.6$ million for the quarter ended June 30, 2015.

Interest income on loans was $\$ 119.4$ million for the quarter ended June 30, 2015, a decrease of $\$ 19.3$ million or $13.9 \%$, compared with $\$ 138.7$ million for the same period in 2014. This was primarily due to a decrease of $\$ 11.8$ million or $46.3 \%$ in purchase accounting loan discount accretion from $\$ 25.4$ million for the quarter ended June 30, 2014 to $\$ 13.6$ million for the quarter ended June 30, 2015. Additionally, interest income on loans was impacted by a decrease in average loans of $\$ 334.5$ million or $3.5 \%$ for the quarter ended June 30, 2015 compared with the quarter ended June 30, 2014.

Interest income on securities was $\$ 48.5$ million for the quarter ended June 30, 2015, an increase of $\$ 860$ thousand or $1.8 \%$, compared with $\$ 47.7$ million for the same period in 2014. This was primarily due to an increase in average securities of $\$ 940.6$ million or $10.8 \%$, partially offset by an 18 basis point decrease in average interest rates from $2.19 \%$ at June 30, 2014 to $2.01 \%$ at June 30, 2015.

Average interest-bearing liabilities were $\$ 13.21$ billion for the quarter ended June 30, 2015, an increase of $\$ 87.9$ million or $0.7 \%$, compared with $\$ 13.12$ billion for the same period in 2014 . The net interest margin on a tax-equivalent basis decreased 44 basis points from $3.83 \%$ for the quarter ended June 30, 2014 to $3.39 \%$ for the quarter ended June 30, 2015. This was due in part to a decrease of $\$ 11.8$ million in purchase accounting adjustments for the quarter ended June 30, 2015 compared with the quarter ended June 30, 2014. Additionally, the tax-equivalent net interest margin was impacted by lower yields on average interest-earnings assets, partially offset by

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lower rates paid on average interest-bearing liabilities.

For the six months ended June 30, 2015

Net interest income before the provision for credit losses was $\$ 321.1$ million for the six months ended June 30, 2015, an increase of $\$ 3.4$ million or $1.1 \%$, compared with $\$ 317.7$ million for the same period in 2014. The increase in net interest income was primarily attributable to a decrease in average rate paid on interest-bearing liabilities and an increase of $8.1 \%$ in average interest-earning assets, partially offset by a decrease in purchase accounting loan discount accretion and average yield on interest-earning assets for the six months ended June 30, 2015 compared to the six months ended June 30, 2014.

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Interest income on loans was $\$ 244.3$ million for the six months ended June 30 , 2015, a decrease of $\$ 1.5$ million or $0.6 \%$, compared with $\$ 245.8$ million for the same period in 2014 . This was primarily due to a decrease in purchase accounting loan discount accretion of $\$ 5.6$ million, partially offset by an increase in average loans of $6.3 \%$ for the six months ended June 30, 2015 compared with the six months ended June 30, 2014. The Company had $\$ 116.2$ million of total outstanding discounts on acquired loans, of which $\$ 74.2$ million was accretable at June 30, 2015.

Interest income on securities was $\$ 97.1$ million for the six months ended June 30, 2015, an increase of $\$ 2.4$ million or $2.5 \%$, compared with $\$ 94.7$ million for the same period in 2014 . This was due in part to an increase in average securities of $\$ 858.0$ million or $10.0 \%$, partially offset by a 15 basis point decrease in average interest rates from $2.22 \%$ at June 30, 2014 to $2.07 \%$ at June 30, 2015.

Average interest-bearing liabilities were $\$ 13.21$ billion for the six months ended June 30, 2015, an increase of $\$ 701.4$ million or $5.6 \%$, compared with $\$ 12.51$ billion for the same period in 2014 . The net interest margin on a tax-equivalent basis decreased 25 basis points from $3.73 \%$ for the six months ended June 30, 2014 to $3.48 \%$ for the six months ended June 30, 2015. This was primarily due to lower yields on average interest-earning assets, partially offset by lower rates paid on average interest-bearing liabilities. Additionally, the tax-equivalent net interest margin was impacted by a $\$ 5.6$ million decrease in purchase accounting adjustments for the six months ended June 30, 2015 compared with the six months ended June 30, 2014.

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The following tables present, for the periods indicated, the total dollar amount of average balances, interest income from average interest-earning assets and the resultant yields, as well as the interest expense on average interest-bearing liabilities, expressed in both dollars and rates. Except as indicated in the footnotes, no tax-equivalent adjustments were made and all average balances are daily average balances. Any nonaccruing loans have been included in the table as loans carrying a zero yield.

| Three Months Ended June 30, 2015 |  |  |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: |
|  | Interest |  |  | Interest |  |
| Average Outstanding | Earned/ | Aver | Average | Earned/ | Average |
|  |  | Yiel | alutstand |  | Yield/Rat |
| Balance | Interest | (4) | Balance | Interest | (4) |
|  | Paid |  |  | Paid |  |

## Assets

Interest-Earning Assets:
Loans
Investment securities
Federal funds sold and other earning assets
Total interest-earning assets
Allowance for credit losses
Noninterest-earning assets
Total assets

| $\$ 9,133,625$ | $\$ 119,404$ | $5.24 \%$ | $\$ 9,468,136$ | $\$ 138,655$ | $5.87 \%$ |
| :---: | :---: | :---: | :---: | :---: | :---: |
| $9,688,961$ | 48,530 | $2.01 \%$ | $8,748,322$ | 47,670 | $2.19 \%$ |
| 79,659 | 47 | $0.24 \%$ | 234,302 | 178 | $0.30 \%$ |
| $18,902,245$ | $\$ 167,981$ | $3.56 \%$ | $18,450,760$ | $\$ 186,503$ | $4.05 \%$ |
| $(80,868$ |  |  | $(72,587$ | $)$ |  |
| $2,817,644$ |  |  | $2,939,375$ |  |  |
| $\$ 21,639,021$ |  |  | $\$ 21,317,548$ |  |  |

Liabilities and Shareholders' Equity
Interest-Bearing Liabilities:
Interest-bearing demand deposits
Savings and money market deposits
Certificates and other time deposits
Other borrowings
Securities sold under repurchase agreements
Junior subordinated debentures
Total interest-bearing liabilities

| $\$ 3,891,682$ | $\$ 2,227$ | $0.23 \%$ | $\$ 3,568,475$ | $\$ 2,272$ | $0.26 \%$ |
| :---: | :--- | :---: | :---: | :---: | :---: |
| $5,476,931$ | 3,374 | $0.25 \%$ | $5,479,978$ | 3,550 | $0.26 \%$ |
| $2,821,058$ | 3,568 | $0.51 \%$ | $3,379,819$ | 5,096 | $0.60 \%$ |
| 684,371 | 365 | $0.21 \%$ | 140,906 | 189 | $0.54 \%$ |
| 333,220 | 208 | $0.25 \%$ | 382,692 | 254 | $0.27 \%$ |
| - | - | - | 167,531 | 1,087 | $2.60 \%$ |
| $13,207,262$ | 9,742 | $0.30 \%$ | $13,119,401$ | 12,448 | $0.38 \%$ |

Noninterest-Bearing Liabilities:
Noninterest-bearing demand deposits
Other liabilities
Total liabilities
Shareholders' equity
Total liabilities and shareholders' equity
4,992,301 4,735,575
98,133 365,169
18,297,696 18,220,145
3,341,325 3,097,403
\$21,639,021 \$21,317,548
Net interest rate spread
Net interest income and margin (1) (2)
$3.26 \%$
3.67\%
$\$ 158,2393.36 \% \quad \$ 174,055 \quad 3.78 \%$

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

Yield is based on amortized cost and does not include any component of unrealized gains or losses.
(2) The net interest margin is equal to net interest income divided by average interest-earning assets.

