PROSPERITY BANCSHARES INC
Form 10-K
February 29, 2008
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

(Mark One)

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

For The Fiscal Year Ended December 31, 2007
OR

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

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

PROSPERITY BANCSHARES, INC.®

(Exact name of registrant as specified in its charter)

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

PROSPERITY BANK PLAZA	
4295 SAN FELIPE	
HOUSTON, TEXAS	**77027**
(Address of principal executive offices)	**(Zip Code)**

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

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

Common Stock, par value $1.00 per share	**Nasdaq Global Select Market**
(Title of each class)	**(Name of each exchange on which registered)**

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

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

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

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

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

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

Large Accelerated Filer x Accelerated Filer ¨ Non-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 x

The aggregate market value of the shares of Common Stock held by non-affiliates as of June 30, 2007, based on the closing price of the Common Stock on the NASDAQ Global Select Market on June 30, 2007 was approximately $1.25 billion.

As of February 26, 2008, the number of outstanding shares of Common Stock was 44,195,710.

Documents Incorporated by Reference:

Portions of the Company s Proxy Statement relating to the 2008 Annual Meeting of Shareholders, which will be filed within 120 days after December 31, 2007, are incorporated by reference into Part III, Items 10-14 of this Annual Report on Form 10-K.

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2007 ANNUAL REPORT ON FORM 10-K

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PART I

ITEM 1. BUSINESS

General

Prosperity Bancshares, Inc.®, a Texas corporation (the Company), was formed in 1983 as a vehicle to acquire the former Allied Bank in Edna, Texas which was chartered in 1949 as The First National Bank of Edna. The Company is a registered financial holding company that derives substantially all of its revenues and income from the operation of its bank subsidiary, Prosperity Bank® (Prosperity Bank® or the Bank). The Bank provides a broad line of financial products and services to small and medium-sized businesses and consumers. As of December 31, 2007, the Bank operated one hundred twenty-four (124) full-service banking locations and one (1) loan production office; with forty (40) in the Greater Houston Consolidated Metropolitan Statistical Area (CMSA), thirty-three (33) in the South Texas area including Corpus Christi and Victoria, twenty-three (23) in the Central Texas area including Austin and Bryan/College Station,, two (2) in East Texas, twenty-six (26) in the Dallas/Fort Worth, Texas area and one (1) loan production office in San Antonio. The Greater Houston CMSA includes Austin, Brazoria, Chambers, Fort Bend, Galveston, Harris, Liberty, Montgomery, San Jacinto and Waller counties. The Company s headquarters are located at Prosperity Bank Plaza, 4295 San Felipe in Houston, Texas and its telephone number is (713) 693-9300. The Company s website address is *www.prosperitybanktx.com*.

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

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

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From December 31, 1998 through December 31, 2007, the Company grew through internal growth and the completion of the following acquisitions:

Acquired Entity	Acquired Bank	Completion Date	Number of Banking Centers Added[1]
South Texas Bancshares, Inc.	Commercial State Bank	1999	3
Compass Bank (5 branches)	N/A	2000	4
Commercial Bancshares, Inc.	Heritage Bank	2001	12
Texas Guaranty Bank, N.A.	Same	2002	3
The First State Bank of Needville	Same	2002	(2)
Paradigm Bancorporation, Inc.	Paradigm Bank Texas	2002	8
Southwest Bank Holding Company	Bank of the Southwest	2002	2
First National Bank of Bay City	Same	2002	(2)
Abrams Centre Bancshares, Inc.	Abrams Centre National Bank	2003	1
Dallas Bancshares, Inc.	BankDallas	2003	1
MainBancorp, Inc.	*m*ain*b*ank, *n.a.*	2003	4
First State Bank of North Texas	Same	2003	3
Liberty Bancshares, Inc.	Liberty Bank, S.S.B.	2004	4
Village Bank and Trust, s.s.b	Same	2004	1
First Capital Bankers, Inc.	FirstCapital Bank, s.s.b.	2005	25
Grapeland Bancshares, Inc.	First State Bank of Grapeland	2005	2
SNB Bancshares, Inc	Southern National Bank of Texas	2006	6(3)
Texas United Bancshares, Inc	State Bank, GNB Financial, n.a., Gateway National Bank and Northwest Bank	2007	41
The Bank of Navasota	Same	2007	1

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

2007 Acquisitions

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

On September 1, 2007, the Company completed its acquisition of The Bank of Navasota, N.A., Navasota, Texas through the merger of the Bank of Navasota into the Bank. The Company issued approximately 251,000 shares of its common stock and paid approximately $8.6 million in cash for all of the issued and outstanding capital stock of the Bank of Navasota. The Bank of Navasota operated one banking office in

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Navasota, Texas, which became a full-service banking center of Prosperity Bank. As of June 30, 2007, the Bank of Navasota had total assets of $73.4 million, loans of $33.0 million, deposits of $63.8 million and shareholders equity of $9.1 million.

Subsequent Events

Acquisition of Branches of Banco Popular North America

On January 10, 2008, the Company completed its acquisition of six (6) Houston retail branches from Banco Popular North America. In connection with the acquisition, the Company assumed approximately $125.0 million in deposits. Since January 11, 2008, all six (6) locations have been operating as full service banking centers of Prosperity Bank.

Acquisition of 1st Choice Bancorp, Inc.

On February 7, 2008, the Company announced the signing of a definitive agreement to acquire 1st Choice Bancorp, Inc and its wholly-owned subsidiary, 1st Choice Bank. 1st Choice Bancorp operates two (2) banking offices in Houston, Texas, with one location in South Houston and another in the Heights area. Prosperity s Heights banking center will be consolidated with the 1st Choice Bancorp Heights location, with the resulting banking center being located in 1st Choice s Heights banking office. As of December 31, 2007, 1st Choice Bancorp had, on a consolidated basis, total assets of $303.1 million, loans of $190.7 million and deposits of $273.3 million. Under the terms of the definitive agreement, Prosperity will issue approximately 1,757,813 shares of Prosperity common stock plus approximately $18,750,000 in cash for all outstanding shares of 1st Choice Bancorp capital stock, subject to decrease in the event 1st Choice Bancorp s equity capital is less than $26.0 million.

Available Information

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

Officers and Associates

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

The Company has invested heavily in its officers and associates by recruiting talented officers in its market areas and providing them with economic incentive in the form of stock-based compensation and bonuses based on cross-selling performance. The senior management team has substantial experience in the Houston, Dallas, Austin, Corpus Christi and San Antonio markets and the surrounding communities in which the Company has a presence. Each banking center location is administered by a local president or manager with knowledge of the community and lending expertise in the specific industries found in the community. The Company entrusts its banking center Presidents and Managers with authority and flexibility within general parameters with respect to product pricing and decision making in order to avoid the bureaucratic structure of larger banks. The Company operates each banking center as a separate profit center, maintaining separate data with respect to each banking center s net interest income, efficiency ratio, deposit growth, loan growth and overall profitability. Banking center presidents and managers are accountable for performance in these areas and compensated accordingly.

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The Company s local banking centers have no 1-800 telephone numbers. Each banking center has its own listed local business telephone number. Customers are served by a local banker with decision making authority.

As of December 31, 2007, the Company and the Bank had 1,359 full-time equivalent associates, 519 of whom were officers of the Bank. The Company provides medical and hospitalization insurance to its full-time associates. The Company considers its relations with associates to be excellent. Neither the Company nor the Bank is a party to any collective bargaining agreement.

Banking Activities

The Company, through the Bank, offers a variety of traditional loan and deposit products to its customers, which consist primarily of consumers and small and medium-sized businesses. The Bank tailors its products to the specific needs of customers in a given market. At December 31, 2007, the Bank maintained approximately 280,000 separate deposit accounts and 39,000 separate loan accounts and 23.5% of the Bank s total deposits were noninterest-bearing demand deposits. For the year ended December 31, 2007, the Company s average cost of funds was 2.80% and the Company s average cost of deposits (excluding all borrowings) was 2.60%.

The Company has been an active real estate lender, with commercial mortgage and 1-4 family residential loans comprising 34.3% and 16.7% of the Company s total loans as of December 31, 2007, respectively. The Company also offers commercial loans, loans for automobiles and other consumer durables, home equity loans, debit cards, internet banking and other cash management services and automated telephone banking. By offering certificates of deposit, interest checking accounts, savings accounts and overdraft protection at competitive rates, the Company gives its depositors a full range of traditional deposit products.

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

Business Strategies

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

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

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

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Increase Loan Volume and Diversify Loan Portfolio. While maintaining its conservative approach to lending, the Company has emphasized both new and existing loan products, focusing on growing its construction, commercial mortgage and commercial loan portfolios. During the two-year period from December 31, 2005 to December 31, 2007, the Company s construction loans grew from $206.7 million to $683.2 million, or 230.6%, and represented 13.4% and 21.7% of the total portfolio, respectively. The Company s commercial and industrial loans grew from $222.8 million to $436.3 million, or 95.9%, and represented 14.4% and 13.9% of the total portfolio, respectively. Commercial mortgages increased from $566.4 million to $1.08 billion, or 89.9%, and represented 36.7% and 34.3% of the total portfolio, respectively, for the same period. In addition, the Company targets professional service firms, including legal and medical practices, for both loans secured by owner-occupied premises and personal loans to their principals.

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

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

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

Competition

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

Supervision and Regulation

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

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

The Company

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

Regulatory Restrictions on Dividends; Source of Strength. It is the policy of the Federal Reserve Board that bank holding companies should pay cash dividends on common stock only out of income available over the past year and only if prospective earnings retention is consistent with the organization s expected future needs and financial condition. The policy provides that bank holding companies should not maintain a level of cash dividends that undermines the bank holding company s ability to serve as a source of strength to its banking subsidiaries.

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

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

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

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

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

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

Safe and Sound Banking Practices. Bank holding companies are not permitted to engage in unsafe and unsound banking practices. The Federal Reserve Board s Regulation Y, for example, generally requires a holding company to give the Federal Reserve Board prior notice of any redemption or repurchase of its own equity securities, if the consideration to be paid, together with the consideration paid for any repurchases or redemptions in the preceding year, is equal to 10% or more of the company s consolidated net worth. The Federal Reserve Board may oppose the transaction if it believes that the transaction would constitute an unsafe or unsound practice or would violate any law or regulation. Depending upon the circumstances, the Federal Reserve Board could take the position that paying a dividend would constitute an unsafe or unsound banking practice.

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

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

Capital Adequacy Requirements. The Federal Reserve Board has adopted a system using risk-based capital guidelines to evaluate the capital adequacy of bank holding companies. Under the guidelines, specific categories of assets are assigned different risk weights, based generally on the perceived credit risk of the asset. These risk weights are multiplied by corresponding asset balances to determine a risk-weighted asset base. The guidelines require a minimum ratio of total capital to total tangible risk-weighted assets of 8.0% (of which at least 4.0% is required to consist of Tier 1 capital elements). Total capital is the sum of Tier 1 and Tier 2 capital. As of December 31, 2007, the Company s ratio of Tier 1 capital to total tangible risk-weighted assets was 13.13% and its ratio of total capital to total tangible risk-weighted assets was 14.11%. Tangible risk-weighted assets are calculated as total risk-weighted assets less intangible assets such as goodwill and core deposit intangibles.

In addition to the risk-based capital guidelines, the Federal Reserve Board uses a leverage ratio as an additional tool to evaluate the capital adequacy of bank holding companies. The leverage ratio is a company s Tier 1 capital divided by its average total tangible consolidated assets. Certain highly rated bank holding companies may maintain a minimum leverage ratio of 3.0%, but other bank holding companies are required to maintain a leverage ratio of 4.0%. As of December 31, 2007, the Company s leverage ratio was 8.09%.

The federal banking agencies risk-based and leverage ratios are minimum supervisory ratios generally applicable to banking organizations that meet certain specified criteria, assuming that they have the highest regulatory rating. Banking organizations not meeting these criteria are expected to operate with capital positions

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well above the minimum ratios. The federal bank regulatory agencies may set capital requirements for a particular banking organization that are higher than the minimum ratios when circumstances warrant. Federal Reserve Board guidelines also provide that banking organizations experiencing internal growth or making acquisitions will be expected to maintain strong capital positions substantially above the minimum supervisory levels, without significant reliance on intangible assets.

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

The aggregate liability of the holding company of an undercapitalized bank is limited to the lesser of 5% of the institution s assets at the time it became undercapitalized or the amount necessary to cause the institution to be adequately capitalized. The bank regulators have greater power in situations where an institution becomes significantly or critically undercapitalized or fails to submit a capital restoration plan. For example, a bank holding company controlling such an institution can be required to obtain prior Federal Reserve Board approval of proposed dividends, or might be required to consent to a consolidation or to divest the troubled institution or other affiliates.

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

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

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

The Bank

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

Equivalence to National Bank Powers. The Texas Constitution, as amended in 1986, provides that a Texas-chartered bank has the same rights and privileges that are or may be granted to national banks domiciled in

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

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

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

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

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

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

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

Restrictions on Distribution of Subsidiary Bank Dividends and Assets. Dividends paid by the Bank have provided a substantial part of the Company s operating funds and for the foreseeable future it is anticipated that dividends paid by the Bank to the Company will continue to be the Company s principal source of operating

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

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

Audit Reports. Insured institutions with total assets of $500 million or more must submit annual audit reports prepared by independent auditors to federal and state regulators. In some instances, the audit report of the institution s holding company can be used to satisfy this requirement. Auditors must receive examination reports, supervisory agreements and reports of enforcement actions. For institutions with total assets of $1 billion or more, financial statements prepared in accordance with generally accepted accounting principles, management s certifications concerning responsibility for the financial statements, internal controls and compliance with legal requirements designated by the FDIC, and an attestation by the auditor regarding the statements of management relating to the internal controls must be submitted. For institutions with total assets of more than $3 billion, independent auditors may be required to review quarterly financial statements. FDICIA requires that independent audit committees be formed, consisting of outside directors only. The committees of such institutions must include members with experience in banking or financial management, must have access to outside counsel, and must not include representatives of large customers.

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

The FDIC s risk-based capital guidelines generally require state banks to have a minimum ratio of Tier 1 capital to total tangible risk-weighted assets of 4.0% and a ratio of total capital to total tangible risk-weighted assets of 8.0%. The capital categories have the same definitions for the Bank as for the Company. As of December 31, 2007, the Bank s ratio of Tier 1 capital to total tangible risk-weighted assets was 12.70% and its ratio of total capital to total tangible risk-weighted assets was 13.68%.

The FDIC s leverage guidelines require state banks to maintain Tier 1 capital of no less than 4.0% of average total tangible assets, except in the case of certain highly rated banks for which the requirement is 3.0% of average total assets. The Texas Banking Department has issued a policy which generally requires state chartered banks to maintain a leverage ratio (defined in accordance with federal capital guidelines) of 5.0%. As of December 31, 2007, the Bank s ratio of Tier 1 capital to average total assets (leverage ratio) was 7.82%.

Corrective Measures for Capital Deficiencies. The federal banking regulators are required to take prompt corrective action with respect to capital-deficient institutions. Agency regulations define, for each capital category, the levels at which institutions are well-capitalized, adequately capitalized, under capitalized, significantly under capitalized and critically under capitalized. A well-capitalized bank has a total risk-based capital ratio of 10.0% or higher; a Tier 1 risk-based capital ratio of 6.0% or higher; a leverage ratio of 5.0%

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or higher; and is not subject to any written agreement, order or directive requiring it to maintain a specific capital level for any capital measure. An adequately capitalized bank has a total risk-based capital ratio of 8.0% or higher; a Tier 1 risk-based capital ratio of 4.0% or higher; a leverage ratio of 4.0% or higher (3.0% or higher if the bank was rated a composite 1 in its most recent examination report and is not experiencing significant growth); and does not meet the criteria for a well capitalized bank. A bank is under capitalized if it fails to meet any one of the ratios required to be adequately capitalized. The Bank is classified as well-capitalized for purposes of the FDIC s prompt corrective action regulations.

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

As an institution s capital decreases, the FDIC s enforcement powers become more severe. A significantly undercapitalized institution is subject to mandated capital raising activities, restrictions on interest rates paid and transactions with affiliates, removal of management and other restrictions. The FDIC has only very limited discretion in dealing with a critically undercapitalized institution and is virtually required to appoint a receiver or conservator.

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

Deposit Insurance Assessments. The Bank must pay assessments to the FDIC for deposit insurance protection. The FDIC maintains the DIF by designating a reserve ratio between a range of 1.15% to 1.50%. If the reserve ratio falls below 1.15%, the FDIC must adopt a restoration plan that provides that the DIF will return to 1.15% generally within 5 years. If the reserve ratio exceeds 1.35%, the FDIC must generally dividend to DIF members half of the amount above the amount necessary to maintain the DIF at 1.35%. The FDIC declares a 50% dividend when the reserve ratio reaches 1.35% and a 100% dividend when the reserve ratio reaches above 1.50%. The designated reserve ratio is currently set at 1.25%. The FDIC has the discretion to price deposit insurance according to the risk for all insured institutions regardless of the level of the reserve ratio.

The DIF reserve ratio is maintained by assessing depository institutions an insurance premium based upon statutory factors that include the balance of insured deposits as well as the degree of risk the institution poses to the insurance fund. Under a risk-based assessment system required by the FDICIA, FDIC-insured depository institutions pay quarterly insurance premiums at rates based on their risk classification. Institutions assigned to higher-risk classifications (that is, institutions that pose a greater risk of loss to their respective deposit insurance funds) pay assessments at higher rates than institutions that pose a lower risk. An institution s risk classification is assigned based on its capital levels and the level of supervisory concern the institution poses to regulators. An institution s risk assignment includes assignment to Risk Category I, II, III, or IV, and, within Risk Category I, assignment to an assessment rate or rates.

Assessment rates range from 5 to 7 basis points for Risk Category I institutions, 10 basis points for Risk Category II institutions, 28 basis points for Risk Category III institutions, and 43 basis points for Risk Category IV institutions. Institutions with $1 billion or more in assets have its assessment base determined using average daily balances, as opposed to utilizing quarter-end balances. Institutions with less than $1 billion in assets have the option of continuing to use quarter-end balances to determine their assessment bases. Assessments are paid quarterly by all institutions and are based upon the assessment base that an institution reports at the end of that quarter. Risk assessments remain in effect for future assessment periods until changed by the FDIC.

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

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

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

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

Anti-Money Laundering and Anti-Terrorism Legislation. Congress enacted the Bank Secrecy Act of 1970 (BSA) to require financial institutions, including the Company and the Bank, to maintain certain records and to report certain transactions to prevent such institutions from being used to hide money derived from criminal activity and tax evasion. The BSA establishes, among other things, (1) record keeping requirements to assist government enforcement agencies in tracing financial transactions and flow of funds; (2) reporting requirements for Suspicious Activity Reports and Currency Transaction Reports to assist government enforcement agencies in detecting patterns of criminal activity; (3) enforcement provisions authorizing criminal and civil penalties for illegal activities and violations of the BSA and its implementing regulations; and (4) safe harbor provisions that protect financial institutions from civil liability for their cooperative efforts.

Title III of the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (Patriot Act) enacted in October 2001 amended the BSA and incorporates anti-terrorist financing provisions into the requirements of the BSA and its implementing regulations. Among other things, the Patriot Act requires all financial institutions, including the Company and the Bank, to institute and maintain a risk-based anti-money laundering compliance program that (i) includes a customer identification program, (ii) provides for information sharing with law enforcement and between certain financial institutions by means of an exemption from the privacy provisions of the Gramm-Leach-Bliley Act, (iii) prohibits U.S. banks and broker-dealers from maintaining accounts with foreign shell banks, (iv) establishes due diligence and enhanced due diligence requirements for certain foreign correspondent banking and foreign private banking accounts and (v) imposes additional record keeping requirements for certain correspondent banking arrangements. The Patriot Act also grants broad authority to the Secretary of the Treasury to take actions to

combat money laundering, and federal bank regulators are required to evaluate the effectiveness of an applicant in combating money laundering in determining whether to approve any application submitted by a financial

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institution. The Company and the Bank have adopted policies, procedures and controls designed to comply with the BSA and the Patriot Act.

The Department of the Treasury s Office of Foreign Asset Control (OFAC) administers and enforces economic and trade sanctions against targeted foreign countries, entities and individuals based on U.S. foreign policy and national security goals. As a result, financial institutions, including the Company and the Bank, must scrutinize transactions to ensure that they do not represent obligations of, or ownership interests in, entities owned or controlled by sanctioned targets. In addition, the Company and the Bank restrict transactions with certain targeted countries except as permitted by OFAC.

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

Legislative Initiatives

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

Enforcement Powers of Federal and State Banking Agencies

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

Effect on Economic Environment

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

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

ITEM 1A. RISK FACTORS

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

Risks Associated with the Company s Business

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

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

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

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

- finding suitable markets for expansion;
- finding suitable candidates for acquisition;
- attracting funding to support additional growth;
- maintaining asset quality;
- attracting and retaining qualified management; and
- maintaining adequate regulatory capital.

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

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

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

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

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

The Company s dependence on loans secured by real estate subjects it to risks relating to fluctuations in the real estate market and related interest rates and legislation that could require additional capital and could adversely affect its financial condition, results of operations and cash flows.

Approximately 80% of the Company s total loans as of December 31, 2007 consisted of loans included in the real estate loan portfolio. The real estate collateral in each case provides an alternate source of repayment in the event of default by the borrower and may deteriorate in value during the time the credit is extended. A weakening of the real estate market in the Company s primary market areas could have an adverse effect on the demand for new loans, the ability of borrowers to repay outstanding loans, the value of real estate and other collateral securing the loans and the value of real estate owned by the Company. If real estate values decline, it is also more likely that the Company would be required to increase its allowance for credit losses, which could adversely affect its financial condition, results of operations and cash flows.

As of December 31, 2007, the Company had $683.2 million or 21.7% of total loans in construction and land development loans. Construction loans are subject to risks during the construction phase that are not present in standard residential real estate and commercial real estate loans. These risks include:

- the viability of the contractor;
- the contractor s ability to complete the project, to meet deadlines and time schedules and to stay within cost estimates; and
- concentrations of such loans with a single contractor and its affiliates.

Real estate construction loans also present risks of default in the event of declines in property values or volatility in the real estate market during the construction phase. If the Company is forced to foreclose on a project prior to completion, it may not be able to recover the entire unpaid portion of the loan, may be required to fund additional amounts to complete a project and may have to hold the property for an indeterminate amount of time. If any of these risks were to occur, it could adversely affect the Company s financial condition, results of operations and cash flows.

In December 2006, banking regulators issued guidance regarding high concentrations of commercial and real estate construction loans within bank loan portfolios. The guidance requires institutions that exceed certain levels of real estate lending to maintain higher capital ratios than institutions with lower concentrations if they do

not have appropriate risk management policies and practices in place. If there is any deterioration in the Company s commercial mortgage or construction and land development portfolios or if its regulators conclude that the Company has not implemented appropriate risk management policies and practices, it could adversely affect the Company s business and result in a requirement of increased capital levels, and such capital may not be available at that time.

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

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

The Company s profitability depends significantly on local economic conditions.

The Company s success depends primarily on the general economic conditions of the primary markets in Texas in which it operates. Unlike larger banks that are more geographically diversified, the Company provides banking and financial services to customers primarily in the greater Houston, Dallas and the central, north central, south central and southeast areas of Texas. The local economic conditions in these areas have a significant impact on the Company s commercial, real estate and construction and land development loans, the ability of its borrowers to repay their loans and the value of the collateral securing these loans. In addition, if the population or income growth in the Company s market areas is slower than projected, income levels, deposits and housing starts could be adversely affected and could result in a reduction of the Company s expansion, growth and profitability. If the Company s market areas experience a downturn or a recession for a prolonged period of time, the Company would likely experience significant increases in nonperforming loans, which could lead to operating losses, impaired liquidity and eroding capital. A significant decline in general economic conditions, caused by inflation, recession, acts of terrorism, outbreak of hostilities or other international or domestic calamities, unemployment or other factors could impact these local economic conditions and negatively affect the Company s financial results.

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

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

The Company maintains an allowance for credit losses in an attempt to cover credit losses inherent in its loan portfolio. Additional credit losses will likely occur in the future and may occur at a rate greater than the Company has experienced to date. In determining the size of the allowance, the Company relies on an analysis of

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its loan portfolio, its historical loss experience and its evaluation of general economic conditions. If the Company s assumptions prove to be incorrect or if it experiences significant loan losses, its current allowance may not be sufficient to cover actual loan losses and adjustments may be necessary to allow for different economic conditions or adverse developments in its loan portfolio. A material addition to the allowance could cause net income to decrease.

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

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

The Company targets its business development and marketing strategy primarily to serve the banking and financial services needs of small to medium-sized businesses. These small to medium-sized businesses generally have fewer financial resources in terms of capital or borrowing capacity than larger entities, may be more vulnerable to economic downturns, often need substantial additional capital to expand or compete and may experience significant volatility in operating results. Any one or more of these factors may impair the borrower s ability to repay a loan. In addition, the success of a small to medium-sized business often depends on the management talents and efforts of one or two persons or a small group of persons, and the death, disability or resignation of one or more of these persons could have a material adverse impact on the business and its ability to repay a loan. Economic downturns and other events that negatively impact the Company s market areas could cause the Company to incur substantial credit losses that could negatively affect the Company s results of operations, financial condition and cash flows may be negatively affected.

An interruption in or breach in security of the Company s information systems may result in a loss of customer business and have an adverse affect on the Company s results of operations, financial condition and cash flows.

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

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

The financial services industry is undergoing rapid technological changes with frequent introductions of new technology driven products and services. In addition to better serving customers, the effective use of technology increases efficiency and enables financial institutions to reduce costs. The Company s future success depends in part upon its ability to address the needs of its customers by using technology to provide products and services that will satisfy customer demands for convenience as well as create additional efficiencies in its operations. Many of the Company s competitors have substantially greater resources to invest in technological improvements. The Company may not be able to effectively implement new technology driven products and services or be successful in marketing these products and services to its customers, which may negatively affect the Company s results of operations, financial condition and cash flows.

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

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

Risks Associated with the Company s Common Stock

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

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

- a board of directors classified into three classes of directors with the directors, of each class having staggered, three year terms;
- a provision that any special meeting of the Company s shareholders may be called only by the chairman of the board and chief executive officer, the president, a majority of the board of directors or the holders of at least 50% of the Company s shares entitled to vote at the meeting;
- a provision establishing certain advance notice procedures for nomination of candidates for election as directors and for shareholder proposals to be considered at an annual or special meeting of shareholders; and
- a provision that denies shareholders the right to amend the Company s bylaws.

