CULLEN/FROST BANKERS, INC.
Form 10-Q
October 29, 2014
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United States
Securities and Exchange Commission
Washington, D.C. 20549
Form 10-Q
ý Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the quarterly period ended: September 30, 2014
Or
¨ Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the transition period from to
Commission file number: 001-13221
Cullen/Frost Bankers, Inc.
(Exact name of registrant as specified in its charter)

Texas	74-1751768
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
100 W. Houston Street, San Antonio, Texas	78205
(Address of principal executive offices)	(Zip code)

(210) 220-4011
(Registrant's telephone number, including area code)
N/A
(Former name, former address and former fiscal year, if changed since last report)
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 ý No ¨
Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ý No ¨
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See 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	ý	Accelerated filer	¨
Non-accelerated filer	¨ (Do not check if a smaller reporting company)	Smaller reporting company	¨

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes ¨ No ý
As of October 23, 2014 there were 63,058,493 shares of the registrant's Common Stock, $.01 par value, outstanding.

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Part I. Financial Information
Item 1. Financial Statements (Unaudited)
Cullen/Frost Bankers, Inc.
Consolidated Balance Sheets
(Dollars in thousands, except per share amounts)

	September 30, 2014	December 31, 2013
Assets:		
Cash and due from banks	$714,851	$885,121
Interest-bearing deposits	4,577,004	3,646,756
Federal funds sold and resell agreements	8,598	24,248
Total cash and cash equivalents	5,300,453	4,556,125
Securities held to maturity, at amortized cost	2,942,012	3,139,748
Securities available for sale, at estimated fair value	6,911,652	5,895,436
Trading account securities	16,552	16,398
Loans, net of unearned discounts	10,746,784	9,515,700
Less: Allowance for loan losses	(98,312)	(92,438)
Net loans	10,648,472	9,423,262
Premises and equipment, net	397,429	313,331
Goodwill	653,849	536,649
Other intangible assets, net	13,121	6,345
Cash surrender value of life insurance policies	171,142	141,108
Accrued interest receivable and other assets	315,951	284,537
Total assets	$27,370,633	$24,312,939
Liabilities:		
Deposits:		
Non-interest-bearing demand deposits	$10,162,415	$8,311,149
Interest-bearing deposits	13,328,188	12,377,637
Total deposits	23,490,603	20,688,786
Federal funds purchased and repurchase agreements	580,965	668,253
Junior subordinated deferrable interest debentures	137,115	123,712
Other long-term borrowings	100,000	100,000
Accrued interest payable and other liabilities	244,098	218,027
Total liabilities	24,552,781	21,798,778
Shareholders' Equity:		
Preferred stock, par value $0.01 per share; 10,000,000 shares authorized; 6,000,000 Series A shares ($25 liquidation preference) issued at September 30, 2014 and December 31, 2013	144,486	144,486
Common stock, par value $0.01 per share; 210,000,000 shares authorized; 63,632,464 shares issued at September 30, 2014 and 61,632,464 shares issued at December 31, 2013	637	617
Additional paid-in capital	883,121	724,197
Retained earnings	1,672,527	1,575,282
Accumulated other comprehensive income, net of tax	155,276	140,434
Treasury stock, at cost; 574,346 shares at September 30, 2014 and 1,066,021 shares at December 31, 2013	(38,195)	(70,855)
Total shareholders' equity	2,817,852	2,514,161

Total liabilities and shareholders’ equity	$27,370,633	$24,312,939

See Notes to Consolidated Financial Statements.

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Cullen/Frost Bankers, Inc.
Consolidated Statements of Income
(Dollars in thousands, except per share amounts)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Interest income:				
Loans, including fees	$116,415	$104,349	$330,998	$309,721
Securities:				
Taxable	22,855	23,007	66,372	75,869
Tax-exempt	39,635	31,402	113,168	88,046
Interest-bearing deposits	2,960	2,077	8,045	4,928
Federal funds sold and resell agreements	20	16	63	67
Total interest income	181,885	160,851	518,646	478,631
Interest expense:				
Deposits	2,991	3,522	8,119	11,412
Federal funds purchased and repurchase agreements	35	30	96	89
Junior subordinated deferrable interest debentures	659	1,710	1,821	5,073
Other long-term borrowings	222	236	668	710
Total interest expense	3,907	5,498	10,704	17,284
Net interest income	177,978	155,353	507,942	461,347
Provision for loan losses	390	5,108	11,914	14,683
Net interest income after provision for loan losses	177,588	150,245	496,028	446,664
Non-interest income:				
Trust and investment management fees	26,807	22,692	78,966	67,138
Service charges on deposit accounts	20,819	20,742	61,255	60,830
Insurance commissions and fees	11,348	10,371	34,297	32,707
Interchange and debit card transaction fees	4,719	4,376	13,589	12,655
Other charges, commissions and fees	9,804	9,266	26,561	25,599
Net gain (loss) on securities transactions	33	(14)	35	(3)
Other	7,332	6,558	22,799	25,354
Total non-interest income	80,862	73,991	237,502	224,280
Non-interest expense:				
Salaries and wages	73,756	68,524	214,446	201,491
Employee benefits	14,639	14,989	46,833	47,609
Net occupancy	14,049	13,094	40,735	37,718
Furniture and equipment	16,078	14,629	46,238	43,800
Deposit insurance	3,421	2,921	9,683	8,645
Intangible amortization	1,029	780	2,524	2,388
Other	40,856	36,886	125,280	115,744
Total non-interest expense	163,828	151,823	485,739	457,395
Income before income taxes	94,622	72,413	247,791	213,549
Income taxes	17,007	11,969	42,518	38,254
Net income	77,615	60,444	205,273	175,295
Preferred stock dividends	2,016	2,015	6,047	4,703
Net income available to common shareholders	$75,599	$58,429	$199,226	$170,592
Earnings per common share:				
Basic	$1.20	$0.96	$3.20	$2.82

Diluted	1.19	0.96	3.18	2.81

See Notes to Consolidated Financial Statements.

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Cullen/Frost Bankers, Inc.
Consolidated Statements of Comprehensive Income
(Dollars in thousands)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Net income	$77,615	$60,444	$205,273	$175,295
Other comprehensive income (loss), before tax:				
Securities available for sale and transferred securities:				
Change in net unrealized gain/loss during the period	9,464	(551)	76,007	(95,920)
Change in net unrealized gain on securities transferred to held to maturity	(8,746)	(8,054)	(27,119)	(26,258)
Reclassification adjustment for net (gains) losses included in net income	(33)	14	(35)	3
Total securities available for sale and transferred securities	685	(8,591)	48,853	(122,175)
Defined-benefit post-retirement benefit plans:				
Change in the net actuarial gain/loss	672	1,640	2,015	4,919
Derivatives:				
Change in the accumulated gain/loss on effective cash flow hedge derivatives	—	(15)	—	(48)
Reclassification adjustments for (gains) losses included in net income:				
Interest rate swaps on variable-rate loans	(9,345)	(9,345)	(28,035)	(28,035)
Interest rate swap on junior subordinated deferrable interest debentures	—	1,120	—	3,308
Total derivatives	(9,345)	(8,240)	(28,035)	(24,775)
Other comprehensive income (loss), before tax	(7,988)	(15,191)	22,833	(142,031)
Deferred tax expense (benefit) related to other comprehensive income	(2,796)	(5,316)	7,991	(49,710)
Other comprehensive income (loss), net of tax	(5,192)	(9,875)	14,842	(92,321)
Comprehensive income	$72,423	$50,569	$220,115	$82,974

See Notes to Consolidated Financial Statements.

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Cullen/Frost Bankers, Inc.
Consolidated Statements of Changes in Shareholders' Equity
(Dollars in thousands, except per share amounts)

	Nine Months Ended September 30,	
	2014	2013
Total shareholders' equity at beginning of period	$2,514,161	$2,417,482
Net income	205,273	175,295
Other comprehensive income (loss)	14,842	(92,321)
Stock option exercises (491,675 shares in 2014 and 1,249,874 shares in 2013)	25,573	65,026
Stock compensation expense recognized in earnings	6,938	7,310
Tax benefits (deficiencies) related to stock compensation	2,286	1,854
Common stock issued in acquisition of WNB Bancshares (2,000,000 shares)	149,720	—
Issuance of preferred stock (6,000,000 shares in 2013)	—	144,486
Purchase of treasury stock (2,236,748 shares in 2013)	—	(144,000)
Cash dividends – preferred stock (approximately $1.01 per share in 2014 and $0.78 per share in 2013)	(6,047)	(4,703)
Cash dividends – common stock ($1.52 per share in 2014 and $1.48 per share in 2013)	(94,894)	(89,261)
Total shareholders' equity at end of period	$2,817,852	$2,481,168

See Notes to Consolidated Financial Statements.