In order to make pretax income and resultant yields on tax-exempt investments and loans comparable to those on
(3)taxable investments and loans, a tax-equivalent adjustment has been computed using a federal income tax rate of $35 \%$.
(4) Annualized and based on an actual/365 day basis for the three months ended June 30, 2015 and 2014.

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## Assets

Interest-Earning Assets:
Loans
Investment securities
Federal funds sold and other earning assets
Total interest-earning assets
Allowance for credit losses
Noninterest-earning assets
Total assets

| Six Months Ended June 30,2015 |  |  |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: |
|  | Interest |  |  | Interest |  |
| Average <br> Outstanding | Earned/ | Average Average |  | Earned/ | Average |
|  |  | Yiel | Cutstand |  | Yield/Rat |
| Balance | Interest | (4) | Balance | Interest | (4) |
|  | Paid |  |  | Paid |  |
| (Dollars in th | ousands) |  |  |  |  |


| \$9,161,349 | \$244,282 | 5.38\% | \$8,616,796 | \$ 245,799 | 5.75\% |
| :---: | :---: | :---: | :---: | :---: | :---: |
| 9,466,434 | 97,092 | 2.07\% | 8,608,411 | 94,726 | 2.22\% |
| 173,147 | 212 | 0.25\% | 168,368 | 226 | 0.27\% |
| 18,800,930 | \$341,586 | 3.66\% | 17,393,575 | \$340,751 | 3.95\% |
| (80,775 ) |  |  | (69,919 ) |  |  |
| 2,843,739 |  |  | 2,746,112 |  |  |
| \$21,563,894 |  |  | \$20,069,768 |  |  |

Liabilities and Shareholders' Equity
Interest-Bearing Liabilities:
Interest-bearing demand deposits
Savings and money market deposits
Certificates and other time deposits
Other borrowings
Securities sold under repurchase agreements
Junior subordinated debentures
Total interest-bearing liabilities

| $\$ 4,034,489$ | $\$ 4,810$ | $0.24 \%$ | $\$ 3,561,460$ | $\$ 4,404$ | $0.25 \%$ |
| :--- | :---: | :---: | :---: | :---: | :---: |
| $5,509,326$ | 6,779 | $0.25 \%$ | $5,237,557$ | 6,705 | $0.26 \%$ |
| $2,888,176$ | 7,157 | $0.50 \%$ | $3,099,815$ | 9,196 | $0.60 \%$ |
| 379,936 | 494 | $0.26 \%$ | 96,666 | 347 | $0.72 \%$ |
| 336,824 | 411 | $0.25 \%$ | 365,316 | 491 | $0.27 \%$ |
| 59,374 | 791 | $2.69 \%$ | 145,881 | 1,862 | $2.57 \%$ |
| $13,208,125$ | 20,442 | $0.31 \%$ | $12,506,695$ | 23,005 | $0.37 \%$ |

Noninterest-Bearing Liabilities:
Noninterest-bearing demand deposits
Other liabilities
Total liabilities
Shareholders' equity
Total liabilities and shareholders' equity
4,946,138 4,378,471
99,375 224,497
18,253,638 17,109,663
3,310,256 2,960,105
$\$ 21,563,894 \quad \$ 20,069,768$

| Net interest rate spread |  | $3.35 \%$ | $3.58 \%$ |  |
| :--- | :--- | :--- | :--- | :--- |
| Net interest income and margin (1) (2) | $\$ 321,144$ | $3.44 \%$ | $\$ 317,746$ | $3.68 \%$ |
| Net interest income and margin (tax equivalent) (3) | $\$ 324,371$ | $3.48 \%$ | $\$ 321,881$ | $3.73 \%$ |

(1) Yield is based on amortized cost and does not include any component of unrealized gains or losses.
(2) The net interest margin is equal to net interest income divided by average interest-earning assets.
(3)In order to make pretax income and resultant yields on tax-exempt investments and loans comparable to those on taxable investments and loans, a tax-equivalent adjustment has been computed using a federal income tax rate of
$35 \%$.
(4) Annualized and based on an actual/365 day basis for the six months ended June 30, 2015 and 2014.

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

|  | Three Months Ended June <br> 30, <br> 2015 vs. 2014 <br> Increase <br> (Decrease) <br> Due to Change in <br> Volume Rate Total <br> (Dollars in thousands) |  |  | Six Mont <br> 2015 vs. <br> Increase <br> (Decrease) <br> Due to C <br> Volume | ths Ended <br> 2014 <br> e) <br> Change in Rate | June 30, <br> Total |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Interest-Earning assets: |  |  |  |  |  |  |
| Loans (1) | \$ $(4,899)$ | \$ $(14,352)$ | \$(19,251) | \$15,534 | \$ $(17,051)$ | \$ $(1,517)$ |
| Investment securities (1) | 5,126 | (4,266 ) | 860 | 9,442 | (7,076 ) | 2,366 |
| Federal funds sold and other earning assets | (117 ) | (14 ) | (131 ) | , | (20 ) | (14 |
| Total increase (decrease) in interest income | 110 | $(18,632)$ | $(18,522)$ | 24,982 | $(24,147)$ | 835 |
| Interest-Bearing liabilities: |  |  |  |  |  |  |
| Interest-bearing demand deposits | 206 | (251 | (45 ) | 585 | (179 ) | 406 |
| Savings and money market deposits | (2) | (174 | (176 ) | 348 | (274 ) | 74 |
| Certificates and other time deposits (1) | (842 ) | (686 | (1,528 ) | (628 | (1,411 ) | $(2,039)$ |
| Other borrowings | 729 | (553 | 176 | 1,017 | (870 ) | 147 |
| Securities sold under repurchase agreements | (33 ) | (13 | (46 ) | (38 | (42 ) | (80 ) |
| Junior subordinated debentures | $(1,087)$ | - | (1,087 ) | (1,104) | 33 | $(1,071)$ |
| Total increase (decrease) in interest expense | $(1,029)$ | (1,677 ) | (2,706 ) | 180 | (2,743 ) | $(2,563)$ |
| Increase (decrease) in net interest income | \$1,139 | \$ $(16,955)$ | \$(15,816) | \$24,802 | \$ $(21,404)$ | \$3,398 |

(1) Includes impact of purchase accounting adjustments.

## Provision for Credit Losses

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

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

The Company recorded a $\$ 500$ thousand provision for credit losses for the quarter ended June 30, 2015 and a $\$ 6.3$ million provision for the quarter ended June 30, 2014. Net charge-offs were $\$ 491$ thousand for the quarter ended June 30,2015 compared with net charge-offs of $\$ 155$ thousand for the quarter ended June 30, 2014. The Company made a $\$ 1.8$ million provision for credit losses for the six months ended June 30,2015 and a $\$ 6.9$ million provision for the six months ended June 30, 2014. Net charge-offs were $\$ 1.5$ million for the six months ended June 30, 2015 compared with $\$ 941$ thousand for the six months ended June 30, 2014. See "Financial Condition - Allowance for Credit Losses" for more information.