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

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

As of December 31, 2007, the Company had $112.9 million in junior subordinated debentures outstanding that were issued to the Company s unconsolidated subsidiary trusts. The subsidiary trusts purchased the junior subordinated debentures from the Company using the proceeds from the sale of trust preferred securities to third party investors. Payments of the principal and interest on the trust preferred securities are conditionally

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guaranteed by the Company to the extent not paid or made by each trust, provided the trust has funds available for such obligations.

The junior subordinated debentures are senior to the Company s shares of Common Stock. As a result, the Company must make interest payments on the junior subordinated debentures (and the related trust preferred securities) before any dividends can be paid on its Common Stock and, in the event of the Company s bankruptcy, dissolution or liquidation, the holders of the debentures must be satisfied before any distributions can be made to the holders of the Common Stock. Additionally, the Company has the right to defer periodic distributions on the junior subordinated debentures (and the related trust preferred securities) for up to five years, during which time the Company would be prohibited from paying dividends on its Common Stock. The Company s ability to pay the future distributions depends upon the earnings of the Bank and dividends from the Bank to the Company, which may be inadequate to service the obligations.

ITEM 1B. UNRESOLVED STAFF COMMENTS

None.

ITEM 2. PROPERTIES

As of December 31, 2007, the Company conducted business at one hundred twenty-four (124) full-service banking centers and one (1) loan production office. The Company s headquarters are located at Prosperity Bank Plaza, 4295 San Felipe, in the Galleria area in Houston, Texas. The Company owns all of the buildings in which its banking centers are located other than those listed below. The expiration dates of the leases range from 2008 to 2015 and do not include renewal periods which may be available at the Company s option.

The following table sets forth specific information regarding the banking centers located in each of the Company s geographical market areas at December 31, 2007:

Geographical Area	Number of Banking Centers	Number of Leased Banking Centers	Deposits at December 31, 2007 (Dollars in thousands)
Houston CMSA	40	15	$ 2,058,916
South Texas area including Corpus Christi	33	5	1,314,824
Dallas/Fort Worth Texas area	26	6	845,622
Central Texas area	23	4	700,031
East Texas area	2		47,014
Total	124	30	$ 4,966,407

ITEM 3. LEGAL PROCEEDINGS

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

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

No matters were submitted to a vote of the Company s security holders during the fourth quarter of 2007.

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PART II.

ITEM 5. MARKET FOR REGISTRANT S COMMON EQUITY, RELATED SHAREHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

Common Stock Market Prices

The Company s Common Stock is listed on the NASDAQ Global Select Market under the symbol PRSP. As of February 26, 2008, there were 44,195,710 shares outstanding and 2,197 shareholders of record. The number of beneficial owners is unknown to the Company at this time.

The following table presents the high and low intra-day sales prices for the Common Stock as reported by NASDAQ during the two years ended December 31, 2007:

2007	High	Low
Fourth Quarter	$ 35.07	$ 28.18
Third Quarter	36.00	27.70
Second Quarter	35.91	32.63
First Quarter	37.11	32.18

2006	High	Low
Fourth Quarter	$ 35.38	$ 32.54
Third Quarter	36.16	31.64
Second Quarter	33.90	29.65
First Quarter	30.54	28.50

Dividends

Holders of Common Stock are entitled to receive dividends when, as and if declared by the Company s Board of Directors out of funds legally available therefor. While the Company has declared dividends on its Common Stock since 1994, and paid quarterly dividends aggregating $0.4625 per share in 2007 and $0.4125 share in 2006, there is no assurance that the Company will continue to pay dividends in the future. Future dividends on the Common Stock will depend upon the Company s earnings and financial condition, liquidity and capital requirements, the general economic and regulatory climate, the Company s ability to service any equity or debt obligations senior to the Common Stock and other factors deemed relevant by the board of directors of the Company.

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

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

	2007	2006
Fourth quarter	$ 0.1250	$ 0.1125
Third quarter	0.1125	0.1000
Second quarter	0.1125	0.1000
First quarter	0.1125	0.1000

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Recent Sales of Unregistered Securities

None.

Securities Authorized for Issuance under Equity Compensation Plans

As of December 31, 2007, the Company had outstanding stock options granted under three stock option plans, all of which were approved by the Company s shareholders. As of such date, the Company also had outstanding stock options granted under stock option plans that it assumed in connection with various acquisition transactions. The following table provides information as of December 31, 2007 regarding the Company s equity compensation plans under which the Company s equity securities are authorized for issuance:

Plan category	Number of securities to be issued upon exercise of outstanding options, warrants and rights (a)	Weighted-average exercise price of outstanding options, warrants and rights (b)	Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a)) (c)
Equity compensation plans approved by security holders	1,088,161(1)	$ 23.26	1,103,214
Equity compensation plans not approved by security holders			
Total	1,088,161	$ 23.26	1,103,214

(1) Includes (a) 4,240 shares which may be issued upon exercise of options outstanding assumed by the Company in connection with the acquisition of Paradigm Bancorporation, Inc. at a weighted average exercise price of $11.50, (b) 31,127 shares which may be issued upon exercise of options outstanding assumed by the Company in connection with the acquisition of MainBancorp, Inc. at a weighted average exercise price of $16.26, (c) 103,962 shares which may be issued upon exercise of options outstanding assumed by the Company in connection with the acquisition of First Capital Bankers, Inc. at a weighted average exercise price of $18.34 (d) 34,977 shares which may be issued upon exercise of options outstanding assumed by the Company in connection with the acquisition of SNB Bancshares, Inc. at a weighted average exercise price of $13.72 and (e) 50,730 shares which may be issued upon exercise of options outstanding assumed by the Company in connection with the acquisition Texas United Bancshares, Inc. at a weighted average exercise price of $15.36.

Purchases of Equity Securities by the Issuer and Affiliated Purchasers

None.

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Performance Graph

The following Performance Graph compares the cumulative total shareholder return on the Company s Common Stock for the period beginning at the close of trading on December 31, 2002 to December 31, 2007, with the cumulative total return of the S&P 500 Total Return Index and the Nasdaq Bank Index for the same period. Dividend reinvestment has been assumed. The Performance Graph assumes $100 invested on December 31, 2002 in the Company s Common Stock, the S&P 500 Total Return Index and the Nasdaq Bank Index. The historical stock price performance for the Company s Common Stock shown on the graph below is not necessarily indicative of future stock performance.

Comparison of 5 year Cumulative Total Return

Prosperity Bancshares, Inc., the S&P 500 Index

and the Nasdaq Bank Index

	12/31/02	12/31/03	12/31/04	12/31/05	12/31/06	12/31/07
Prosperity Bancshares, Inc.	**$ 100.00**	**$ 120.66**	**$ 157.54**	**$ 156.91**	**$ 190.81**	**$ 164.81**
S&P 500	**100.00**	**128.68**	**142.69**	**149.70**	**173.34**	**182.87**
NASDAQ Bank	**100.00**	**130.51**	**144.96**	**141.92**	**159.42**	**125.80**

www.researchdatagroup.com/S&P.htm

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ITEM 6. SELECTED CONSOLIDATED FINANCIAL DATA

The following selected consolidated financial data of the Company for, and as of the end of, each of the years in the five-year period ended December 31, 2007 is derived from and should be read in conjunction with the Company s consolidated financial statements and the notes thereto appearing elsewhere in this Annual Report on Form 10-K.

	As of and for the Years Ended December 31,				
	2007[1]	2006	2005	2004	2003
	(Dollars in thousands, except per share data)				
Income Statement Data:					
Interest income	$ 340,608	$ 231,739	$ 162,123	$ 111,756	$ 90,845
Interest expense	140,173	93,594	51,226	29,789	26,346
Net interest income	200,435	138,145	110,897	81,967	64,499
Provision for credit losses	760	504	480	880	483
Net interest income after provision for credit losses	199,675	137,641	110,417	81,087	64,016
Noninterest income	52,923	33,982	30,021	23,071	16,966
Noninterest expense	126,843	77,669	68,957	51,707	42,021
Income before taxes	125,755	93,954	71,481	52,451	38,961
Provision for income taxes	41,604	32,229	23,621	17,744	12,413
Net income	$ 84,151(2)	$ 61,725	$ 47,860	$ 34,707	$ 26,548
Per Share Data:					
Basic earnings per share	$ 1.96(2)	$ 1.96	$ 1.79	$ 1.61	$ 1.38
Diluted earnings per share	1.94(2)	1.94	1.77	1.59	1.36
Book value per share	25.54	20.26	16.69	12.32	10.49
Cash dividends declared.	0.46	0.41	0.35	0.31	0.25
Dividend payout ratio	24.15%	21.10%	20.11%	19.22%	18.29%
Weighted average shares outstanding (basic) (in thousands).	42,928	31,491	26,706	21,534	19,225
Weighted average shares outstanding (diluted) (in thousands).	43,310	31,893	27,024	21,804	19,536
Shares outstanding at end of period (in thousands).	44,151	32,793	27,821	22,381	20,930
Balance Sheet Data (at period end):					
Total assets	$ 6,372,343	$ 4,586,769	$ 3,585,982	$ 2,697,228	$ 2,400,487
Securities	1,857,606	1,590,303	1,572,602	1,302,792	1,376,880
Loans	3,142,971	2,176,507	1,542,125	1,035,513	770,053
Allowance for credit losses	32,543	23,990	17,203	13,105	10,345
Total goodwill and intangibles	799,978	447,371	284,425	164,672	124,755
Total deposits	4,966,407	3,725,678	2,920,318	2,317,076	2,083,748
Borrowings and notes payable.	116,047	73,633	102,389	38,174	30,936
Junior subordinated debentures	112,885(3)	100,519	75,775	47,424	59,804
Total shareholders equity	1,127,431	664,411	464,717	275,647	219,588
Average Balance Sheet Data:					
Total assets	$ 6,094,064	$ 4,283,795	$ 3,361,617	$ 2,543,088	$ 2,006,869
Securities	1,849,613	1,612,221	1,471,067	1,383,790	1,108,153
Loans	3,092,797	2,037,379	1,435,376	871,736	697,235
Allowance for credit losses	34,705	22,476	16,334	11,454	9,525

Total goodwill and intangibles	759,733	406,920	253,703	139,405	81,485
Total deposits	4,727,519	3,449,100	2,791,813	2,189,695	1,749,045
Junior subordinated debentures	124,613	92,271	69,869	59,288	39,400
Total shareholders equity	1,039,955	602,712	413,864	243,274	170,167

(Table continued on next page)

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	As of and for the Years Ended December 31,				
	2007[1]	2006	2005	2004	2003
	(Dollars in thousands, except per share data)				
Performance Ratios:					
Return on average assets	1.38%[4]	1.44%	1.42%	1.36%	1.32%
Return on average equity	8.09[4]	10.24	11.56	14.27	15.60
Net interest margin (tax equivalent)	4.06	3.80	3.81	3.63	3.64
Efficiency ratio[5]	46.29	45.29	48.93	49.45	51.82
Asset Quality Ratios[6]:					
Nonperforming assets to total loans and other real estate.	0.49%	0.05%	0.09%	0.17%	0.13%
Net charge-offs to average loans	0.18	0.04	0.03	0.06	0.23
Allowance for credit losses to total loans.	1.04	1.10	1.12	1. 27	1.34
Allowance for credit losses to nonperforming loans[7]	634.7	2,530.6	1,505.1	949.6	1,519.1
Capital Ratios[6]:					
Leverage ratio	8.09%	7.76%	7.83%	6.30%	7.10%
Average shareholders equity to average total assets	17.07	14.07	12.31	9.57	8.48
Tier 1 risk-based capital ratio.	13.13	13.52	15.34	13.56	15.82
Total risk-based capital ratio	14.11	14.55	16.37	14.67	16.90

(1) The Company completed the acquisition of Texas United Bancshares, Inc. on January 31, 2007 and The Bank of Navasota, N.A. on September 1, 2007.

(2) Includes a $10.0 million pre-tax, or $6.5 million after-tax, impairment charge on write-down of securities, which resulted in a decrease of basic and diluted earnings per share of $0.15 for the year ended December 31, 2007.

(3) Consists of $15.5 million of junior subordinated debentures of Prosperity Statutory Trust II due July 31, 2031, $12.9 million of junior subordinated debentures of Prosperity Statutory Trust III due September 17, 2033, $12.9 million of junior subordinated debentures of Prosperity Statutory Trust IV due December 30, 2033, $10.3 million of junior subordinated debentures of SNB Statutory Trust II due March 26, 2033 (assumed by the Company on April 1, 2006), $10.3 million of junior subordinated debentures of SNB Capital Trust III due March 27, 2033 (assumed by the Company on April 1, 2006), $10.3 million of junior subordinated debentures of SNB Capital Trust IV due September 25, 2033 (assumed by the Company on April 1, 2006), $7.2 million of junior subordinated debentures of TXUI Statutory Trust I due September 7, 2030 (assumed by the Company on January 31, 2007), $5.2 million of junior subordinated debentures of TXUI Statutory Trust II due December 19, 2033 (assumed by the Company on January 3l, 2007), $16.0 million of junior subordinated debentures of TXUI Statutory Trust III due December 15, 2035 (assumed by the Company on January 3l, 2007) and $12.3 million of junior subordinated debentures of TXUI Statutory Trust IV due June 30, 2036 (assumed by the Company on January 3l, 2007).

(4) Includes a $10.0 million pre-tax, or $6.5 million after-tax, impairment charge on write-down of securities, which resulted in a decrease of return on average assets of 11 basis points and a decrease of return on average equity of 63 basis points for the year ended December 31, 2007.

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

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

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

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ITEM 7. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Special Cautionary Notice Regarding Forward-Looking Statements

Statements and financial discussion and analysis contained in this annual report on Form 10-K that are not statements of historical fact constitute forward-looking statements made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. These forward-looking statements are based on assumptions and involve a number of risks and uncertainties, many of which are beyond the Company s control. Many possible events or factors could affect the future financial results and performance of the Company and could cause such results or performance to differ materially from those expressed in the forward-looking statements. These possible events or factors include, but are not limited to:

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

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

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

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

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

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

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

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

- a determination 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;

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

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

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

A forward-looking statement may include a statement of the assumptions or bases underlying the forward-looking statement. The Company believes it has chosen these assumptions or bases in good faith and that they are reasonable. However, the Company cautions you that assumptions or bases almost always vary from actual results, and the differences between assumptions or bases and actual results can be material. Therefore, the Company cautions you not to place undue reliance on its forward-looking statements. The forward-looking statements are made as of the date the statement is made. The Company undertakes no obligation to publicly update or otherwise revise any forward-looking statements, whether as a result of new information, future events or otherwise.

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

For the Years Ended December 31, 2007, 2006 and 2005

Overview

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

Three principal components of the Company s growth strategy are internal growth, stringent cost control practices and strategic merger transactions. The Company focuses on continual internal growth. Each banking center is operated as a separate profit center, maintaining separate data with respect to its net interest income, efficiency ratio, deposit growth, loan growth and overall profitability. Banking center presidents and managers are accountable for performance in these areas and compensated accordingly. The Company also focuses on maintaining stringent cost control practices and policies. The Company has invested significantly in the infrastructure required to centralize many of its critical operations, such as data processing and loan processing. Management believes that this centralized infrastructure can accommodate substantial additional growth while enabling the Company to minimize operational costs through certain economies of scale. The Company also intends to continue to seek expansion opportunities. During 2005, twenty-seven (27) banking centers were acquired in the acquisition of First Capital Bankers, Inc. (the First Capital acquisition) on March 1, 2005, two of which was subsequently closed and consolidated into existing banking centers of the Company. Two (2) additional banking centers were acquired in the acquisition of Grapeland Bancshares, Inc. (the Grapeland acquisition) on December 1, 2005. On April 1, 2006, the Company acquired SNB Bancshares, Inc. (the SNB Bancshares acquisition) which added five (5) banking centers. At the time of acquisition, SNB had an additional banking office under construction in Katy, Texas, which became a full-service banking center of the Company upon completion in July 2006. During 2007, forty-one (41) banking centers were acquired in the acquisition of Texas United Bancshares, Inc. (the TXUI acquisition). The acquisition of The Bank of Navasota, N.A. (the Navasota acquisition) was completed on September 1, 2007 and added one (1) banking center.

Net income was $84.2 million, $61.7 million and $47.9 million for the years ended December 31, 2007, 2006 and 2005, respectively, and diluted earnings per share were $1.94, $1.94 and $1.77, respectively, for these same periods. Net income growth during both 2007 and 2006 resulted principally from an increase in loan volume and acquisitions, including the TXUI acquisition in January 2007 and the SNB acquisition in April 2006. Net income growth during 2005 also resulted principally from an increase in loan volume and acquisitions, including the First Capital acquisition. The Company posted returns on average assets of 1.38%, 1.44% and 1.42% and returns on average equity of 8.09%, 10.24% and 11.56% for the years ended December 31, 2007,

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2006 and 2005, respectively. The Company s efficiency ratio was 46.29% in 2007, 45.29% in 2006 and 48.93% in 2005. The efficiency ratio is calculated by dividing total noninterest expense (excluding credit loss provisions) by net interest income plus noninterest income (excluding net gains and losses on the sale of securities and assets and impairment write-down on securities). Additionally, taxes are not part of this calculation.

The Company recognized an other-than-temporary impairment charge of $10.0 million pre-tax ($6.5 million after tax) on Federal Home Loan Mortgage Corporation (FHLMC or Freddie Mac) and on Federal National Mortgage Association (FNMA or Fannie Mae) government sponsored, investment grade perpetual callable preferred securities. The other-than-temporary-impairment charge was recorded on six perpetual preferred stock issues classified as available for sale investment securities with a total book value (prior to recognition of the impairment charge) of $24.0 million. The Company reclassified the unrealized mark-to-market loss on these investment grade securities to an other-than-temporary impairment charge because of the recent significant decline in the market value of these securities and because management believes it is unlikely that these securities will recover their original book value within a reasonable amount of time. Both FHLMC and FNMA securities were investment grade at the time of purchase and remain investment grade with ratings of AA- by S&P and Aa3 by Moody s. The securities continue to perform according to their contractual terms and all dividend payments are current. Market value decreases on available for sale securities which are not other-than-temporary are recorded as an unrealized mark-to-market loss and reflected as a reduction to shareholders equity through other comprehensive income. Accordingly, the reclassification of the unrealized after tax loss to an other-than-temporary impairment non-cash charge did not affect shareholders equity or tangible shareholders equity.

Total assets at December 31, 2007 and 2006 were $6.372 billion and $4.587 billion, respectively. Total deposits at December 31, 2007 and 2006 were $4.966 billion and $3.726 billion, respectively. Total loans were $3.143 billion at December 31, 2007, an increase of $966.5 million or 44.4% compared with $2.177 billion at December 31, 2006. At December 31, 2007, the Company had $5.1 million in nonperforming loans and its allowance for credit losses was $32.5 million compared with $948,000 in nonperforming loans and an allowance for credit losses of $24.0 million at December 31, 2006. Shareholders equity was $1.127 billion and $664.4 million at December 31, 2007 and 2006, respectively.

Subsequent Events

Acquisition of Branches of Banco Popular North America

On January 10, 2008, the Company completed its acquisition of six (6) Houston retail branches from Banco Popular North America. In connection with the acquisition, the Company assumed approximately $125.0 million in deposits. Since January 11, 2008, all six (6) locations have been operating as full service banking centers of Prosperity Bank.

Acquisition of 1st Choice Bancorp, Inc.

On February 7, 2008, the Company announced the signing of a definitive agreement to acquire 1st Choice Bancorp, Inc and its wholly- owned subsidiary, 1st Choice Bank. 1st Choice Bancorp operates two (2) banking offices in Houston, Texas, with one location in South Houston and another in the Heights area. Prosperity s Heights banking center will be consolidated with the 1st Choice Bancorp Heights location, with the resulting banking center being located in 1st Choice s Heights banking office. As of December 31, 2007, 1st Choice Bancorp had, on a consolidated basis, total assets of $303.1 million, loans of $190.7 million and deposits of $273.3 million. Under the terms of the definitive agreement, Prosperity will issue approximately 1,757,813 shares of Prosperity common stock plus approximately $18,750,000 in cash for all outstanding shares of 1st Choice Bancorp capital stock, subject to decrease in the event 1st Choice Bancorp s equity capital is less than $26.0 million.

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Critical Accounting Policies

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

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

Goodwill and Intangible Assets Goodwill and intangible assets that have indefinite useful lives are subject to an impairment test at least annually and more frequently if circumstances indicate their value may not be recoverable. Goodwill is tested for impairment using a two-step process that begins with an estimation of the fair value of each of the Company s reporting units compared with its carrying value. If the carrying amount exceeds the fair value of a reporting unit, a second test is completed comparing the implied fair value of the reporting unit s goodwill to its carrying value to measure the amount of impairment. Intangible assets that are not amortized will be tested for impairment at least annually by comparing the fair values of those assets to their carrying values. Other identifiable intangible assets that are subject to amortization are amortized on an accelerated basis over the years expected to be benefited, which the Company believes is between eight and ten years. These amortizable intangible assets are reviewed for impairment if circumstances indicate their value may not be recoverable based on a comparison of fair value to carrying value. Based on the Company s annual goodwill impairment test as of September 30, 2007, management does not believe any of its goodwill is impaired as of December 31, 2007. While the Company believes no impairment existed at December 31, 2007 under accounting standards applicable at that date, different conditions or assumptions, or changes in cash flows or profitability, if significantly negative or unfavorable, could have a material adverse effect on the outcome of the Company s impairment evaluation and financial condition or future results of operations.

Stock-Based Compensation The Company adopted the provisions of SFAS No. 123R *Share-Based Payment (Revised 2004)*, on January 1, 2006 and its adoption did not have a material impact on the Company s financial statements. The Company had previously adopted SFAS No. 123 on January 1, 2003. Among other things, SFAS No. 123R eliminates the ability to account for stock-based compensation using the intrinsic value based method of accounting and requires that such transactions be recognized as compensation expense in the income statement based on their fair values on the date of the grant. SFAS No. 123R requires that management make assumptions including stock price volatility and employee turnover that are utilized to measure compensation expense. The fair value of stock options granted is estimated at the date of grant using the Black-Scholes option-pricing model. This model requires the input of subjective assumptions.

Valuation of Securities The Company s available for sale securities portfolio is reported at fair value. When the fair value of a security is below its amortized cost, and depending on the length of time the condition

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exists and the extent the fair value is below amortized cost, additional analysis is performed to determine whether an impairment exists. Available for sale and held to maturity securities are analyzed quarterly for possible other-than-temporary impairment. The analysis considers the financial condition and near-term prospects of the issuer, as well as the value of any security we may have in the investment. Often, the information available to conduct these assessments is limited and rapidly changing, making estimates of fair value subject to judgment. If actual information or conditions are different than estimated, the extent of the impairment of the security may be different than previously estimated, which could have a material effect on the Company s results of operations and financial condition.

Results of Operations

Net Interest Income

The Company s operating results depend primarily on its net interest income, which is the difference between interest income on interest-earning assets, including securities and loans, and interest expense incurred on interest-bearing liabilities, including deposits and other borrowed funds. Interest rate fluctuations, as well as changes in the amount and type of earning assets and liabilities, combine to affect net interest income. The Company s net interest income is affected by changes in the amount and mix of interest-earning assets and interest-bearing liabilities, referred to as a volume change. It is also affected by changes in yields earned on interest-earning assets and rates paid on interest-bearing deposits and other borrowed funds, referred to as a rate change.

2007 versus 2006. Net interest income before the provision for credit losses for the year ended December 31, 2007 was $200.4 million compared with $138.1 million for the year ended December 31, 2006, an increase of $62.3 million or 45.1%. The improvement in net interest income for 2007 was principally due to a $1.332 billion or 36.2% increase in average interest-earning assets to $5.014 billion at December 31, 2007 compared with $3.682 billion at December 31 2006. The increase in average interest-earning assets was primarily due to the TXUI acquisition. The improvement in net interest income for 2007 was also partially due to an increase in the yield on interest-earning assets. The rate paid on interest-bearing liabilities increased 37 basis points from 3.26% for the year ended December 31, 2006 to 3.63% for the year ended December 31, 2007 and total yield on interest-earning assets increased 50 basis points from 6.29% at December 31, 2006 to 6.79% at December 31, 2007. At December 31, 2007, period end demand deposits represented an important component of funding sources and was 23.5% of total period end deposits compared with 22.4% at December 31, 2006.

Net interest margin on a tax equivalent basis, defined as net interest income divided by average interest-earning assets, for 2007 was 4.06%, up 26 basis points from 3.80% for 2006. The increase was primarily due to the TXUI acquisition.

2006 versus 2005. Net interest income before the provision for credit losses for the year ended December 31, 2006 was $138.1 million compared with $110.9 million for the year ended December 31, 2005, an increase of $27.2 million or 24.6%. The improvement in net interest income for 2006 was principally due to a $732.8 million or 24.8% increase in average interest-earning assets to $3.682 billion at December 31, 2006 from $2.949 billion at December 31 2005. The increase in average interest-earning assets was primarily due to the SNB acquisition. The improvement in net interest income for 2006 was also partially due to an increase in the yield on interest-earning assets. The rate paid on interest-bearing liabilities increased 105 basis points from 2.21% for the year ended December 31, 2005 to 3.26% for the year ended December 31, 2006 and total yield on interest-earning assets increased 79 basis points from 5.50% at December 31, 2005 to 6.29% at December 31, 2006. At December 31, 2006, period end demand deposits represented an important component of funding sources and was 22.4% of total period end deposits compared with 23.1% at December 31, 2005.

Net interest margin on a tax equivalent basis for 2006 was 3.80%, down 1 basis point from 3.81% for 2005.