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Cullen/Frost Bankers, Inc.
Consolidated Statements of Cash Flows
(Dollars in thousands)

	Nine Months Ended September 30,	
	2014	2013
Operating Activities:		
Net income	$205,273	$175,295
Adjustments to reconcile net income to net cash from operating activities:		
Provision for loan losses	11,914	14,683
Deferred tax expense (benefit)	(7,324)	271
Accretion of loan discounts	(10,561)	(9,423)
Securities premium amortization (discount accretion), net	43,965	30,054
Net (gain) loss on securities transactions	(35)	3
Depreciation and amortization	29,593	28,835
Net (gain) loss on sale/write-down of assets/foreclosed assets	863	2,958
Stock-based compensation	6,938	7,310
Net tax benefit (deficiency) from stock-based compensation	24	(396)
Excess tax benefits from stock-based compensation	(2,262)	(2,250)
Earnings on life insurance policies	(2,311)	(2,399)
Net change in:		
Trading account securities	710	14,785
Accrued interest receivable and other assets	(43,688)	11,556
Accrued interest payable and other liabilities	(58,261)	(170,982)
Net cash from operating activities	174,838	100,300
Investing Activities:		
Securities held to maturity:		
Purchases	—	(257,571)
Maturities, calls and principal repayments	152,459	13,561
Securities available for sale:		
Purchases	(8,799,362)	(9,128,340)
Sales	3,651,982	8,497,061
Maturities, calls and principal repayments	4,396,491	1,192,979
Net change in loans	(557,817)	(102,195)
Net cash (paid) received in acquisitions	830,656	—
Proceeds from sales of premises and equipment	35	16,312
Purchases of premises and equipment	(80,557)	(24,783)
Proceeds from sales of repossessed properties	8,412	6,363
Net cash from investing activities	(397,701)	213,387
Financing Activities:		
Net change in deposits	1,177,774	481,528
Net change in short-term borrowings	(137,477)	26,076
Principal payments on long-term borrowings	—	(7)
Proceeds from stock option exercises	25,573	65,026
Excess tax benefits from stock-based compensation	2,262	2,250
Proceeds from issuance of preferred stock	—	144,486
Purchase of treasury stock	—	(144,000)

Cash dividends paid on preferred stock	(6,047)	(4,703)
Cash dividends paid on common stock	(94,894)	(89,261)
Net cash from financing activities	967,191	481,395
Net change in cash and cash equivalents	744,328	795,082
Cash and equivalents at beginning of period	4,556,125	3,524,979
Cash and equivalents at end of period	$5,300,453	$4,320,061

See Notes to Consolidated Financial Statements.

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Notes to Consolidated Financial Statements
(Table amounts in thousands, except for share and per share amounts)
Note 1 - Significant Accounting Policies
Nature of Operations. Cullen/Frost Bankers, Inc. (Cullen/Frost) is a financial holding company and a bank holding company headquartered in San Antonio, Texas that provides, through its subsidiaries, a broad array of products and services throughout numerous Texas markets. In addition to general commercial and consumer banking, other products and services offered include trust and investment management, investment banking, insurance, brokerage, leasing, treasury management and item processing.
Basis of Presentation. The consolidated financial statements in this Quarterly Report on Form 10-Q include the accounts of Cullen/Frost and all other entities in which Cullen/Frost has a controlling financial interest (collectively referred to as the "Corporation"). All significant intercompany balances and transactions have been eliminated in consolidation. The accounting and financial reporting policies the Corporation follows conform, in all material respects, to accounting principles generally accepted in the United States and to general practices within the financial services industry.
The consolidated financial statements in this Quarterly Report on Form 10-Q have not been audited by an independent registered public accounting firm, but in the opinion of management, reflect all adjustments necessary for a fair presentation of the Corporation's financial position and results of operations. All such adjustments were of a normal and recurring nature. The consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and with the instructions to Form 10-Q adopted by the Securities and Exchange Commission ("SEC"). Accordingly, the financial statements do not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements and should be read in conjunction with the Corporation's consolidated financial statements, and notes thereto, for the year ended December 31, 2013, included in the Corporation's Annual Report on Form 10-K filed with the SEC on February 6, 2014 (the "2013 Form 10-K"). Operating results for the interim periods disclosed herein are not necessarily indicative of the results that may be expected for a full year or any future period.
Use of Estimates. The preparation of financial statements in conformity with accounting principles generally accepted in the United States 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. Actual results could differ from those estimates. The allowance for loan losses, the fair value of stock-based compensation awards, the fair values of financial instruments and the status of contingencies are particularly subject to change.
Cash Flow Reporting. Additional cash flow information was as follows:

	Nine Months Ended September 30,	
	2014	2013
Cash paid for interest	$10,519	$17,681
Cash paid for income taxes	45,186	42,944
Significant non-cash transactions:		
Securities purchased not yet settled	61,974	36,301
Loans foreclosed and transferred to other real estate owned and foreclosed assets	1,993	3,251
Premises and equipment transferred to other real estate owned and foreclosed assets	1,799	—
Loans to facilitate the sale of other real estate owned	102	228
Deferred gain on sale of building and parking garage	—	922

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Note 2 - Mergers and Acquisitions

On May 30, 2014, the Corporation acquired WNB Bancshares, Inc. ("WNB"), including its subsidiary Western National Bank ("Western"), a privately-held bank holding company and bank located in the Permian Basin region of Texas. The Corporation purchased all of the outstanding shares of WNB for approximately $198.8 million. The total purchase price included $149.7 million of the Corporation’s common stock (2 million shares) and $49.1 million in cash. Western was integrated into Frost Bank as of the close of business on June 20, 2014.

The acquisition of WNB was accounted for using the acquisition method with all cash consideration funded through internal sources. The operating results of WNB are included with the Corporation’s results of operations since the date of acquisition. The total purchase price paid for the acquisition of WNB was allocated based on the estimated fair values of the assets acquired and liabilities assumed as set forth below. The purchase price allocation is preliminary and is subject to final determination and valuation of the fair value of assets acquired and liabilities assumed.

Cash and cash equivalents	$879,735
Securities available for sale	154,227
Loans	670,637
Premises and equipment	22,912
Core deposit intangible asset	9,300
Goodwill	117,200
Other assets	33,621
Deposits	(1,624,043)
Other borrowings	(63,592)
Other liabilities	(1,199)
	$198,798

The loans acquired in this transaction were recorded at fair value with no carryover of any existing allowance for loan losses. Loans that were not deemed to be credit impaired at acquisition were subsequently considered as a part of the Corporation's determination of the adequacy of the allowance for loan losses. Purchased credit-impaired loans, meaning those loans with evidence of credit quality deterioration at acquisition, were not significant. The core deposit intangible asset acquired in this transaction will be amortized using an accelerated method over a period of 10 years.

Pro forma condensed consolidated results of operations assuming WNB had been acquired at the beginning of the reported periods are not presented because the effect of this acquisition was not considered significant based on the SEC significance tests.

Expenditures related to the acquisition of WNB totaled $1.1 million and $7.1 million during the three and nine months ended September 30, 2014, respectively, and are reported as a component of other non-interest expense in the accompanying consolidated income statements. During the third and fourth quarters of 2013, expenditures related to the acquisition of WNB totaled $1.4 million.

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Note 3 - Securities

A summary of the amortized cost and estimated fair value of securities, excluding trading securities, is presented below.

	September 30, 2014				December 31, 2013			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Held to Maturity								
U.S. Treasury	$248,902	$15,844	$—	$264,746	$248,592	$20,139	$—	$268,731
Residential mortgage-backed securities	8,445	67	20	8,492	9,674	89	143	9,620
States and political subdivisions	2,683,315	28,822	15,940	2,696,197	2,880,482	7,691	137,861	2,750,312
Other	1,350	—	—	1,350	1,000	—	—	1,000
Total	$2,942,012	$44,733	$15,960	$2,970,785	$3,139,748	$27,919	$138,004	$3,029,663
Available for Sale								
U.S. Treasury	$2,892,208	$16,937	$889	$2,908,256	$2,522,159	$18,395	$—	$2,540,554
U.S. Government agencies/corporations	—	—	—	—	54,024	—	44	53,980
Residential mortgage-backed securities	1,415,433	68,839	661	1,483,611	1,710,664	66,791	1,439	1,776,016
States and political subdivisions	2,388,740	88,047	—	2,476,787	1,476,316	20,090	7,492	1,488,914
Other	42,998	—	—	42,998	35,972	—	—	35,972
Total	$6,739,379	$173,823	$1,550	$6,911,652	$5,799,135	$105,276	$8,975	$5,895,436

All mortgage-backed securities included in the above table were issued by U.S. government agencies and corporations. At September 30, 2014, approximately 97.0% of the securities in the Corporation's municipal bond portfolio were issued by political subdivisions or agencies within the State of Texas, of which approximately 62.3% are either guaranteed by the Texas Permanent School Fund, which has a "triple A" insurer financial strength rating, or secured by U.S. Treasury securities via defeasance of the debt by the issuers. Securities with limited marketability, such as stock in the Federal Reserve Bank and the Federal Home Loan Bank, are carried at cost and are reported as other available for sale securities in the above table. The carrying value of securities pledged to secure public funds, trust deposits, repurchase agreements and for other purposes, as required or permitted by law was $2.7 billion at September 30, 2014 and $3.0 billion and December 31, 2013.

During the fourth quarter of 2012, the Corporation reclassified certain securities from available for sale to held to maturity. The securities had an aggregate fair value of $2.3 billion with an aggregate net unrealized gain of $165.7 million ($107.7 million, net of tax) on the date of the transfer. The net unamortized, unrealized gain on the transferred securities included in accumulated other comprehensive income in the accompanying balance sheet as of September 30, 2014 totaled $102.2 million ($66.4 million, net of tax). This amount will be amortized out of accumulated other comprehensive income over the remaining life of the underlying securities as an adjustment of the yield on those securities.

As of September 30, 2014, securities, with unrealized losses segregated by length of impairment, 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
Held to Maturity						
	$3,242	$20	$—	$—	$3,242	$20

Residential mortgage-backed securities						
States and political subdivisions	87,246	277	985,618	15,663	1,072,864	15,940
Total	$90,488	$297	$985,618	$15,663	$1,076,106	$15,960
Available for Sale						
U.S. Treasury	$247,480	$889	$—	$—	$247,480	$889
Residential mortgage-backed securities	7,423	54	17,105	607	24,528	661
Total	$254,903	$943	$17,105	$607	$272,008	$1,550

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Declines in the fair value of held-to-maturity and available-for-sale securities below their cost that are deemed to be other than temporary are reflected in earnings as realized losses to the extent the impairment is related to credit losses. The amount of the impairment related to other factors is recognized in other comprehensive income. 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 Corporation to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in cost.