## Noninterest Income

The Company's primary sources of recurring noninterest income are NSF fees, credit, debit and ATM card income and service charges on deposit accounts. Noninterest income does not include loan origination fees which are recognized over the life of the related loan as an adjustment to yield using the interest method. Noninterest income totaled $\$ 30.3$ million for the three months ended June 30, 2015 compared with $\$ 32.6$ million for the same period in 2014, a decrease of $\$ 2.3$ million or $7.1 \%$. This was due to a decrease in net gain on sale of assets and a decrease in NSF fees.
Noninterest income totaled $\$ 58.7$ million for the six months ended June 30, 2015 compared with $\$ 61.3$ million for the same period in 2014, a decrease of $\$ 2.5$ million or $4.2 \%$. This decrease was primarily due to a decrease in net gain on sale of assets and a decrease in NSF fees, partially offset by an increase in mortgage income and an increase in credit card, debit card and ATM card income.

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

|  | Three Months <br> Ended June 30, | onths <br> ne 30, <br> 2014 <br> in thousan | Six Mont <br> Ended Ju <br> 2015 <br> nds) | $\begin{aligned} & \text { ths } \\ & \text { une } 30, \end{aligned}$ $2014$ |
| :---: | :---: | :---: | :---: | :---: |
| Nonsufficient funds (NSF) fees | \$8,310 | \$9,099 | \$16,228 | \$17,969 |
| Credit card, debit card and ATM card income | 6,003 | 6,030 | 11,641 | 11,182 |
| Service charges on deposit accounts | 4,189 | 4,325 | 8,368 | 7,934 |
| Trust income | 2,047 | 2,044 | 4,056 | 3,844 |
| Mortgage income | 1,513 | 1,208 | 2,661 | 1,801 |
| Brokerage income | 1,541 | 1,401 | 2,950 | 2,670 |
| Bank owned life insurance income | 1,390 | 1,365 | 2,770 | 2,393 |
| Net gain on sale of assets | 270 | 1,301 | 1,649 | 4,611 |
| Other | 5,034 | 5,824 | 8,395 | 8,857 |
| Total noninterest income | \$30,297 | \$32,597 | \$58,718 | \$61,261 |

## Noninterest Expense

Noninterest expense totaled $\$ 79.7$ million for the quarter ended June 30, 2015 compared with $\$ 87.3$ million for the quarter ended June 30, 2014, a decrease of $\$ 7.6$ million or $8.7 \%$. This was primarily due to a decrease in salary and benefits expense. Noninterest expense totaled $\$ 159.2$ million for the six months ended June 30, 2015 compared with $\$ 158.4$ million for the six months ended June 30, 2014, an increase of $\$ 811$ thousand or $0.5 \%$. This was primarily due to an increase in regulatory assessments and FDIC insurance, partially offset by a decrease in professional fees.

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

|  | Three Months Ended June 30, |  | Six Months Ended June 30, |  |
| :---: | :---: | :---: | :---: | :---: |
| Salaries and employee benefits (1) | \$47,819 | \$54,126 | \$97,785 | \$97,534 |
| Non-staff expenses: |  |  |  |  |
| Net occupancy and equipment | 5,812 | 5,996 | 11,776 | 11,335 |
| Credit and debit card, data processing and software amortization | 4,045 | 4,009 | 7,862 | 7,193 |
| Regulatory assessments and FDIC insurance | 4,253 | 3,886 | 8,607 | 6,612 |
| Core deposit intangibles amortization | 2,390 | 2,630 | 4,879 | 4,675 |
| Depreciation | 3,420 | 3,522 | 6,336 | 6,723 |

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Communications (2)
Other real estate expense
Professional fees
Printing and supplies
Other
Total noninterest expense

| 2,835 | 2,919 | 5,644 | 5,656 |
| :--- | :--- | :--- | :--- |
| 129 | 188 | 261 | 584 |
| 1,111 | 1,818 | 1,312 | 2,782 |
| 503 | 593 | 1,015 | 1,136 |
| 7,418 | 7,605 | 13,720 | 14,156 |
| $\$ 79,735$ | $\$ 87,292$ | $\$ 159,197$ | $\$ 158,386$ |

Includes stock-based compensation expense of $\$ 2.9$ million and $\$ 2.5$ million for the three months ended June 30, (1) 2015 and 2014, respectively, and $\$ 5.7$ million and $\$ 3.7$ million for the six months ended June 30, 2015 and 2014, respectively.
(2)Communications expense includes telephone, data circuits, postage and courier expenses.

## Income Taxes

Income tax expense decreased $\$ 1.2$ million or $3.1 \%$, to $\$ 36.4$ million for the quarter ended June 30, 2015 compared with $\$ 37.5$ million for the same period in 2014. This decrease was primarily attributable to lower pretax net income for the three months ended June 30, 2015 compared with the same period in 2014. For the six months ended June 30, 2015 , income tax expense totaled $\$ 73.3$ million, an increase of $\$ 2.3$ million or $3.2 \%$, compared with $\$ 71.1$ million for the same period in 2014. This increase was primarily attributable to higher pretax net income for the six months ended June 30, 2015 compared with the same period in 2014. The Company's effective tax rate for the three months ended June 30,2015 and 2014 was $33.6 \%$ and $33.2 \%$, respectively. The Company's effective tax rate for the six months ended June 30, 2015 and 2014 was $33.5 \%$ and $33.2 \%$, respectively.

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## FINANCIAL CONDITION

## Loan Portfolio

At June 30, 2015, total loans were $\$ 9.11$ billion, a decrease of $\$ 129.8$ million or $1.4 \%$, compared with $\$ 9.24$ billion at December 31, 2014. Loans at June 30, 2015 included $\$ 10.5$ million of loans held for sale. Average outstanding loans at June 30, 2015 represented $48.3 \%$ of average interest-earning assets for the quarter ended June 30, 2015.

The following tables summarize the Company's legacy and acquired loan portfolios broken out into legacy loans, acquired legacy loans, Non-PCI loans and PCI loans, as of the dates indicated. The Company separates its loan portfolio into two general categories of loans: (1) loans originated by Prosperity Bank and made pursuant to the Company's loan policy and procedures in effect at the time the loan was made are referred to as "legacy loans" and (2) "acquired loans," which are loans acquired in a business combination. Those acquired loans that are renewed or substantially modified after the date of the business combination, which therefore causes them to become subject to the Company's allowance for credit losses methodology, are referred to as "acquired legacy loans." If a renewal or substantial modification of an acquired loan is underwritten by the Company with a new credit analysis, the loan will no longer be categorized as an acquired loan. For example, acquired loans to one borrower may be combined into a new loan with a new loan number and categorized as a legacy loan. Acquired loans with a fair value discount or premium at the date of the business combination that remained at the reporting date are referred to as "fair-valued acquired loans." All fair-valued acquired loans are further categorized into "Non-PCI loans" and "PCI loans" (purchased credit impaired loans). Acquired loans with evidence of credit quality deterioration at acquisition for which it is probable that the Company would not be able to collect all contractual amounts due are PCI loans.