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

	Years Ended December 31, 2007			2006			2005		
	Average Outstanding Balance	Interest Earned/ Paid	Average Yield/ Rate	Average Outstanding Balance	Interest Earned/ Paid	Average Yield/ Rate	Average Outstanding Balance	Interest Earned/ Paid	Average Yield/ Rate
	(Dollars in thousands)								
Assets									
Interest-earning assets:									
Loans	$ 3,092,797	$ 247,600	8.01%	$ 2,037,379	$ 157,426	7.73%	$ 1,435,376	$ 99,958	6.96%
Securities(1)	1,849,613	89,467	4.84	1,612,221	72,632	4.51	1,471,067	60,866	4.14
Federal funds sold and other temporary investments	71,462	3,541	4.96	32,522	1,681	5.17	42,859	1,299	3.03
Total interest-earning assets.	5,013,872	340,608	6.79%	3,682,122	231,739	6.29%	2,949,302	162,123	5.50%
Less allowance for credit losses	(34,705)			(22,476)			(16,334)		
Total interest-earning assets, net of allowance.	4,979,167			3,659,646			2,932,968		
Noninterest-earning assets	1,114,897			624,149			428,649		
Total assets	$ 6,094,064			$ 4,283,795			$ 3,361,617		
Liabilities and shareholders equity									
Interest-bearing liabilities:									
Interest-bearing demand deposits	$ 829,757	$ 16,313	1.97%	$ 602,946	$ 11,440	1.90%	$ 477,199	$ 4,666	0.98%
Savings and money market accounts.	1,205,584	35,089	2.91	897,667	23,539	2.62	696,237	10,683	1.53
Certificates of deposit.	1,549,064	71,280	4.60	1,165,056	45,963	3.95	1,009,147	28,294	2.80
Junior subordinated debentures	124,613	10,058	8.07	92,271	7,592	8.23	69,869	4,895	7.00
Securities sold under repurchase agreements	71,165	3,026	4.25	45,488	1,820	4.00	29,850	768	2.57
Other borrowings	83,478	4,407	5.28	64,052	3,240	5.06	40,794	1,920	4.71
Total interest-bearing liabilities	3,863,661	140,173	3.63%	2,867,480	93,594	3.26%	2,323,096	51,226	2.21%
Noninterest-bearing liabilities:									
Noninterest-bearing demand deposits	1,143,114			783,431			609,230		
Other liabilities.	47,334			30,172			15,427		
Total liabilities.	5,054,109			3,681,083			2,947,753		
Shareholders equity	1,039,955			602,712			413,864		
Total liabilities and shareholders equity.	$ 6,094,064			$ 4,283,795			$ 3,361,617		
Net interest rate spread			3.16%			3.03%			3.29%
Net interest income and margin(2)		$ 200,435	4.00%		$ 138,145	3.75%		$ 110,897	3.76%

Net interest income and margin (tax-equivalent basis)[3]	$ 203,554	4.06%	$ 139,961	3.80%	$ 112,262	3.81%

(1) Yield is based on amortized cost and does not include any component of unrealized gains or losses.
(2) The net interest margin is equal to net interest income divided by average interest-earning assets.
(3) In order to make pretax income and resultant yields on tax-exempt investments and loans comparable to those on taxable investments and loans, a tax-equivalent adjustment has been computed using a federal income tax rate of 35% for the years ended December 31, 2007, 2006 and 2005 and other applicable effective tax rates.

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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.

	Years Ended December 31,					
	2007 vs. 2006			2006 vs. 2005		
	Increase (Decrease) Due to Change in			Increase (Decrease) Due to Change in		
	Volume	Rate	Total	Volume	Rate	Total
	(Dollars in thousands)					
Interest-earning assets:						
Loans	$ 81,551	$ 8,623	$ 90,174	$ 41,923	$ 15,545	$ 57,468
Securities	10,695	6,140	16,835	5,840	5,926	11,766
Federal funds sold and other temporary investments	2,013	(153)	1,860	(313)	695	382
Total increase in interest income	94,259	14,610	108,869	47,450	22,166	69,616
Interest-bearing liabilities:						
Interest-bearing demand deposits	4,303	570	4,873	1,230	5,544	6,774
Savings and money market accounts.	8,074	3,476	11,550	3,091	9,765	12,856
Certificates of deposit	15,150	10,167	25,317	4,371	13,298	17,669
Junior subordinated debentures	2,661	(195)	2,466	1,569	1,128	2,697
Securities sold under repurchase agreements	1,027	179	1,206	402	650	1,052
Other borrowings	983	184	1,167	1,095	225	1,320
Total increase in interest expense	32,198	14,381	46,579	11,758	30,610	42,368
Increase (decrease) in net interest income	$ 62,061	$ 229	$ 62,290	$ 35,692	$ (8,444)	$ 27,248

Provision for Credit Losses

The Company s provision for credit losses is established through charges to income in the form of the provision in order to bring the Company s allowance for credit losses to a level deemed appropriate by management based on the factors discussed under Financial Condition Allowance for Credit Losses. The allowance for credit losses at December 31, 2007 was $32.5 million, representing 1.04% of outstanding loans as of such date. The provision for credit losses for the year ended December 31, 2007 was $760,000 compared with $504,000 for the year ended December 31, 2006. Net charge-offs for the year ended December 31, 2007 were $5.6 million compared with $771,000 in net charge-offs for the year ended December 31, 2006. The increased charge-offs were mainly due to the TXUI acquisition. The provision for credit losses for the year ended December 31, 2006 was $504,000 compared with $480,000 for the year ended December 31, 2005. Net charge-offs for the year ended December 31, 2005 were $410,000.

Noninterest Income

The Company s primary sources of recurring noninterest income are service charges on deposit accounts and other banking service related fees. Noninterest income does not include loan origination fees which are recognized over the life of the related loan as an adjustment to yield using the interest method. Banking related service fees include check cashing fees, official check fees, safe deposit box rent and currency handling fees. For the year ended December 31, 2007, noninterest income totaled $52.9 million, an increase of $18.9 million or 55.7% compared with $34.0 million in 2006. The increase was primarily due to an increase in insufficient funds

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charges and customer service charges which resulted from an increase in the number of accounts due to the TXUI acquisition completed in January 2007 and the Navasota acquisition completed in September 2007. As of December 31, 2007, the two acquisitions added approximately 88,000 deposit accounts and over 35,000 debit cards. Noninterest income for 2006 was $34.0 million, an increase of $4.0 million or 13.2% compared with $30.0 million in 2005, resulting largely from an increase in service charges due to the additional deposit accounts from the SNB acquisition completed in April 2006 and the First Capital acquisition in March 2005.

Trust and investment income increased $994,000 to $1.2 million for the year ended December 31, 2007 compared with $208,000 for the year ended December 31, 2006. The increase was primarily due to the addition of a trust and investment department acquired in February 2007 in conjunction with the TXUI acquisition. The trust department of TXUI was dissolved in 2007.

Income from leased assets increased $248,000 from $1.1 million for the year ended December 31, 2006 to $1.3 million for the year ended December 31, 2007. Additional leased assets were acquired in the TXUI acquisition. The expiration dates of the leased assets range from 2009 to 2011 and the related depreciation expense for the leased assets was $1.0 million and $756,000 for the years ended December 31, 2007 and 2006, respectively. Income from Bank Owned Life Insurance (BOLI) increased $1.4 million from $500,000 for the year ended December 31, 2006 to $1.9 million for the year ended December 31, 2007. Additional bank owned life insurance was acquired in the TXUI acquisition.

The $1.3 million gain on held for sale loans for the year ended December 31, 2007 resulted from the sale of mortgage loans. The loans were originated for the purpose of sale into the secondary market in connection with mortgage banking activities acquired in the TXUI acquisition. The Company does not intend to continue to originate loans for sale into the secondary market, and does not expect to have significant gains from this activity going forward.

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

	Years Ended December 31,		
	2007	2006	2005
	(Dollars in thousands)		
Service charges on deposit accounts.	$ 40,937	$ 27,379	$ 24,985
Banking related service fees	1,737	1,358	1,133
Brokered mortgage income	679	839	695
Trust and investment income	1,202	208	274
Income from leased assets	1,323	1,075	895
Bank Owned Life Insurance income (BOLI)	1,893	500	397
Gains on sales of assets (net)	819(1)	622(2)	72(3)
Net gain (loss) on sale of securities	86		(79)
Gain on held for sale loans	1,334		173
Other noninterest income	2,913	2,001	1,476
Total noninterest income.	$ 52,923	$ 33,982	$ 30,021

(1) Includes gains on the sale of various other real estate properties of $546,000 and gains on the sale of real estate in Crockett, Texas.
(2) Includes gains on the sale of real estate in Beeville, Palacios, Red Oak and Victoria, Texas.
(3) Includes gains on the sale of TIB-The Independent BankersBank stock acquired in various acquisitions and a gain on the sale of real property acquired in the Paradigm acquisition.

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Noninterest Expense

For the year ended December 31, 2007, noninterest expense totaled $126.8 million, an increase of $49.2 million or 63.3% compared with $77.7 million for the same period in 2006. This increase was principally due to increases in salaries and employee benefits, net occupancy, depreciation costs, and core deposit intangibles amortization primarily as a result of the TXUI acquisition and the $10.0 million impairment write-down on Fannie Mae and Freddie Mac preferred stock discussed further under Securities, . For the year ended December 31, 2006, noninterest expense totaled $77.7 million, an increase of $8.7 million or 12.6% compared with $69.0 million for the same period in 2005. The increase was primarily attributable to the additional general operating costs associated with the acquisition completed in 2006 and the full year effect of the acquisitions completed in 2005. These items and other changes in the various components of noninterest expense are discussed in more detail below.

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

	Years Ended December 31,		
	2007	2006	2005
	(Dollars in thousands)		
Salaries and employee benefits	$ 63,910	$ 41,298	$ 36,672
Non-staff expenses:			
Net occupancy expense	10,534	7,884	6,663
Depreciation expense	7,611	5,048	4,462
Data processing	4,570	3,612	2,837
Regulatory assessments and FDIC insurance	1,035	716	548
Ad valorem and franchise taxes	2,462	2,246	1,594
Core deposit intangibles amortization	9,917	4,869	3,912
Communications expense[(1)]	6,351	4,339	3,782
Impairment write-down on securities	9,975		
Other	10,478	7,657	8,487
Total noninterest expense[(2)]	$ 126,843	$ 77,669	$ 68,957

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

(2) Total noninterest expense includes $2.0 million, $850,000 and $751,000 in 2007, 2006 and 2005 respectively, in stock-based compensation expense.

Salaries and Employee Benefits. Salaries and employee benefits increased $22.6 million to $63.9 million at December 31, 2007 compared with $41.3 million at December 31, 2006 primarily due to increased staff added with the TXUI acquisition in January 2007. The number of associates employed by the Company increased from 908 at December 31, 2006 to 1,359 at December 31, 2007. Salaries and employee benefits increased $4.6 million from $36.7 million at December 31, 2005 to $41.3 million at December 31, 2006 primarily due to increased staff added with the SNB acquisition. The number of associates employed by the Company increased from 859 at December 31, 2005 to 908 at December 31, 2006. In accordance with the Company s adoption of SFAS 123R, total noninterest expense for the year ended December 31, 2007 includes $2.0 million in stock-based compensation expense compared with $850,000 and $751,000 recorded for the years ended December 31, 2006 and 2005, respectively.

Net Occupancy and Depreciation Expenses. Net occupancy expense increased $2.7 million or 33.6% to $10.5 million for the year ended December 31, 2007 compared with $7.9 million for the year ended December 31, 2006. Depreciation expense increased $2.6 million to $7.6 million compared with $5.0 million for the same periods. These increases were primarily attributable to the addition of forty-two (42) banking centers. Net occupancy expense increased $1.2 million or 18.3% to $7.9 million for the year ended December 31, 2006 compared with $6.7 million for the year ended December 31, 2005. Depreciation expense increased $586,000 to

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$5.0 million compared with $4.5 million for the same periods. These increases were primarily attributable to the additional banking centers acquired in 2005 and 2006.

Communications Expense. Communications expense includes telephone, data circuits, postage and courier expenses. Communications expense increased $2.0 million or 46.4% from $4.3 million for the year ended December 31, 2006 to $6.4 million for the year ended December 31, 2007. The increase was primarily associated with the TXUI acquisition. Communications expense was $4.3 million for the year ended December 31, 2006 compared with $3.8 million for the same period in 2005, an increase of $557,000 or 14.7%. The increase was primarily associated with the addition of six banking centers in 2006.

Core Deposit Intangibles Amortization. Core deposit intangibles amortization increased $5.0 million or 103.7% from $4.9 million for the year December 31, 2006 to $9.9 million for the year ended December 31, 2007. The increase was associated with the addition of $31.0 million in core deposit intangible assets related to the TXUI acquisition and $2.0 million in core deposit intangible assets related to the Navasota acquisition. Core deposit intangibles amortization was $4.9 million for the year ended December 31, 2006 compared with $3.9 million for the same period in 2005, an increase of $1.0 million or 24.5%. The increase was associated with the addition of $5.7 million in core deposit intangible assets related to the SNB acquisition. Core deposit intangibles are being amortized on an accelerated basis over an estimated life of eight to ten years.

Other Noninterest Expense. Other operating expenses increased $2.8 million or 36.8% from $7.7 million at December 31, 2006 to $10.5 million for the year ended December 31, 2007. The increase was primarily attributable to the additional general expenses incurred due to the TXUI acquisition. Other operating expenses of $7.7 million for the year ended December 31, 2006 represented a decrease of $830,000 or 9.8% compared with $8.5 million in 2005. The decrease was primarily attributable to a decrease in advertising expense which is a component of other expenses

Efficiency Ratio. The efficiency ratio is a supplemental financial measure utilized in management s internal evaluation of the Company and is not defined under generally accepted accounting principles. The efficiency ratio is calculated by dividing total noninterest expense, excluding credit loss provisions and impairment write-down on available for sale securities, by net interest income plus noninterest income, excluding net gains and losses on the sale of securities and on the sale of assets. Taxes are not part of this calculation. An increase in the efficiency ratio indicates that more resources are being utilized to generate the same volume of income, while a decrease would indicate a more efficient allocation of resources. The Company s efficiency ratio was 46.29% at December 31, 2007, an increase from 45.29% at December 31, 2006. The Company s efficiency ratio was 48.93% at December 31, 2005.

Income Taxes

The amount of federal income tax expense is influenced by the amount of taxable income, the amount of tax-exempt income, the amount of nondeductible interest expense and the amount of other nondeductible expenses. For the year ended December 31, 2007, income tax expense was $41.6 million compared with $32.2 million for the year ended December 31, 2006 and $23.6 million for the year ended December 31, 2005. The increases were primarily attributable to higher pretax net earnings which resulted from an increase in net interest income for the year ended December 31, 2007 compared with the same period in 2006 and 2005. The effective tax rate for the years ended December 31, 2007, 2006 and 2005 was 33.1%, 34.3% and 33.0%, respectively. The effective income tax rates differed from the U.S. statutory rate of 35% during the comparable periods primarily due to the effect of tax-exempt income from loans and securities.

Impact of Inflation

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

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

Financial Condition

Loan Portfolio

At December 31, 2007, total loans were $3.143 billion, an increase of $966.5 million or 44.4% compared with $2.177 billion at December 31, 2006. The growth in loans was primarily attributable to the TXUI and Navasota acquisitions. At December 31, 2007, total loans at the banking centers acquired in 2007 totaled $987.6 million. At December 31, 2007, total loans were 63.3% of deposits and 49.3% of total assets. At December 31, 2006, total loans were 58.4% of deposits and 47.5% of total assets. Loans increased 41.1% during 2006 from $1.542 billion at December 31, 2005 to $2.177 billion at December 31, 2006. The growth in loans was primarily attributable to internal growth and the SNB acquisition.

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

	December 31,									
	2007		2006		2005		2004		2003	
	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent
	(Dollars in thousands)									
Commercial and industrial	$ 436,338	13.9%	$ 280,957	12.9%	$ 222,773	14.4%	$ 144,432	13.9%	$ 93,989	12.2%
Real estate:										
Construction and land development	683,171	21.7	433,178	19.9	206,653	13.4	100,591	10.6	36,470	4.7
1-4 family residential	526,338	16.7	376,996	17.3	313,184	20.3	260,453	25.2	237,055	30.8
Home equity	93,877	3.0	63,427	2.9	58,729	3.8	34,453	3.3	27,943	3.6
Commercial mortgages	1,075,285	34.3	803,145	36.9	566,356	36.7	369,151	35.6	260,882	33.9
Farmland	63,873	2.0	30,925	1.4	30,920	2.0	22,240	2.1	15,247	2.0
Multifamily residential	73,424	2.3	77,980	3.6	32,039	2.1	18,187	1.9	20,679	2.7
Agriculture	50,146	1.6	26,504	1.2	25,429	1.6	21,906	2.1	20,693	2.7
Consumer (net of unearned discount).	123,213	3.9	66,675	3.1	65,183	4.3	52,854	5.1	54,821	7.1
Other	17,306	0.6	16,720	0.8	20,859	1.4	2,246	0.2	2,274	0.3
Total loans[(1)].	$ 3,142,971	100.0%	$ 2,176,507	100.0%	$ 1,542,125	100.0%	$ 1,035,513	100.0%	$ 770,053	100.0%

(1) Includes loans held for sale.

The Company is focused on growing its construction and land development, commercial mortgage and commercial and industrial loan portfolios. The Company s construction and land development loans grew from $433.2 million at December 31, 2006 to $683.2 million at December 31, 2007, an increase of $250.0 million or 57.7%. The Company s commercial mortgages grew from $803.1 million at December 31, 2006 to $1.075 billion at December 31, 2007, an increase of $272.1 million or 33.9%. The Company s commercial and industrial loans grew from $281.0 million at December 31, 2006 to $436.3 million at December 31, 2007, an increase of $155.4 million or 55.3%. The Company offers a variety of commercial lending products including term loans and lines of credit. The Company offers a broad range of short to medium-term commercial loans, primarily collateralized, to businesses for working capital (including inventory and receivables), business expansion (including acquisitions of real estate and improvements) and the purchase of equipment and machinery. Historically, the

Company has originated loans for its own account and has not securitized its loans. The purpose of a particular loan generally determines its structure. All loans in the 1-4 family residential category were originated by the Company.

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

Commercial and Industrial Loans. In nearly all cases, the Company s commercial loans are made in the Company s market areas and are underwritten on the basis of the borrower s ability to service the debt from income. As a general practice, the Company takes as collateral a lien on any available real estate, equipment or other assets owned by the borrower and obtains a personal guaranty of the borrower or principal. Working capital loans are primarily collateralized by short-term assets whereas term loans are primarily collateralized by long-term assets. In general, commercial loans involve more credit risk than residential mortgage loans and commercial mortgage loans and, therefore, usually yield a higher return. The increased risk in commercial loans is due to the type of collateral securing these loans. The increased risk also derives from the expectation that commercial loans generally will be serviced principally from the operations of the business, and those operations may not be successful. Historical trends have shown these types of loans to have higher delinquencies than mortgage loans. As a result of these additional complexities, variables and risks, commercial loans require more thorough underwriting and servicing than other types of loans.

Commercial Mortgages. The Company makes commercial mortgage loans collateralized by real estate to finance the purchase of real estate. The Company s commercial mortgage loans are collateralized by first liens on real estate, typically have variable interest rates and amortize over a ten to 15 year period. Payments on loans secured by such properties are often dependent on the successful operation or management of the properties. Accordingly, repayment of these loans may be subject to adverse conditions in the real estate market or the economy to a greater extent than other types of loans. The Company seeks to minimize these risks in a variety of ways, including giving careful consideration to the property s operating history, future operating projections, current and projected occupancy, location and physical condition in connection with underwriting these loans. The underwriting analysis also includes credit verification, appraisals and a review of the financial condition of the borrower.

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

Construction Loans. The Company makes loans to finance the construction of residential and, to a limited extent, nonresidential properties. Construction loans generally are collateralized by first liens on real estate and have floating interest rates. The Company conducts periodic inspections, either directly or through an agent, prior to approval of periodic draws on these loans. Underwriting guidelines similar to those described above are also used in the Company s construction lending activities. Construction loans involve additional risks attributable to the fact that loan funds are advanced upon the security of a project under construction, and the project is of uncertain value prior to its completion. Because of uncertainties inherent in estimating construction costs, the market value of the completed project and the effects of governmental regulation on real property, it can be difficult to accurately evaluate the total funds required to complete a project and the related loan to value ratio.

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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.

Agriculture Loans. The Company provides agriculture loans for short-term crop production, including rice, cotton, milo and corn, farm equipment financing and agriculture real estate financing. The Company evaluates agriculture borrowers primarily based on their historical profitability, level of experience in their particular agriculture industry, overall financial capacity and the availability of secondary collateral to withstand economic and natural variations common to the industry. Because agriculture loans present a higher level of risk associated with events caused by nature, the Company routinely makes on-site visits and inspections in order to monitor and identify such risks.

Consumer Loans. Consumer loans made by the Company include direct A -credit automobile loans, recreational vehicle loans, boat loans, home improvement loans, home equity loans, personal loans (collateralized and uncollateralized) and deposit account collateralized loans. The terms of these loans typically range from 12 to 120 months and vary based upon the nature of collateral and size of loan. 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 contractual maturity ranges of the 1-4 family residential, home equity, commercial and industrial, commercial mortgage, construction and land development and agriculture portfolios and the amount of such loans with predetermined interest rates and floating rates in each maturity range as of December 31, 2007 are summarized in the following table:

	December 31, 2007			
	One Year or Less	After One Through Five Years	After Five Years	Total
	(Dollars in thousands)			
1-4 family residential and home equity	$ 26,630	$ 68,787	$ 524,798	$ 620,215
Commercial and industrial	213,140	156,637	66,561	436,338
Commercial mortgages	90,294	219,227	765,76	1,075,285
Construction and land development	343,650	112,981	226,540	683,171
Agriculture	28,249	19,365	2,532	50,146
Total	$ 701,963	$ 576,997	$ 1,586,195	$ 2,865,155
Loans with a predetermined interest rate.	$ 198,895	$ 348,879	$ 572,302	$ 1,120,076
Loans with a floating interest rate.	503,068	228,118	1,013,893	1,745,079
Total	$ 701,693	$ 576,997	$ 1,586,195	$ 2,865,155

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Nonperforming Assets

The Company has several procedures in place to assist it in maintaining the overall quality of its loan portfolio. The Company has established underwriting guidelines to be followed by its officers and the Company also monitors its delinquency levels for any negative or adverse trends. There can be no assurance, however, that the Company s loan portfolio will not become subject to increasing pressures from deteriorating borrower credit due to general economic conditions.

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

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.

The Company s conservative lending approach has resulted in strong asset quality. The Company had $15.4 million in nonperforming assets at December 31, 2007 compared with $1.1 million at December 31, 2006 and $1.4 million at December 31, 2005. The nonperforming assets at December 31, 2007 consisted of ninety-two (92) separate credits or ORE properties, of which 54 credits were related to loans acquired in the Company s 2007 acquisitions. If interest on nonaccrual loans had been accrued under the original loan terms, approximately $47,000, $30,000 and $35,000 would have been recorded as income for the years ended December 31, 2007, 2006 and 2005, respectively.

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

	December 31,				
	2007	2006	2005	2004	2003
	(Dollars in thousands)				
Nonaccrual loans.	$ 1,035	$ 181	$ 355	$ 297	$ 2
Restructured loans.					
Accruing loans 90 or more days past due	4,092	767	788	1,083	679
Total nonperforming loans	5,127	948	1,143	1,380	681
Repossessed assets	56	32	26		40
Other real estate	10,207	140	239	341	246
Total nonperforming assets	$ 15,390	$ 1,120	$ 1,408	$ 1,721	$ 967
Nonperforming assets to total loans and other real estate	0.49%	0.05%	0.09%	0.17%	0.13%
Nonperforming assets to average earning assets	0.31%	0.03%	0.05%	0.07%	0.05%

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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:

	Years Ended December 31,				
	2007	2006	2005	2004	2003
	(Dollars in thousands)				
Average loans outstanding	$ 3,092,797	$ 2,037,379	$ 1,435,376	$ 871,739	$ 697,235
Gross loans outstanding at end of period.	$ 3,142,971	$ 2,176,507	$ 1,542,125	$ 1,035,513	$ 770,053
Allowance for credit losses at beginning of period	$ 23,990	$ 17,203	$ 13,105	$ 10,345	$ 9,580
Balance acquired with acquisitions	13,386	7,054	4,028	2,365	1,900
Provision for credit losses	760	504	480	880	483
Charge-offs:					
Commercial and industrial	(1,045)	(353)	(410)	(139)	(810)
Real estate and agriculture	(4,143)	(128)	(242)	(613)	(960)
Consumer.	(2,974)	(696)	(240)	(198)	(471)
Recoveries:					
Commercial and industrial	1,175	95	188	239	159
Real estate and agriculture	208	59	184	65	198
Consumer.	1,186	252	110	161	266
Net charge-offs	(5,593)	(771)	(410)	(485)	(1,618)
Allowance for credit losses at end of period.	$ 32,543	$ 23,990	$ 17,203	$ 13,105	$ 10,345
Ratio of allowance to end of period loans	1.04%	1.10%	1.12%	1.27%	1.34%
Ratio of net charge-offs to average loans	0.18	0.04	0.03	0.06	0.23
Ratio of allowance to end of period nonperforming loans	634.7	2,530.6	1,505.1	949.6	1,519.1

The allowance for credit losses is a valuation established through charges to earnings in the form of a provision for credit losses. Management has established an allowance for credit losses which it believes is adequate for estimated losses in the Company s loan portfolio. Based on an evaluation of the loan portfolio, management presents a quarterly review of the allowance for credit losses to the Bank s Board of Directors, indicating any change in the allowance since the last review and any recommendations as to adjustments in the allowance. In making its evaluation, management considers factors such as historical loan loss experience, industry diversification of the Company s commercial loan portfolio, the amount of nonperforming assets and related collateral, the volume, growth and composition of the Company s loan portfolio, current economic changes that may affect the borrower s ability to pay and the value of collateral, the evaluation of the Company s loan portfolio through its internal loan review process and other relevant factors. Charge-offs occur when loans are deemed to be uncollectible.

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

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

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

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

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- for construction and land development loans, the perceived feasibility of the project including the ability to sell developed lots or improvements constructed for resale or ability to lease property constructed for lease, the quality and nature of contracts for presale or preleasing, if any, experience and ability of the developer and loan to value ratio;

- for commercial and industrial loans, the operating results of the commercial, industrial or professional enterprise, the borrower s business, professional and financial ability and expertise, the specific risks and volatility of income and operating results typical for businesses in that category and the value, nature and marketability of collateral; and

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

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

The Company follows a loan review program to evaluate the credit risk in the loan portfolio. Through the loan review process, the Company maintains an internal list of impaired loans which, along with the delinquency list of loans, helps management assess the overall quality of the loan portfolio and the adequacy of the allowance for credit losses. For each impaired loan, the Company allocates a specific loan loss reserve primarily based on the value of the collateral securing the impaired loan in accordance with Statement of Financial Accounting Standards (SFAS) No. 114, Accounting by Creditors for Impairment of a Loan, as amended.