Management has the ability and intent to hold the securities classified as held to maturity in the table above until they mature, at which time the Corporation will receive full value for the securities. Furthermore, as of September 30, 2014, management does not have the intent to sell any of the securities classified as available for sale in the table above and believes that it is more likely than not that the Corporation will not have to sell any such securities before a recovery of cost. Any 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 bonds approach their maturity date or repricing date or if market yields for such investments decline. Management does not believe any of the securities are impaired due to reasons of credit quality. Accordingly, as of September 30, 2014, management believes the impairments detailed in the table above are temporary and no impairment loss has been realized in the Corporation’s consolidated income statement.

The amortized cost and estimated fair value of securities, excluding trading securities, at September 30, 2014 are presented below by contractual maturity. Expected maturities may differ from contractual maturities because issuers may have the right to call or prepay obligations. Residential mortgage-backed securities and equity securities are shown separately since they are not due at a single maturity date.

	Held to Maturity		Available for Sale	
	Amortized Cost	Estimated Fair Value	Amortized Cost	Estimated Fair Value
Due in one year or less	$124,693	$127,767	$787,678	$791,624
Due after one year through five years	498,817	530,551	1,792,593	1,806,723
Due after five years through ten years	186,813	186,085	1,459,094	1,488,506
Due after ten years	2,123,244	2,117,890	1,241,583	1,298,190
Residential mortgage-backed securities	8,445	8,492	1,415,433	1,483,611
Equity securities	—	—	42,998	42,998
Total	$2,942,012	$2,970,785	$6,739,379	$6,911,652

Sales of securities available for sale were as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Proceeds from sales	$3,649,954	$1,474	$3,651,982	$8,497,061
Gross realized gains	33	—	36	11
Gross realized losses	—	(14)	(1)	(14)
Tax (expense) benefit of securities gains/losses	(11)	5	(12)	1

Purchase premiums and discounts on securities are amortized or accreted to interest income over the expected lives of the securities using the interest method with a constant effective yield. Expectations related to prepayments are considered in the calculation of the constant effective yield necessary to apply the interest method for mortgage-backed securities and certain pools of municipal securities. Premium amortization and discount accretion for mortgage-backed securities and pools of municipal securities is adjusted for changes in prepayment estimates, as applicable. Premium amortization and discount accretion included in interest income on securities was as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Premium amortization	(17,471)	(13,526)	(48,862)	(34,942)

Discount accretion	$1,865	$1,596	$4,897	$4,888
Net (premium amortization) discount accretion	$(15,606)	$(11,930)	$(43,965)	$(30,054)

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Trading account securities, at estimated fair value, were as follows:

	September 30, 2014	December 31, 2013
U.S. Treasury	$15,689	$15,389
States and political subdivisions	863	1,009
Total	$16,552	$16,398

Net gains and losses on trading account securities were as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Net gain on sales transactions	$167	$108	$660	$684
Net mark-to-market gains (losses)	13	(29)	10	(409)
Net gain (loss) on trading account securities	$180	$79	$670	$275

Note 4 - Loans

Loans were as follows:

	September 30, 2014	Percentage of Total	December 31, 2013	Percentage of Total
Commercial and industrial:				
Commercial	$5,188,609	48.3 %	$4,587,499	48.2 %
Leases	322,278	3.0	319,577	3.4
Total commercial and industrial	5,510,887	51.3	4,907,076	51.6
Commercial real estate:				
Commercial mortgages	3,077,172	28.6	2,800,760	29.4
Construction	642,992	6.0	426,639	4.5
Land	300,314	2.8	239,937	2.5
Total commercial real estate	4,020,478	37.4	3,467,336	36.4
Consumer real estate:				
Home equity loans	337,879	3.1	329,853	3.5
Home equity lines of credit	216,281	2.0	195,132	2.1
1-4 family residential mortgages	28,416	0.3	32,447	0.3
Construction	17,080	0.2	13,123	0.1
Other	247,412	2.3	237,649	2.5
Total consumer real estate	847,068	7.9	808,204	8.5
Total real estate	4,867,546	45.3	4,275,540	44.9
Consumer and other:				
Consumer installment	384,931	3.6	350,827	3.7
Other	6,567	—	7,289	0.1
Total consumer and other	391,498	3.6	358,116	3.8
Unearned discounts	(23,147)	(0.2)	(25,032)	(0.3)
Total loans	$10,746,784	100.0 %	$9,515,700	100.0 %

Loan Origination/Risk Management. The Corporation has certain lending policies and procedures in place that are designed to maximize loan income within an acceptable level of risk. Management reviews and approves these policies and procedures on a regular basis. A reporting system supplements the review process by providing management with frequent reports related to loan production, loan quality, concentrations of credit, loan delinquencies and non-performing and potential problem loans. Diversification in the loan portfolio is a means of managing risk associated with fluctuations in economic conditions.

Commercial and industrial loans are underwritten after evaluating and understanding the borrower's ability to operate profitably and prudently expand its business. Underwriting standards are designed to promote relationship banking rather than transactional banking. Once it is determined that the borrower's management possesses sound ethics and

solid business acumen, the Corporation’s management examines current and projected cash flows to determine the ability of the borrower to repay their obligations as agreed. Commercial and industrial loans are primarily made based on the identified cash flows of the borrower and secondarily on the underlying collateral provided by the borrower. The cash flows of borrowers, however, may not be as expected and the

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collateral securing these loans may fluctuate in value. Most commercial and industrial loans are secured by the assets being financed or other business assets such as accounts receivable or inventory and may incorporate a personal guarantee; however, some short-term loans may be made on an unsecured basis. In the case of loans secured by accounts receivable, the availability of funds for the repayment of these loans may be substantially dependent on the ability of the borrower to collect amounts due from its customers.

Commercial real estate loans are subject to underwriting standards and processes similar to commercial and industrial loans, in addition to those of real estate loans. These loans are viewed primarily as cash flow loans and secondarily as loans secured by real estate. Commercial real estate lending typically involves higher loan principal amounts and the repayment of these loans is generally largely dependent on the successful operation of the property securing the loan or the business conducted on the property securing the loan. Commercial real estate loans may be more adversely affected by conditions in the real estate markets or in the general economy. The properties securing the Corporation’s commercial real estate portfolio are diverse in terms of type and geographic location. This diversity helps reduce the Corporation’s exposure to adverse economic events that affect any single market or industry. Management monitors and evaluates commercial real estate loans based on collateral, geography and risk grade criteria. As a general rule, the Corporation avoids financing single-purpose projects unless other underwriting factors are present to help mitigate risk. The Corporation also utilizes third-party experts to provide insight and guidance about economic conditions and trends affecting market areas it serves. In addition, management tracks the level of owner-occupied commercial real estate loans versus non-owner occupied loans. At September 30, 2014, approximately 55% of the outstanding principal balance of the Corporation’s commercial real estate loans were secured by owner-occupied properties.

With respect to loans to developers and builders that are secured by non-owner occupied properties that the Corporation may originate from time to time, the Corporation generally requires the borrower to have had an existing relationship with the Corporation and have a proven record of success. Construction loans are underwritten utilizing feasibility studies, independent appraisal reviews, sensitivity analysis of absorption and lease rates and financial analysis of the developers and property owners. Construction loans are generally based upon estimates of costs and value associated with the completed project. These estimates may be inaccurate. Construction loans often involve the disbursement of substantial funds with repayment substantially dependent on the success of the ultimate project. Sources of repayment for these types of loans may be pre-committed permanent loans from approved long-term lenders, sales of developed property or an interim loan commitment from the Corporation until permanent financing is obtained. These loans are closely monitored by on-site inspections and are considered to have higher risks than other real estate loans due to their ultimate repayment being sensitive to interest rate changes, governmental regulation of real property, general economic conditions and the availability of long-term financing.

The Corporation originates consumer loans utilizing a computer-based credit scoring analysis to supplement the underwriting process. To monitor and manage consumer loan risk, policies and procedures are developed and modified, as needed, jointly by line and staff personnel. This activity, coupled with relatively small loan amounts that are spread across many individual borrowers, minimizes risk. Additionally, trend and outlook reports are reviewed by management on a regular basis. Underwriting standards for home equity loans are heavily influenced by statutory requirements, which include, but are not limited to, a maximum loan-to-value percentage of 80%, collection remedies, the number of such loans a borrower can have at one time and documentation requirements.

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

Concentrations of Credit. Most of the Corporation’s lending activity occurs within the State of Texas, including the four largest metropolitan areas of Austin, Dallas/Ft. Worth, Houston and San Antonio, as well as other markets. The majority of the Corporation’s loan portfolio consists of commercial and industrial and commercial real estate loans. As of September 30, 2014, there were no concentrations of loans related to any single industry in excess of 10% of total loans other than energy loans, which totaled 14.9% of total loans.

Foreign Loans. The Corporation has U.S. dollar denominated loans and commitments to borrowers in Mexico. The outstanding balance of these loans and the unfunded amounts available under these commitments were not significant

at September 30, 2014 or December 31, 2013.

