FEDERAL RESERVE SYSTEM

Prosperity Bancshares, Inc.
Houston, Texas

Order Approving the Acquisition of a Bank Holding Company

Prosperity Bancshares, Inc. ("Prosperity"), a bank holding company within the meaning of the Bank Holding Company Act ("BHC Act"), has requested the Board's approval under section 3 of the BHC Act (12 U.S.C. § 1842) to merge with Commercial Bancshares, Inc., Houston, Texas ("Commercial"), and thereby acquire Heritage Bancshares, Inc., Wilmington, Delaware ("Heritage Holdco"), a bank holding company that is a wholly owned subsidiary of Commercial, and its subsidiary bank, Heritage Bank, Wharton, Texas.[1]

Notice of the proposal, affording interested persons an opportunity to submit comments, has been published (65 Federal Register 70,911 (2000)). The time for filing comments has expired, and the Board has considered the proposal in light of the factors set forth in section 3 of the BHC Act.

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[1] Under the proposal, Commercial would be merged into Prosperity, which would be the surviving corporation. Immediately following that merger, Prosperity's wholly owned subsidiary, Prosperity Holdings, Inc., Wilmington, Delaware ("Prosperity Holdco"), which is also a bank holding company, would be merged into Heritage Holdco. Heritage Holdco would be the surviving corporation of this second transaction. In addition, Heritage Bank, currently a state nonmember bank subsidiary of Heritage Holdco, would be merged into First Prosperity Bank, which is a subsidiary of Prosperity Holdco and which would be the surviving corporation of this transaction. The merger of Heritage Bank and First Prosperity Bank is subject to review by the Federal Deposit Insurance Corporation ("FDIC") under the Bank Merger Act (12 U.S.C. § 1828(c)).

Prosperity operates the 35th largest depository institution in Texas, controlling $519 million in deposits, which represent less than 1 percent of total deposits in depository institutions in the state.[2] Commercial operates the 54th largest depository institution in Texas, controlling $356 million in deposits. On consummation of this proposal, Prosperity would control the 23rd largest depository institution in Texas, with deposits of $875 million, representing less than 1 percent of the total deposits in depository institutions in the state.

Competitive Considerations

The BHC Act prohibits the Board from approving an application under section 3 of the BHC Act if the proposal would result in a monopoly or would be in furtherance of any attempt to monopolize the business of banking. The BHC Act also prohibits the Board from approving a proposed combination that would substantially lessen competition or tend to create a monopoly in any relevant banking market, unless the Board finds that the anticompetitive effects of the proposal are clearly outweighed in the public interest by the probable effect of the proposal in meeting the convenience and needs of the community to be served.[3]

Prosperity and Commercial compete directly in two banking markets in Texas, the Houston banking market and the Wharton County banking market.[4] The Board has carefully reviewed the competitive effects of the proposal in each

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[2] All data are as of June 30, 2000. In this context, depository institutions include commercial banks, savings banks, and savings associations.

[3] 12 U.S.C. § 1842(c).

[4] The Houston banking market is defined as the Houston Ranally Metropolitan Area. The Wharton County banking market is defined as Wharton County, Texas.

of these banking markets in light of all the facts of record, including, among other market characteristics, the share of total deposits in depository institutions ("market deposits") controlled by each competitor in the markets,[5] the concentration level of market deposits, and the increase in this level as measured by the Herfindahl-Hirschman Index ("HHI").[6]

Houston Banking Market

Consummation of the proposal in the Houston banking market would be consistent with the DOJ Guidelines and Board precedent.[7] Prosperity operates the 51st largest depository institution in the market, controlling less than 1 percent of market deposits. Commercial operates the 26th largest depository institution in

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[5] Market share data are based on calculations that take into account the deposits of thrift institutions, which include savings banks and savings associations, weighted at 50 percent. The Board previously has indicated that thrift institutions have become, or have the potential to become, significant competitors of commercial banks. See, e.g., Midwest Financial Group, 75 Federal Reserve Bulletin 386 (1989); National City Corporation, 70 Federal Reserve Bulletin 743 (1984). Thus, the Board regularly has included thrift deposits in the calculation of market share at a weighting of 50 percent. See, e.g., First Hawaiian, Inc., 77 Federal Reserve Bulletin 52 (1991).

[6] Under the Department of Justice Merger Guidelines ("DOJ Guidelines"), 49 Federal Register 26,823 (June 29, 1984), a market in which the post-merger HHI is more than 1800 is considered to be highly concentrated. The Department of Justice has informed the Board that a bank merger or acquisition generally will not be challenged (in the absence of other factors indicating anticompetitive effects) unless the post-merger HHI is at least 1800 and the merger increases the HHI by more than 200 points. The Department of Justice has stated that the higher than normal HHI thresholds for screening bank mergers for anticompetitive effects implicitly recognize the competitive effects of limited-purpose lenders and other nondepository financial institutions.

[7] Under the DOJ Guidelines, a market in which the post-merger HHI is less than 1000 points is considered to be unconcentrated.

the market, controlling less than 1 percent of market deposits. On consummation of the proposal, Prosperity would operate the 20th largest depository institution in the market, controlling deposits of $330 million, representing less than 1 percent of market deposits. The HHI for the market would increase 1 point to 869. The market would remain unconcentrated after consummation of the proposal, and numerous competitors would remain in the market.

Wharton County Banking Market

In the Wharton County banking market, consummation of the proposal would increase the level of market concentration, as measured by the HHI, to levels that, according to the DOJ Guidelines and Board precedent, exceed the threshold for in-depth review of the transaction. Prosperity operates the largest of the ten depository institutions in the market, and controls deposits of $139.3 million, representing 25.3 percent of market deposits. Commercial operates the third largest depository institution in the market, and controls deposits of $69.4 million, representing 12.6 percent of market deposits. On consummation of the proposal, Prosperity would operate the largest depository institution in the market with deposits of $208.7 million, representing 37.9 percent of market deposits. The HHI for the market would increase 639 points to 2,078.