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

At December 31, 2007, the allowance for credit losses totaled $32.5 million, or 1.04% of total loans. At December 31, 2006, the allowance aggregated $24.0 million or 1.10% of total loans and at December 31, 2005, the allowance was $17.2 million or 1.12% of total loans.

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The following tables describe the allocation of the allowance for credit losses among various categories of loans and certain other information as of the dates indicated. The allocation is made for analytical purposes and is not necessarily indicative of the categories in which future losses may occur. The total allowance is available to absorb losses from any loan category.

	December 31, 2007		2006[(1)]	
	Amount	Percent of Loans to Total Loans	Amount	Percent of Loans to Total Loans
	(Dollars in thousands)			
Balance of allowance for credit losses applicable to:				
Commercial and industrial	$ 4,790	13.9%	$ 3,660	12.9%
Real estate	22,505	80.0	18,140	82.0
Agriculture	506	1.6	131	1.2
Consumer and other.	2,153	4.5	732	3.9
Unallocated[(1)]	2,589		1,327	
Total allowance for credit losses.	$ 32,543	100.0%	$ 23,990	100.0%

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

	December 31, 2005		2004		2003	
	Amount	Percent of Loans to Total Loans	Amount	Percent of Loans to Total Loans	Amount	Percent of Loans to Total Loans
	(Dollars in thousands)					
Balance of allowance for credit losses applicable to:						
Commercial and industrial	$ 636	14.4%	$ 274	13.9%	$ 253	12.2%
Real estate	923	78.3	503	78.7	957	77.7
Agriculture	28	1.6	12	2.1	35	2.7
Consumer and other.	53	5.7	26	5.3	34	7.4
Unallocated	15,563		12,290		9,066	
Total allowance for credit losses	$ 17,203	100.0%	$ 13,105	100.0%	$ 10,345	100.0%

The Company believes that the allowance for credit losses at December 31, 2007 is adequate to cover losses inherent 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 December 31, 2007.

Securities

The Company uses its securities portfolio as a source of income, as a source of liquidity for cash requirements and to manage interest rate risk. At December 31, 2007, investment securities totaled $1.857 billion, an increase of $267.3 million or 16.8% compared with $1.590 billion at December 31, 2006. The increase in securities was primarily due to the TXUI acquisition. Securities increased to $1.590 billion at December 31, 2006 from $1.573 billion at December 31, 2005, an increase of $17.8 million or 1.1%. At December 31, 2007, securities represented 29.1% of total assets compared with 34.7% of total assets at December 31, 2006.

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

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

	December 31,				
	2007	2006	2005	2004	2003
	(Dollars in thousands)				
U.S. Treasury securities and obligations of U.S. government agencies.	$ 229,119	$ 402,328	$ 296,349	$ 30,726	$ 48,762
70% non-taxable preferred stock	14,025	24,000	24,000	24,000	44,015
States and political subdivisions	87,517	44,378	31,250	37,698	45,738
Corporate debt securities	3,215	6,218	8,550	10,491	15,619
Collateralized mortgage obligations	223,952	276,629	222,615	238,994	178,487
Mortgage-backed securities	1,282,338	829,195	987,088	957,354	1,032,861
Qualified Zone Academy Bond (QZAB)	8,000	8,000	8,000	8,000	8,000
Other	7,260	4,093	814	296	283
Total	$ 1,855,426	$ 1,594,841	$ 1,578,666	$ 1,307,559	$ 1,373,765

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The following table summarizes the contractual maturity of securities and their weighted average yields as of December 31, 2007. The contractual maturity of a mortgage backed security is the date at which the last underlying mortgage matures. Available-for-sale securities are shown at fair value and held-to-maturity securities are shown at amortized cost. Other securities are included in the corporate debt securities category. For purposes of the table below, tax-exempt states and political subdivisions are calculated on a tax equivalent basis. The QZAB bond is not calculated on a tax equivalent basis and it generates a tax credit of 7.18%, which is included in gross income.

	December 31, 2007									
	Within One Year		After One Year but Within Five Years		After Five Years but Within Ten Years		After Ten Years		Total	
	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield	Total	Yield
	(Dollars in thousands)									
U.S. Treasury securities and obligations of U.S. government agencies	$ 55,558	4.46%	$ 146,096	5.45%	$ 6,094	5.27%	$ 21,384	5.72%	$ 229,132	5.23%
70% non-taxable preferred stock							14,025	4.75	14,025	4.75
States and political subdivisions.	4,788	5.37	7,577	5.96	19,988	6.54	55,978	6.30	88,331	6.27
Corporate debt securities and other	7,260	4.39	254	5.03	3,014	7.63			10,528	2.21
Collateralized mortgage obligations.	156	4.31	1,822	4.80	110,196	4.64	111,740	4.58	223,914	4.61
Mortgage-backed securities	1,720	5.49	58,960	4.54	418,785	4.51	804,211	5.33	1,283,676	5.03
Qualified Zone Academy Bond (QZAB)			8,000	2.00					8,000	2.00
Total	$ 69,482	4.08%	$ 222,709	5.21%	$ 558,077	4.63%	$ 1,007,338	5.30%	$ 1,857,606	5.03%

The contractual maturity of mortgage-backed securities and collateralized mortgage obligations is not a reliable indicator of their expected life because borrowers have the right to prepay their obligations at any time. Mortgage-backed securities monthly pay downs cause the average lives of the securities to be much different than their stated lives. The weighted average life of the Company s complete portfolio is 4.1 years with an effective duration of 3.2 years at December 31, 2007. The 70% non-taxable preferred stock includes investments in FNMA (Fannie Mae) and FHLMC (Freddie Mac) preferred stock.

At December 31, 2007 and 2006, 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.

The average yield of the securities portfolio was 4.84% in 2007 compared with 4.51% in 2006 and 4.14% in 2005. The 33 basis point increase in 2007 was primarily due to the Company reinvesting funds at higher rates in 2007 compared to 2006. The overall growth in the securities portfolio over the comparable periods was primarily funded by deposit growth and securities acquired in acquisitions.

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

	December 31,				
	2007	2006	2005	2004	2003
	(Dollars in thousands)				
Available-for-sale	$ 260,444	$ 434,331	$ 410,361	$ 177,683	$ 263,648
Held-to-maturity	1,597,162	1,155,972	1,162,241	1,125,109	1,113,232
Total	$ 1,857,606	$ 1,590,303	$ 1,572,602	$ 1,302,792	$ 1,376,880

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The following tables present the amortized cost and fair value of securities classified as available-for-sale at December 31, 2007, 2006 and 2005:

	December 31, 2007				December 31, 2006			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
	(Dollars in thousands)				(Dollars in thousands)			
U.S. Treasury securities and obligations of U.S. government agencies.	$ 3,986	$ 15	$ 2	$ 3,999	$ 290,629	$	$ 794	$ 289,835
70% non-taxable preferred stock	14,025			14,025	24,000		3,795	20,205
States and political subdivisions.	51,119	962	148	51,933	14,098	604		14,702
Collateralized mortgage obligations	1,890		38	1,852	5,352	12	36	5,328
Mortgage-backed securities	170,269	1,614	276	171,607	90,986	172	729	90,429
Qualified Zone Academy Bond (QZAB)	8,000			8,000	8,000			8,000
Other	8,975	53		9,028	5,804	28		5,832
Total.	$ 258,264	$ 2,644	$ 464	$ 260,444	$ 438,869	$ 816	$ 5,354	$ 434,331

	December 31, 2005			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
	(Dollars in thousands)			
U.S. Treasury securities and obligations of U.S. government agencies.	$ 231,399	$ 430	$ 1,752	$ 230,077
70% non-taxable preferred stock	24,000		5,334	18,666
States and political subdivisions	14,102	1,005		15,107
Collateralized mortgage obligations	8,096	45	34	8,107
Mortgage-backed securities.	130,014	277	701	129,590
Qualified Zone Academy Bond (QZAB)	8,000			8,000
Other	814			814
Total.	$ 416,425	$ 1,757	$ 7,821	$ 410,361

The following tables present the amortized cost and fair value of securities classified as held-to-maturity at December 31, 2007, 2006 and 2005:

	December 31, 2007				December 31, 2006			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
	(Dollars in thousands)				(Dollars in thousands)			
U.S. Treasury securities and obligations of U.S. government agencies.	$ 225,133	$ 1,572	$ 28	$ 226,677	$ 111,699	$ 405	$ 588	$ 111,516
States and political subdivisions	36,398	286	304	36,380	30,280	255	53	30,482
Corporate debt securities	1,500	14		1,514	4,507	6	10	4,503
Collateralized mortgage obligations.	222,062	744	1,914	220,892	271,277	337	5,260	266,354
Mortgage-backed securities	1,112,069	6,603	6,537	1,112,135	738,209	616	20,584	718,241
Total	$ 1,597,162	$ 9,219	$ 8,783	$ 1,597,598	$ 1,155,972	$ 1,619	$ 26,495	$ 1,131,096

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	December 31, 2005			
		Gross	Gross	
	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
	(Dollars in thousands)			
U.S. Treasury securities and obligations of U.S. government agencies.	$ 64,950	$ 409	$ 564	$ 64,795
States and political subdivisions	17,148	173	31	17,290
Corporate debt securities	8,550	108	3	8,655
Collateralized mortgage obligations	214,519	313	5805	209,027
Mortgage-backed securities.	857,074	721	21,868	835,927
Total	$ 1,162,241	$ 1,724	$ 28,271	$ 1,135,694

As part of its regular quarterly review for impairment of marketable securities, the Company recognized an other-than-temporary impairment charge of $10.0 million pre-tax on Fannie Mae and Freddie Mac government sponsored, investment grade perpetual callable preferred securities as of December 31, 2007. The other-than-temporary-impairment charge was recorded on six perpetual preferred stock issues classified as available for sale investment securities, which are included in the tables above as 70% non-taxable preferred stock, with a total book value of $24.0 million prior to recognition of the impairment charge and $14.0 million after the charge. The Company reclassified the unrealized mark-to-market loss on these investment grade securities to an other-than-temporary impairment charge because of the recent significant decline in the market value of these securities and because management believes it is unlikely that these securities will recover their original book value within a reasonable amount of time. Both Fannie Mae and Freddie Mac securities were investment grade at the time of purchase and remain investment grade with ratings of AA- by S&P and Aa3 by Moody s. The securities continue to perform according to their contractual terms and all dividend payments are current.

Management believes that the unrealized losses in the Company s securities portfolio at December 31, 2007 were primarily due to interest rate increases. Because the decline in market value of such securities was primarily attributable to changes in interest rates and not credit quality, and because the Company has the ability and intent to hold such securities until a recovery of fair value, which may be at maturity, the Company does not consider such securities to be other-than-temporarily impaired at December 31, 2007.

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

Unlike U.S. Treasury and U.S. government agency securities, which have a lump sum payment at maturity, mortgage-backed securities provide cash flows from regular principal and interest payments and principal prepayments throughout the lives of the securities. Mortgage-backed securities which are purchased at a premium will generally suffer decreasing net yields as interest rates drop because home owners tend to refinance their mortgages. Thus, the premium paid must be amortized over a shorter period. Therefore, these securities purchased at a discount will obtain higher net yields in a decreasing interest rate environment. As interest rates rise, the opposite will generally be true. During a period of increasing interest rates, fixed rate mortgage-backed securities do not tend to experience heavy prepayments of principal and consequently, the average life of this security will be lengthened. If interest rates begin to fall, prepayments will increase, thereby shortening the estimated life of this security. At December 31, 2007, 62.6% of the mortgage-backed securities held by the Company had contractual final maturities of more than ten years with a weighted average life of 3.81 years.

Collateralized mortgage obligations (CMOs) are bonds that are backed by pools of mortgages. The pools can be Ginnie Mae, Fannie Mae or Freddie Mac pools or they can be private-label pools. CMOs are designed so

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

Deposits

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

Total deposits at December 31, 2007 were $4.97 billion, an increase of $1.24 billion or 33.3% compared with $3.73 billion at December 31, 2006. The increase was primarily attributable to the TXUI and Navasota acquisitions in 2007. As of December 31, 2007, the banking centers acquired in 2007 had approximately $1.22 billion in total deposits. Noninterest-bearing deposits were $1.17 million at December 31, 2007, an increase of $332.2 million or 39.7% compared with $835.9 million at December 31, 2006. Noninterest-bearing deposits at December 31, 2006 were $835.9 million compared with $674.4 million at December 31, 2005. Interest-bearing deposits at December 31, 2007 were $3.80 billion, up $908.5 million or 31.4% compared with $2.89 billion at December 31, 2006. Interest-bearing deposits at December 31, 2006 of $2.89 billion represented a $64.0 million increase compared with $2.25 billion at December 31, 2005. Total deposits at December 31, 2005 were $2.92 billion. There were no major concentrations of deposits at December 31, 2007, 2006 or 2005.

The daily average balances and weighted average rates paid on deposits for each of the years ended December 31, 2007, 2006 and 2005 are presented below:

	Years Ended December 31,					
	2007		2006		2005	
	Amount	Rate	Amount	Rate	Amount	Rate
	(Dollars in thousands)					
Interest-bearing checking	$ 829,757	1.97%	$ 602,946	1.90%	$ 477,199	0.98%
Regular savings	222,397	0.99	164,963	1.11	150,577	0.83
Money market savings	983,187	3.34	732,704	2.96	545,660	1.73
Time deposits	1,549,064	4.60	1,165,056	3.95	1,009,147	2.80
Total interest-bearing deposits	3,584,405	3.42	2,665,669	3.04	2,182,583	2.00
Noninterest-bearing deposits	1,143,114		783,431		609,230	
Total deposits	$ 4,727,519	2.60%	$ 3,449,100	2.35%	$ 2,791,813	1.56%

The Company s ratio of average noninterest-bearing deposits to average total deposits for the years ended December 31, 2007, 2006, and 2005 was 24.2%, 22.7%, and 21.8%, respectively.

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

	December 31, 2007 (Dollars in thousands)
Three months or less	$ 234,171
Over three through six months.	241,556
Over six through 12 months	215,930
Over 12 months	116,829
Total	$ 808,486

Other Borrowings

The Company utilizes borrowings to supplement deposits to fund its lending and investment activities. Borrowings consist of funds from the Federal Home Loan Bank (FHLB) and correspondent banks. FHLB advances are considered short-term, overnight borrowings. At December 31, 2007, the Company had no FHLB advances and $31.5 million in FHLB borrowings, all of which consisted of long-term FHLB notes payable compared with $26.4 million in FHLB borrowings at December 31, 2006, all of which consisted of long-term FHLB notes payable. The $5.1 million increase was primarily attributable to the TXUI acquisition. The weighted average interest rate paid on the FHLB notes payable at period end was 5.3%. The maturity dates on the FHLB notes payable range from the years 2008 to 2028 and have interest rates ranging from 3.08% to 6.26%. The highest outstanding balance of FHLB advances during 2007 was $240.0 million compared with $116.0 million during 2006. The Company had no federal funds purchased at December 31, 2007 or 2006.

At December 31, 2007, the Company had $84.6 million in securities sold under repurchase agreements compared with $47.2 million at December 31, 2006, an increase of $37.4 million or 79.1%. The increase was primarily attributable to normal customer activity and the TXUI acquisition.

The following table presents the Company s borrowings at December 31, 2007 and December 31, 2006:

	December 31, 2007	December 31, 2006
	(Dollars in thousands)	
FHLB advances	$	$
FHLB long-term notes payable	31,466	26,408
Total other borrowings	31,466	26,408
Federal funds purchased		
Securities sold under repurchase agreements	84,581	47,225
Total	$ 116,047	$ 73,633

At December 31, 2007 and 2006, the Company had outstanding $112.9 million and $100.5 million, respectively, in junior subordinated debentures issued to the Company s unconsolidated subsidiary trusts. The increase of $12.4 million was due to the Company s assumption on January 31, 2007 of $44.8 million in junior subordinated debentures issued by TXUI to its five subsidiary trusts, partially offset by the redemption of the debentures held by First Capital Statutory Trust I in the amount of $20.6 million on June 26, 2007, the redemption of the debentures held by Gateway Statutory Trust I in the amount of $4.1 million on June 26, 2007 and the redemption of the debentures held by First Capital Statutory Trust II in the amount $7.7 million on September 26, 2007. The debentures redeemed on June 26, 2007 bore interest at a floating rate of 3 month LIBOR + 3.60% and the debentures redeemed on September 26, 2007 bore interest at a floating rate of 3 month LIBOR + 3.40%. The trusts in turn redeemed in full the trust preferred securities and common securities they issued.

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A summary of pertinent information related to the Company s ten issues of junior subordinated debentures outstanding at December 31, 2007 is set forth in the table below:

Description	Issuance Date	Trust Preferred Securities Outstanding	Interest Rate[(1)]	Junior Subordinated Debt Owed to Trusts	Maturity Date[(2)]
Prosperity Statutory Trust II	July 31, 2001	$ 15,000,000	3-month LIBOR + 3.58%, not to exceed 12.50%	$ 15,464,000	July 31, 2031
Prosperity Statutory Trust III	Aug. 15, 2003	12,500,000	6.50%[(3)]	12,887,000	Sept. 17, 2033
Prosperity Statutory Trust IV	Dec. 30, 2003	12,500,000	6.50%[(4)]	12,887,000	Dec. 30, 2033
SNB Statutory Trust II[(5)]	Mar. 26, 2003	10,000,000	3-month LIBOR + 3.15%	10,310,000	Mar. 26, 2033
SNB Capital Trust III[(5)]	Mar. 27, 2003	10,000,000	3-month LIBOR + 3.15%	10,310,000	Mar. 27, 2033
SNB Capital Trust IV[(5)]	Sept. 25, 2003	10,000,000	3-month LIBOR + 3.00%	10,310,000	Sept. 25, 2033
TXUI Statutory Trust I[(6)]	Sept. 07, 2000	7,000,000	10.60%	7,210,000	Sept. 07, 2030
TXUI Statutory Trust II[(6)]	Dec. 19, 2003	5,000,000	6.45%[(7)]	5,155,000	Dec. 19, 2033
TXUI Statutory Trust III[(6)]	Nov. 30, 2005	15,500,000	3-month LIBOR + 1.39%	15,980,000	Dec. 15, 2035
TXUI Statutory Trust IV[(6)]	Mar. 31, 2006	12,000,000	3-month LIBOR + 1.39%	12,372,000	June 30, 2036

(1) The 3-month LIBOR in effect as of December 31, 2007 was 4.70%.
(2) All debentures are callable five years from issuance date except for TXUI Statutory Trust I which is callable ten years from issuance date.
(3) The debentures bear a fixed interest rate until September 17, 2008, when the rate begins to float on a quarterly basis based on the three-month LIBOR plus 3.00%.
(4) The debentures bear a fixed interest rate until December 30, 2008, when the rate begins to float on a quarterly basis based on the three-month LIBOR plus 2.85%.
(5) Assumed in connection with the SNB acquisition on April 1, 2006.
(6) Assumed in connection with the TXUI acquisition on January 31, 2007.
(7) The debentures bear a fixed interest rate until December 19, 2008, when the rate begins to float on a quarterly basis based on the three-month LIBOR plus 2.85%.

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

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

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Interest Rate Sensitivity and Market Risk

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

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

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

The Company s exposure to interest rate risk is managed by the Asset Liability Committee (ALCO), which is composed of senior officers of the Company, in accordance with policies approved by the Company s Board of Directors. The ALCO formulates strategies based on appropriate levels of interest rate risk. In determining the appropriate level of interest rate risk, the ALCO considers the impact on earnings and capital of the current outlook on interest rates, potential changes in interest rates, regional economies, liquidity, business strategies and other factors. The ALCO meets regularly to review, among other things, the sensitivity of assets and liabilities to interest rate changes, the book and market values of assets and liabilities, unrealized gains and losses, purchase and sale activities, commitments to originate loans and the maturities of investments and borrowings. Additionally, the ALCO reviews liquidity, cash flow flexibility, maturities of deposits and consumer and commercial deposit activity. Management uses two methodologies to manage interest rate risk: (1) an analysis of relationships between interest-earning assets and interest-bearing liabilities; and (2) an interest rate shock simulation model. The Company has traditionally managed its business to reduce its overall exposure to changes in interest rates.

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

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The following table sets forth the Company s interest rate sensitivity analysis at December 31, 2007:

	Volumes Subject to Repricing Within				
	0-30 days	31-180 days	181-365 days	Greater than one year	Total
			(Dollars in thousands)		
Interest-earning assets:					
Securities (excluding unrealized gain of $2,180)	$ 64,726	$ 207,520	$ 259,577	$ 1,323,603	$ 1,855,426
Loans	948,725	274,149	277,837	1,642,260	3,142,971
Federal funds sold and other temporary investments	192,843	200			193,043
Total interest-earning assets	$ 1,206,294	$ 481,869	$ 537,414	$ 2,965,863	$ 5,191,440
Interest-bearing liabilities:					
Demand, money market and savings deposits	$ 2,198,035	$	$	$	$ 2,198,035
Certificates of deposit and other time deposits.	176,967	723,970	437,302	262,064	1,600,303
Junior subordinated debentures	59,939			52,946	112,885
Securities sold under repurchase agreements	84,581				84,581
Other borrowings	171	454	701	30,140	31,466
Total interest-bearing liabilities	$ 2,519,693	$ 724,424	$ 438,003	$ 345,150	$ 4,027,270
Period GAP	$ (1,313,399)	$ (242,555)	$ 99,411	$ 2,620,713	$ 1,164,170
Cumulative GAP	$ (1,313,399)	$ (1,555,954)	$ (1,456,543)	$ 1,164,170	
Period GAP to total assets	(20.60)%	(3.80)%	1.56%	41.10%	
Cumulative GAP to total assets	(20.60)%	(24.40)%	(22.84)%	18.26%	

While the GAP position is a useful tool in measuring interest rate risk and contributes toward effective asset and liability management, it is difficult to predict the effect of changing interest rates solely on that measure, without accounting for alterations in the maturity or repricing characteristics of the balance sheet that occur during changes in market interest rates. For example, the GAP position reflects only the prepayment assumptions pertaining to the current rate environment. Assets tend to prepay more rapidly during periods of declining interest rates than during periods of rising interest rates. Because of this and other risk factors not contemplated by the GAP position, an institution could have a matched GAP position in the current rate environment and still have its net interest income exposed to increased rate risk. Additionally, the Company had $1.168 billion in noninterest-bearing deposits at December 31, 2007 which are not reflected in the table above and are not directly impacted by interest rate changes.

The assumptions used are inherently uncertain and, as a result, the model cannot precisely measure future net interest income or precisely predict the impact of fluctuations in market interest rates on net interest income. Actual results will differ from the model s simulated results due to timing, magnitude and frequency of interest rate changes as well as changes in market conditions and the application and timing of various management strategies.

In addition to GAP analysis, the Company uses an interest rate risk simulation model and shock analysis to test the interest rate sensitivity of net interest income and the balance sheet, respectively. Contractual maturities and repricing opportunities of loans are incorporated in the model as are prepayment assumptions, maturity data and call options within the investment portfolio. Assumptions based on past experience are incorporated into the model for nonmaturity deposit accounts. The assumptions used are inherently uncertain and, as a result, the model cannot precisely measure future net interest income or precisely predict the impact of fluctuations in market interest rates on net interest income. Actual results will differ from the model s simulated results due to timing, magnitude and frequency of interest rate changes as well as changes in market conditions and the application and timing of various management strategies.

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The Company s simulation analysis as of December 31, 2007 estimates a percentage of change in these metrics from the stable rate base scenario versus alternative scenarios of rising and falling market interest rates by instantaneously shocking a static balance sheet. The following table summarizes the simulated change in net interest income over a 12-month horizon in the event of an immediate and sustained change in interest rates:

Change in Interest Rates (Basis Points)	Percent Change in Net Interest Income
+200	0.3%
+100	(0.6)%
Base	
-100	0.5%
-200	0.6%

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

Liquidity

Liquidity involves the Company s ability to raise funds to support asset growth or reduce assets to meet deposit withdrawals and other payment obligations, to maintain reserve requirements and otherwise to operate the Company on an ongoing basis. During the three years ended December 31, 2007, the Company s liquidity needs have primarily been met by growth in core deposits and the issuance of junior subordinated debentures, as previously discussed. Although access to purchased funds from correspondent banks is available and has been utilized on occasion to take advantage of investment opportunities, the Company does not generally rely on these external funding sources. The cash and federal funds sold position, supplemented by amortizing investment and loan portfolios, have generally created an adequate liquidity position.

Asset liquidity is provided by cash and assets which are readily marketable or which will mature in the near future. As of December 31, 2007, the Company had cash and cash equivalents of $371.1 million compared with $269.7 million at December 31, 2006. The increase was mainly due to an increase in federal funds sold of $39.2 million and an increase in cash and due from banks of $62.2 million due to the TXUI acquisition.

Contractual Obligations

The following table summarizes the Company s contractual obligations and other commitments to make future payments as of December 31, 2007 (other than deposit obligations). The Company s future cash payments associated with its contractual obligations pursuant to its junior subordinated debentures, FHLB notes payable and operating leases as of December 31, 2007 are summarized below. Payments for FHLB notes payable includes interest of $8.1 million that will be paid over the future periods. Payments related to leases are based on actual payments specified in underlying contracts.