Non-Accrual and Past Due Loans. Loans are considered past due if the required principal and interest payments have not been received as of the date such payments were due. Loans are placed on non-accrual status when, in management's opinion, the borrower may be unable to meet payment obligations as they become due, as well as when required by regulatory provisions. In determining whether or not a borrower may be unable to meet payment obligations for each class of loans, the Corporation considers the borrower's debt service capacity through the analysis of current financial information, if available, and/or current information with regards to the Corporation's collateral position. Regulatory provisions would typically require the placement of a loan on

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non-accrual status if (i) principal or interest has been in default for a period of 90 days or more unless the loan is both well secured and in the process of collection or (ii) full payment of principal and interest is not expected. Loans may be placed on non-accrual status regardless of whether or not such loans are considered past due. When interest accrual is discontinued, all unpaid accrued interest is reversed. Interest income on non-accrual loans is recognized only to the extent that cash payments are received in excess of principal due. A loan may be returned to accrual status when all the principal and interest amounts contractually due are brought current and future principal and interest amounts contractually due are reasonably assured, which is typically evidenced by a sustained period (at least six months) of repayment performance by the borrower.

Non-accrual loans, segregated by class of loans, were as follows:

	September 30, 2014	December 31, 2013
Commercial and industrial:		
Energy	$638	$590
Other commercial	33,331	26,143
Commercial real estate:		
Buildings, land and other	20,390	27,035
Construction	289	—
Consumer real estate	1,973	2,207
Consumer and other	479	745
Total	$57,100	$56,720

As of September 30, 2014, non-accrual loans reported in the table above included $6.5 million related to loans that were restructured as “troubled debt restructurings” during 2014. Had non-accrual loans performed in accordance with their original contract terms, the Corporation would have recognized additional interest income, net of tax, of approximately $414 thousand and $1.1 million for the three and nine months ended September 30, 2014, compared to $568 thousand and $1.8 million for the same periods in 2013.

An age analysis of past due loans (including both accruing and non-accruing loans), segregated by class of loans, as of September 30, 2014 was as follows:

	Loans 30-89 Days Past Due	Loans 90 or More Days Past Due	Total Past Due Loans	Current Loans	Total Loans	Accruing Loans 90 or More Days Past Due
Commercial and industrial:						
Energy	$4,689	$—	$4,689	$1,595,777	$1,600,466	$—
Other commercial	27,801	14,772	42,573	3,867,848	3,910,421	10,740
Commercial real estate:						
Buildings, land and other	19,129	16,855	35,984	3,341,502	3,377,486	7,216
Construction	7,111	—	7,111	635,881	642,992	1,503
Consumer real estate	3,777	1,727	5,504	841,564	847,068	828
Consumer and other	4,428	828	5,256	386,242	391,498	—
Unearned discounts	—	—	—	(23,147)	(23,147)	—
Total	$66,935	$34,182	$101,117	$10,645,667	$10,746,784	$20,287

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

charged off when deemed uncollectible.

Regulatory guidelines require the Corporation to reevaluate the fair value of collateral supporting impaired collateral dependent loans on at least an annual basis. While the Corporation’s policy is to comply with the regulatory guidelines, the Corporation’s general practice is to reevaluate the fair value of collateral supporting impaired collateral dependent loans on a quarterly basis. Thus, appraisals are never considered to be outdated, and the Corporation does not need to make any adjustments to the appraised values. The fair value of collateral supporting impaired collateral dependent loans is evaluated by the Corporation’s internal

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appraisal services using a methodology that is consistent with the Uniform Standards of Professional Appraisal Practice. The fair value of collateral supporting impaired collateral dependent construction loans is based on an "as is" valuation.

Impaired loans are set forth in the following table. No interest income was recognized on impaired loans subsequent to their classification as impaired.

	Unpaid Contractual Principal Balance	Recorded Investment With No Allowance	Recorded Investment With Allowance	Total Recorded Investment	Related Allowance
September 30, 2014					
Commercial and industrial:					
Energy	$706	$637	$—	$637	$—
Other commercial	42,058	27,967	3,082	31,049	1,413
Commercial real estate:					
Buildings, land and other	24,032	17,512	992	18,504	776
Construction	476	289	—	289	—
Consumer real estate	825	624	—	624	—
Consumer and other	—	—	—	—	—
Total	$68,097	$47,029	$4,074	$51,103	$2,189
December 31, 2013					
Commercial and industrial:					
Energy	$545	$531	$—	$531	$—
Other commercial	31,429	15,337	7,004	22,341	4,140
Commercial real estate:					
Buildings, land and other	27,792	15,697	8,870	24,567	2,786
Construction	—	—	—	—	—
Consumer real estate	907	745	—	745	—
Consumer and other	334	278	—	278	—
Total	$61,007	$32,588	$15,874	$48,462	$6,926

The average recorded investment in impaired loans was as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Commercial and industrial:				
Energy	$581	$269	$555	$402
Other commercial	31,088	33,613	25,977	38,032
Commercial real estate:				
Buildings, land and other	19,198	37,960	20,998	37,149
Construction	295	508	226	793
Consumer real estate	657	788	694	818
Consumer and other	126	338	199	365
Total	$51,945	$73,476	$48,649	$77,559

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Troubled Debt Restructurings. The restructuring of a loan is considered a "troubled debt restructuring" if both (i) the borrower is experiencing financial difficulties and (ii) the creditor has granted a concession. Concessions may include interest rate reductions or below market interest rates, principal forgiveness, restructuring amortization schedules, reductions in collateral and other actions intended to minimize potential losses.

Troubled debt restructurings during the nine months ended September 30, 2014 and September 30, 2013 are set forth in the following table.

	Nine Months Ended September 30, 2014		Nine Months Ended September 30, 2013	
	Balance at Restructure	Balance at Period-End	Balance at Restructure	Balance at Period-End
Commercial and industrial:				
Energy	$—	$—	$528	$537
Other commercial	3,752	3,516	5,862	5,067
Commercial real estate:				
Buildings, land and other	3,122	3,008	7,443	7,000
	$6,874	$6,524	$13,833	$12,604

The modifications during the reported periods primarily related to extending amortization periods, converting the loans to interest only for a limited period of time, consolidating notes and/or reducing collateral or interest rates. The modifications did not significantly impact the Corporation's determination of the allowance for loan losses. Approximately $2.9 million of commercial and industrial loans and $3.1 million of the commercial real estate loans restructured during the nine months ended September 30, 2014 were related to a single loan relationship that was previously restructured during the third quarter of 2013. As of September 30, 2014, there were no loans restructured during the last year that were in excess of 90 days past due. During the nine months ended September 30, 2014, the Corporation charged-off $627 thousand of commercial and industrial loans that were restructured during 2013. During the nine months ended September 30, 2014, the Corporation also foreclosed upon certain commercial real estate loans that were restructured during 2013. The Corporation recognized $500 thousand of other real estate owned and no charge-offs in connection with these foreclosures. The aforementioned charge-offs, foreclosures and past due loans did not significantly impact the Corporation's determination of the allowance for loan losses.

Credit Quality Indicators. As part of the on-going monitoring of the credit quality of the Corporation's loan portfolio, management tracks certain credit quality indicators including trends related to (i) the weighted-average risk grade of commercial loans, (ii) the level of classified commercial loans, (iii) the delinquency status of consumer loans (see details above), (iv) net charge-offs, (v) non-performing loans (see details above) and (vi) the general economic conditions in the State of Texas.

The Corporation utilizes a risk grading matrix to assign a risk grade to each of its commercial loans. Loans are graded on a scale of 1 to 14. A description of the general characteristics of the 14 risk grades is as follows:

- Grades 1, 2 and 3 – These grades include loans to very high credit quality borrowers of investment or near investment grade. These borrowers are generally publicly traded (grades 1 and 2), have significant capital strength, moderate leverage, stable earnings and growth, and readily available financing alternatives. Smaller entities, regardless of strength, would generally not fit in these grades.
- Grades 4 and 5 – These grades include loans to borrowers of solid credit quality with moderate risk. Borrowers in these grades are differentiated from higher grades on the basis of size (capital and/or revenue), leverage, asset quality and the stability of the industry or market area.
- Grades 6, 7 and 8 – These grades include "pass grade" loans to borrowers of acceptable credit quality and risk. Such borrowers are differentiated from Grades 4 and 5 in terms of size, secondary sources of repayment or they are of lesser stature in other key credit metrics in that they may be over-leveraged, under capitalized, inconsistent in performance or in an industry or an economic area that is known to have a higher level of risk, volatility, or susceptibility to weaknesses in the economy.
- Grade 9 – This grade includes loans on management's "watch list" and is intended to be utilized on a temporary basis for pass grade borrowers where a significant risk-modifying action is anticipated in the near term.

- Grade 10 – This grade is for “Other Assets Especially Mentioned” in accordance with regulatory guidelines. This grade is intended to be temporary and includes loans to borrowers whose credit quality has clearly deteriorated and are at risk of further decline unless active measures are taken to correct the situation.
- Grade 11 – This grade includes “Substandard” loans, in accordance with regulatory guidelines, for which the accrual of interest has not been stopped. By definition under regulatory guidelines, a “Substandard” loan has defined weaknesses

which make payment default or principal exposure likely, but not yet certain. Such loans are apt to be dependent upon collateral liquidation, a secondary source of repayment or an event outside of the normal course of business.

- Grade 12 – This grade includes "Substandard" loans, in accordance with regulatory guidelines, for which the accrual of interest has been stopped. This grade includes loans where interest is more than 120 days past due and not fully secured and loans where a specific valuation allowance may be necessary, but generally does not exceed 30% of the principal balance.
- Grade 13 – This grade includes "Doubtful" loans in accordance with regulatory guidelines. Such loans are placed on non-accrual status and may be dependent upon collateral having a value that is difficult to determine or upon some near-term event which lacks certainty. Additionally, these loans generally have a specific valuation allowance in excess of 30% of the principal balance.
- Grade 14 – This grade includes "Loss" loans in accordance with regulatory guidelines. Such loans are to be charged-off or charged-down when payment is acknowledged to be uncertain or when the timing or value of payments cannot be determined. "Loss" is not intended to imply that the loan or some portion of it will never be paid, nor does it in any way imply that there has been a forgiveness of debt.