| Residential mortgage loans held for sale | $\$ 10,482$ | $\$-$ | $\$-$ | $\$-$ | $\$ 10,482$ |
| :--- | :--- | :--- | :--- | :--- | :--- |
| Commercial and industrial | 906,030 | 444,671 | 285,772 | 18,044 | $1,654,517$ |
| Real estate: |  |  |  |  |  |
| Construction, land development and other land loans | 896,518 | 86,738 | 83,234 | 1,566 | $1,068,056$ |
| 1-4 family residential (including home equity) | $1,978,694$ | 95,105 | 472,646 | 5,725 | $2,552,170$ |
| Commercial real estate (including multi-family | $1,943,668$ | 307,047 | 687,035 | 20,489 | $2,958,239$ |
| residential) | 299,501 | 15,931 | 83,777 | 445 | 399,654 |
| Farmland |  |  |  |  |  |

Agriculture
Consumer and other
Total loans held for investment
Total

| 125,402 | 66,626 | 9,008 | 55 | 201,091 |
| :---: | :--- | :--- | :--- | :---: |
| 203,778 | 28,592 | 37,756 | - | 270,126 |
| $6,353,591$ | $1,044,710$ | $1,659,228$ | 46,324 | $9,103,853$ |
| $\$ 6,364,073$ | $\$ 1,044,710$ | $\$ 1,659,228$ | $\$ 46,324$ | $\$ 9,114,335$ |

December 31, 2014
Acquired Loans

| Legacy | Acquired | Non-PCI | PCI | Total |
| :--- | :--- | :--- | :--- | :--- |
| Loans | Legacy <br> Loans | Loans | Loans | Loans |

(Dollars in thousands)

| Residential mortgage loans held for sale | $\$ 8,602$ | $\$-$ | $\$-$ | $\$-$ | $\$ 8,602$ |
| :--- | :--- | :--- | :--- | :--- | :--- |
|  |  |  |  |  |  |
| Commercial and industrial | 846,665 | 518,855 | 414,647 | 26,100 | $1,806,267$ |
| Real estate: |  |  |  |  |  |
| Construction, land development and other land loans | 801,321 | 114,066 | 109,946 | 1,142 | $1,026,475$ |
| 1-4 family residential (including home equity) | $1,877,843$ | 94,331 | 535,479 | 5,926 | $2,513,579$ |
| Commercial real estate (including multi-family | $1,883,267$ | 263,904 | 859,702 | 23,467 | $3,030,340$ |
| residential | 244,162 | 13,520 | 103,809 | 452 | 361,943 |
| Farmland | 105,448 | 72,051 | 12,149 | 55 | 189,703 |
| Agriculture | 189,161 | 56,839 | 61,274 | - | 307,274 |
| Consumer and other | $5,947,867$ | $1,133,566$ | $2,097,006$ | 57,142 | $9,235,581$ |
| Total loans held for investment | $\$ 5,956,469$ | $\$ 1,133,566$ | $\$ 2,097,006$ | $\$ 57,142$ | $\$ 9,244,183$ |

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Nonperforming Assets

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

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

Nonperforming assets decreased $\$ 1.8$ million or $4.9 \%$ to $\$ 35.1$ million at June 30, 2015 compared with $\$ 36.9$ million at December 31, 2014, of which $\$ 30.3$ million and $\$ 30.7$ million, respectively, were attributable to acquired loans.

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

Nonaccrual loans (1)
Accruing loans 90 or more days past due
Total nonperforming loans
Repossessed assets
Other real estate
Total nonperforming assets
June 30, 2015
Acquired Loans

|  | Acquired | Non-PCI | PCI |  |
| :--- | :--- | :--- | :--- | :--- |
| Legacy | Legacy <br> Loans | Loans | Loans | Loans |$\quad$ Total

(Dollars in thousands)

| $\$ 3,850$ | $\$ 14,502$ | $\$ 5,162$ | $\$ 8,473$ | $\$ 31,987$ |
| :--- | :--- | :--- | :--- | :--- |
| 153 | - | - | - | 153 |
| 4,003 | 14,502 | 5,162 | 8,473 | 32,140 |
| 17 | - | 56 | 100 | 173 |
| 771 | 11 | 1,947 | 77 | 2,806 |
| $\$ 4,791$ | $\$ 14,513$ | $\$ 7,165$ | $\$ 8,650$ | $\$ 35,119$ |

Nonperforming assets to total loans and other real estate by category
$0.08 \quad \% \quad 1.39 \quad \% \quad 0.43 \quad \% \quad 18.64 \% \quad 0.39 \quad \%$

December 31, 2014
Acquired Loans

| Legacy <br> Loans | Acquired <br> Legacy <br> Loans | Non-PCI <br> Loans | PCI <br> Loans | Total |
| :--- | :--- | :--- | :--- | :--- |
| (Dollars in thousands) |  |  |  |  |
| $\$ 4,197$ | $\$ 11,194$ | $\$ 2,947$ | $\$ 13,084$ | $\$ 31,422$ |
| 377 | 1,816 | - | - | $\$ 2,193$ |
| 4,574 | 13,010 | 2,947 | 13,084 | 33,615 |
| 12 | - | 55 | - | 67 |
| 1,608 | 23 | 1,556 | 50 | 3,237 |
| $\$ 6,194$ | $\$ 13,033$ | $\$ 4,558$ | $\$ 13,134$ | $\$ 36,919$ |

Nonperforming assets to total loans and other real estate by category
$0.10 \quad \% \quad 1.15 \quad \% \quad 0.22 \quad \% \quad 22.96 \% ~ 0.40 \quad \%$
Nonaccrual loans (1)
Accruing loans 90 or more days past due
Total nonperforming loans
Repossessed assets
Other real estate
Total nonperforming assets
Nonperforming assets to total loans and other real estate by

$$
0.10 \quad \% \quad 1.15 \quad \% \quad 0.22 \quad \% \quad 22.96 \%
$$

(1) Includes troubled debt restructurings of $\$ 661$ thousand and $\$ 911$ thousand as of June 30, 2015 and December 31,
2014,

Nonperforming assets were $0.39 \%$ of total loans and other real estate at June 30, 2015 compared with $0.40 \%$ of total loans and other real estate at December 31, 2014. Nonperforming assets were $0.08 \%$ of total legacy loans and other real estate at June 30, 2015 compared with $0.10 \%$ of total legacy loans and other real estate at December 31, 2014. Nonperforming assets were $1.39 \%$ of total acquired legacy loans and other real estate at June 30, 2015 compared with $1.15 \%$ of total acquired legacy loans and other real estate at December 31, 2014. Nonperforming assets were $0.43 \%$ of total Non-PCI loans and other real estate and $18.64 \%$ of total PCI loans and other real estate at June 30, 2015 compared with $0.22 \%$ of total Non-PCI and other real estate and $22.96 \%$ of total PCI loans and other real estate at December 31, 2014. The allowance for credit losses as a percentage of total nonperforming loans was $251.9 \%$ at June 30, 2015 and $240.3 \%$ at December 31, 2014. For the six months ended June 30, 2015, the Company had one loan totaling $\$ 10$ thousand in new troubled debt restructurings, of which $\$ 9$ thousand was still outstanding on June 30, 2015.