	Payments due in:				
	1 year or less	More than 1 year but less than 3 years	3 years or more but less than 5 years	5 years or more	Total
			(Dollars in thousands)		
Junior subordinated debentures	$	$	$	$ 112,885	$ 112,885
Federal Home Loan Bank notes payable	3,459	17,621	4,013	14,440	39,533
Operating leases	3,375	4,876	2,412	2,000	12,663
Total.	$ 6,834	$ 22,497	$ 6,425	129,325	$ 165,081

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Off-Balance Sheet Items

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

The Company s commitments associated with outstanding standby letters of credit and commitments to extend credit expiring by period as of December 31, 2007 are summarized below. Since commitments associated with letters of credit and commitments to extend credit may expire unused, the amounts shown do not necessarily reflect the actual future cash funding requirements:

	1 year or less	More than 1 year but less than 3 years	3 years or more but less than 5 years	5 years or more	Total
			(Dollars in thousands)		
Standby letters of credit	$ 14,207	$ 901	$ 657	$ 347	$ 16,112
Commitments to extend credit	538,457	45,704	8,240	88,651	681,052
Total	$ 552,664	$ 46,605	$ 8,897	$ 88,998	$ 697,164

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

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

Capital Resources

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

The risk-based capital standards issued by the Federal Reserve Board require all bank holding companies to have Tier 1 capital of at least 4.0% and total risk-based capital (Tier 1 and Tier 2) of at least 8.0% of total risk-weighted tangible assets. Tier 1 capital generally includes common shareholders equity and qualifying perpetual preferred stock together with related surpluses and retained earnings, less deductions for goodwill and

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various other intangibles. Tier 2 capital may consist of a limited amount of intermediate-term preferred stock, a limited amount of term subordinated debt, certain hybrid capital instruments and other debt securities, perpetual preferred stock not qualifying as Tier 1 capital, and a limited amount of the general valuation allowance for loan losses. The sum of Tier 1 capital and Tier 2 capital is total risk-based capital.

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

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

Total shareholders equity increased to $1.127 billion at December 31, 2007 compared with $664.4 million at December 31, 2006, an increase of $463.0 million or 69.7%. This increase was primarily the result of net income of $84.2 million and $389.4 million in Common Stock issued in connection with the TXUI and Navasota acquisitions, partially offset by dividends paid on the Common Stock of $20.3 million. During 2006, shareholders equity increased by $199.7 million or 43.0% compared with $464.7 million at December 31, 2005, primarily due to net income of $61.7 million and $141.4 million in Common Stock issued in connection with the SNB acquisition, partially offset by dividends paid on the Common Stock of $13.0 million.

The following table provides a comparison of the Company s and the Bank s leverage and risk-weighted capital ratios as of December 31, 2007 to the minimum and well-capitalized regulatory standards:

	Minimum Required for Capital Adequacy Purposes	To Be Categorized as Well-Capitalized Under Prompt Corrective Action Provisions	Actual Ratio at December 31, 2007
The Company			
Leverage ratio	3.00%(1)	N/A	8.09%
Tier 1 risk-based capital ratio	4.00	N/A	13.13
Total risk-based capital ratio	8.00	N/A	14.11
The Bank			
Leverage ratio	3.00%(2)	5.00%	7.82%
Tier 1 risk-based capital ratio	4.00	6.00	12.70
Total risk-based capital ratio	8.00	10.00	13.68

(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.

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

Assuming these final rules were effective at December 31, 2007, all trust preferred securities would count as Tier 1 capital. If applicable, the excess amount of trust preferred securities may be included in Tier 2 capital. Assuming these final rules were effective at December 31, 2007, the Company s consolidated capital ratios would have been unchanged.

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

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

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

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ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

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

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

CONSOLIDATED QUARTERLY FINANCIAL DATA OF THE COMPANY

	Quarter Ended 2007			
	December 31	September 30	June 30	March 31
	(Dollars in thousands, except per share data) (unaudited)			
Interest income	$ 85,441	$ 88,004	$ 87,300	$ 79,863
Interest expense	33,807	36,635	35,956	33,775
Net interest income	51,634	51,369	51,344	46,088
Provision for credit losses	120	75	320	245
Net interest income after provision	51,514	51,294	51,024	45,843
Noninterest income	13,248	14,159	13,845	11,671
Noninterest expense	39,413	30,087	30,072	27,271
Income before income taxes	25,349	35,366	34,797	30,243
Provision for income taxes	8,268	11,518	11,804	10,014
Net income	$ 17,081(1)	$ 23,848	$ 22,993	$ 20,229
Earnings per share(2):				
Basic	$ 0.39(1)	$ 0.54	$ 0.53	$ 0.51
Diluted	$ 0.38(1)	$ 0.54	$ 0.52	$ 0.50

	Quarter Ended 2006			
	December 31	September 30	June 30	March 31
	(Dollars in thousands, except per share data) (unaudited)			
Interest income	$ 62,893	$ 62,150	$ 61,012	$ 45,684
Interest expense	26,487	26,183	24,430	16,494
Net interest income	36,406	35,967	36,582	29,190
Provision for credit losses	144	120	120	120
Net interest income after provision	36,262	35,847	36,462	29,070
Noninterest income	8,241	8,918	9,156	7,667
Noninterest expense	19,192	19,829	21,399	17,249
Income before income taxes	25,311	24,936	24,219	19,488

Provision for income taxes	8,709	8,572	8,324	6,624
Net income	$ 16,602	$ 16,364	$ 15,895	$ 12,864
Earnings per share[2]:				
Basic	$ 0.51	$ 0.50	$ 0.49	$ 0.46
Diluted	$ 0.50	$ 0.49	$ 0.48	$ 0.46

(1) Includes a $10.0 million pre-tax, or $6.5 million after-tax, impairment charge on write-down of securities.

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

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

None.

ITEM 9A. CONTROLS AND PROCEDURES

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

Changes in internal control over financial reporting. There were no changes in the Company s internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) that occurred during the quarter ended December 31, 2007, that have materially affected, or are reasonably likely to materially affect, the Company s internal control over financial reporting.

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MANAGEMENT S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

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

As of December 31, 2007, management assessed the effectiveness of the Company s internal control over financial reporting based on the criteria for effective internal control over financial reporting established in Internal Control Integrated Framework, issued by the Committee of Sponsoring Organizations (COSO) of the Treadway Commission. This assessment included controls over the preparation of the schedules equivalent to the basic financial statements in accordance with the instructions for the Consolidated Financial Statements for Bank Holding Companies (Form FR Y-9C) to meet the reporting requirements of Section 112 of the Federal Deposit Insurance Corporation Improvement Act. Based on the assessment, management determined that the Company maintained effective internal control over financial reporting as of December 31, 2006, based on those criteria.

Deloitte & Touche LLP the independent registered public accounting firm that audited the consolidated financial statements of the Company included in this Annual Report on Form 10-K, has issued an attestation report on the Company s internal control over financial reporting as of December 31, 2007. The report is included in this Item under the heading Report of Independent Registered Public Accounting Firm.

Compliance with Designated Laws and Regulations

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

Management assessed its compliance with the designated safety and soundness laws and regulations and has maintained records of its determinations and assessments as required by the FDIC. Based on this assessment, management believes that the Company has complied, in all material respects, with the designated safety and soundness laws and regulations for the year ended December 31, 2007.

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Shareholders of

Prosperity Bancshares, Inc.

Houston, Texas

We have audited the internal control over financial reporting of Prosperity Bancshares, Inc. and subsidiaries (the Bank) as of December 31, 2007, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Because management s assessment and our audit were conducted to meet the reporting requirements of Section 112 of the Federal Deposit Insurance Corporation Improvement Act (FDICIA), management s assessment and our audit of the Bank s internal control over financial reporting included controls over the preparation of the schedules equivalent to the basic financial statements in accordance with the instructions for the Consolidated Financial Statements for Bank Holding Companies (Form FR Y-9C). The Bank s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management s Report on Internal Control Over Financial Reporting. Our responsibility is to express an opinion on the Bank s internal control over financial reporting based on our audit.

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

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

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

In our opinion, the Bank maintained, in all material respects, effective internal control over financial reporting as of December 31, 2007, based on the criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

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

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We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the financial statements as of and for the year ended December 31, 2007 of the Bank and our report dated February 28, 2008 expressed an unqualified opinion on those financial statements.

Houston, Texas

February 28, 2008

ITEM 9B. OTHER INFORMATION

None.

PART III.

ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE

The information required by this Item is incorporated herein by reference to the information under the captions Election of Directors, Continuing Directors and Executive Officers, Section 16(a) Beneficial Ownership Reporting Compliance, Corporate Governance Committees of the Board of Directors Audit Committee, Corporate Governance Director Nomination Process and Corporate Governance Code of Ethics in the Company s definitive Proxy Statement for its 2008 Annual Meeting of Shareholders (the 2008 Proxy Statement) to be filed with the Commission pursuant to Regulation 14A under the Exchange Act within 120 days of the Company s fiscal year end.

ITEM 11. EXECUTIVE COMPENSATION

The information required by this Item is incorporated herein by reference to the information under the captions Executive Compensation and Other Matters and Director Compensation in the 2008 Proxy Statement.

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

Certain information required by this Item 12 is included under Securities Authorized for Issuance under Equity Compensation Plans in Part II, Item 5 of this annual report on Form 10-K. The other information required by this Item is incorporated herein by reference to the information under the caption Beneficial Ownership of Common Stock by Management of the Company and Principal Shareholders in the 2008 Proxy Statement.

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS AND DIRECTOR INDEPENDENCE

The information required by this Item is incorporated herein by reference to the information under the captions Corporate Governance Director Independence and Certain Relationships and Related Transactions in the 2008 Proxy Statement.

ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES

The information required by this Item is incorporated herein by reference to the information under the caption Fees and Services of Independent Registered Public Accounting Firm in the 2008 Proxy Statement.

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PART IV.

ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES

(a) The following documents are filed as part of this Annual Report on Form 10-K:

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

Report of Independent Registered Public Accounting Firm

Consolidated Balance Sheets as of December 31, 2007 and 2006

Consolidated Statements of Income for the Years Ended December 31, 2007, 2006, and 2005

Consolidated Statements of Changes in Shareholders Equity for the Years Ended December 31, 2007, 2006 and 2005

Consolidated Statements of Cash Flows for the Years Ended December 31, 2007, 2006 and 2005

Notes to Consolidated Financial Statements

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

3. The exhibits to this Annual Report on Form 10-K listed below have been included only with the copy of this report filed with the Securities and Exchange Commission. The Company will furnish a copy of any exhibit to shareholders upon written request to the Company and payment of a reasonable fee not to exceed the Company s reasonable expense.

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

Exhibit Number[(1)]	Description
3.1	Amended and Restated Articles of Incorporation of Prosperity Bancshares, Inc. (incorporated herein by reference to Exhibit 3.1 to the Company s Registration Statement on Form S-1 (Registration No. 333-63267))
3.2	Articles of Amendment to Amended and Restated Articles of Incorporation of Prosperity Bancshares, Inc. (incorporated herein by reference to Exhibit 3.2 to the Company s Quarterly Report on Form 10-Q for the quarter ended March 31, 2006)
3.3	Amended and Restated Bylaws of Prosperity Bancshares, Inc. (incorporated herein by reference to Exhibit 3.1 to the Company s Current Report on Form 8-K filed October 19, 2007)
4.1	Form of certificate representing shares of Prosperity Bancshares, Inc. common stock (incorporated herein by reference to Exhibit 4 to the Company s Registration Statement on Form S-1 (Registration No. 333-63267))
4.2	Indenture dated as of July 31, 2001 by and between Prosperity Bancshares, Inc., as Issuer, and State Street Bank and Trust Company of Connecticut, National Association, with respect to the Floating Rate Junior Subordinated Deferrable Interest Debentures of Prosperity Bancshares, Inc. (incorporated herein by reference to Exhibit 4.1 to the Company s Quarterly Report on Form 10-Q for the quarter ended September 30, 2001)
4.3	Amended and Restated Declaration of Trust of Prosperity Statutory Trust II dated as of July 31, 2001 (incorporated herein by reference to Exhibit 4.2 to the Company s Quarterly Report on Form 10-Q for the quarter ended September 30, 2001)

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

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

Management contract or compensatory plan or arrangement.

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

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

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

(b) Exhibits. See the exhibit list included in Item 15(a)3 of this Annual Report on Form 10-K.

(c) Financial Statement Schedules. See Item 15(a)2 of this Annual Report on Form 10-K.

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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.

Date: February 29, 2008

PROSPERITY BANCSHARES, INC.® (Registrant)

By: /s/ DAVID ZALMAN
David Zalman

Chairman of the Board and Chief Executive Officer

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

Signature	Positions	Date
/s/ DAVID ZALMAN **David Zalman**	Chairman of the Board and Chief Executive Officer (principal executive officer); Director	February 29, 2008
/s/ DAVID HOLLAWAY **David Hollaway**	Chief Financial Officer (principal financial officer and principal accounting officer)	February 29, 2008
/s/ JAMES A. BOULIGNY **James A. Bouligny**	Director	February 29, 2008
/s/ WILLIAM H. FAGAN, M.D. **William Fagan, M.D.**	Director	February 29, 2008
/s/ LEAH HENDERSON **Leah Henderson**	Director	February 29, 2008
/s/ NED S. HOLMES **Ned S. Holmes**	Director	February 29, 2008
/s/ D. MICHAEL HUNTER **D. Michael Hunter**	Director	February 29, 2008
/s/ S. REED MORIAN **S. Reed Morian**	Director	February 29, 2008

/s/ PERRY MUELLER, JR., D.D.S. **Perry Mueller, Jr., D.D.S.**	Director	February 29, 2008
/s/ JAMES D. ROLLINS III **James D. Rollins III**	Director	February 29, 2008

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Signature	Positions	Date
/s/ TRACY T. RUDOLPH	Director	February 29, 2008
Tracy T. Rudolph		
/s/ HARRISON STAFFORD II	Director	February 29, 2008
Harrison Stafford II		
/s/ ROBERT STEELHAMMER	Director	February 29, 2008
Robert Steelhammer		
/s/ H.E. TIMANUS, JR.	Director	February 29, 2008
H.E. Timanus, Jr.		

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Shareholders of

Prosperity Bancshares, Inc.

Houston, Texas

We have audited the accompanying consolidated balance sheets of Prosperity Bancshares Inc. and subsidiaries (the Bank) as of December 31, 2007 and 2006, and the related consolidated statements of income, shareholders equity, and cash flows for each of the three years in the period ended December 31, 2007. These financial statements are the responsibility of the Bank s management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of Prosperity Bancshares, Inc. and subsidiaries at December 31, 2007 and 2006, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2007, in conformity with accounting principles generally accepted in the United States of America.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the Bank s internal control over financial reporting as of December 31, 2007, based on the criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated February 28, 2008 expressed an unqualified opinion on the Bank s internal control over financial reporting.

Houston, Texas

February 28, 2008

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PROSPERITY BANCSHARES, INC.® AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

	December 31, 2007	December 31, 2006
	(Dollars in thousands)	
ASSETS		
Cash and due from banks	$ 178,247	$ 116,078
Federal funds sold	192,843	153,643
Total cash and cash equivalents	371,090	269,721
Interest bearing deposits in financial institutions	200	397
Available for sale securities, at fair value	260,444	434,331
Held to maturity securities, at cost (fair value of $1,597,598 and $1,131,096, respectively)	1,597,162	1,155,972
Loans held for investment	3,132,025	2,176,507
Loans held for sale	10,946	
Less allowance for credit losses	(32,543)	(23,990)
Loans, net	3,110,428	2,152,517
Accrued interest receivable	27,940	20,364
Goodwill	753,909	424,339
Core deposit intangibles, net of accumulated amortization of $21,490 and $11,573, respectively	46,069	23,032
Bank premises and equipment, net	120,044	63,057
Other real estate owned	10,207	140
Bank Owned Life Insurance (BOLI), net	45,486	14,176
Leased assets	3,559	3,709
Other assets	25,805	25,014
TOTAL ASSETS	$ 6,372,343	$ 4,586,769
LIABILITIES AND SHAREHOLDERS EQUITY		
LIABILITIES:		
Deposits:		
Noninterest-bearing	$ 1,168,069	$ 835,876
Interest-bearing	3,798,338	2,889,802
Total deposits	4,966,407	3,725,678
Other borrowings	31,466	26,408
Securities sold under repurchase agreements	84,581	47,225
Accrued interest payable	11,761	8,451
Other liabilities	37,812	14,077
Junior subordinated debentures	112,885	100,519
Total liabilities	5,244,912	3,922,358
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; 44,225,411 and 32,829,873 shares issued at December 31, 2007 and 2006, respectively; 44,188,323 and 32,792,785 shares outstanding at December 31, 2007 and 2006, respectively	44,188	32,830

Capital surplus	809,026	425,557
Retained earnings	273,407	209,581
Accumulated other comprehensive income (loss) net unrealized gain (loss) on available for sale securities, net of tax and tax benefit of $763 and $1,588, respectively	1,417	(2,950)
Less treasury stock, at cost, 37,088 shares	(607)	(607)
Total shareholders equity	1,127,431	664,411
TOTAL LIABILITIES AND SHAREHOLDERS EQUITY	$ 6,372,343	$ 4,586,769

See notes to consolidated financial statements.

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PROSPERITY BANCSHARES, INC.® AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF INCOME

	For the Years Ended December 31,		
	2007	2006	2005
	(Dollars in thousands, except per share data)		
INTEREST INCOME:			
Loans, including fees	$ 247,600	$ 157,426	$ 99,958
Securities:			
Taxable	84,840	69,896	59,066
Nontaxable	3,615	1,821	1,286
70% nontaxable preferred dividends	1,012	915	514
Federal funds sold	3,526	1,667	1,292
Deposits in financial institutions	15	14	7
Total interest income	340,608	231,739	162,123
INTEREST EXPENSE:			
Deposits	122,682	80,942	43,643
Junior subordinated debentures	10,058	7,592	4,895
Securities sold under repurchase agreements	3,026	1,820	768
Other borrowings	4,407	3,240	1,920
Total interest expense	140,173	93,594	51,226
NET INTEREST INCOME	200,435	138,145	110,897
PROVISION FOR CREDIT LOSSES	760	504	480
NET INTEREST INCOME AFTER PROVISION FOR CREDIT LOSSES	199,675	137,641	110,417
NONINTEREST INCOME:			
Service charges on deposit accounts	40,937	27,379	24,985
Gain (loss) on sale of securities, net	86		(79)
Other	11,900	6,603	5,115
Total noninterest income	52,923	33,982	30,021
NONINTEREST EXPENSE:			
Salaries and employee benefits	63,910	41,298	36,672
Net occupancy expense	10,534	7,884	6,663
Data processing	4,570	3,612	2,837
Core deposit intangibles amortization	9,917	4,869	3,912
Depreciation expense	7,611	5,048	4,462
Impairment write-down on securities	9,975		
Other	20,326	14,958	14,411
Total noninterest expense	126,843	77,669	68,957

INCOME BEFORE INCOME TAXES	125,755	93,954	71,481
PROVISION FOR INCOME TAXES	41,604	32,229	23,621
NET INCOME	$ 84,151	$ 61,725	$ 47,860
EARNINGS PER SHARE:			
Basic	$ 1.96	$ 1.96	$ 1.79
Diluted	$ 1.94	$ 1.94	$ 1.77

See notes to consolidated financial statements.

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PROSPERITY BANCSHARES, INC.® AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS EQUITY

	Common Stock				Accumulated Other		Total
	Shares	Amount	Capital Surplus	Retained Earnings	Comprehensive Income (loss)	Treasury Stock	Shareholders Equity
	(Dollars in thousands, except share data)						
BALANCE AT JANUARY 1, 2005	22,418,128	$ 22,418	$ 134,288	$ 122,647	$ (3,099)	$ (607)	$ 275,647
Comprehensive income:							
Net income				47,860			47,860
Net change in unrealized loss on available for sale securities					(894)		(894)
Add: Reclassification adjustment for net losses included in net income, net of tax benefit of $28					51		51
Total comprehensive income							47,017
Issuance of common stock in connection with the exercise of stock options	128,015	128	1,089				1,217
Common stock issued in connection with the First Capital acquisition	5,078,856	5,079	137,439				142,518
Common stock issued in connection with the Grapeland acquisition	232,888	233	6,894				7,127
Stock option compensation expense			619				619
Cash dividends declared, $0.35 per share				(9,624)			(9,624)
Other			196				196
BALANCE AT DECEMBER 31, 2005	27,857,887	27,858	280,525	160,883	(3,942)	(607)	464,717
Comprehensive Income:							
Net income				61,725			61,725
Net change in unrealized gain (loss) on available for sale securities					992		992
Total comprehensive income							62,717
Issuance of common stock in connection with the exercise of stock options and restricted stock awards	523,761	524	7,268				7,792
Common stock issued in connection with the SNB acquisition	4,448,225	4,448	136,914				141,362
Stock based compensation expense			850				850
Cash dividends declared, $0.41 per share				(13,027)			(13,027)
BALANCE AT DECEMBER 31, 2006	32,829,873	32,830	425,557	209,581	(2,950)	(607)	664,411
Comprehensive Income:							
Net income				84,151			84,151
Net change in unrealized gain (loss) on available for sale securities					4,367		4,367
Total comprehensive income							88,518
Issuance of common stock in connection with the exercise of stock options and restricted stock awards	337,148	337	3,148				3,485
Common stock issued in connection with the TXUI acquisition	10,769,942	10,770	370,116				380,886

Common stock issued in connection with the Bank of Navasota acquisition	251,360	251	8,237				8,488
Stock based compensation expense			1,968				1,968
Cash dividends declared, $0.425 per share				(20,325)			(20,325)
BALANCE AT DECEMBER 31, 2007	44,188,323	$ 44,188	$ 809,026	$ 273,407	$ 1,417	$ (607)	$ 1,127,431

See notes to consolidated financial statements.

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PROSPERITY BANCSHARES, INC.® AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

	For the Years Ended December 31, 2007	2006	2005
	(Dollars in thousands)		
CASH FLOWS FROM OPERATING ACTIVITIES:			
Net income	$ 84,151	$ 61,725	$ 47,860
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	17,528	9,917	8,374
Provision for credit losses	760	504	480
Net (amortization) accretion of premium/discount on investments	(7,279)	(736)	2,781
Gain on sale of premises, equipment and other real estate	(819)	(622)	(72)
Gain on held for sale loans	(1,334)		(173)
(Gain) loss on sale of securities	(86)		79
Impairment write-down of securities	9,975		
Net amortization of premium on loans	(1,264)		
Funding of held for sale loans	(52,258)		(14,540)
Proceeds from sale of held for sale loans	165,488		14,717
Stock based compensation expense	1,968	850	751
Decrease (increase) in accrued interest receivable and other assets	23,690	(3,041)	5,891
(Decrease) increase in accrued interest payable and other liabilities	(4,444)	6,637	(446)
Net cash provided by operating activities	236,076	75,234	65,702
CASH FLOWS FROM INVESTING ACTIVITIES:			
Proceeds from maturities and principal paydowns of held to maturity securities	304,964	297,721	263,966
Purchase of held to maturity securities	(603,605)	(79,638)	(254,476)
Proceeds from maturities and principal paydowns of available for sale securities	1,014,952	1,724,786	81,916
Proceeds from the sales of available for sale securities	722,904	7,193	
Purchase of available for sale securities	(1,434,953)	(1,739,992)	(224,203)
Net decrease (increase) in loans	137,802	(36,946)	2,279
Purchase of bank premises and equipment	(7,175)	(4,430)	(1,745)
Proceeds from sale of bank premises, equipment and other real estate	9,132	3,499	2,428
Purchase of SNB Bancshares, Inc.		(93,861)	
Cash and cash equivalents acquired in the purchase of SNB Bancshares, Inc.		18,020	
Purchase of First Capital Bankers, Inc			(2,182)
Cash and cash equivalents acquired in the purchase of First Capital Bankers, Inc.			58,972
Purchase of Grapeland Bancshares, Inc.		(77)	(163)
Cash and cash equivalents acquired in the purchase of Grapeland Bancshares, Inc.			4,525
Purchase of Texas United Bancshares, Inc	(2,152)		
Cash and cash equivalents acquired in the purchase of Texas United Bancshares, Inc.	114,469		
Purchase of the Bank of Navasota	(8,858)		
Cash and cash equivalents acquired in the purchase of the Bank of Navasota	19,175		
Net decrease (increase) in interest-bearing deposits in financial institutions	197	(100)	(1)
Net cash provided by (used in) investing activities	266,852	96,175	(68,684)
CASH FLOWS FROM FINANCING ACTIVITIES:			
Net (decrease) increase in noninterest-bearing deposits	$ (78,238)	$ 31,652	$ 60,252
Net (decrease) increase in interest-bearing deposits	(72,384)	29,787	(122,734)
(Repayments) proceeds of other borrowings and securities sold under repurchase agreements (net)	(201,622)	(49,256)	33,457
Redemption of junior subordinated debentures	(32,475)	(6,000)	
Proceeds from stock option exercises	3,485	7,792	1,085
Payments of cash dividends	(20,325)	(13,027)	(9,624)

Net cash (used in) provided by financing activities	(401,559)	948	(37,564)
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	$ 101,369	$ 172,357	$ (40,546)
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	269,721	97,364	137,910
CASH AND CASH EQUIVALENTS, END OF PERIOD	$ 371,090	$ 269,721	$ 97,364
NONCASH ACTIVITIES:			
Stock issued in connection with the SNB Bancshares, Inc. acquisition		141,362	
Stock issued in connection with the First Capital Bankers, Inc. acquisition			142,518
Stock issued in connection with the Grapeland Bancshares, Inc. acquisition			7,127
Stock issued in connection with the Texas United Bancshares, Inc. acquisition	380,886		
Stock issued in connection with the Bank of Navasota acquisition	8,488		
SUPPLEMENTAL INFORMATION:			
Income taxes paid	$ 34,400	$ 20,650	$ 21,350
Interest paid	$ 140,268	$ 91,689	$ 47,782

See notes to consolidated financial statements.

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PROSPERITY BANCSHARES, INC.® AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. NATURE OF OPERATIONS AND SUMMARY OF SIGNIFICANT ACCOUNTING AND REPORTING POLICIES

Nature of Operations Prosperity Bancshares, Inc.® (Bancshares) and its subsidiaries, Prosperity Holdings of Delaware, LLC (Holdings) and Prosperity Bank® (the Bank , and together with Bancshares and Holdings, collectively referred to as the Company) provide retail and commercial banking services. The Company operates its business as one domestic segment.

The Bank operates one hundred twenty-four (124) full-service banking locations and one (1) loan production office; with forty (40) in the Greater Houston Consolidated Metropolitan Statistical Area (CMSA), thirty-three (33) in the South Texas area including Corpus Christi and Victoria, twenty-three (23) in the Central Texas area including Austin and Bryan/College Station,, two (2) in East Texas, twenty-six (26) in the Dallas/Fort Worth, Texas area and one (1) loan production office in San Antonio.

Principles of Consolidation The consolidated financial statements include the accounts of Bancshares and its wholly owned subsidiaries. All intercompany transactions have been eliminated in consolidation. The accounting and reporting policies of the Company conform to accounting principles generally accepted in the United States of America (GAAP) and the prevailing practices within the banking industry. A summary of significant accounting and reporting policies is as follows:

Use of Estimates The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from these estimates.