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In monitoring credit quality trends in the context of assessing the appropriate level of the allowance for loan losses, the Corporation monitors portfolio credit quality by the weighted-average risk grade of each class of commercial loan. Individual relationship managers review updated financial information for all pass grade loans to recalculate the risk grade on at least an annual basis. When a loan has a calculated risk grade of 9, it is still considered a pass grade loan; however, it is considered to be on management's "watch list," where a significant risk-modifying action is anticipated in the near term. When a loan has a calculated risk grade of 10 or higher, a special assets officer monitors the loan on an on-going basis. The following table presents weighted average risk grades for all commercial loans by class.

	September 30, 2014		December 31, 2013	
	Weighted Average Risk Grade	Loans	Weighted Average Risk Grade	Loans
Commercial and industrial:				
Energy				
Risk grades 1-8	5.29	$1,566,621	5.37	$1,106,348
Risk grade 9	9.00	24,212	9.00	7,726
Risk grade 10	10.00	3,161	10.00	245
Risk grade 11	11.00	5,835	11.00	500
Risk grade 12	12.00	637	12.00	590
Risk grade 13	13.00	—	13.00	—
Total energy	5.38	$1,600,466	5.40	$1,115,409
Other commercial				
Risk grades 1-8	5.94	$3,697,503	5.95	$3,507,963
Risk grade 9	9.00	58,045	9.00	74,766
Risk grade 10	10.00	65,561	10.00	89,878
Risk grade 11	11.00	55,403	11.00	92,917
Risk grade 12	12.00	32,008	12.00	21,389
Risk grade 13	13.00	1,901	13.00	4,754
Total other commercial	6.18	$3,910,421	6.27	$3,791,667
Commercial real estate:				
Buildings, land and other				
Risk grades 1-8	6.51	$3,164,357	6.59	$2,844,665
Risk grade 9	9.00	80,878	9.00	65,770
Risk grade 10	10.00	70,312	10.00	49,881
Risk grade 11	11.00	41,549	11.00	53,208
Risk grade 12	12.00	19,614	12.00	24,387
Risk grade 13	13.00	776	13.00	2,786
Total commercial real estate	6.73	$3,377,486	6.83	$3,040,697
Construction				
Risk grades 1-8	7.00	$631,616	7.05	$418,999
Risk grade 9	9.00	2,494	9.00	1,301
Risk grade 10	10.00	5,855	10.00	5,931
Risk grade 11	11.00	2,738	11.00	408
Risk grade 12	12.00	289	12.00	—
Risk grade 13	13.00	—	13.00	—
Total construction	7.05	$642,992	7.10	$426,639

The Corporation has established maximum loan to value standards to be applied during the origination process of commercial and consumer real estate loans. The Corporation does not subsequently monitor loan-to-value ratios (either individually or on a weighted-average basis) for loans that are subsequently considered to be of a pass grade (grades 9 or better) and/or current with respect to principal and interest payments. As stated above, when an individual

commercial real estate loan has a calculated risk grade of 10 or higher, a special assets officer analyzes the loan to determine whether the loan is impaired. At that time, the Corporation reassesses the loan to value position in the loan. If the loan is determined to be collateral dependent, specific allocations of the allowance for loan losses are made for the amount of any collateral deficiency. If a collateral deficiency is ultimately deemed to be uncollectible, the amount is charged-off. These loans and related assessments of collateral position are monitored on an individual, case-by-case basis. The Corporation does not monitor loan-to-value ratios on a weighted-average basis for commercial real estate loans having a calculated risk grade of 10 or higher. Nonetheless, there were five commercial real estate loans having

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a calculated risk grade of 10 or higher in excess of $5 million as of September 30, 2014, which totaled $33.0 million and had a weighted-average loan-to-value ratio of approximately 59.8%. When an individual consumer real estate loan becomes past due by more than 10 days, the assigned relationship manager will begin collection efforts. The Corporation only reassesses the loan to value position in a consumer real estate loan if, during the course of the collections process, it is determined that the loan has become collateral dependent, and any collateral deficiency is recognized as a charge-off to the allowance for loan losses. Accordingly, the Corporation does not monitor loan-to-value ratios on a weighted-average basis for collateral dependent consumer real estate loans.

Generally, a commercial loan, or a portion thereof, is charged-off immediately when it is determined, through the analysis of any available current financial information with regards to the borrower, that the borrower is incapable of servicing unsecured debt, there is little or no prospect for near term improvement and no realistic strengthening action of significance is pending or, in the case of secured debt, when it is determined, through analysis of current information with regards to the Corporation's collateral position, that amounts due from the borrower are in excess of the calculated current fair value of the collateral. Notwithstanding the foregoing, generally, commercial loans that become past due 180 cumulative days are classified as a loss and charged-off. Generally, a consumer loan, or a portion thereof, is charged-off in accordance with regulatory guidelines which provide that such loans be charged-off when the Corporation becomes aware of the loss, such as from a triggering event that may include new information about a borrower's intent/ability to repay the loan, bankruptcy, fraud or death, among other things, but in no case should the charge-off exceed specified delinquency time frames. Such delinquency time frames state that closed-end retail loans (loans with pre-defined maturity dates, such as real estate mortgages, home equity loans and consumer installment loans) that become past due 120 cumulative days and open-end retail loans (loans that roll-over at the end of each term, such as home equity lines of credit) that become past due 180 cumulative days should be classified as a loss and charged-off.

Net (charge-offs)/recoveries, segregated by class of loans, were as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Commercial and industrial:				
Energy	$2	$—	$449	$(900)
Other commercial	738	(4,296)	(2,539)	(22,806)
Commercial real estate:				
Buildings, land and other	53	110	(1,965)	81
Construction	31	16	346	246
Consumer real estate	(609)	(457)	(613)	(718)
Consumer and other	(579)	(734)	(1,718)	(1,892)
Total	$(364)	$(5,361)	$(6,040)	$(25,989)

In assessing the general economic conditions in the State of Texas, management monitors and tracks the Texas Leading Index ("TLI"), which is produced by the Federal Reserve Bank of Dallas. The TLI is a single summary statistic that is designed to signal the likelihood of the Texas economy's transition from expansion to recession and vice versa. Management believes this index provides a reliable indication of the direction of overall credit quality. The TLI is a composite of the following eight leading indicators: (i) Texas Value of the Dollar, (ii) U.S. Leading Index, (iii) real oil prices (iv) well permits, (v) initial claims for unemployment insurance, (vi) Texas Stock Index, (vii) Help-Wanted Index and (viii) average weekly hours worked in manufacturing. The TLI totaled 132.4 at August 31, 2014 (most recent date available) and 129.1 at December 31, 2013. A higher TLI value implies more favorable economic conditions.

Allowance for Loan Losses. The allowance for loan losses is a reserve established through a provision for loan losses charged to expense, which represents management's best estimate of probable losses that have been incurred within the existing portfolio of loans. The allowance, in the judgment of management, is necessary to reserve for estimated loan losses and risks inherent in the loan portfolio. The Corporation's allowance for loan loss methodology follows the accounting guidance set forth in U.S. generally accepted accounting principles and the Interagency Policy Statement

on the Allowance for Loan and Lease Losses, which was jointly issued by U.S. bank regulatory agencies. In that regard, the Corporation's allowance for loan losses includes allowance allocations calculated in accordance with ASC Topic 310, "Receivables" and allowance allocations calculated in accordance with ASC Topic 450, "Contingencies." Accordingly, the methodology is based on historical loss experience by type of credit and internal risk grade, specific homogeneous risk pools and specific loss allocations, with adjustments for current events and conditions. The Corporation's process for determining the appropriate level of the allowance for loan losses is designed to account for credit deterioration as it occurs. The provision for loan losses reflects loan quality trends, including the levels of and trends related to non-accrual loans, past due loans, potential problem loans, criticized loans and net charge-offs or recoveries, among other factors. The provision for loan losses also reflects the totality of actions taken on all loans for a particular period. In

other words, the amount of the provision reflects not only the necessary increases in the allowance for loan losses related to newly identified criticized loans, but it also reflects actions taken related to other loans including, among other things, any necessary increases or decreases in required allowances for specific loans or loan pools.

The level of the allowance reflects management's continuing evaluation of industry concentrations, specific credit risks, loan loss and recovery experience, current loan portfolio quality, present economic, political and regulatory conditions and unidentified losses inherent in the current loan portfolio. 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. While management utilizes its best judgment and information available, the ultimate determination of the appropriate level of the allowance is dependent upon a variety of factors beyond the Corporation's control, including, among other things, the performance of the Corporation's loan portfolio, the economy, changes in interest rates and the view of the regulatory authorities toward loan classifications. The Corporation monitors whether or not the allowance for loan loss allocation model, as a whole, calculates an appropriate level of allowance for loan losses that moves in direct correlation to the general macroeconomic and loan portfolio conditions the Corporation experiences over time.

The Corporation's allowance for loan losses consists of three elements: (i) specific valuation allowances determined in accordance with ASC Topic 310 based on probable losses on specific loans; (ii) historical valuation allowances determined in accordance with ASC Topic 450 based on historical loan loss experience for similar loans with similar characteristics and trends, adjusted, as necessary, to reflect the impact of current conditions; and (iii) general valuation allowances determined in accordance with ASC Topic 450 based on general economic conditions and other risk factors both internal and external to the Corporation.