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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:

Average loans outstanding
Gross loans outstanding at end of period
Allowance for credit losses at beginning of period
Provision for credit losses
Charge-offs:
Commercial and industrial
Real estate and agriculture
Consumer and other
Recoveries:
Commercial and industrial
Real estate and agriculture
Consumer and other
Net charge-offs
Allowance for credit losses at end of period
Ratio of allowance to end of period loans
Ratio of net charge-offs to average loans (annualized)
Ratio of allowance to end of period nonperforming loans

## As of and for the Six Months Ended June 30, 20152014 <br> (Dollars in thousands)

$\$ 9,161,349 \quad \$ 8,616,796$

| $\$ 9,114,335$ | $\$ 9,308,162$ |
| :---: | :---: |
| $\$ 80,762$ | $\$ 67,282$ |
| 1,750 | 6,925 |


| $(826$ | $)$ | $(202$ | $)$ |
| :--- | :--- | :--- | :--- |
| $(459$ | $)$ | $(960$ | $)$ |
| $(1,473$ | $)$ | $(1,924$ | $)$ |
|  |  |  |  |
| 350 |  | 185 |  |
| 214 | 7764 |  |  |
| 654 |  | $(941$ |  |
| $(1,540$ | $)$ | $\$ 73,266$ |  |


| 0.89 | $\%$ | 0.79 | $\%$ |
| :--- | :--- | :--- | :--- |
| 0.03 | $\%$ | 0.02 | $\%$ |
| 251.9 | $\%$ | 312.9 | $\%$ |

The allowance for credit losses is a valuation established through charges to earnings in the form of a provision for credit losses. Management has established an allowance for credit losses which it believes is adequate for estimated losses in the Company's loan portfolio. The amount of the allowance for credit losses is affected by the following: (1) charge-offs of loans that occur when loans are deemed uncollectible and decrease the allowance, (2) recoveries on loans previously charged off that increase the allowance and (3) provisions for credit losses charged to earnings that increase the allowance. Based on an evaluation of the loan portfolio and consideration of the factors listed below, management presents a quarterly review of the allowance for credit losses to the Bank's Board of Directors, indicating any change in the allowance since the last review and any recommendations as to adjustments in the allowance. Although management believes it uses the best information available to make determinations with respect to the allowance for credit losses, further adjustments may be necessary if economic conditions differ from the assumptions used in making the initial determinations.

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

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

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

A change in the allowance for credit losses can be attributable to several factors, most notably (1) specific reserves identified for impaired loans, (2) historical credit loss information, (3) changes in environmental factors and (4) growth in the balance of legacy loans and the re-categorization of fair-valued acquired loans to acquired legacy loans, which subjects such loans to the allowance methodology.

Changes in the Company's asset quality are reflected in the allowance in several ways. Specific reserves that are calculated on a loan-by-loan basis and the qualitative assessment of all other loans reflect current changes in the credit quality of the loan portfolio. Historical credit losses, on the other hand, are based on a three-year look back period, which are then applied to estimate current credit losses inherent in the loan portfolio. A deterioration in the credit quality of the loan portfolio in the current period would increase the historical credit loss factor to be applied in future periods, just as an improvement in credit quality would decrease the historical credit loss factor.

The allowance for credit losses is further determined by the size of the loan portfolio subject to the allowance methodology and environmental factors that include Company-specific risk indicators and general economic conditions, both of which are constantly changing. The Company evaluates the economic and portfolio-specific factors on a quarterly basis to determine a qualitative component of the general valuation allowance. The factors include economic metrics, business conditions, delinquency trends, credit concentrations, nature and volume of the portfolio and other adjustments for items not covered by specific reserves and historical loss experience. Management's assessment of qualitative factors is a statistically based approach to determine the inherent probable loss associated with such factors. Based on the Company's actual historical loan loss experience relative to economic and loan portfolio-specific factors at the time the losses occurred, management is able to identify the probabilities of default and loss severity based on current economic conditions. The correlation of historical loss experience with current economic conditions provides an estimate of inherent and probable losses that has not been previously factored into the general valuation allowance by the determination of specific reserves and recent historical losses. Additionally, through back-testing, the Company is able to adjust the outputs of the analysis for imprecision.

Utilizing the aggregation of specific reserves, historical loss experience and a qualitative component, management is able to determine the valuation allowance to reflect the full inherent probable loss.

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

Loans acquired in business combinations are initially recorded at fair value, which includes an estimate of inherent credit losses expected to be realized over the remaining lives of the loans, and therefore no corresponding allowance for credit losses is recorded for these loans at acquisition. When a fair-valued acquired loan is renewed at its maturity date, the loan is re-categorized as an acquired legacy loan. When a fair-valued acquired loan is modified after acquisition, the loan is independently evaluated subsequent to the modification decision to determine whether the modification was substantial, and therefore, requires that the loan be re-categorized as an acquired legacy loan. This determination is based on a discounted cash-flow analysis. Generally, when a change in discounted cash-flow of greater than $10 \%$ is identified, the fair-valued acquired loan becomes categorized as an acquired legacy loan. If and when a fair-valued acquired loan becomes an acquired legacy loan, the acquired legacy loan is evaluated at the time of renewal or modification in accordance with the Company's allowance for credit losses methodology described above.

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

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Non-PCI loans that have deteriorated to an impaired status subsequent to acquisition are evaluated for a specific reserve on a quarterly basis which, when identified, is added to the allowance for credit losses. The Company reviews impaired Non-PCI loans on a loan-by-loan basis and determines the specific reserve based on the difference between the recorded investment in the loan and one of three factors: expected future cash flows, observable market price or fair value of the collateral. Because essentially all of the Company's impaired Non-PCI loans have been collateral-dependent, the amount of the specific reserve historically has been determined by comparing the fair value of the collateral securing the Non-PCI loan with the recorded investment in such loan. In the future, the Company will continue to analyze impaired Non-PCI loans on a loan-by-loan basis and may use an alternative measurement method to determine the specific reserve, as appropriate and in accordance with applicable accounting standards.

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

As described in the section captioned "Critical Accounting Policies" above, the Company's determination of the allowance for credit losses involves a high degree of judgment and complexity. The Company's analysis of qualitative, or environmental, factors on pools of loans with common risk characteristics, in combination with the quantitative historical loss information and specific reserves, provides the Company with an estimate of inherent losses. The allowance must reflect changes in the balance of loans subject to the allowance methodology, as well as the estimated imminent losses associated with those loans.

Beginning in 2013, the Company began to further disaggregate its allowance for credit losses to distinguish between the portion of the allowance attributed to legacy loans and the portion attributed to acquired loans.

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

Average loans outstanding
Gross loans outstanding at end of period
Allowance for credit losses at beginning of period
Provision for credit losses
Charge-offs:
Commercial and industrial
Real estate and agriculture
Consumer and other
Recoveries:
Commercial and industrial
Real estate and agriculture
Consumer and other
Net charge-offs
Allowance for credit losses at end of period
Ratio of allowance to end of period loans
Ratio of net charge-offs to average loans (annualized)
Ratio of allowance to end of period nonperforming loans

## As of and for the Six Months Ended June 30, 2015

## Acquired

Legacy $\quad$ Loans
Loans
(Dollars in thousands)
\$6,144,136 $\quad \$ 3,017,213 \quad \$ 9,161,349$
\$6,364,073 \$2,750,262 \$9,114,335

| $\$ 61,745$ | $\$ 19,017$ | $\$ 80,762$ |
| :---: | :---: | :---: |
| 2,953 | $(1,203$ | $)$ |
| 1,750 |  |  |