Securities Securities held to maturity are carried at cost, adjusted for the amortization of premiums and the accretion of discounts. Management has the positive intent and the Company has the ability to hold these assets as long-term securities until their estimated maturities.

Securities available for sale are carried at fair value. Unrealized gains and losses are excluded from earnings and reported, net of tax, as a separate component of shareholders equity until realized. Securities within the available for sale portfolio may be used as part of the Company s asset/liability strategy and may be sold in response to changes in interest risk, prepayment risk or other similar economic factors.

Declines in the fair value of individual held to maturity and available for sale securities below their cost that are other than temporary would result in write-downs of the individual securities to their fair value. The related write-downs would be included in earnings as realized losses.

Premiums and discounts are amortized and accreted to operations using the level-yield method of accounting, adjusted for prepayments as applicable. The specific identification method of accounting is used to compute gains or losses on the sales of these assets. Interest earned on these assets is included in interest income.

Loans Held for Investment Loans are stated at the principal amount outstanding, net of unearned discount and fees. Unearned discount relates principally to consumer installment loans. The related interest income for multipayment loans is recognized principally by the sum of the digits method which records interest in proportion to the declining outstanding balances of the loans; for single payment loans, such income is recognized using the straight-line method.

Nonrefundable Fees and Costs Associated with Lending Activities Loan origination fees in excess of the associated costs are recognized over the life of the related loan as an adjustment to yield using the interest method.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Loan commitment fees and loan origination costs are deferred, except for certain retrospectively determined fees, and recognized as an adjustment of yield by the interest method over the related loan life or, if the commitment expires unexercised, recognized in income upon expiration of the commitment.

Nonperforming and Past Due Loans Included in the nonperforming loan category are loans which have been categorized by management as nonaccrual because collection of interest is doubtful and loans which have been restructured to provide a reduction in the interest rate or a deferral of interest or principal payments. When the payment of principal or interest on a loan is delinquent for 90 days, or earlier in some cases, the loan is placed on nonaccrual status unless the loan is in the process of collection and the underlying collateral fully supports the carrying value of the loan. If the decision is made to continue accruing interest on the loan, periodic reviews are made to confirm the accruing status of the loan. When a loan is placed on nonaccrual status, interest accrued during the current year prior to the judgment of uncollectibility is charged to operations. Interest accrued during prior periods is charged to allowance for credit losses. Any payments received on nonaccrual loans are applied first to outstanding loan amounts and next to the recovery of charged-off loan amounts. Any excess is treated as recovery of lost interest.

Restructured loans are those loans on which concessions in terms have been granted because of a borrower s financial difficulty. Interest is generally accrued on such loans in accordance with the new terms.

Allowance for Credit Losses The allowance for credit losses is a valuation allowance available for losses incurred on loans. All losses are charged to the allowance when the loss actually occurs or when a determination is made that such a loss is probable. Recoveries are credited to the allowance at the time of recovery.

Throughout the year, management estimates the probable level of losses to determine whether the allowance for credit losses is adequate to absorb losses inherent in the loan portfolio. Based on these estimates, an amount is charged to the provision for credit losses and credited to the allowance for credit losses in order to adjust the allowance to a level determined to be adequate to absorb losses.

In making its evaluation of the adequacy of the allowance for credit losses, management considers factors such as historical loan loss experience, industry diversification of the Company s commercial loan portfolio, the amount of nonperforming assets and related collateral, the volume, growth and composition of the Company s loan portfolio, current economic changes that may affect the borrower s ability to pay and the value of collateral, the evaluation of the Company s loan portfolio through its internal loan review process and other relevant factors.

Estimates of credit losses involve an exercise of judgment. While it is possible that in the short term the Company may sustain losses which are substantial in relation to the allowance for credit losses, it is the judgment of management that the allowance for credit losses reflected in the consolidated balance sheets is adequate to absorb probable losses that exist in the current loan portfolio.

Statement of Financial Accounting Standards (SFAS) No. 114, *Accounting by Creditors for Impairment of a Loan*, as amended by SFAS No. 118, *Accounting by Creditors for Impairment of a Loan Income Recognition and Disclosure* applies to all impaired loans, with the exception of groups of smaller-balance homogeneous loans that are collectively evaluated for impairment. A loan is defined as impaired by SFAS No. 114 if, based on current information and events, it is probable that a creditor will be unable to collect all amounts due, both interest and principal, according to the contractual terms of the loan agreement. Specifically, SFAS No. 114 requires that the allowance for credit losses related to impaired loans be determined based on the difference of carrying value of loans and the present value of expected cash flows discounted at the loan s effective interest

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

rate or, as a practical expedient, the loan s observable market price or the fair value of the collateral if the loan is collateral dependent. At December 31, 2007, the Company had $1.0 million in nonaccrual loans, $4.1 million in 90 days or more past due loans and no restructured loans. At December 31, 2006, the Company had $181,000 in nonaccrual loans, $767,000 in 90 days or more past due loans and no restructured loans.

Interest revenue received on impaired loans is either applied against principal or realized as interest revenue, according to management s judgment as to the collectibility of principal.

Premises and Equipment Premises and equipment are carried at cost less accumulated depreciation. Depreciation expense is computed principally using the straight-line method over the estimated useful lives of the assets which range from three to 30 years. Leasehold improvements are amortized using the straight-line method over the periods of the leases or the estimated useful lives, whichever is shorter.

Goodwill Goodwill is annually assessed for impairment or when events or changes in circumstances indicate that the carrying amount of the asset may not be recoverable. The Company bases its evaluation on such impairment factors as the nature of the assets, the future economic benefit of the assets, any historical or future profitability measurements, as well as other external market conditions or factors that may be present.

Amortization of Core Deposit Intangibles Core deposit intangibles are amortized using an accelerated amortization method over an 8 to 10 year period.

Income Taxes Bancshares files a consolidated federal income tax return. The Bank computes federal income taxes as if it filed a separate return and remits to, or is reimbursed by, Bancshares based on the portion of taxes currently due or refundable.

Deferred tax assets and liabilities are recognized for the estimated tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax basis.

Stock-Based Compensation As of December 31, 2007, the Company had three stock-based employee compensation plans. Prior to 2003, the Company accounted for awards granted under stock-based compensation plans under the recognition and measurement provisions of APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and related Interpretations. No stock-based employee compensation cost was reflected in previously reported results, as all options granted under those plans had an exercise price equal to the market value of the underlying common stock on the date of grant. Effective January 1, 2003, the Company adopted the fair value recognition provisions of FASB Statement No. 123, *Accounting for Stock-Based Compensation*, as provided by SFAS No. 148 for stock-based employee compensation. On January 1, 2006, the Company adopted FASB Statement No. 123(R) (see Note 14).

Cash and Cash Equivalents For purposes of reporting cash flows, cash and cash equivalents include cash and due from banks as well as federal funds sold that mature in three days or less.

Reclassifications Certain reclassifications have been made to prior year amounts to conform to current year presentation. All reclassifications have been applied consistently for the periods presented. During 2005, the Company elected to reclassify brokered mortgage income from other noninterest income to a separate category and reclassify net gains on held for sale loans from net gains on sales of assets to a separate category. These reclassifications had no impact on financial condition, net income or equity in any of the reported periods.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Earnings Per Share SFAS No. 128, *Earnings Per Share*, requires presentation of basic and diluted earnings per share. Basic earnings per share has been computed by dividing net income available to common shareholders by the weighted average number of common shares outstanding for the reporting period. Diluted earnings per share reflects the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock. Net income per common share for all periods presented has been calculated in accordance with SFAS 128. 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:

	December 31,					
	2007		2006		2005	
	Amount	Per Share Amount	Amount	Per Share Amount	Amount	Per Share Amount
	(In thousands, except per share data)					
Net income	$ 84,151		$ 61,725		$ 47,860	
Basic:						
Weighted average shares outstanding	42,928	$ 1.96	31,491	$ 1.96	26,706	$ 1.79
Diluted:						
Weighted average shares outstanding	42,928		31,491		26,706	
Effect of dilutive securities options	382		402		318	
Total	43,310	$ 1.94	31,893	$ 1.94	27,024	$ 1.77

The incremental shares for the assumed exercise of the outstanding options were determined by application of the treasury stock method. There were no stock options exercisable at December 31, 2007, 2006 and 2005 that would have had an anti-dilutive effect on the above computation.

New Accounting Standards

Statements of Financial Accounting Standards

SFAS No. 141, Business Combinations (Revised 2007). SFAS 141R replaces SFAS 141, Business Combinations, and applies to all transactions and other events in which one entity obtains control over one or more other businesses. SFAS 141R requires an acquirer, upon initially obtaining control of another entity, to recognize the assets, liabilities and any non-controlling interest in the acquiree at fair value as of the acquisition date. Contingent consideration is required to be recognized and measured at fair value on the date of acquisition rather than at a later date when the amount of that consideration may be determinable beyond a reasonable doubt. This fair value approach replaces the cost-allocation process required under SFAS 141 whereby the cost of an acquisition was allocated to the individual assets acquired and liabilities assumed based on their estimated fair value. SFAS 141R requires acquirers to expense acquisition-related costs as incurred rather than allocating such costs to the assets acquired and liabilities assumed, as was previously the case under SFAS 141. Under SFAS 141R, the requirements of SFAS 146, Accounting for Costs Associated with Exit or Disposal Activities, would have to be met in order to accrue for a restructuring plan in purchase accounting. Pre-acquisition contingencies are to be recognized at fair value, unless it is a non-contractual contingency that is not likely to materialize, in which case, nothing should be recognized in purchase accounting and, instead, that contingency would be subject to the probable and estimable recognition criteria of SFAS 5, Accounting for Contingencies. The Company is currently evaluating the impact of the adoption of SFAS 141R on the Company s accounting for business combinations closing on or after January 1, 2009.

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SFAS No. 155, Accounting for Certain Hybrid Financial Instruments. SFAS 155 amends SFAS 133, Accounting for Derivative Instruments and Hedging Activities and SFAS 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities. SFAS 155 (i) permits fair value remeasurement for any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation, (ii) clarifies which interest-only strips and principal-only strips are not subject to the requirements of SFAS 133, (iii) establishes a requirement to evaluate interests in securitized financial assets to identify interests that are freestanding derivatives or that are hybrid financial instruments that contain an embedded derivative requiring bifurcation, (iv) clarifies that concentrations of credit risk in the form of subordination are not embedded derivatives, and (v) amends SFAS 140 to eliminate the prohibition on a qualifying special purpose entity from holding a derivative financial instrument that pertains to a beneficial interest other than another derivative financial instrument. The adoption of SFAS 155 on January 1, 2007 did not significantly impact the Company s financial statements.

SFAS No. 157, Fair Value Measurements. SFAS 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS 157 is effective for the Company on January 1, 2008 and its adoption did not have a significant impact on the Company s financial statements.

SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities Including an amendment of FASB Statement No. 115. SFAS 159 permits entities to choose to measure eligible items at fair value at specified election dates. Unrealized gains and losses on items for which the fair value option has been elected are reported in earnings at each subsequent reporting date. The fair value option (i) may be applied instrument by instrument, with certain exceptions, (ii) is irrevocable (unless a new election date occurs) and (iii) is applied only to entire instruments and not to portions of instruments. SFAS 159 is effective for the Company on January 1, 2008 and its adoption did not have a significant impact on the Company s financial statements.

SFAS No. 160, Noncontrolling Interest in Consolidated Financial Statements, an amendment of ARB Statement No. 51. SFAS 160 amends Accounting Research Bulletin (ARB) No. 51, Consolidated Financial Statements, to establish accounting and reporting standards for the non-controlling interest in a subsidiary and for the deconsolidation of a subsidiary. SFAS 160 clarifies that a non-controlling interest in a subsidiary, which is sometimes referred to as minority interest, is an ownership interest in the consolidated entity that should be reported as a component of equity in the consolidated financial statements. Among other requirements, SFAS 160 requires consolidated net income to be reported at amounts that include the amounts attributable to both the parent and the non-controlling interest. It also requires disclosure, on the face of the consolidated income statement, of the amounts of consolidated net income attributable to the parent and to the non-controlling interest. SFAS 160 is effective for the Company on January 1, 2009 and is not expected to have a significant impact on the Company s financial statements.

Financial Accounting Standards Board Staff Positions and Interpretations

FASB Staff Position (FSP) No. 157-2. FSP 157-2 delays the effective date of FASB Statement No. 157, *Fair Value Measurements,* for nonfinancial assets and nonfinancial liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). The delay is intended to allow the Board and constituents additional time to consider the effect of various implementation issues that have arisen, or that may arise, from the application of Statement 157. This FSP defers the effective date of Statement 157 to fiscal years beginning after November 15, 2008, and interim periods within those fiscal years for items within the scope of this FSP. FSP 157-2 was effective for the Company on January 1, 2008 and did not have a significant impact on the Company s financial statements.

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PROSPERITY BANCSHARES, INC.® AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement 109. Interpretation 48 prescribes a recognition threshold and a measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. Benefits from tax positions should be recognized in the financial statements only when it is more likely than not that the tax position will be sustained upon examination by the appropriate taxing authority that would have full knowledge of all relevant information. A tax position that meets the more-likely-than-not recognition threshold is measured at the largest amount of benefit that is greater than fifty percent likely of being realized upon ultimate settlement. Tax positions that previously failed to meet the more-likely-than-not recognition threshold should be recognized in the first subsequent financial reporting period in which that threshold is met. Previously recognized tax positions that no longer meet the more-likely-than-not recognition threshold should be derecognized in the first subsequent financial reporting period in which that threshold is no longer met. Interpretation 48 also provides guidance on the accounting for and disclosure of unrecognized tax benefits, interest and penalties. The adoption of Interpretation 48 on January 1, 2007 did not significantly impact the Company s financial statements.

FSP No. 48-1 Definition of Settlement in FASB Interpretation No. 48. FSP 48-1 provides guidance on how to determine whether a tax position is effectively settled for the purpose of recognizing previously unrecognized tax benefits. FSP 48-1 was effective retroactively to January 1, 2007 and did not significantly impact the Company s financial statements.

Emerging Issues Task Force Issues

Emerging Issues Task Force (EITF) Issue No. 06-4, Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split Dollar Life Insurance Arrangements. EITF 06-4 requires the recognition of a liability and related compensation expense for endorsement split-dollar life insurance policies that provide a benefit to an employee that extends to post-retirement periods. Under EITF 06-4, life insurance policies purchased for the purpose of providing such benefits do not effectively settle an entity s obligation to the employee. Accordingly, the entity must recognize a liability and related compensation expense during the employee s active service period based on the future cost of insurance to be incurred during the employee s retirement. If the entity has agreed to provide the employee with a death benefit, then the liability for the future death benefit should be recognized by following the guidance in SFAS 106, Employer s Accounting for Postretirement Benefits Other Than Pensions. The Company expects to adopt EITF 06-4 effective as of January 1, 2008 as a change in accounting principle through a cumulative-effect adjustment to retained earnings. The amount of the adjustment was not significant.

SEC Staff Accounting Bulletins

SAB No. 109, Written Loan Commitments Recorded at Fair Value Through Earnings. SAB No. 109 supersedes SAB 105, Application of Accounting Principles to Loan Commitments, and indicates that the expected net future cash flows related to the associated servicing of the loan should be included in the measurement of all written loan commitments that are accounted for at fair value through earnings. The guidance in SAB 109 is applied on a prospective basis to derivative loan commitments issued or modified in fiscal quarters beginning after December 15, 2007. SAB 109 did not significantly impact the Company s financial statements.

2. ACQUISITIONS

Acquisitions are an integral part of the Company s growth strategy. All acquisitions were accounted for using the purchase method of accounting. Accordingly, the assets and liabilities of the acquired entities were recorded at their fair values at the acquisition date. The excess of the purchase price over the estimated fair value of the net assets for each acquisition was recorded as goodwill, none of which was deductible for tax purposes.

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The identified core deposit intangibles for each acquisition are being amortized using an accelerated amortization method over an 8 to 10 year life. The results of operations for each acquisition have been included in the Company s consolidated financial results beginning on the respective acquisition date. The following acquisitions were completed on the dates indicated:

On January 31, 2007, the Company completed its acquisition of Texas United Bancshares, Inc., La Grange, Texas (TXUI). Under the terms of the merger agreement, TXUI was merged into the Company and subsequently each of TXUI s wholly owned subsidiary banks, State Bank, GNB Financial, n.a., Gateway National Bank and Northwest Bank, was merged into the Bank. The Company issued approximately 10.770 million shares of its common stock for all of the issued and outstanding capital stock of TXUI. In addition, options to acquire 179,956 shares of TXUI common stock were converted into options to acquire 179,956 shares of Company common stock. In connection with the acquisition, the Company assumed $44.8 million in junior subordinated debentures issued to five subsidiary trusts. TXUI was publicly traded and operated forty-one (41) banking offices in Texas. As of December 31, 2006, TXUI had, on a consolidated basis, total assets of $1.806 billion, loans (including loans held for sale) of $1.212 billion, deposits of $1.362 billion and shareholders equity of $161.9 million.

The table below summarizes select pro forma data for the combined company for the periods indicated assuming the TXUI merger was effective on January 1 of the indicated periods. The information in the table below also gives effect to the Company s acquisition of SNB in April 2006.

	For the twelve months ended December 31,	
	2007	2006
	(In thousands) (unaudited)	
Net interest income	$ 206,685	$ 218,986
Net income	$ 86,063(1)	$ 87,039
Earnings per share (diluted)	$ 1.94(1)	$ 2.04
Weighted average diluted shares	44,254	42,612

(1) Includes a $10.0 million pre-tax, or $6.5 million after-tax, impairment charge on write-down of securities.

The pro forma results are not necessarily indicative of what actually would have occurred if the TXUI merger had occurred on January 1 of each indicated period, or of any future consolidated results.

In connection with the purchase, the Company recorded a premium of $353.5 million, of which $31.0 million was identified as core deposit intangibles. The remaining $322.5 million of the premium was recorded as goodwill.

On September 1, 2007, the Company completed its acquisition of The Bank of Navasota, N.A., Navasota, Texas through the merger of the Bank of Navasota into the Bank. The Company issued approximately 251,000 shares of its common stock and paid approximately $8.6 million in cash for all of the issued and outstanding capital stock of the Bank of Navasota. The Bank of Navasota operated one banking office in Navasota, Texas, which became a full-service banking center of Prosperity Bank. As of June 30, 2007, the Bank of Navasota had total assets of $73.4 million, loans of $33.0 million, deposits of $63.8 million and shareholders equity of $9.1 million.

In connection with the purchase, the Company recorded a premium of $9.1 million, of which $2.0 million was identified as core deposit intangibles. The remaining $7.1 million of the premium was recorded as goodwill.

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PROSPERITY BANCSHARES, INC.® AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

The table below summarizes select pro forma data for the combined company for the periods indicated assuming the SNB merger was effective on January 1 of the indicated periods. The information in the table below also gives effect to the Company s acquisition of First Capital on March 1, 2005 and Grapeland on December 1, 2005.

	For the twelve months ended December 31, 2006	2005
	(In thousands) (unaudited)	
Net interest income	$ 146,224	$ 127,420
Net income	$ 63,870	$ 59,175
Earnings per share (diluted)	$ 1.94	$ 1.82
Weighted average diluted shares	33,002	32,521

The pro forma results are not necessarily indicative of what actually would have occurred if the SNB merger had occurred on January 1 of each indicated period, or of any future consolidated results.

In connection with the purchase, the Company recorded a premium of $166.7 million, of which $5.7 million was identified as core deposit intangibles. The remaining $161.0 million of the premium was recorded as goodwill.

On December 1, 2005, the Company completed its acquisition of Grapeland Bancshares, Inc. (Grapeland), Grapeland, Texas. Under the terms of the agreement, Grapeland merged into the Company and subsequently, Grapeland s wholly owned subsidiary, First State Bank of Grapeland, merged into the Bank. The Company issued 232,888 shares of its Common Stock for all of the issued and outstanding capital stock of Grapeland. Grapeland was privately held and operated two (2) banking offices in Grapeland and Crockett, Texas, both of which became full service banking centers of the Company. As of September 30, 2005, Grapeland had, on a consolidated basis, total assets of $72.2 million, loans of $43.7 million, deposits of $46.6 million and shareholders equity of $3.8 million.

In connection with the purchase, the Company recorded a premium of $5.4 million, of which $1.5 million was identified as core deposit intangibles. The remaining $3.9 million of the premium was recorded as goodwill.

On March 1, 2005, the Company completed its acquisition of First Capital Bankers, Inc. (First Capital), Corpus Christi, Texas. Under the terms of the agreement, First Capital was merged into the Company and

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

subsequently, First Capital s wholly owned subsidiary, First Capital Bank, s.s.b., was merged into the Bank. The Company issued approximately 5.079 million shares of its Common Stock for all of the issued and outstanding capital stock of First Capital and converted all outstanding options to acquire First Capital common stock into options to acquire approximately 234,000 shares of Company common stock. First Capital was privately held and operated thirty-two (32) banking offices in and around Corpus Christi, Houston and Victoria, Texas, five of which were closed and consolidated with existing banking centers of the Company. As of December 31, 2004, First Capital had, on a consolidated basis, total assets of $761.6 million, loans of $499.0 million, deposits of $629.6 million and shareholders equity of $61.7 million.

In connection with the purchase, the Company recorded a premium of $116.6 million, of which $13.4 million was identified as core deposit intangibles. The remaining $103.2 million of the premium was recorded as goodwill.

3. GOODWILL AND OTHER INTANGIBLE ASSETS

Changes in the carrying amount of the Company s goodwill and core deposit intangibles for fiscal 2007 and 2006 were as follows:

	Goodwill	Core Deposit Intangibles
	(Dollars in thousands)	
Balance as of December 31, 2005	$ 261,964	$ 22,461
Less:		
Amortization		(4,869)
Add:		
Acquisition of Grapeland Bancshares	667	(294)
Acquisition of First Capital Bankers	371	
Acquisition of SNB Bancshares	160,921	5,734
Purchase accounting adjustments to prior year acquisitions (deferred tax adjustments)	416	
Balance as of December 31, 2006	$ 424,339	$ 23,032
Less:		
Amortization		(9,917)
Add:		
Acquisition of Texas United Bancshares, Inc.	322,491	30,995
Acquisition of Bank of Navasota	7,162	1,959
Purchase accounting adjustments to prior year acquisitions (deferred tax adjustments)	(83)	
Balance as of December 31, 2007	$ 753,909	$ 46,069

Purchase accounting adjustments to prior year acquisitions were made to adjust deferred tax asset and liability balances. Goodwill is recorded on the acquisition date of each entity. The Company may record subsequent adjustments to goodwill for amounts undeterminable at acquisition date, such as deferred taxes and real estate valuations, and therefore the goodwill amounts reflected in the table above may change accordingly. The Company initially records the total premium paid on acquisitions as goodwill. After finalizing the valuation, core deposit intangibles are identified and reclassified from goodwill to core deposit intangibles on the balance sheet. This reclassification has no effect on total assets, liabilities, shareholders equity, net income or cash flows. Management performs an evaluation annually, and more frequently if a triggering event occurs, of whether any impairment of the goodwill and other intangibles has occurred. If any such impairment is determined, a write down is recorded. As of December 31, 2007, there was no impairment recorded on goodwill.

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Core deposit intangibles are amortized on an accelerated basis over their estimated lives, which the Company believes is between 8 and 10 years. Gross core deposit intangibles outstanding were $67.6 million and $34.6 million at December 31, 2007 and December 31, 2006, respectively. Net core deposit intangibles outstanding were $46.1 million and $23.0 million at the same dates, respectively. Amortization expense related to intangible assets totaled $9.9 million and $4.9 million for the years ended December 31, 2007 and 2006, respectively. Both increases are primarily due to the core deposit intangibles from the TXUI and Bank of Navasota acquisitions. The estimated aggregate future amortization expense for intangible assets remaining as of December 31, 2007 is as follows (dollars in thousands):

2008	$ 9,504
2009	8,448
2010	7,403
2011	6,254
2012	5,022
Thereafter	9,438
Total	$ 46,069

4. CASH AND DUE FROM BANKS

The Bank is required by the Federal Reserve Bank to maintain average reserve balances. Cash and due from banks in the consolidated balance sheets includes amounts so restricted of $25.6 million and $19.1 million at December 31, 2007 and 2006, respectively.

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5. SECURITIES

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

	December 31, 2007				
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses (Dollars in thousands)	Fair Value	Carrying Value
Available for Sale					
U.S. Treasury securities and obligations of U.S. government agencies	$ 3,986	$ 15	$ 2	$ 3,999	$ 3,999
70% non-taxable preferred stock	14,025			14,025	14,025
States and political subdivisions	51,119	962	148	51,933	51,933
Collateralized mortgage obligations	1,890		38	1,852	1,852
Mortgage-backed securities	170,269	1,614	276	171,607	171,607
Qualified Zone Academy Bond	8,000			8,000	8,000
Other securities	8,975	53		9,028	9,028
Total	$ 258,264	$ 2,644	$ 464	$ 260,444	$ 260,444
Held to Maturity					
U.S. Treasury securities and obligations of U.S. government agencies	$ 225,133	$ 1,572	$ 28	$ 226,677	$ 225,133
States and political subdivisions	36,398	286	304	36,380	36,398
Corporate debt securities	1,500	14		1,514	1,500
Collateralized mortgage obligations	222,062	744	1,914	220,892	222,062
Mortgage-backed securities	1,112,069	6,603	6,537	1,112,135	1,112,069
Total	$ 1,597,162	$ 9,219	$ 8,783	$ 1,597,598	$ 1,597,162

	December 31, 2006				
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses (Dollars in thousands)	Fair Value	Carrying Value
Available for Sale					
U.S. Treasury securities and obligations of U.S. government agencies	$ 290,629	$	$ 794	$ 289,835	$ 289,835
70% non-taxable preferred stock	24,000		3,795	20,205	20,205
States and political subdivisions	14,098	604		14,702	14,702
Collateralized mortgage obligations	5,352	12	36	5,328	5,328
Mortgage-backed securities	90,986	172	729	90,429	90,429
Qualified Zone Academy Bond	8,000			8,000	8,000

Other securities	5,804	28		5,832	5,832
Total	$ 438,869	$ 816	$ 5,354	$ 434,331	$ 434,331
Held to Maturity					
U.S. Treasury securities and obligations of U.S. government agencies	$ 111,699	$ 405	$ 588	$ 111,516	$ 111,699
States and political subdivisions	30,280	255	53	30,482	30,280
Corporate debt securities	4,507	6	10	4,503	4,507
Collateralized mortgage obligations	271,277	337	5,260	266,354	271,277
Mortgage-backed securities	738,209	616	20,584	718,241	738,209
Total	$ 1,155,972	$ 1,619	$ 26,495	$ 1,131,096	$ 1,155,972

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In estimating other-than-temporary impairment losses, management considers, among other things, (i) the length of time and the extent to which the fair value has been less than cost, (ii) the financial condition and near-term prospects of the issuer and (iii) the intent and ability of the Company to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value.