The allowances established for probable losses on specific loans are based on a regular analysis and evaluation of problem loans. Loans are classified based on an internal credit risk grading process that evaluates, among other things: (i) the obligor's ability to repay; (ii) the underlying collateral, if any; and (iii) the economic environment and industry in which the borrower operates. This analysis is performed at the relationship manager level for all commercial loans. When a loan has a calculated grade of 10 or higher, a special assets officer analyzes the loan to determine whether the loan is impaired and, if impaired, the need to specifically allocate a portion of the allowance for loan losses to the loan. Specific valuation allowances are determined by analyzing the borrower's ability to repay amounts owed, collateral deficiencies, the relative risk grade of the loan and economic conditions affecting the borrower's industry, among other things.

Historical valuation allowances are calculated based on the historical gross loss experience of specific types of loans and the internal risk grade of such loans at the time they were charged-off. The Corporation calculates historical gross loss ratios for pools of similar loans with similar characteristics based on the proportion of actual charge-offs experienced to the total population of loans in the pool. The historical gross loss ratios are periodically (no less than annually) updated based on actual charge-off experience. A historical valuation allowance is established for each pool of similar loans based upon the product of the historical gross loss ratio and the total dollar amount of the loans in the pool. The Corporation's pools of similar loans include similarly risk-graded groups of commercial and industrial loans, commercial real estate loans, consumer real estate loans and consumer and other loans.

The components of the general valuation allowance include (i) the additional reserves allocated as a result of applying an environmental risk adjustment factor to the base historical loss allocation, (ii) the additional reserves allocated for loans to borrowers in distressed industries and (iii) the additional reserves allocated for groups of similar loans with risk characteristics that exceed certain concentration limits established by management.

The environmental adjustment factor is based upon a more qualitative analysis of risk and is calculated through a survey of senior officers who are involved in credit making decisions at a corporate-wide and/or regional level. On a quarterly basis, survey participants rate the degree of various risks utilizing a numeric scale that translates to varying grades of high, moderate or low levels of risk. The results are then input into a risk-weighting matrix to determine an appropriate environmental risk adjustment factor. The various risks that may be considered in the determination of the environmental adjustment factor include, among other things, (i) the experience, ability and effectiveness of the bank's lending management and staff; (ii) the effectiveness of the Corporation's loan policies, procedures and internal controls; (iii) changes in asset quality; (iv) the impact of legislative and governmental influences affecting industry

sectors; (v) the effectiveness of the internal loan review function; (vi) the impact of competition on loan structuring and pricing; and (vii) the impact of rising interest rates on portfolio risk. In periods where the surveyed risks are perceived to be higher, the risk-weighting matrix will generally result in a higher environmental adjustment factor, which, in turn will result in higher levels of general valuation allowance allocations. The opposite holds true in periods where the surveyed risks are perceived to be lower.

General valuation allowances also include amounts allocated for loans to borrowers in distressed industries. To determine the amount of the allocation for each loan portfolio segment, management calculates the weighted-average risk grade for all loans to borrowers in distressed industries by loan portfolio segment. A multiple is then applied to the amount by which the weighted-

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average risk grade for loans to borrowers in distressed industries exceeds the weighted-average risk grade for all pass-grade loans within the loan portfolio segment to derive an allocation factor for loans to borrowers in distressed industries. The amount of the allocation for each loan portfolio segment is the product of this allocation factor and the outstanding balance of pass-grade loans within the identified distressed industries that have a risk grade of 6 or higher. Management identifies potential distressed industries by analyzing industry trends related to delinquencies, classifications and charge-offs. At September 30, 2014 and December 31, 2013, certain segments of contractors were considered to be a distressed industry based on elevated levels of delinquencies, classifications and charge-offs relative to other industries within the Corporation’s loan portfolio. Furthermore, the Corporation determined, through a review of borrower financial information that, as a whole, contractors have experienced, among other things, decreased revenues, reduced backlog of work, compressed margins and little, if any, net income.

General valuation allowances also include allocations for groups of loans with similar risk characteristics that exceed certain concentration limits established by management and/or the Corporation’s board of directors. Concentration risk limits have been established, among other things, for certain industry concentrations, large balance and highly leveraged credit relationships that exceed specified risk grades, and loans originated with policy, credit and/or collateral exceptions that exceed specified risk grades. Additionally, general valuation allowances are provided for loans that did not undergo a separate, independent concurrence review during the underwriting process (generally those loans under $1.0 million at origination). The Corporation’s allowance methodology for general valuation allowances also includes a reduction factor for recoveries of prior charge-offs to compensate for the fact that historical loss allocations are based upon gross charge-offs rather than net. The adjustment for recoveries is based on the lower of annualized, year-to-date gross recoveries or the total gross recoveries for the preceding four quarters, adjusted, when necessary, for expected future trends in recoveries. General valuation allowances are also allocated for general macroeconomic risk related to current economic trends and other quantitative and qualitative factors that could impact the Corporation's loan portfolio segments.

The following table presents details of the allowance for loan losses, segregated by loan portfolio segment.

	Commercial and Industrial	Commercial Real Estate	Consumer Real Estate	Consumer and Other	Unallocated	Total
September 30, 2014						
Historical valuation allowances	$32,092	$14,638	$2,003	$10,425	$—	$59,158
Specific valuation allowances	1,413	776	—	—	—	2,189
General valuation allowances:						
Environmental risk adjustment	6,713	3,548	474	2,668	—	13,403
Distressed industries	3,784	2	—	—	—	3,786
Excessive industry concentrations	1,871	299	—	—	—	2,170
Large relationship concentrations	2,012	1,469	—	—	—	3,481
Highly-leveraged credit relationships	3,662	1,061	—	—	—	4,723
Policy exceptions	2,054	938	—	—	—	2,992
Credit and collateral exceptions	1,148	524	—	—	—	1,672
Loans not reviewed by concurrence	2,121	2,295	2,315	1,185	—	7,916
Adjustment for recoveries	(4,517)	(1,640)	(264)	(7,372)	—	(13,793)
General macroeconomic risk	6,283	2,870	579	883	—	10,615
Total	$58,636	$26,780	$5,107	$7,789	$—	$98,312
December 31, 2013						
Historical valuation allowances	$29,357	$13,042	$2,644	$8,695	$—	$53,738
Specific valuation allowances	4,140	2,786	—	—	—	6,926
General valuation allowances:						

Environmental risk adjustment	5,497	3,314	664	2,331	—	11,806
Distressed industries	7,812	384	—	—	—	8,196
Excessive industry concentrations	1,499	367	—	—	—	1,866
Large relationship concentrations	1,529	1,081	—	—	—	2,610
Highly-leveraged credit relationships	4,535	619	—	—	—	5,154
Policy exceptions	—	—	—	—	2,492	2,492
Credit and collateral exceptions	—	—	—	—	1,398	1,398
Loans not reviewed by concurrence	2,009	2,201	2,250	1,064	—	7,524
Adjustment for recoveries	(3,588)	(1,204)	(328)	(7,080)	—	(12,200)
General macroeconomic risk	—	—	—	—	2,928	2,928
Total	$52,790	$22,590	$5,230	$5,010	$6,818	$92,438

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The Corporation monitors whether or not the allowance for loan loss allocation model, as a whole, calculates an appropriate level of allowance for loan losses that moves in direct correlation to the general macroeconomic and loan portfolio conditions the Corporation experiences over time. In assessing the general macroeconomic trends/conditions, the Corporation analyzes trends in the components of the TLI, as well as any available information related to regional, national and international economic conditions and events and the impact such conditions and events may have on the Corporation and its customers. With regard to assessing loan portfolio conditions, the Corporation analyzes trends in weighted-average portfolio risk-grades, classified and non-performing loans and charge-off activity. In periods where general macroeconomic and loan portfolio conditions are in a deteriorating trend or remain at deteriorated levels, based on historical trends, the Corporation would expect to see the allowance for loan loss allocation model, as a whole, calculate higher levels of required allowances than in periods where general macroeconomic and loan portfolio conditions are in an improving trend or remain at an elevated level, based on historical trends.

The following table details activity in the allowance for loan losses by portfolio segment for the three and nine months ended September 30, 2014 and 2013. Allocation of a portion of the allowance to one category of loans does not preclude its availability to absorb losses in other categories.