$\left.\begin{array}{lllll}(397 & ) & (429 & ) & (826\end{array}\right)$
$(1,406) \quad(67) \quad(1,473)$
$278 \quad 72 \quad 350$
$213 \quad 1 \quad 214$
$653 \quad 1 \quad 654$
(976 ) (564 ) (1,540 )
$\$ 63,722 \quad \$ 17,250 \quad \$ 80,972$

| 1.00 | $\%$ | 0.63 | $\%$ | 0.89 | $\%$ |
| :--- | :--- | :--- | :--- | :--- | :--- |
| 0.03 | $\%$ | 0.04 | $\%$ | 0.03 | $\%$ |
| 1591.9 | $\%$ | 61.3 | $\%$ | 251.9 | $\%$ |

Average loans outstanding
Gross loans outstanding at end of period

## As of and for the Six Months Ended June 30, 2014

## Acquired

| Legacy $\quad$ Loans | Total |
| :--- | :--- | :--- |
| Loans <br> (Dollars in thousands) |  |

\$5,117,142 \$3,499,654 \$8,616,796
$\$ 5,260,467 \quad \$ 4,047,695 \quad \$ 9,308,162$

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$\left.\begin{array}{lccccl}\text { Allowance for credit losses at beginning of period } & \$ 60,115 & \$ 7,167 & & \$ 67,282 \\ \text { Provision for credit losses } & 68 & 6,857 & & 6,925 & \\ \text { Charge-offs: } & & & & & \\ \text { Commercial and industrial } & (71 & ) & (131 & ) & (202 \\ \text { Real estate and agriculture } & (367 & ) & (593 & ) & (960 \\ \text { Consumer and other } & (1,844 & ) & (80 & ) & (1,924\end{array}\right)$

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The Company had gross charge-offs on legacy loans of $\$ 2.1$ million during the six months ended June 30, 2015. Partially offsetting these charge-offs were recoveries on legacy loans of $\$ 1.1$ million. Total charge-offs for the six months ended June 30, 2015 were $\$ 2.8$ million, partially offset by total recoveries of $\$ 1.2$ million.

The following tables show the allocation of the allowance for credit losses among various categories of loans disaggregated between legacy loans, acquired legacy loans, Non-PCI loans and PCI loans at 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, regardless of whether allocated to a legacy loan or an acquired loan.

June 30, 2015
Acquired Loans
Percent

December 31, 2014
Acquired Loans

| Legacy <br> Loans | Acquired | Non-PCI | PCI | Total | Percent of Loans |
| :---: | :---: | :---: | :---: | :---: | :---: |
|  |  |  |  |  |  |
|  | Legacy | Loans | Loans | Allowance |  |
|  |  |  |  |  | Total |
|  |  |  |  |  | Loans |

(Dollars in thousands)
Balance of allowance for credit losses applicable to:
Commercial and industrial
Real estate
Agriculture and agriculture real estate
Consumer and other

| $\$ 17,511$ | $\$ 11,818$ | $\$ 673$ | $\$$ | - | $\$ 30,002$ | 19.5 | $\%$ |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| 40,138 | 4,580 | 228 |  | - | 44,946 | 71.2 | $\%$ |
| 2,278 | 1,440 | 4 |  | - | 3,722 | 6.0 | $\%$ |
| 1,818 | 123 | 151 |  | - | 2,092 | 3.3 | $\%$ |

At June 30, 2015, the allowance for credit losses totaled $\$ 81.0$ million compared with $\$ 80.8$ million at December 31, 2014, an increase of $\$ 210$ thousand or $0.3 \%$. The allowance for credit losses at June 30, 2015 totaled $0.89 \%$ of total loans compared with $0.87 \%$ of total loans at December 31, 2014.

At June 30, 2015, $\$ 63.7$ million of the allowance was attributable to legacy loans, an increase of $\$ 2.0$ million or $3.2 \%$ compared with the allowance of $\$ 61.7$ million attributable to legacy loans at December 31, 2014. This was primarily due to the increase in the legacy loan balance as a result of the re-categorization from Non-PCI loans to legacy loans and organic loan growth. At June 30, 2015, $\$ 15.3$ million of the allowance for credit losses was attributable to acquired legacy loans compared with $\$ 18.0$ million of the allowance at December 31, 2014, a decrease of $\$ 2.7$ million or $14.9 \%$. This was primarily due to a decrease in specific reserves on acquired legacy loans with improved credit conditions. At June 30, 2015, $\$ 1.8$ million of the allowance for credit losses was attributable to Non-PCI loans compared with $\$ 1.1$ million of the allowance at December 31, 2014, an increase of $\$ 747$ thousand or $70.7 \%$. At June 30, 2015, $\$ 163$ thousand of the allowance for credit losses was attributable to PCI loans compared with no allowance at December 31, 2014. The increase in allowance attributable to Non-PCI and PCI loans was primarily attributable to specific reserves identified for loans with deteriorated credit quality.

At June 30, 2015, the Company had $\$ 116.2$ million of total outstanding discounts on Non-PCI and PCI loans, of which $\$ 74.2$ million was accretable.

The Company believes that the allowance for credit losses at June 30, 2015 is adequate to cover estimated losses in the loan 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 June 30, 2015.

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## Securities

The carrying cost of securities totaled $\$ 9.70$ billion at June 30, 2015 compared with $\$ 9.05$ billion at December 31, 2014, an increase of $\$ 652.3$ million or $7.2 \%$. At June 30, 2015, securities represented $44.7 \%$ of total assets compared with $42.1 \%$ of total assets at December 31, 2014.

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

## Available for Sale

| States and political subdivisions | \$9,207 | \$ 65 | \$ | \$9,272 |
| :---: | :---: | :---: | :---: | :---: |
| Collateralized mortgage obligations | 29,824 | 103 | (10 | 29,917 |
| Mortgage-backed securities | 66,955 | 4,380 | (12 | ) 71,323 |
| Other securities | 12,588 | 160 | (31 | ) 12,717 |
| Total | \$118,574 | \$ 4,708 | \$ (53 | ) $\$ 123,229$ |

## Held to Maturity

U.S. Treasury securities and obligations of U.S. Government agencies

| States and political subdivisions | 388,356 | 5,335 | $(1,319$ | $)$ | 392,372 |
| :--- | :--- | :--- | :--- | :--- | :--- |
| Collateralized mortgage obligations | 7,899 | 62 | $(3$ | $)$ | 7,958 |
| Mortgage-backed securities | $9,126,659$ | 92,646 | $(79,716$ | $9,139,589$ |  |
| Total | $\$ 9,574,850$ | $\$ 99,014$ | $\$(81,039$ | $\$ 9,592,825$ |  |

Available for Sale
$\begin{array}{lcccc}\text { States and political subdivisions } & \$ 14,402 & \$ 183 & \$- & \$ 14,585 \\ \text { Collateralized mortgage obligations } & 33,519 & 91 & (37 & 33,573\end{array}$

Mortgage-backed securities
Other securities
Total

| 79,153 | 5,344 | $(14$ | $)$ |
| :---: | :---: | :---: | :---: |
| 12,588 | 201 | $(31$ | $)$ |
| 12,783 |  |  |  |
| $\$ 139,662$ | $\$ 5,819$ | $\$(82$ | $)$ | 145,399

## Held to Maturity

U.S. Treasury securities and obligations of U.S. Government agencies
States and political subdivisions
Collateralized mortgage obligations
Mortgage-backed securities
Total

| $\$ 52,353$ | $\$ 360$ | $\$(74$ | $) \$ 52,639$ |
| :---: | :---: | :---: | :---: |
| 404,356 | 6,147 | $(1,422$ | $) 409,081$ |
| 19,585 | 215 | $(8$ | $)$ |
| $8,424,083$ | 96,650 | $(53,553$ | $)$ |
| $\$, 467,180$ |  |  |  |
| $\$ 8,900,377$ | $\$ 103,372$ | $\$(55,057$ | $) \$ 8,948,692$ |

Management evaluates securities for other-than-temporary impairment ("OTTI") at least on a quarterly basis, and more frequently when economic or market conditions warrant such an evaluation. In determining OTTI, management considers many factors, including: (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, (3) whether the market decline was affected by macroeconomic conditions, and (4) whether the entity has the intent to sell the debt security or more likely than not will be required to sell the debt security before its anticipated recovery. The assessment of whether an other-than-temporary decline exists involves a high degree of subjectivity and judgment and is based on the information available to management at a point in time.