As part of its regular quarterly review for impairment of marketable securities, the Company recognized an other-than-temporary impairment charge of $10.0 million pre-tax on Federal Home Loan Mortgage Corporation (FHLMC or Freddie Mac) and on Federal National Mortgage Association (FNMA or Fannie Mae) government sponsored, investment grade perpetual callable preferred securities as of December 31, 2007. The other-than-temporary-impairment charge was recorded on six perpetual preferred stock issues classified as available for sale investment securities with a total book value (prior to recognition of the impairment charge) of $24.0 million. The Company decided to reclassify the unrealized mark-to-market loss on these investment grade securities to an other-than-temporary impairment charge because of the recent significant decline in the market value of these securities and because management believes it is unlikely that these securities will recover their original book value within a reasonable amount of time. Both FHLMC and FNMA securities were investment grade at the time of purchase and remain investment grade with ratings of AA- by S&P and Aa3 by Moody s. The preferred securities continue to perform according to their contractual terms and all dividend payments are current. Market value decreases on available for sale securities are recorded as an unrealized mark-to-market loss and reflected as a reduction to shareholders equity through other comprehensive income. Accordingly, the reclassification of the unrealized after tax loss to an other-than-temporary impairment non-cash charge did not affect shareholders equity, or tangible shareholders equity.

Management has the ability and intent to hold its securities until they mature, at which time the Company will receive full value for the securities. The unrealized losses are largely due to increases in market interest rates over the yields available at the time the underlying securities were purchased. The fair value is expected to recover as the investments approach their maturity date or repricing date or if market yields for such investments decline. Management does not believe any of the securities in an unrealized loss position at December 31, 2007 are impaired due to reasons of credit quality. Accordingly, as of December 31, 2007, management believes the impairments detailed in the table above are 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 such securities have been in a continuous loss position at December 31, 2007 were as follows:

	Less than 12 Months		More than 12 Months		Total	
	Estimated Fair Value	Unrealized Losses	Estimated Fair Value	Unrealized Losses	Estimated Fair Value	Unrealized Losses
			(Dollars in thousands)			
Available for Sale						
U.S. Treasury securities and obligations of U.S. government agencies	$	$	$ 502	$ 2	$ 502	$ 2
States and political subdivisions	7,982	148			7,982	148
70% non-taxable preferred stock						
Collateralized mortgage obligations	150		1,688	38	1,838	38
Mortgage-backed securities	12,623	41	22,368	235	34,991	276
Total	$ 20,755	$ 189	$ 24,558	$ 276	$ 45,313	$ 464
Held to Maturity						
U.S. Treasury securities and obligations of U.S. government agencies	$	$	$ 24,972	$ 28	$ 24,972	$ 28
States and political subdivisions	12,931	296	2,054	8	14,985	304
Corporate debt securities						
Collateralized mortgage obligations	4,399	27	127,997	1,887	132,396	1,914
Mortgage-backed securities	188,612	178	472,073	6,359	660,685	6,537
Total	$ 205,942	$ 501	$ 627,096	$ 8,282	$ 833,038	$ 8,783

Securities with unrealized losses segregated by length of time such securities have been in a continuous loss position at December 31, 2006 were as follows:

	Less than 12 Months		More than 12 Months		Total	
	Estimated Fair Value	Unrealized Losses	Estimated Fair Value	Unrealized Losses	Estimated Fair Value	Unrealized Losses
			(Dollars in thousands)			
Available for Sale						
U.S. Treasury securities and obligations of U.S. government agencies	$ 147,810	$ 311	$ 142,026	$ 483	$ 289,836	$ 794
70% non-taxable preferred stock			20,205	3,795	20,205	3,795
Collateralized mortgage obligations	48	1	2,024	35	2,072	36
Mortgage-backed securities	14,277	69	48,376	660	62,653	729
Total	$ 162,135	$ 381	$ 212,631	$ 4,973	$ 374,766	$ 5,354
Held to Maturity						

U.S. Treasury securities and obligations of U.S. government agencies	$ 27,635	$ 156	$ 24,568	$ 432	$ 52,203	$ 588
States and political subdivisions	3,891	22	2,234	31	6,125	53
Corporate debt securities	1,490	10			1,490	10
Collateralized mortgage obligations	31,712	166	154,663	5,094	186,375	5,260
Mortgage-backed securities	38,236	203	600,635	20,381	638,871	20,584
Total	$ 102,964	$ 557	$ 782,100	$ 25,938	$ 885,064	$ 26,495

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PROSPERITY BANCSHARES, INC.® AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

At December 31, 2007, there were approximately 323 securities in an unrealized loss position for more than 12 months.

The amortized cost and fair value of investment securities at December 31, 2007, 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.

	December 31, 2007			
	Held to Maturity		Available for Sale	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
	(Dollars in thousands)			
Due in one year or less	$ 56,339	$ 56,380	$ 11,253	$ 11,266
Due after one year through five years	153,172	154,275	8,733	8,755
Due after five years through ten years	14,859	15,137	13,784	14,238
Due after ten years	38,661	38,779	52,335	52,726
Subtotal	263,031	264,571	86,105	86,985
Mortgage-backed securities and collateralized mortgage obligations	1,334,131	1,333,027	172,159	173,459
Total	$ 1,597,162	$ 1,597,598	$ 258,264	$ 260,444

Gross proceeds from the sale of securities classified as available for sale were approximately $723.0 million for the year ended December 31, 2007 and resulted in a gain of $86,000. Gross proceeds from the sale of securities classified as available for sale was approximately $6.2 million for the year ended December 31, 2006. The one sale occurred in conjunction with the SNB acquisition and did not result in a gain or loss. Any difference in sales price compared to market price was booked as a purchase accounting adjustment.

At December 31, 2007 and 2006, 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 $1.52 billion and $1.34 billion and a fair value of $1.53 billion and $1.32 billion at December 31, 2007 and 2006, respectively, were pledged to collateralize public deposits and for other purposes required or permitted by law.

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6. LOANS

The loan portfolio consists of various types of loans made principally to borrowers located in South and Southeast Texas, the Houston CMSA, Austin, Corpus Christi and Dallas and is classified by major type as follows:

	December 31, 2007	December 31, 2006
	(Dollars in thousands)	
Commercial and industrial	$ 436,338	$ 280,957
Real estate:		
Construction and land development	683,171	433,178
1-4 family residential	526,338	376,996
Home equity	93,877	63,427
Commercial mortgages	1,075,285	803,145
Farmland	63,873	30,925
Multi-family residential	73,424	77,980
Agriculture	50,146	26,504
Consumer	123,213	66,675
Other	17,306	16,720
Total	3,142,971	2,176,507
Less unearned discount		
Total(1)	$ 3,142,971	$ 2,176,507

(1) Includes loans held for sale.

The Company s allowance for credit losses consists of three elements: (i) specific valuation allowances determined in accordance with SFAS 114 based on probable losses on specific loans; (ii) historical valuation allowances determined in accordance with SFAS 5 based on historical loan loss experience for similar loans with similar characteristics and trends; and (iii) general valuation allowances determined in accordance with SFAS 5 based on general economic conditions and other qualitative risk factors both internal and external to the Company. The recorded investment in impaired loans is $42.9 million and $15.0 million at December 31, 2007 and 2006, respectively. Such impaired loans required an allowance for credit losses of $2.4 million and $1.4 million at December 31, 2007 and 2006, respectively.

The Company had $15.4 million in nonperforming assets at December 31, 2007 compared with $1.1 million at December 31, 2006. The non-performing assets at December 31, 2007 consisted of ninety-two (92) separate credits or ORE properties of which 54 credits were acquired in the Company s 2007 acquisitions. Interest foregone on nonaccrual loans for the years ended December 31, 2007, 2006 and 2005 was $47,000, $30,000 and $35,000, respectively.

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The contractual maturity ranges of the 1-4 family residential, home equity, commercial and industrial, commercial mortgage, construction and land development, and agriculture portfolios and the amount of such loans with predetermined interest rates and floating rates in each maturity range are summarized in the following table:

	December 31, 2007			
	One Year or Less	After One Through Five Years	After Five Years	Total
	(Dollars in thousands)			
1-4 family residential and home equity	$ 26,630	$ 68,787	$ 524,798	$ 620,215
Commercial and industrial	213,140	156,637	66,561	436,338
Commercial mortgages	90,294	219,227	765,764	1,075,285
Construction and land development	343,650	112,981	226,540	683,171
Agriculture	28,249	19,365	2,532	50,146
Total	$ 701,963	$ 576,997	$ 1,586,195	$ 2,865,155
Loans with a predetermined interest rate.	$ 198,895	$ 348,879	$ 572,302	$ 1,120,076
Loans with a floating interest rate.	503,068	228,118	1,013,893	1,745,079
Total	$ 701,963	$ 576,997	$ 1,586,195	$ 2,865,155

As of December 31, 2007 and 2006, loans outstanding to directors, officers and their affiliates totaled $6.7 million and $7.2 million, respectively. All transactions entered into between the Company and such related parties have been, and are, in the ordinary course of business, made on the same terms and conditions as similar transactions with unaffiliated persons.

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

	Year Ended December 31,	
	2007	2006
	(Dollars in thousands)	
Beginning balance	$ 7,213	$ 7,620
New loans and reclassified related loans	1,836	2,757
Repayments	(2,364)	(3,164)
Ending balance	$ 6,685	$ 7,213

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PROSPERITY BANCSHARES, INC.® AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

7. ALLOWANCE FOR CREDIT LOSSES

An analysis of activity in the allowance for credit losses is as follows:

	Year Ended December 31,		
	2007	2006	2005
	(Dollars in thousands)		
Balance at beginning of year.	$ 23,990	$ 17,203	$ 13,105
Balance acquired in the TXUI and Navasota acquisitions	13,386		
Balance acquired in the SNB acquisition		7,054	
Balance acquired in the First Capital and Grapeland acquisitions			4,028
Addition provision charged to operations	760	504	480
(Charge-offs) and recoveries:			
Loans charged off	(8,162)	(1,177)	(892)
Loan recoveries	2,569	406	482
Net charge-offs	(5,593)	(771)	(410)
Balance at end of year.	$ 32,543	$ 23,990	$ 17,203

8. PREMISES AND EQUIPMENT

Premises and equipment are summarized as follows:

	Year Ended December 31,	
	2007	2006
	(Dollars in thousands)	
Land	$ 34,343	$ 20,298
Buildings	90,508	46,585
Furniture, fixtures and equipment	21,053	15,432
Construction in progress	1,191	1,395
Total	147,095	83,710
Less accumulated depreciation	(27,051)	(20,653)
Premises and equipment, net	$ 120,044	$ 63,057

Depreciation expense was $7.6 million, $5.0 million and $4.5 million for the years ended December 31, 2007, 2006 and 2005 respectively.

9. DEPOSITS

Included in interest-bearing deposits are certificates of deposit in amounts of $100,000 or more. These certificates and their remaining maturities at December 31, 2007 were as follows:

	December 31, 2007	
	(Dollars in thousands)	
Three months or less	$	234,171
Over three through six months.		241,556
Over six through 12 months		215,930
Over 12 months		116,829
Total	$	808,486

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Interest expense for certificates of deposit in excess of $100,000 was $36.4 million, $24.1 million and $14.2 million, for the years ended December 31, 2007, 2006 and 2005, respectively.

The Company has no brokered deposits and there are no major concentrations of deposits with any one depositor.

10. BORROWINGS

The Company utilizes borrowings to supplement deposits to fund its lending and investment activities. Borrowings consist of funds from the Federal Home Loan Bank (FHLB) and correspondent banks. FHLB advances are considered short-term, overnight borrowings. At December 31, 2007, the Company had $31.5 million in FHLB borrowings all of which consisted of long-term FHLB notes payable compared with $26.4 million in FHLB borrowings at December 31, 2006, all of which were long-term FHLB notes payable. The $5.1 million increase was primarily attributable to the TXUI acquisition. The weighted average interest rate paid on the FHLB notes payable at period end was 5.3%. The maturity dates on the FHLB notes payable range from the years 2008 to 2028 and have interest rates ranging from 3.08% to 6.26%. The highest outstanding balance of FHLB advances during 2007 was $240.0 million compared with $116.0 million during 2006. The Company had no federal funds purchased at December 31, 2007 or 2006.

At December 31, 2007, the Company had $84.6 million in securities sold under repurchase agreements compared with $47.2 million at December 31, 2006, an increase of $37.4 million or 79.1%. The increase was primarily attributable to normal customer activity and the TXUI acquisition.

The following table presents the Company s borrowings at December 31, 2007 and December 31, 2006:

	December 30, 2007	December 31, 2006
	(Dollars in thousands)	
FHLB long-term notes payable	$ 31,466	$ 26,408
Total other borrowings	31,466	26,408
Securities sold under repurchase agreements	84,581	47,225
Total	$ 116,047	$ 73,633

11. INTEREST RATE RISK

The Company is principally engaged in providing real estate, consumer and commercial loans, with interest rates that are both fixed and variable. These loans are primarily funded through short-term demand deposits and longer-term certificates of deposit with variable and fixed rates. The fixed real estate loans are more sensitive to interest rate risk because of their fixed rates and longer maturities.

12. FINANCIAL INSTRUMENTS WITH OFF-BALANCE-SHEET RISK

In the normal course of business, the Company is a party to various financial instruments with off-balance-sheet risk to meet the financing needs of its customers. These financial instruments include commitments to extend credit and standby letters of credit, which involve, to varying degrees, elements of credit and interest rate risk in excess of the amounts recognized in the consolidated balance sheets. The contract or notional amounts of these instruments reflect the extent of the Company s involvement in particular classes of financial instruments.

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The Company s exposure to credit loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit and standby letters of credit is represented by the contractual amount of these instruments. The Company uses the same credit policies in making these commitments and conditional obligations as it does for on-balance-sheet instruments.

The following is a summary of the contract or notional amount of the various financial instruments entered into by the Company:

	December 31,	
	2007	2006
	(Dollars in thousands)	
Commitments to extend credit	$ 681,052	$ 509,776
Standby letters of credit	16,112	9,696

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being fully drawn upon, the total commitment amounts disclosed above do not necessarily represent future cash funding requirements. At December 31, 2007, $75.7 million of commitments to extend credit have fixed rates ranging from 3.15% to 18.05%.

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

The Company evaluates customer creditworthiness on a case-by-case basis. The amount of collateral obtained, if considered necessary by the Company upon extension of credit, is based on management s credit evaluation of the customer.

13. INCOME TAXES

The components of the provision for federal income taxes are as follows:

	Year Ended December 31,		
	2007	2006	2005
	(Dollars in thousands)		
Current	$ 35,709	$ 26,695	$ 17,566
Deferred.	5,895	5,534	6,055
Total	$ 41,604	$ 32,229	$ 23,621

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PROSPERITY BANCSHARES, INC.® AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The provision for federal income taxes differs from the amount computed by applying the federal income tax statutory rate on income as follows:

	Year Ended December 31,		
	2007	2006	2005
	(Dollars in thousands)		
Taxes calculated at statutory rate	$ 44,014	$ 32,884	$ 25,018
Increase (decrease) resulting from:			
Tax-exempt interest	(1,579)	(773)	(538)
Qualified Zone Academy Bond credit	(373)	(373)	(373)
Dividends received deduction	(288)	(175)	(126)
BOLI income	(663)	(175)	(139)
Qualified stock options	280	251	
Other, net	213	590	(221)
Total	$ 41,604	$ 32,229	$ 23,621

Deferred tax assets and liabilities are as follows:

	December 31,	
	2007	2006
	(Dollars in thousands)	
Deferred tax assets:		
Allowance for credit losses	$ 11,134	$ 8,376
Accrued liabilities	3,854	642
Unrealized loss on available for sale securities		1,588
Loss carry forwards (expire 2022)	1,572	3,743
Credit carry forwards (expire 2021)	64	739
Securities	2,667	
Write down of securities	3,491	
Loans	844	
Restricted stock	391	47
Other		6
Total deferred tax assets	24,017	15,141
Deferred tax liabilities:		
Accretion on investments	$	$ (563)
Goodwill and core deposit intangibles	(17,879)	(9,565)
Unrealized gain on available for sale securities	(763)	
Bank premises and equipment	(4,559)	(573)
Basis difference in loans	(211)	(60)
Investments in partnerships	(6,889)	(2,048)
Prepaid expenses	(506)	(514)

FHLB dividends	(52)	(185)
Other	(53)	
Total deferred tax liabilities.	(30,912)	(13,508)
Net deferred tax (liabilities) assets	$ (6,895)	$ 1,633

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The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. Management considers the scheduled reversal of deferred tax liabilities, projected future taxable income, and tax planning strategies in making this assessment. Based upon the level of historical taxable income and estimates of future taxable income over the periods for which the deferred tax assets are deductible, management believes it is more likely than not the Company will realize the benefits of these deductible differences at December 31, 2007. The change in the Company s deferred tax assets and liabilities include purchase accounting adjustments.

The Company adopted *FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement 109* on January 1, 2007. Interpretation 48 prescribes a recognition threshold and a measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. Benefits from tax positions should be recognized in the financial statements only when it is more likely than not that the tax position will be sustained upon examination by the appropriate taxing authority that would have full knowledge of all relevant information. A tax position that meets the more-likely-than-not recognition threshold is measured at the largest amount of benefit that is greater than fifty percent likely of being realized upon ultimate settlement. Tax positions that previously failed to meet the more-likely-than-not recognition threshold should be recognized in the first subsequent financial reporting period in which that threshold is met. Previously recognized tax positions that no longer meet the more-likely-than-not recognition threshold should be derecognized in the first subsequent financial reporting period in which that threshold is no longer met. Interpretation 48 also provides guidance on the accounting for and disclosure of unrecognized tax benefits, interest and penalties. The Company s policy for recording interest and penalties associated with audits is to record such items as a component of income before taxes. Penalties are recorded in other (gains) losses and interest paid or received is recorded in interest expense or interest income, respectively, in the consolidated statement of income. The Company has identified its federal tax return and its state tax return in Texas as major tax jurisdictions, as defined. The only periods subject to examination for the Company s federal return are the 2003 through 2006 tax years.

14. STOCK INCENTIVE PROGRAMS

At December 31, 2007, the Company had three stock-based employee compensation plans and four stock option plans assumed in connection with acquisitions under which no additional options will be granted. Prior to 2003, the Company accounted for those plans under the recognition and measurement provisions of APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and related Interpretations. Effective January 1, 2003, the Company prospectively adopted the fair value recognition provisions of SFAS No. 123, *Accounting for Stack-Based Compensation*, as provided by SFAS No. 148 for stock-based employee compensation. The Company adopted SFAS 123(R) on January 1, 2006. The Company recognized $2.0 million and $850,000 in stock-based compensation expense for the year ended December 31, 2007 and 2006, respectively. There was approximately $409,000 and $47,000 of income tax benefit recorded for the stock-based compensation expense for the same periods.

During 1995, the Company s Board of Directors approved a stock option plan (the 1995 Plan) for executive officers and key associates to purchase common stock of Bancshares. A total of 675,000 options have been granted under the 1995 plan as of December 31, 2007. The maximum number of shares reserved for issuance pursuant to options granted under the 1995 Plan was 680,000 (after two-for-one and four-for-one stock splits). Options to acquire a total of 27,000 shares of common stock of Bancshares were outstanding at December 31, 2007, of which none were exercisable. The 1995 Plan expired on July 31, 2005 and therefore no additional options may be issued from the 1995 Plan.

PROSPERITY BANCSHARES, INC.® AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

During 1998, the Company s Board of Directors and shareholders approved the Prosperity Bancshares, Inc. 1998 Stock Incentive Plan (the 1998 Plan) which authorizes 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 provides for the granting of restricted stock awards, stock appreciation rights, phantom stock awards and performance awards on substantially similar terms. A total of 840,375 options have been granted under the 1998 Plan as of December 31, 2007. Options to purchase a total of 699,625 shares of common stock of Bancshares were outstanding at December 31, 2007, of which 156,000 options were exercisable.

In December 2004, the Company s Board of Directors established the Prosperity Bancshares, Inc. 2004 Stock Incentive Plan (the 2004 Plan), which was approved by the Company s shareholders on February 23, 2005. The 2004 Plan authorizes 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 provides for the granting of incentive and nonqualified stock options to employees and nonqualified stock options to directors who are not employees. The 2004 Plan also provides for the granting of shares of restricted stock, stock appreciation rights, phantom stock awards and performance awards on substantially similar terms. A total of 136,500 options and 89,911 shares of restricted stock have been granted under the 2004 Plan as of December 31, 2007. Options to purchase a total of 136,500 shares of common stock of Bancshares were outstanding at December 31, 2007, of which none were exercisable. At December 31, 2007, 79,161 shares of restricted stock were outstanding and subject to forfeiture restrictions.

On September 1, 2002, the Company acquired Paradigm Bancorporation. The options to purchase shares of Paradigm common stock outstanding at the effective time of the transaction were converted into options to purchase a total of 34,673 shares of Bancshares Common Stock at exercise prices ranging from $8.28 to $11.50 per share. The converted options are governed by the original plan under which they were issued. A total of 4,240 options were outstanding at December 31, 2007.

On November 1, 2003, the Company acquired MainBancorp, Inc. A portion of the options to purchase shares of MainBancorp common stock outstanding at the effective time of the transaction were converted at the option of the holder into options to purchase a total of 100,851 shares of Bancshares Common Stock at exercise prices ranging from $8.03 to $16.26 per share. The converted options are governed by the original plan under which they were issued. A total of 31,127 options were outstanding at December 31, 2007.

On March 1, 2005, the Company acquired First Capital Bankers, Inc. The options to purchase shares of First Capital Bankers, Inc. common stock outstanding at the effective time of the transaction were converted into options to purchase a total of 233,779 shares of Bancshares Common Stock at exercise prices ranging from $8.60 to $20.26 per share. The converted options are governed by the original plans under which they were issued. A total of 103,962 options were outstanding at December 31, 2007.

On April 1, 2006, the Company acquired SNB Bancshares, Inc. The options to purchase shares of SNB Bancshares, Inc. common stock outstanding at the effective time of the transaction were converted into options to purchase a total of 467,578 shares of Bancshares Common Stock at exercise prices ranging from $8.15 to $19.65 per share. The converted options are governed by the original plan under which they were issued. A total of 34,977 options were outstanding at December 31, 2007.

On January 31, 2007, the Company acquired Texas United Bancshares, Inc. The options to purchase shares of Texas United Bancshares, Inc. common stock outstanding at the effective time of the transaction were converted into options to purchase a total of 179,956 shares of Bancshares Common Stock at exercise prices

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PROSPERITY BANCSHARES, INC.® AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

ranging from $5.00 to $20.16 per share. The converted options are governed by the original plan under which they were issued. A total of 50,730 options were outstanding at December 31, 2007.

Stock options are issued at the current market price on the date of the grant, subject to a pre-determined vesting period with a contractual term of 10 years. Options assumed in connection with acquisitions have contractual terms as established in the original option grant agreements entered into prior to acquisition. The fair value of stock options granted is estimated at the date of grant using the Black-Scholes option-pricing model. Stock-based compensation expense is recognized ratably over the requisite service period for all awards.

The fair value of options was estimated using an option-pricing model with the following weighted average assumptions:

	December 31,		
	2007	2006	2005
Expected life in years	4.69	4.64	4.66
Risk free interest rate	4.20%	4.18%	4.19%
Volatility	21.04%	21.28%	21.43%
Dividend yield	1.23%	1.27%	1.30%

A summary of changes in outstanding vested and unvested options during the year ended December 31, 2007 is set forth below:

	Number of Options (In thousands)	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value (In thousands)
Options outstanding, beginning of period	1,142	$ 21.68		
Options granted(1)	235	17.84		
Options forfeited	(27)	24.42		
Options exercised	(262)	13.29		
Options outstanding, end of period	1,088	$ 23.26	5.87	$ 6,668
Options exercisable, end of period	381	$ 16.40	3.95	$ 4,951

(1) Includes options to acquire 179,956 shares of Common Stock assumed in connection with the TXUI acquisition.

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PROSPERITY BANCSHARES, INC.® AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The weighted-average grant date fair value of the options assumed in connection with the TXUI acquisition in January 2007 was $21.88. The total intrinsic value of the options exercised during the year ended December 31, 2007 and 2006 was $4.2 million and $9.9 million, respectively. The total fair value of shares vested and forfeited during the year ended December 31, 2007 was $321,000 and $138,000, respectively.

A summary of changes in unvested options during the year ended December 31, 2007 is set forth below:

	Number of Options (In thousands)	Weighted Average Grant Date Fair Value
Unvested options outstanding, beginning of period	778	$ 5.93
Options granted	55	8.28
Unvested options forfeited	(27)	5.17
Options vested	(99)	3.23
Unvested options outstanding, end of period	707	$ 6.52

The Company received $3.5 million and $7.8 million in cash from the exercise of stock options during the years ended December 31, 2007 and 2006, respectively. In 2006, the increase in cash received for the exercise of stock options was primarily due to the exercise of options assumed in connection with the SNB acquisition. The Company assumed 467,578 options with a weighted average exercise price of $15.10, of which 392,406 were exercised by December 31, 2006. There was no tax benefit realized from exercises of the stock-based compensation arrangements during the years ended December 31, 2007 and 2006.

As of December 31, 2007, there was $3.1 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 1.7 years.