	Commercial and Industrial	Commercial Real Estate	Consumer Real Estate	Consumer and Other	Unallocated	Total
Three months ended:						
September 30, 2014						
Beginning balance	$55,672	$22,046	$4,659	$6,427	$9,482	$98,286
Provision for loan losses	2,224	4,650	1,057	1,941	(9,482)	390
Charge-offs	(3,631)	(393)	(714)	(2,523)	—	(7,261)
Recoveries	4,371	477	105	1,944	—	6,897
Net charge-offs	740	84	(609)	(579)	—	(364)
Ending balance	$58,636	$26,780	$5,107	$7,789	$—	$98,312
September 30, 2013						
Beginning balance	$50,814	$23,573	$4,917	$4,130	$9,966	$93,400
Provision for loan losses	8,060	(1,983)	638	1,286	(2,893)	5,108
Charge-offs	(4,962)	(56)	(514)	(2,610)	—	(8,142)
Recoveries	666	182	57	1,876	—	2,781
Net charge-offs	(4,296)	126	(457)	(734)	—	(5,361)
Ending balance	$54,578	$21,716	$5,098	$4,682	$7,073	$93,147
Nine months ended:						
September 30, 2014						
Beginning balance	$52,790	$22,590	$5,230	$5,010	$6,818	$92,438
Provision for loan losses	7,936	5,809	490	4,497	(6,818)	11,914
Charge-offs	(9,026)	(3,119)	(840)	(7,279)	—	(20,264)
Recoveries	6,936	1,500	227	5,561	—	14,224
Net charge-offs	(2,090)	(1,619)	(613)	(1,718)	—	(6,040)
Ending balance	$58,636	$26,780	$5,107	$7,789	$—	$98,312
September 30, 2013						
Beginning balance	$54,164	$29,346	$5,252	$3,507	$12,184	$104,453
Provision for loan losses	24,120	(7,957)	564	3,067	(5,111)	14,683
Charge-offs	(25,700)	(737)	(1,009)	(7,161)	—	(34,607)
Recoveries	1,994	1,064	291	5,269	—	8,618
Net charge-offs	(23,706)	327	(718)	(1,892)	—	(25,989)

Ending balance	$54,578	$21,716	$5,098	$4,682	$7,073	$93,147

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

	Commercial and Industrial	Commercial Real Estate	Consumer Real Estate	Consumer and Other	Unallocated	Total
September 30, 2014						
Loans individually evaluated for impairment	$13,104	$1,867	$—	$—	$—	$14,971
Loans collectively evaluated for impairment	45,532	24,913	5,107	7,789	—	83,341
Balance at September 30, 2014	$58,636	$26,780	$5,107	$7,789	$—	$98,312
December 31, 2013						
Loans individually evaluated for impairment	$16,682	$3,914	$—	$—	$—	$20,596
Loans collectively evaluated for impairment	36,108	18,676	5,230	5,010	6,818	71,842
Balance at December 31, 2013	$52,790	$22,590	$5,230	$5,010	$6,818	$92,438
September 30, 2013						
Loans individually evaluated for impairment	$15,912	$3,511	$—	$—	$—	$19,423
Loans collectively evaluated for impairment	38,666	18,205	5,098	4,682	7,073	73,724
Balance at September 30, 2013	$54,578	$21,716	$5,098	$4,682	$7,073	$93,147

The Corporation’s recorded investment in loans as of September 30, 2014, December 31, 2013 and September 30, 2013 related to each balance in the allowance for loan losses by portfolio segment and detailed on the basis of the impairment methodology used by the Corporation was as follows:

	Commercial and Industrial	Commercial Real Estate	Consumer Real Estate	Consumer and Other	Unearned Discounts	Total
September 30, 2014						
Loans individually evaluated for impairment	$164,506	$141,133	$624	$—	$—	$306,263
Loans collectively evaluated for impairment	5,346,381	3,879,345	846,444	391,498	(23,147)	10,440,521
Ending balance	$5,510,887	$4,020,478	$847,068	$391,498	$(23,147)	$10,746,784
December 31, 2013						
Loans individually evaluated for impairment	$210,273	$136,601	$745	$278	$—	$347,897
Loans collectively evaluated for impairment	4,696,803	3,330,735	807,459	357,838	(25,032)	9,167,803
Ending balance	$4,907,076	$3,467,336	$808,204	$358,116	$(25,032)	$9,515,700
September 30, 2013						
Loans individually evaluated for impairment	$173,513	$147,302	$773	$311	$—	$321,899
Loans collectively evaluated for impairment	4,635,159	3,223,667	799,054	349,801	(23,126)	8,984,555
Ending balance	$4,808,672	$3,370,969	$799,827	$350,112	$(23,126)	$9,306,454

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Note 5 - Goodwill and Other Intangible Assets

Goodwill and other intangible assets are presented in the table below. During 2014, the Corporation preliminarily recorded goodwill totaling $117.2 million and a core deposit intangible asset totaling $9.3 million in connection with the acquisition of WNB. See Note 2 - Mergers and Acquisitions.

	September 30, 2014	December 31, 2013
Goodwill	$653,849	$536,649
Other intangible assets:		
Core deposits	$10,468	$3,005
Customer relationships	2,291	2,828
Non-compete agreements	362	512
	$13,121	$6,345

The estimated aggregate future amortization expense for intangible assets remaining as of September 30, 2014 is as follows:

Remainder of 2014	$997
2015	3,324
2016	2,412
2017	1,619
2018	1,346
Thereafter	3,423
	$13,121

Note 6 - Deposits

Deposits were as follows:

	September 30, 2014	Percentage of Total		December 31, 2013	Percentage of Total	
Non-interest-bearing demand deposits:						
Commercial and individual	$9,321,120	39.7	%	$7,445,656	36.0	%
Correspondent banks	387,048	1.7		427,134	2.1	
Public funds	454,247	1.9		438,359	2.1	
Total non-interest-bearing demand deposits	10,162,415	43.3		8,311,149	40.2	
Interest-bearing deposits:						
Private accounts:						
Savings and interest checking	4,313,781	18.4		4,020,313	19.4	
Money market accounts	7,669,157	32.6		6,883,869	33.3	
Time accounts of $100,000 or more	523,615	2.2		508,441	2.5	
Time accounts under $100,000	458,874	2.0		438,800	2.1	
Total private accounts	12,965,427	55.2		11,851,423	57.3	
Public funds:						
Savings and interest checking	251,303	1.1		305,976	1.5	
Money market accounts	44,284	0.1		56,015	0.2	
Time accounts of $100,000 or more	65,739	0.3		160,637	0.8	
Time accounts under $100,000	1,435	—		3,586	—	
Total public funds	362,761	1.5		526,214	2.5	
Total interest-bearing deposits	13,328,188	56.7		12,377,637	59.8	
Total deposits	$23,490,603	100.0	%	$20,688,786	100.0	%

The following table presents additional information about the Corporation's deposits:

	September 30, 2014	December 31, 2013
Deposits from the Certificate of Deposit Account Registry Service (CDARS)	$31,150	$200

Deposits from the Promontory Interfinancial Network Insured Cash Sweep Service (acquired in the acquisition of WNB)	117,278	—
Deposits from foreign sources (primarily Mexico)	737,435	769,970

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Note 7 - Commitments and Contingencies

Financial Instruments with Off-Balance-Sheet Risk. In the normal course of business, the Corporation enters into various transactions, which, in accordance with generally accepted accounting principles are not included in its consolidated balance sheets. The Corporation 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 Corporation minimizes its exposure to loss under these commitments by subjecting them to credit approval and monitoring procedures.

The Corporation 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 Corporation's commitments to extend credit are contingent upon customers maintaining specific credit standards at the time of loan funding. Standby letters of credit are written conditional commitments issued by the Corporation 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 Corporation would be required to fund the commitment. The maximum potential amount of future payments the Corporation could be required to make is represented by the contractual amount of the commitment. If the commitment were funded, the Corporation would be entitled to seek recovery from the customer. The Corporation's policies generally require that standby letter of credit arrangements contain security and debt covenants similar to those contained in loan agreements.

The Corporation considers the fees collected in connection with the issuance of standby letters of credit to be representative of the fair value of its obligation undertaken in issuing the guarantee. In accordance with applicable accounting standards related to guarantees, the Corporation defers fees collected in connection with the issuance of standby letters of credit. The fees are then recognized in income proportionately over the life of the standby letter of credit agreement. The deferred standby letter of credit fees represent the fair value of the Corporation's potential obligations under the standby letter of credit guarantees.

Financial instruments with off-balance-sheet risk were as follows:

	September 30, 2014	December 31, 2013
Commitments to extend credit	$7,698,297	$6,919,942
Standby letters of credit	228,265	186,857
Deferred standby letter of credit fees	1,532	1,450

Lease Commitments. The Corporation leases certain office facilities and office equipment under operating leases. Rent expense for all operating leases totaled $7.0 million and $20.5 million during the three and nine months ended September 30, 2014 and $6.4 million and $18.4 million during the three and nine months ended September 30, 2013. There has been no significant change in the future minimum lease payments payable by the Corporation since December 31, 2013. See the 2013 Form 10-K for information regarding these commitments.

Litigation. The Corporation is subject to various claims and legal actions that have arisen in the course of conducting business. Management does not expect the ultimate disposition of these matters to have a material adverse impact on the Corporation's financial statements.

Note 8 - Capital and Regulatory Matters

Regulatory Capital Requirements. Banks and bank holding companies are subject to various regulatory capital requirements administered by state and federal banking agencies. Capital adequacy guidelines and, additionally for banks, prompt corrective action regulations, involve quantitative measures of assets, liabilities, and certain off-balance-sheet items calculated under regulatory accounting practices. Capital amounts and classifications are also subject to qualitative judgments by regulators about components, risk weighting and other factors.

Quantitative measures established by regulations to ensure capital adequacy require the maintenance of minimum amounts and ratios (set forth in the table below) of total and Tier 1 capital (as defined in the regulations) to risk-weighted assets (as defined), and of Tier 1 capital to adjusted quarterly average assets (as defined).

Cullen/Frost's and Frost Bank's Tier 1 capital consists of shareholders' equity excluding unrealized gains and losses on securities available for sale, the accumulated gain or loss on effective cash flow hedging derivatives, the net actuarial

gain/loss on the Corporation's defined benefit post-retirement benefit plans, goodwill and other intangible assets. Tier 1 capital for Cullen/Frost also includes $144.5 million of 5.375% non-cumulative perpetual preferred stock and $133 million of trust preferred securities issued by its unconsolidated subsidiary trusts. Cullen/Frost's and Frost Bank's total capital is comprised of Tier 1 capital for each entity plus a permissible portion of the allowance for loan losses and outstanding subordinated debt. The Corporation's aggregate $100 million of floating rate subordinated notes are not included in Tier 1 capital but the permissible portion (which decreases

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20% per year during the final five years of the term of the notes) totaling $40 million at September 30, 2014 and $60 million at December 31, 2013, is included in total capital of Cullen/Frost.