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

As of June 30, 2015, management does not have the intent to sell any of its securities and believes that it is more likely than not that the Company will not have to sell any such securities before a recovery of cost. The unrealized losses are largely due to increases in market interest rates over the yields available at the time the underlying securities were purchased. The fair value is expected to recover as the securities approach their maturity date or repricing date or if market yields for such investments decline. Management does not believe any of the securities are impaired due to reasons of credit quality. Accordingly, as of June 30, 2015, management believes any impairment in the Company's securities is temporary, and therefore no impairment loss has been realized in the Company's consolidated statements of income.

## Deposits

Total deposits were $\$ 17.00$ billion at June 30, 2015 compared with $\$ 17.69$ billion at December 31, 2014, a decrease of $\$ 691.5$ million or $3.9 \%$. At June 30, 2015, noninterest-bearing deposits totaled $\$ 5.04$ billion compared with $\$ 4.94$ billion at December 31, 2014, an increase of $\$ 104.2$ million or $2.1 \%$. Interest-bearing deposits totaled $\$ 11.96$ billion at June 30, 2015 compared with $\$ 12.76$ billion at December 31, 2014, a decrease of $\$ 795.7$ million or $6.2 \%$.

Average deposits for the six months ended June 30,2015 were $\$ 17.38$ billion, an increase of $\$ 1.10$ billion or $6.8 \%$, compared with $\$ 16.28$ billion for the six months ended June 30, 2014. Deposit growth was impacted by the acquisition of $\mathrm{F} \& \mathrm{M}$ on April 1, 2014. Deposits for $\mathrm{F} \& \mathrm{M}$ totaled $\$ 2.27$ billion at acquisition date. The ratio of average interest-bearing deposits to total average deposits was $71.5 \%$ during the first six months of 2015 compared to $73.1 \%$ during the first six months of 2014.

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

|  | Six Months Ended June 30, |  |  |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  | 2015 |  |  | 2014 |  |  |
|  | Average | Averag |  | Average | Average |  |
|  | Balance | Rate |  | Balance | Rate |  |
|  | (Dollars in th | ousands |  |  |  |  |
| Interest-bearing demand deposits | \$4,034,489 | 0.24 | \% | \$3,561,460 | 0.25 | \% |
| Regular savings | 1,817,147 | 0.20 | \% | 1,638,139 | 0.20 | \% |
| Money market savings | 3,692,179 | 0.27 | \% | 3,599,418 | 0.28 | \% |
| Certificates and other time deposits | 2,888,176 | 0.50 | \% | 3,099,815 | 0.60 | \% |
| Total interest-bearing deposits | 12,431,991 | 0.30 | \% | 11,898,832 | 0.34 | \% |
| Noninterest-bearing deposits | 4,946,138 |  |  | 4,378,471 |  |  |
| Total deposits | \$17,378,129 | 0.22 | \% | \$16,277,303 | 0.25 | \% |

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Other Borrowings

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

|  | June 30, | December <br> 31, |
| :--- | :---: | :---: |
|  | $\mathbf{2 0 1 5}$ | $\mathbf{2 0 1 4}$ |
|  | (Dollars in |  |
|  | $\$ 880,000$ | $\$-$ |
| FHLB |  |  |
| FHLB advances | 6,741 | 8,724 |
| Total other borrowings | 886,741 | 8,724 |
| Securities sold under repurchase agreements | 334,189 | 315,523 |
| Total | $\$ 1,220,930$ | $\$ 324,247$ |

FHLB advances and long-term notes payable - The Company has an available line of credit with the FHLB of Dallas, which allows the Company to borrow on a collateralized basis. FHLB advances are considered short-term, overnight borrowings and are used to manage liquidity as needed. Maturing advances are replaced by drawing on available cash, making additional borrowings or through increased customer deposits. At June 30, 2015, the Company had total funds of $\$ 5.72$ billion available under this agreement, of which $\$ 886.7$ million was outstanding. Short-term overnight FHLB advances of $\$ 880.0$ million were outstanding at June 30 , 2015, at a weighted average rate of $0.10 \%$. Long-term notes payable were $\$ 6.7$ million at June 30 , 2015, with a weighted average rate of $5.63 \%$. The maturity dates on the FHLB notes payable range from the years 2015 to 2027 and have interest rates ranging from $4.51 \%$ to 6.10\%.

Securities sold under repurchase agreements- At June 30, 2015, the Company had $\$ 334.2$ million in securities sold under repurchase agreements compared with $\$ 315.5$ million at December 31, 2014, an increase of $\$ 18.7$ million or $5.9 \%$. Repurchase agreements with banking customers are generally settled on the following business day; however, approximately $\$ 14.4$ million of the repurchase agreements outstanding at June 30, 2015 have maturity dates ranging from 3 to 24 months. All securities sold under agreements to repurchase are collateralized by certain pledged securities.

During the first quarter of 2015, the Company redeemed all of its outstanding junior subordinated debentures. Accordingly, as of June 30, 2015, the Company had no junior subordinated debentures outstanding compared with $\$ 167.5$ million at December 31, 2014.

## Liquidity

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

As of June 30, 2015, the Company had outstanding $\$ 1.86$ billion in commitments to extend credit and $\$ 101.8$ million in commitments associated with outstanding standby letters of credit. Since commitments associated with letters of credit and commitments to extend credit may expire unused, the total outstanding may not necessarily reflect the actual future cash funding requirements.

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

Asset liquidity is provided by cash and assets which are readily marketable or which will mature in the near future. As of June 30, 2015, the Company had cash and cash equivalents of $\$ 354.5$ million compared with $\$ 677.9$ million at December 31, 2014, a decrease of $\$ 323.4$ million. The decrease was primarily due to the purchase of $\$ 3.33$ billion of securities, a decrease in interest-bearing deposits of $\$ 795.1$ million, the redemption of $\$ 167.5$ million of junior subordinated debentures and dividends paid of $\$ 38.2$ million. This decrease was partially offset by proceeds from the maturities and repayments of securities of $\$ 2.65$ billion, net proceeds from short-term borrowings of $\$ 880.0$ million, a decrease in loans of $\$ 162.0$ million, net increase in noninterest-bearing deposits of $\$ 104.2$ million and net income of $\$ 145.6$ million.