The following table presents information relating to the Company s stock options outstanding at December 31, 2007:

	Options Outstanding			Options Exercisable	
Range of Exercise Prices	Number Outstanding	Weighted Average Exercise Price	Weighted Average Remaining Life (years)	Number Outstanding	Weighted Average Exercise Price
$ 0.00 - $ 5.00	12,000	$ 3.13	0.34		$
$ 5.01 - $10.00	30,730	7.61	3.67	30,730	7.61
$10.01 - $15.00	70,121	10.50	3.13	70,121	10.50
$15.00 - $20.00	222,561	17.80	5.15	183,811	17.79
$20.01 - $25.00	130,749	21.56	3.10	96,374	20.84
$25.01 - $31.00	525,500	27.28	6.92		
$25.01 - $31.00	96,500	32.61	8.77		

1,088,161	$	23.26	5.87	381,036	$	16.40

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PROSPERITY BANCSHARES, INC.® AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

15. OTHER NONINTEREST INCOME AND EXPENSE

Other noninterest income and expense totals are presented in the following tables. Components of these totals exceeding 1% of the aggregate of total net interest income and total noninterest income for any of the years presented is stated separately.

	Years Ended December 31,		
	2007	2006	2005
	(Dollars in thousands)		
Other noninterest expense			
Communications expense	$ 6,351	$ 4,339	$ 3,782
Ad valorem and franchise taxes	2,462	2,246	1,594
Regulatory assessments and FDIC insurance	1,035	716	548
Other	10,478	7,657	8,487
Total	$ 20,326	$ 14,958	$ 14,411
Other noninterest income			
Banking related service fees	$ 1,737	$ 1,358	$ 1,133
Brokered mortgage income	679	839	695
Income from leased assets	1,323	1,075	895
Other	8,161	3,331	2,392
Total	$ 11,900	$ 6,603	$ 5,115

16. PROFIT SHARING PLAN

The Company has adopted a profit sharing plan pursuant to Section 401(k) of the Internal Revenue Code whereby the participants may contribute a percentage of their compensation as permitted under the Code. Matching contributions are made at the discretion of the Company. Presently, the Company matches 50% of an employee s contributions, up to 15% of such employee s compensation, not to exceed the maximum allowable pursuant to the Internal Revenue Code and excluding catch-up contributions. Such matching contributions were approximately $1.6 million, $1.0 million and $866,000, for the years ended December 31, 2007, 2006 and 2005, respectively.

17. COMMITMENTS AND CONTINGENCIES

Leases The following table presents a summary of non-cancelable future operating lease commitments as of December 31, 2007 (dollars in thousands):

2008	$ 3,375
2009	2,791
2010	2,085
2011	1,332
2012	1,080

Thereafter	2,000
Total	$ 12,663

It is expected that in the normal course of business, expiring leases will be renewed or replaced by leases on other property or equipment.

PROSPERITY BANCSHARES, INC.® AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Rent expense under all noncancelable operating lease obligations aggregated approximately $3.9 million for the year ended December 31, 2007, $3.4 million for the year ended December 31, 2006 and $3.0 million for the year ended December 31, 2005.

Litigation The Company has been named as a defendant in various legal actions arising in the normal course of business. In the opinion of management, after reviewing such claims with outside counsel, resolution of such matters will not have a materially adverse impact on the consolidated financial statements.

18. REGULATORY MATTERS

The Company and the Bank are subject to various regulatory capital requirements administered by the federal banking agencies. Any institution that fails to meet its minimum capital requirements is subject to actions by regulators that could have a direct material effect on the Company s and the Bank s financial statements. Under the capital adequacy guidelines and the regulatory framework for prompt corrective action, the Bank must meet specific capital guidelines based on the Bank s assets, liabilities and certain off-balance-sheet items as calculated under regulatory accounting practices. The Company s and the Bank s capital amounts and the Bank s classification under the regulatory framework for prompt corrective action are also subject to qualitative judgements by the regulators about the components, risk weightings and other factors.

To meet the capital adequacy requirements, the Company and the Bank must maintain minimum capital amounts and ratios as defined in the regulations. As of December 31, 2007, the Company and the Bank met all capital adequacy requirements to which they are subject.

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PROSPERITY BANCSHARES, INC.® AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

At December 31, 2007, the most recent notification from the FDIC categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized the Bank must maintain minimum total risk-based, Tier I risk-based and Tier I leverage ratios as set forth in the table. There have been no conditions or events since that notification which management believes have changed the Bank s category.

The following is a summary of the Company s and the Bank s capital ratios at December 31, 2007 and 2006:

	Actual		For Capital Adequacy Purposes		To Be Categorized As Well Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
			(Dollars in thousands)			
CONSOLIDATED:						
As of December 31, 2007:						
Total Capital (to Risk Weighted Assets)	$ 468,077	14.11%	$ 265,384	8.00%	N/A	N/A
Tier I Capital (to Risk Weighted Assets)	435,534	13.13	132,692	4.00	N/A	N/A
Tier I Capital (to Average Tangible Assets)	435,534	8.09	161,471	3.00	N/A	N/A
As of December 31, 2006:						
Total Capital (to Risk Weighted Assets)	$ 339,033	14.55%	$ 186,361	8.0%	N/A	N/A
Tier I Capital (to Risk Weighted Assets)	315,043	13.52	93,180	4.0	N/A	N/A
Tier I Capital (to Average Tangible Assets)	315,043	7.76	121,798	3.0	N/A	N/A

	Actual		For Capital Adequacy Purposes		To Be Categorized As Well Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
			(Dollars in thousands)			
PROSPERITY BANK® ONLY:						
As of December 31, 2007:						
Total Capital (to Risk Weighted Assets)	$ 452,342	13.68%	$ 264,487	8.00%	$ 330,609	10.00%
Tier I Capital (to Risk Weighted Assets)	419,799	12.70	132,692	4.00	198,365	6.00
Tier I Capital (to Average Tangible Assets)	419,799	7.82	161,471	3.00	268,559	5.00
As of December 31, 2006:						
Total Capital (to Risk Weighted Assets)	$ 332,556	14.31%	$ 185,915	8.0%	$ 232,394	10.0%

Tier I Capital (to Risk Weighted Assets)	308,566	13.28	92,958	4.0	139,436	6.0
Tier I Capital (to Average Tangible Assets)	308,566	7.61	121,659	3.0	202,764	5.0

PROSPERITY BANCSHARES, INC.® AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Dividends paid by Bancshares and the Bank are subject to restrictions by certain regulatory agencies. Dividends paid by Bancshares during the years ended December 31, 2007, 2006 and 2005 were $20.3 million, $13.0 million and $9.6 million, respectively. Dividends paid by the Bank to Bancshares during the years ended December 31, 2007, 2006 and 2005 were $69.0 million, $102.0 million and $6.0 million, respectively.

19. DISCLOSURES ABOUT FAIR VALUE OF FINANCIAL INSTRUMENTS

Disclosures of the estimated fair value amounts of financial instruments have been determined by the Company using available market information and appropriate valuation methodologies. However, considerable judgment is necessarily required in interpreting market data to develop the estimates of fair value. Accordingly, the estimates presented herein are not necessarily indicative of the amounts the Company could realize in a current market exchange. The use of different market assumptions and/or estimation methodologies could have a material effect on the estimated fair value amounts.

The following methods and assumptions were used to estimate the fair value of each class of financial instruments for which it is practicable to estimate that value:

Cash and Cash Equivalents For these short-term instruments, the carrying amount is a reasonable estimate of fair value.

Interest-Bearing Deposits in Financial Institutions The carrying amount is a reasonable estimate of fair value.

Federal Funds Sold The carrying amount is a reasonable estimate of fair value.

Securities For securities held as investments, fair value equals quoted market price, if available. If a quoted market price is not available, fair value is estimated using quoted market prices for similar securities.

Loans Held for Investment For certain homogeneous categories of loans (such as some residential mortgages and other consumer loans), fair value is estimated by discounting the future cash flows using the risk-free Treasury rate for the applicable maturity, adjusted for servicing and credit risk. The carrying value of variable rate loans approximates fair value because the loans reprice frequently to current market rates.

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

Junior Subordinated Debentures The fair value of the junior subordinated debentures was calculated using the quoted market prices, if available. If a quoted market prices are not available, fair value is estimated using quoted market prices for similar subordinated debentures.

Other Borrowings Rates currently available to the Company for debt with similar terms and remaining maturities are used to estimate the fair value of existing debt using a discounted cash flows methodology.

Securities Sold Under Repurchase Agreements The fair value of securities sold under repurchase agreements is the amount payable on demand at the reporting date.

Federal Home Loan Bank Notes Payable Rates currently available to the Company for debt with similar terms and remaining maturities are used to estimate the fair value of existing debt using a discounted cash flows methodology.

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PROSPERITY BANCSHARES, INC.® AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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 estimated fair values of the Company s interest-earning financial instruments are as follows:

	December 31,			
	2007		2006	
	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
	(Dollars in thousands)			
Financial assets:				
Cash and due from banks	$ 178,247	$ 178,247	$ 116,078	$ 116,078
Interest bearing deposits in financial institutions	200	200	397	397
Federal funds sold	192,843	192,843	153,643	153,643
Held to maturity securities	1,597,162	1,597,598	1,155,972	1,131,096
Available for sale securities	260,444	260,444	434,331	434,331
Loans held for investment and sale	3,142,971	3,177,228	2,176,507	2,151,957
Less allowance for credit losses	(32,543)	(32,543)	(23,990)	(23,990)
Total	$ 5,339,324	$ 5,374,017	$ 4,012,938	$ 3,963,512
Financial liabilities:				
Deposits	$ 4,966,407	$ 4,971,408	$ 3,725,678	$ 3,724,984
Junior subordinated debentures	112,885	117,803	100,519	104,329
Other borrowings				
Securities sold under repurchase agreements	84,581	84,581	47,225	47,225
Federal Home Loan Bank notes payable	31,466	32,524	26,408	26,967
Total	$ 5,195,339	$ 5,206,316	$ 3,899,830	$ 3,903,505

The differences in fair value and carrying value of commitments to extend credit and standby letters of credit were not material at December 31, 2007 and 2006.

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

20. JUNIOR SUBORDINATED DEBENTURES

At December 31, 2007 and 2006, the Company had outstanding $112.9 million and $100.5 million, respectively, in junior subordinated debentures issued to the Company s unconsolidated subsidiary trusts. The increase of $12.4 million was due to the Company s assumption on January 31, 2007 of $44.8 million in junior subordinated debentures issued by TXUI to its five subsidiary trusts, partially offset by the redemption of the debentures held by First Capital Statutory Trust I in the amount of $20.6 million on June 26, 2007, the redemption of the debentures held by Gateway Statutory Trust I in the amount of $4.1 million on June 26, 2007 and the redemption of the debentures held by First Capital Statutory Trust II in the amount $7.7 million on

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PROSPERITY BANCSHARES, INC.® AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 26, 2007. The debentures redeemed on June 26, 2007 bore interest at a floating rate of 3 month LIBOR + 3.60% and the debentures redeemed on September 26, 2007 bore interest at a floating rate of 3 month LIBOR + 3.40%. The trusts in turn redeemed in full the trust preferred securities and common securities they issued.

A summary of pertinent information related to the Company s ten issues of junior subordinated debentures outstanding at December 31, 2007 is set forth in the table below:

Description	Issuance Date	Trust Preferred Securities Outstanding	Interest Rate(1)	Junior Subordinated Debt Owed to Trusts	Maturity Date(2)
Prosperity Statutory Trust II	July 31, 2001	$ 15,000,000	3-month LIBOR + 3.58%, not to exceed 12.50%	$ 15,464,000	July 31, 2031
Prosperity Statutory Trust III	Aug. 15, 2003	12,500,000	6.50%(3)	12,887,000	Sept. 17, 2033
Prosperity Statutory Trust IV	Dec. 30, 2003	12,500,000	6.50%(4)	12,887,000	Dec. 30, 2033
SNB Statutory Trust II(5)	Mar. 26, 2003	10,000,000	3-month LIBOR +3.15%	10,310,000	Mar. 26, 2033
SNB Capital Trust III(5)	Mar. 27, 2003	10,000,000	3-month LIBOR +3.15%	10,310,000	Mar. 27, 2033
SNB Capital Trust IV(5)	Sept. 25, 2003	10,000,000	3-month LIBOR +3.00%	10,310,000	Sept. 25, 2033
TXUI Statutory Trust I(6)	Sept. 07, 2000	7,000,000	10.60%	7,210,000	Sept. 07, 2030
TXUI Statutory Trust II(6)	Dec. 19, 2003	5,000,000	6.45%(7)	5,155,000	Dec. 19, 2033
TXUI Statutory Trust III(6)	Nov. 30, 2005	15,500,000	3-month LIBOR +1.39%	15,980,000	Dec. 15, 2035
TXUI Statutory Trust IV(6)	Mar. 31, 2006	12,000,000	3-month LIBOR +1.39%	12,372,000	June 30, 2036

(1) The 3-month LIBOR in effect as of December 31, 2007 was 4.70%.
(2) All debentures are callable five years from issuance date except for TXUI Statutory Trust I which is callable ten years from issuance date.
(3) The debentures bear a fixed interest rate until September 17, 2008, when the rate begins to float on a quarterly basis based on the three-month LIBOR plus 3.00%.
(4) The debentures bear a fixed interest rate until December 30, 2008, when the rate begins to float on a quarterly basis based on the three-month LIBOR plus 2.85%.
(5) Assumed in connection with the SNB acquisition on April 1, 2006.
(6) Assumed in connection with the TXUI acquisition on January 31, 2007.
(7)

The debentures bear a fixed interest rate until December 19, 2008, when the rate begins to float on a quarterly basis based on the three-month LIBOR plus 2.85%.

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

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PROSPERITY BANCSHARES, INC.® AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

21. PARENT COMPANY ONLY FINANCIAL STATEMENTS

PROSPERITY BANCSHARES, INC.

(Parent Company Only)

CONDENSED BALANCE SHEETS

	December 31, 2007	December 31, 2006
	(Dollars in thousands)	
ASSETS		
Cash	$ 2,928	$ 2,727
Investment in subsidiary	1,214,821	751,512
Investment in Capital and Statutory Trusts	3,385	3,019
Goodwill, net	6,433	3,983
Other assets	13,619	4,326
TOTAL	$ 1,241,186	$ 765,567
LIABILITIES AND SHAREHOLDERS EQUITY		
LIABILITIES:		
Accrued interest payable and other liabilities	$ 870	$ 637
Junior subordinated debentures	112,885	100,519
Total liabilities	113,755	101,156
SHAREHOLDERS EQUITY:		
Common stock	44,188	32,830
Capital surplus.	809,026	425,557
Retained earnings	273,407	209,581
Unrealized gain (loss) on available for sale securities, net of tax benefit	1,417	(2,950)
Less treasury stock, at cost, 37,088 shares	(607)	(607)
Total shareholders equity	1,127,431	664,411
TOTAL	$ 1,241,186	$ 765,567

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PROSPERITY BANCSHARES, INC.® AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

PROSPERITY BANCSHARES, INC.

(Parent Company Only)

CONDENSED STATEMENTS OF INCOME

	For the Years Ended December 31,		
	2007	2006	2005
	(Dollars in thousands)		
OPERATING INCOME:			
Dividends from subsidiaries	$ 69,000	$ 102,000	$ 6,000
Other income	383	224	142
Total income	69,383	102,224	6,142
OPERATING EXPENSE:			
Junior subordinated debentures interest expense	10,058	7,592	4,895
Stock-based compensation expense (includes restricted stock)	1,968	850	751
Other expenses	432	333	353
Total operating expense	12,458	8,775	5,999
INCOME BEFORE INCOME TAX BENEFIT AND EQUITY IN UNDISTRIBUTED EARNINGS OF SUBSIDIARIES	56,925	93,449	143
FEDERAL INCOME TAX BENEFIT	4,018	2,783	1,833
INCOME BEFORE EQUITY IN UNDISTRIBUTED EARNINGS OF SUBSIDIARIES	60,943	96,232	1,976
EQUITY (DISTRIBUTIONS IN EXCESS OF EARNINGS) IN UNDISTRIBUTED EARNINGS OF SUBSIDIARIES	23,208	(34,507)	45,884
NET INCOME	$ 84,151	$ 61,725	$ 47,860

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PROSPERITY BANCSHARES, INC.® AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

PROSPERITY BANCSHARES, INC.

(Parent Company Only)

CONDENSED STATEMENTS OF CASH FLOWS

	For the Years Ended December 31,		
	2007	2006	2005
	(Dollars in thousands)		
CASH FLOWS FROM OPERATING ACTIVITIES:			
Net income	$ 84,151	$ 61,725	$ 47,860
Adjustments to reconcile net income to net cash provided by operating activities:			
(Distributions in excess of earnings) equity in undistributed earnings of subsidiaries	(23,208)	34,507	(45,883)
Stock based compensation expense (includes restricted stock)	1,968	850	751
(Increase) decrease in other assets	(2,065)	1,367	(277)
Decrease in accrued interest payable and other liabilities	(8,192)	(59)	(117)
Net cash provided by operating activities	52,654	98,390	2,334
CASH FLOWS FROM INVESTING ACTIVITIES:			
Cash paid for acquisitions	(8,629)	(93,275)	
Cash acquired from acquisitions	5,491	6,688	3,757
Capital contribution to subsidiary		(7)	
Net cash (used in) provided by investing activities	(3,138)	(86,594)	3,757
CASH FLOWS FROM FINANCING ACTIVITIES:			
Proceeds from stock option exercises	3,485	7,792	1,085
Redemption of junior subordinated debentures (net)	(32,475)	(6,000)	
Payments of cash dividends	(20,325)	(13,027)	(9,624)
Net cash used in financing activities	(49,315)	(11,235)	(8,539)
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	201	561	(2,448)
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	2,727	2,166	4,614
CASH AND CASH EQUIVALENTS, END OF PERIOD	$ 2,928	$ 2,727	$ 2,166

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PROSPERITY BANCSHARES, INC.® AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

22. SUBSEQUENT EVENTS (Unaudited)

Acquisition of Branches of Banco Popular North America

On January 10, 2008, the Company completed its acquisition of six (6) Houston retail branches from Banco Popular North America. In connection with the acquisition, the Company assumed approximately $125.0 million in deposits. Since January 11, 2008, all six (6) locations have been operating as full service banking centers of Prosperity Bank.

Acquisition of 1st Choice Bancorp, Inc.

On February 7, 2008, the Company announced the signing of a definitive agreement to acquire 1st Choice Bancorp, Inc and its wholly- owned subsidiary, 1st Choice Bank. 1st Choice Bancorp operates two (2) banking offices in Houston, Texas, with one location in South Houston and another in the Heights area. Prosperity s Heights banking center will be consolidated with the 1st Choice Bancorp Heights location, with the resulting banking center being located in 1st Choice s Heights banking office. As of December 31, 2007, 1st Choice Bancorp had, on a consolidated basis, total assets of $303.1 million, loans of $190.7 million and deposits of $273.3 million. Under the terms of the definitive agreement, Prosperity will issue approximately 1,757,813 shares of Prosperity common stock plus approximately $18,750,000 in cash for all outstanding shares of 1st Choice Bancorp capital stock, subject to decrease in the event 1st Choice Bancorp s equity capital is less than $26.0 million.

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EXHIBIT INDEX

Exhibit Number[1]	Description
3.1	Amended and Restated Articles of Incorporation of Prosperity Bancshares, Inc. (incorporated herein by reference to Exhibit 3.1 to the Company s Registration Statement on Form S-1 (Registration No. 333-63267))
3.2	Articles of Amendment to Amended and Restated Articles of Incorporation of Prosperity Bancshares, Inc. (incorporated herein by reference to Exhibit 3.2 to the Company s Quarterly Report on Form 10-Q for the quarter ended March 31, 2006)
3.3	Amended and Restated Bylaws of Prosperity Bancshares, Inc. (incorporated herein by reference to Exhibit 3.1 to the Company s Current Report on Form 8-K filed October 19, 2007)
4.1	Form of certificate representing shares of Prosperity Bancshares, Inc. common stock (incorporated herein by reference to Exhibit 4 to the Company s Registration Statement on Form S-1 (Registration No. 333-63267))
4.2	Indenture dated as of July 31, 2001 by and between Prosperity Bancshares, Inc., as Issuer, and State Street Bank and Trust Company of Connecticut, National Association, with respect to the Floating Rate Junior Subordinated Deferrable Interest Debentures of Prosperity Bancshares, Inc. (incorporated herein by reference to Exhibit 4.1 to the Company s Quarterly Report on Form 10-Q for the quarter ended September 30, 2001)
4.3	Amended and Restated Declaration of Trust of Prosperity Statutory Trust II dated as of July 31, 2001 (incorporated herein by reference to Exhibit 4.2 to the Company s Quarterly Report on Form 10-Q for the quarter ended September 30, 2001)
4.4	Guarantee Agreement dated as of July 31, 2001 by and between Prosperity Bancshares, Inc. and State Street Bank and Trust Company of Connecticut, National Association (incorporated herein by reference to Exhibit 4.3 to the Company s Quarterly Report on Form 10-Q for the quarter ended September 30, 2001)
10.1	Prosperity Bancshares, Inc. 1995 Stock Option Plan (incorporated herein by reference to Exhibit 10.1 to the Company s Registration Statement on Form S-1 (Registration No. 333-63267))
10.2	Prosperity Bancshares, Inc. 1998 Stock Incentive Plan (incorporated herein by reference to Exhibit 10.2 to the Company s Registration Statement on Form S-1 (Registration No. 333-63267))
10.3	Prosperity Bancshares, Inc. 2004 Stock Incentive Plan (incorporated herein by reference to Exhibit 10.3 to the Company s Registration Statement on Form S-4 (Registration No. 333-121767))
10.4	Amended and Restated Employment Agreement by and between Prosperity Bank and David Zalman (incorporated herein by reference to Exhibit 10.1 to the Company s Current Report on Form 8-K filed January 24, 2005)
10.5	Amended and Restated Employment Agreement by and between Prosperity Bank and H. E. Timanus, Jr. (incorporated herein by reference to Exhibit 10.2 to the Company s Current Report on Form 8-K filed January 24, 2005)
10.6	Employment Agreement, dated as of August 10, 2006, by and among Prosperity Bancshares, Inc., Prosperity Bank and James D. Rollins III (incorporated herein by reference to Exhibit 10.1 to the Company s Current Report on Form 8-K filed on August 15, 2006)
10.7	Employment Agreement, dated as of August 10, 2006, by and among Prosperity Bancshares, Inc., Prosperity Bank and David Hollaway (incorporated herein by reference to Exhibit 10.2 to the Company s Current Report on Form 8-K filed on August 15, 2006)

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Exhibit Number(1)	Description
10.8	First Amendment to Employment and Non-Competition Agreement, dated as of September 19, 2006, by and between Prosperity Bank and Peter E. Fisher (incorporated herein by reference to Exhibit 10.1 to the Company s Current Report on Form 8-K filed on September 21, 2006)
10.9	Employment and Non-Competition Agreement, dated as of September 1, 2002, by and between Prosperity Bank and Peter E. Fisher (incorporated herein by reference to Exhibit 10.2 to the Company s Current Report on Form 8-K filed on September 21, 2006)
10.10	Termination Agreement dated as of December 8, 2005 by and among Prosperity Bancshares, Inc., Prosperity Bank and D. Michael Hunter (incorporated herein by reference to Exhibit 10.1 to the Company s Current Report on Form 8-K filed December 9, 2005)
10.11	Non-Competition Agreement dated as of December 8, 2005 by and among Prosperity Bancshares, Inc., Prosperity Bank and D. Michael Hunter (incorporated herein by reference to Exhibit 10.2 to the Company s Current Report on Form 8-K filed December 9, 2005)
10.12	Paradigm Bancorporation, Inc. 1999 Stock Incentive Plan (incorporated herein by reference to Exhibit 4.2 to the Company s Registration Statement on Form S-8 (Registration No. 333-100815))
10.13	MainBancorp, Inc. 1996 Employee Stock Option Plan (incorporated herein by reference to Exhibit 4.2 to the Company s Registration Statement on Form S-8 (Registration No. 333-110755))
10.14	Form of MainBancorp, Inc. Non-Qualified Stock Option Agreement (incorporated herein by reference to Exhibit 4.3 to the Company s Registration Statement on Form S-8 (Registration No. 333-110755))
10.15	First Capital Bankers, Inc. 1996 Executive Stock Option Plan (incorporated herein by reference to Exhibit 10.11 to the Company s Annual Report on Form 10-K for the year ended December 31, 2004)
10.16	First Capital Bankers, Inc. Amended and Restated 1998 Stock Option Plan (incorporated herein by reference to Exhibit 10.12 to the Company s Annual Report on Form 10-K for the year ended December 31, 2004)
10.17	SNB Bancshares, Inc. 2002 Stock Option Plan, as amended and restated (incorporated herein by reference to Exhibit 4.2 to the Company s Registration Statement on Form S-8 (Registration No. 333-133214))
10.18	Texas United Bancshares, Inc. 1998 Incentive Stock Option Plan (incorporated herein by reference to Exhibit 4.2 to the Company s Registration Statement on Form S-8 (Registration No. 333-140425))
10.19	Texas United Bancshares, Inc. 2004 Stock Incentive Plan (incorporated herein by reference to Exhibit 4.3 to the Company s Registration Statement on Form S-8 (Registration No. 333-140425))
10.20	1998 Incentive Stock Option Plan for Gateway Holding Company, Inc. (incorporated herein by reference to Exhibit 4.4 to the Company s Registration Statement on Form S-8 (Registration No. 333-140425))
10.21	Stock Option Agreement dated July 1, 1998 by and between Texas United Bancshares, Inc. and L. Steve Stapp (incorporated herein by reference to Exhibit 4.5 to the Company s Registration Statement on Form S-8 (Registration No. 333-140425))
21.1*	Subsidiaries of Prosperity Bancshares, Inc.
23.1*	Consent of Deloitte & Touche LLP

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Exhibit Number[(1)]	Description
31.1*	Certification of the Chief Executive Officer pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended.
31.2*	Certification of the Chief Financial Officer pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended.
32.1**	Certification of the Chief Executive Officer pursuant to 18 U.S.C. Section 1350, adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2**	Certification of the Chief Financial Officer pursuant to 18 U.S.C. Section 1350, adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

Management contract or compensatory plan or arrangement.
* Filed with this Annual Report on Form 10-K.
** Furnished with this Annual Report on Form 10-K.
(1) The Company has other long-term debt agreements that meet the exclusion set forth in Section 601(b)(4)(iii)(A) of Regulation S-K. The Company hereby agrees to furnish a copy of such agreements to the Commission upon request.