The Board believes that a number of circumstances mitigate the potential anticompetitive effects of the transaction.[8] In considering the

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[8] As the Board has indicated in previous cases, in a market in which the competitive effects of a proposal exceed the DOJ Guidelines, the Board will consider whether other factors tend to mitigate the proposal's competitive effects. The number and strength of factors necessary to mitigate the competitive effects of a proposal depend on the level of market concentration and the size of the

competitive effects of this proposal in the Wharton County banking market, the Board has evaluated the presence of two savings associations operating in the market and has concluded that deposits controlled by the institutions should be weighted at 100 percent in market share calculations.[9] Each of these savings associations engages actively in commercial lending activities and offers a wide variety of business loan products and other banking services. Accounting for the revised weighting of these deposits, Prosperity would control 32.8 percent of market deposits, and the HHI would increase 480 points to 1900 on consummation of the proposal.

The Board has also taken account of other market characteristics. For example, after consummation of the proposal, nine competitors would remain in the market. Two competitors, in addition to Prosperity, would each control more than 10 percent of market deposits and four others would control between 5 and 10 percent of market deposits. In addition, the proximity of the Wharton County banking market to the Houston banking market and other factors make the Wharton County banking market an attractive market for entry. The percentage increases in per capita income and market deposits are more than the

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increase in market concentration after consummation of the proposal. See NationsBank Corporation, 84 Federal Reserve Bulletin 129 (1998).

[9] The Board previously has indicated that, when analyzing the competitive effects of a proposal, it may consider the competitiveness of savings associations based on a deposit weighting greater than 50 percent if appropriate. See, e.g., Banknorth Group, Inc., 75 Federal Reserve Bulletin 703 (1989). Of the two savings associations in the Wharton County banking market, one maintains 7.7 percent and the other maintains 4.6 percent of the loan assets in commercial loans. This level of commercial lending at these institutions compares favorably with the national average of 3.8 percent of the loan assets in thrift portfolios that are commercial loan holdings. See First Union Corporation, 84 Federal Reserve Bulletin 489 (1998).

average percentage increases in these categories for all non-MSA counties in Texas. The attractiveness of entry into the Wharton County banking market is also demonstrated by the de novo entry into the market of a depository institution in May 2000. In addition, the market gained an additional bank competitor in April 1999 when an out-of-market bank acquired a savings association operating in the market.

The Department of Justice has reviewed the proposal and advised the Board that consummation of the proposal would not likely have any significantly adverse competitive effects in the Wharton County banking market or any other relevant banking market. The FDIC has also not objected to the proposal.

After carefully reviewing all the facts of record, and for the reasons discussed in the order, the Board concludes that consummation of the proposal would not likely result in a significantly adverse effect on competition or on the concentration of banking resources in any of the banking markets in which Prosperity and Commercial directly compete or in any other relevant banking market. Accordingly, based on all the facts of record, the Board has determined that the competitive factors are consistent with approval of the proposal.

<u>Other Considerations</u>

The BHC Act requires the Board, in acting on an application, to consider the financial and managerial resources and future prospects of the companies and banks involved in the proposal, the convenience and needs of the communities to be served, and certain supervisory factors. The Board has reviewed these factors in light of the record, including supervisory reports of examination assessing the financial and managerial resources of the organizations and financial information provided by Prosperity. Based on all the facts of record, the Board concludes that the financial and managerial resources and the future prospects of Prosperity, Commercial, and their respective depository institutions, are consistent with approval, as are the other supervisory factors that the Board must consider under section 3 of the BHC Act. In addition, considerations relating to the convenience and needs of the communities to be served, including the records of performance of the institutions involved under the Community Reinvestment Act (12 U.S.C. § 2901 et seq.), are consistent with approval of the application.[10]

Conclusion

Based on the foregoing, and in light of all the facts of record, the Board has determined that the application should be, and hereby is, approved. The Board's approval is specifically conditioned on compliance by Prosperity with all the commitments and representations made in connection with this application. For purposes of this action, the commitments and conditions relied on by the Board in reaching its decision are deemed to be conditions imposed in writing by the Board in connection with its findings and decision and, as such, may be enforced in proceedings under applicable law.

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[10] First Prosperity Bank received a "satisfactory" rating from the FDIC, as of March 1, 2000, and Heritage Bank received a "satisfactory" rating from the FDIC, as of July 1, 2000.

The acquisition of Commercial shall not be consummated before the fifteenth calendar day following the effective date of this order, or later than three months after the effective date of this order, unless such period is extended for good cause by the Board or by the Federal Reserve Bank of Dallas, acting pursuant to delegated authority.

By order of the Board of Governors,[11] effective February 5, 2001.

(signed)

Robert deV. Frierson
Associate Secretary of the Board

[11] Voting for this action: Chairman Greenspan, Vice Chairman Ferguson, and Governors Kelley, Meyer, and Gramlich.

Concurring Statement of Governor Meyer

I believe the proposed acquisition presents a close case because it allows a very large change in the HHI of the Wharton County banking market that will take the market into the highly concentrated range based on the DOJ Guidelines. I believe we should pay attention to the relationship between the change in the HHI and the post-merger level of the HHI. For example, only modest mitigating factors would suffice when a modest change in the HHI takes the post-merger level of the HHI into the highly concentrated range. On the other hand, when a larger change in the HHI brings about this result, I would expect correspondingly more compelling mitigating factors. The relationship between the change in the HHI and the post-merger level in this case is uncomfortably high and the relative strength of the mitigating factors make this an extremely close case.