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## Contractual Obligations

The following table summarizes the Company's contractual obligations and other commitments to make future payments as of June 30, 2015 (other than deposit obligations). The payments do not include pre-payment options that may be available to the Company. The Company's future cash payments associated with its contractual obligations pursuant to its FHLB borrowings and operating leases as of June 30, 2015 are summarized below. Payments for FHLB borrowings include interest of $\$ 1.2$ million that will be paid over the future periods. Payments related to leases are based on actual payments specified in underlying contracts.

|  | 1 year or less <br> (Dollars in | More than 1 <br> year but less <br> than 3 years thousan | 3 <br> years or more but less than 5 years ds) | 5 <br> years <br> or <br> more | Total |
| :---: | :---: | :---: | :---: | :---: | :---: |
| Federal Home Loan Bank notes payable | \$881,056 | \$1,843 | \$4,417 | \$650 | \$887,966 |
| Operating leases | 6,268 | 8,319 | 3,898 | 7,321 | 25,806 |
| Total | \$887,324 | \$ 10,162 | \$8,315 | \$7,971 | \$913,772 |

## Off-Balance Sheet Items

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

The Company's commitments associated with outstanding standby letters of credit and commitments to extend credit as of June 30, 2015 are summarized below. Since commitments associated with letters of credit and commitments to extend credit may expire unused, the amounts shown do not necessarily reflect the actual future cash funding requirements:

|  | 1 year or less <br> (Dollars in | More <br> than 1 <br> year but <br> less <br> than 3 <br> years <br> thousands) | 3 years or more but less than 5 years | 5 years or more | Total |
| :---: | :---: | :---: | :---: | :---: | :---: |
| Standby letters of credit | \$84,099 | \$16,570 | \$1,136 | \$- | \$ 101,805 |
| Commitments to extend credit | 1,082,493 | 309,405 | 40,698 | 429,991 | 1,862,587 |
| Total | \$ 1,166,592 | \$325,975 | \$41,834 | \$429,991 | \$1,964,392 |

## Capital Resources

Total shareholders' equity was $\$ 3.36$ billion at June 30, 2015 compared with $\$ 3.24$ billion at December 31, 2014, an increase of $\$ 112.5$ million or $3.5 \%$. The increase was due primarily to net income of $\$ 145.6$ million, partially offset by dividends paid of $\$ 38.2$ million for the six months ended June 30, 2015.

The Basel III Capital Rules adopted by the federal regulatory authorities in 2013 substantially revised the risk-based capital requirements applicable to the Company and the Bank. The Basel III Capital Rules became effective for the Company on January 1, 2015, subject to a phase-in period for certain provisions. Among other things, the Basel III Capital Rules introduced a new capital measure called "Common Equity Tier 1," which is a comparison of the sum of certain equity capital components to total risk-weighted assets, and revised the risk-weighting approach of the capital ratios with a more risk-sensitive approach that expanded the risk-weighting categories from the previous Basel I derived categories to a much larger and more risk-sensitive number of categories, depending on the nature of the assets.

Financial institutions are categorized as well capitalized or adequately capitalized based on minimum total risk-based, Tier 1 risk-based, common equity Tier 1 and Tier 1 leverage ratios. As of June 30, 2015, the Company's capital ratios exceeded the regulatory definition of adequately capitalized and the Bank's capital ratios were above the levels required for the Bank to be designated as "well capitalized" by the FDIC.

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The following table provides a comparison of the Company's and the Bank's risk-weighted and leverage capital ratios to the minimum and well-capitalized regulatory standards as of June 30, 2015:

## To Be Categorized As

|  | To Be Categorized As <br> Minimum <br> Required |  | Well Capitalized Under |
| :--- | :--- | :--- | :--- |

(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.

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

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

The Company uses simulation analysis to examine the potential effects of market changes on net interest income and market value. The Company considers macroeconomic variables, Company strategy, liquidity and other factors as it quantifies market risk. See Item 7 "Management's Discussion and Analysis of Financial Condition and Results of Operations-Interest Rate Sensitivity and Liquidity" in the Company's Annual Report on Form 10-K for the year ended December 31, 2014, filed on March 2, 2015, for further discussion.

## ITEM 4. CONTROLS AND PROCEDURES

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

Changes in internal control over financial reporting. There were no changes in the Company's internal control over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) during the quarter ended June 30, 2015 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

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## PART II—OTHER INFORMATION

## ITEM 1. LEGAL PROCEEDINGS

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

## ITEM 1A. RISK FACTORS

There have been no material changes in the Company's risk factors from those disclosed in the Company's Annual Report on Form 10-K for the year ended December 31, 2014.

## ITEM 2.

UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS
a. None.
b. None.
c. None.

## ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

## ITEM 4. MINE SAFETY DISCLOSURES

Not applicable.

## ITEM 5. OTHER INFORMATION

None.

## ITEM 6. EXHIBITS

## Exhibit

## Description of Exhibit

Number to Section 906 of the Sarbanes-Oxley Act of 2002 herein by reference to Exhibit 3.1 to the Company's Registration Statement on Form S-1 (Registration No. 333-63267) (the "Registration Statement"))

Articles of Amendment to Amended and Restated Articles of Incorporation of Prosperity Bancshares, Inc. (incorporated herein by reference to Exhibit 3.2 to the Company's Quarterly Report on Form 10-Q for the quarter ended March 31, 2006)

Amended and Restated Bylaws of Prosperity Bancshares, Inc. (incorporated herein by reference to Exhibit 3.1 to the Company's Current Report on Form 8-K filed on April 23, 2015)

Form of certificate representing shares of the Company's common stock (incorporated by reference to Exhibit 4 to the Registration Statement)

Employment Agreement, dated July 30, 2004, by and between Prosperity Bank and Edward Z. Safady

|  | $*$ | Amendment to Employment Agreement, dated December 24, 2008, by and between Prosperity <br> Bank and Edward Safady |
| :--- | :--- | :--- |
| 0.2 | $*$ | Non- Disclosure and Non-Solicitation Agreement, effective May 15, 2015, by and between <br> Prosperity Bank and Edward Safady |
| 1.1 | $*$ | Certification of the Chief Executive Officer pursuant to Rule 13a-14(a) of the Securities Exchange <br> Act of 1934, as amended |
| 31.2 | $*$ | Certification of the Chief Financial Officer pursuant to Rule 13a-14(a) of the Securities Exchange <br> Act of 1934, as amended |
| 32.1 | $* *$ | Certification of the Chief Executive Officer pursuant to 18 U.S.C. Section 1350, adopted pursuant <br> to Section 906 of the Sarbanes-Oxley Act of 2002 |

Amended and Restated Articles of Incorporation of Prosperity Bancshares, Inc. (incorporated

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

* Interactive Financial Data
* Filed with this Quarterly Report on Form 10-Q.
**Furnished with this Quarterly Report on Form 10-Q.


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## SIGNATURES

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

PROSPERITY BANCSHARES, INC. ©
(Registrant)
Date: 8/7/15/S/ DAVID ZALMAN
David Zalman
Chairman and Chief Executive Officer
Date: 8/7/15/S/ DAVID HOLLAWAY
David Hollaway
Chief Financial Officer

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[^0]:    Available for Sale

[^1]:    (1) Includes $\$ 10.5$ million and $\$ 8.6$ million of residential mortgage loans held for sale at June 30, 2015 and December 31, 2014, respectively.

[^2]:    (1) Includes troubled debt restructurings of $\$ 661$ thousand and $\$ 911$ thousand as of June 30, 2015 and December 31, 2014, respectively.