The Tier 1 and total capital ratios are calculated by dividing the respective capital amounts by risk-weighted assets. Risk-weighted assets are calculated based on regulatory requirements and include total assets, excluding goodwill and other intangible assets, allocated by risk weight category, and certain off-balance-sheet items (primarily loan commitments). The leverage ratio is calculated by dividing Tier 1 capital by adjusted quarterly average total assets, which exclude goodwill and other intangible assets.

Actual and required capital ratios for Cullen/Frost and Frost Bank were as follows:

	Actual			Minimum Required for Capital Adequacy Purposes			Required to be Considered Well Capitalized		
	Capital Amount	Ratio		Capital Amount	Ratio		Capital Amount	Ratio	
September 30, 2014									
Total Capital to Risk-Weighted Assets									
Cullen/Frost	$2,272,967	14.81	%	$1,228,072	8.00	%	$1,535,090	10.00	%
Frost Bank	2,023,592	13.21		1,225,704	8.00		1,532,130	10.00	
Tier 1 Capital to Risk-Weighted Assets									
Cullen/Frost	2,134,655	13.91		614,036	4.00		921,054	6.00	
Frost Bank	1,932,526	12.61		612,852	4.00		919,278	6.00	
Leverage Ratio									
Cullen/Frost	2,134,655	8.27		1,031,906	4.00		1,289,883	5.00	
Frost Bank	1,932,526	7.50		1,030,358	4.00		1,287,947	5.00	
December 31, 2013									
Total Capital to Risk-Weighted Assets									
Cullen/Frost	$2,110,774	15.52	%	$1,088,349	8.00	%	$1,360,437	10.00	%
Frost Bank	1,780,313	13.12		1,085,447	8.00		1,356,809	10.00	
Tier 1 Capital to Risk-Weighted Assets									
Cullen/Frost	1,958,336	14.39		544,175	4.00		816,262	6.00	
Frost Bank	1,707,307	12.58		542,724	4.00		814,085	6.00	
Leverage Ratio									
Cullen/Frost	1,958,336	8.49		922,728	4.00		1,153,410	5.00	
Frost Bank	1,707,307	7.42		920,107	4.00		1,150,134	5.00	

Management believes that, as of September 30, 2014, Cullen/Frost and its bank subsidiary, Frost Bank, were “well capitalized” based on the ratios presented above. In July 2013, Cullen/Frost’s and Frost Bank’s primary federal regulator, the Federal Reserve, published final rules establishing a new comprehensive capital framework for U.S. banking organizations which will become effective on January 1, 2015 (subject to a phase-in period) (the "Basel III Capital Rules"). Management believes that, as of September 30, 2014, Cullen/Frost and Frost Bank would meet all capital adequacy requirements under the Basel III Capital Rules on a fully phased-in basis as if such requirements were currently in effect. See the section captioned “Supervision and Regulation” in Item 1. Business of the Corporation’s 2013 Form 10-K for more information on the Basel III Capital Rules.

Cullen/Frost and Frost Bank are subject to the regulatory capital requirements administered by the Federal Reserve, and, for Frost Bank, the Federal Deposit Insurance Corporation (“FDIC”). Regulatory authorities can initiate certain mandatory actions if Cullen/Frost or Frost Bank fail to meet the minimum capital requirements, which could have a direct material effect on the Corporation’s financial statements. Management believes, as of September 30, 2014, that

Cullen/Frost and Frost Bank meet all capital adequacy requirements to which they are subject.

Trust Preferred Securities. In accordance with the applicable accounting standard related to variable interest entities, the accounts of the Corporation’s wholly owned subsidiary trusts, Cullen/Frost Capital Trust II and WNB Capital Trust I, have not been included in the Corporation’s consolidated financial statements. However, the $133.0 million in trust preferred securities issued by these subsidiary trusts have been included in the Tier 1 capital of Cullen/Frost for regulatory capital purposes pursuant to guidance from the Federal Reserve. As more fully discussed in the Corporation's 2013 Form 10-K, new rules related to the implementation of the Basel III capital framework will require the phase-out of certain hybrid securities, such as trust preferred securities, as Tier 1 capital of bank holding companies beginning January 1, 2015.

Preferred Stock. On February 15, 2013, the Corporation issued and sold 6,000,000 shares, or $150.0 million in aggregate liquidation preference, of its 5.375% Non-Cumulative Perpetual Preferred Stock, Series A, par value $0.01 and liquidation

preference $25 per share (“Series A Preferred Stock”). Dividends on the Series A Preferred stock, if declared, accrue and are payable quarterly, in arrears, at a rate of 5.375%. The Series A Preferred Stock qualifies as Tier 1 capital for the purposes of the regulatory capital calculations. The net proceeds from the issuance and sale of the Series A Preferred Stock, after deducting underwriting discount and commissions, and the payment of expenses, were approximately $144.5 million. The net proceeds from the offering were used to fund the accelerated share repurchase further discussed below.

Stock Repurchase Plans. From time to time, the Corporation’s board of directors has authorized stock repurchase plans. In general, stock repurchase plans allow the Corporation to proactively manage its capital position and return excess capital to shareholders. Shares purchased under such plans also provide the Corporation with shares of common stock necessary to satisfy obligations related to stock compensation awards. The accelerated share repurchase discussed below was part of a stock repurchase program that was authorized by the Corporation’s board of directors in December 2012 to buy up to $150.0 million of the Corporation’s common stock.

Accelerated Share Repurchase. Concurrent with the issuance and sale of the Series A Preferred Stock, on February 12, 2013, the Corporation entered into an accelerated share repurchase agreement (the “ASR agreement”) with Goldman, Sachs & Co. (“Goldman Sachs”). Under the ASR agreement, the Corporation paid $144.0 million to Goldman Sachs and received from Goldman Sachs 1,905,077 shares of the Corporation’s common stock, representing approximately 80% of the estimated total number of shares to be repurchased. Goldman Sachs borrowed such shares delivered to the Corporation from stock lenders, and during the term of the ASR agreement, purchased shares in the open market to return to those stock lenders. Final settlement of the ASR agreement occurred on August 13, 2013 and the Corporation received an additional 331,671 shares. The total number of shares that the Corporation repurchased was based on the volume-weighted-average price per share of the Corporation’s common stock during the repurchase period as adjusted pursuant to the terms and conditions of the ASR agreement.

Dividend Restrictions. In the ordinary course of business, Cullen/Frost is dependent upon dividends from Frost Bank to provide funds for the payment of dividends to shareholders and to provide for other cash requirements. Banking regulations may limit the amount of dividends that may be paid. Approval by regulatory authorities is required if the effect of dividends declared would cause the regulatory capital of Frost Bank to fall below specified minimum levels. Approval is also required if dividends declared exceed the net profits for that year combined with the retained net profits for the preceding two years. Under the foregoing dividend restrictions and while maintaining its “well capitalized” status, at September 30, 2014, Frost Bank could pay aggregate dividends of up to $321.8 million to Cullen/Frost without prior regulatory approval.

Under the terms of the junior subordinated deferrable interest debentures that Cullen/Frost has issued to Cullen/Frost Capital Trust II and WNB Capital Trust I, Cullen/Frost has the right at any time during the term of the debentures to defer the payment of interest at any time or from time to time for an extension period not exceeding 20 consecutive quarterly periods with respect to each extension period. In the event that the Corporation has elected to defer interest on the debentures, the Corporation may not, with certain exceptions, declare or pay any dividends or distributions on its capital stock or purchase or acquire any of its capital stock.

Under the terms of the Series A Preferred Stock, in the event that the Corporation does not declare and pay dividends on the Series A Preferred Stock for the most recent dividend period, the Corporation may not, with certain exceptions, declare or pay dividends on, or purchase, redeem or otherwise acquire, shares of its common stock or any securities of the Corporation that rank junior to the Series A Preferred Stock.

Note 9 - Derivative Financial Instruments

The fair value of derivative positions outstanding is included in accrued interest receivable and other assets and accrued interest payable and other liabilities in the accompanying consolidated balance sheets and in the net change in each of these financial statement line items in the accompanying consolidated statements of cash flows.

Interest Rate Derivatives. The Corporation utilizes interest rate swaps, caps and floors to mitigate exposure to interest rate risk and to facilitate the needs of its customers. The Corporation’s objectives for utilizing these derivative instruments is described below:

The Corporation has entered into certain interest rate swap contracts that are matched to specific fixed-rate commercial loans or leases that the Corporation has entered into with its customers. These contracts have been

designated as hedging instruments to hedge the risk of changes in the fair value of the underlying commercial loan/lease due to changes in interest rates. The related contracts are structured so that the notional amounts reduce over time to generally match the expected amortization of the underlying loan/lease.

During 2007, the Corporation entered into three interest rate swap contracts on variable-rate loans with a total notional amount of $1.2 billion. The interest rate swap contracts were designated as hedging instruments in cash flow hedges with the objective of

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protecting the overall cash flows from the Corporation's monthly interest receipts on a rolling portfolio of $1.2 billion of variable-rate loans outstanding throughout the 84-month period beginning in October 2007 and ending in October 2014 from the risk of variability of those cash flows such that the yield on the underlying loans would remain constant. As more fully discussed in the 2013 Form 10-K, the Corporation terminated portions of the hedges and settled portions of the interest rate swap contracts during November 2009 and terminated the remaining portions of the hedges and settled the remaining portions of the interest rate swap contracts during November 2010. The deferred accumulated gain applicable to the settled interest rate swap contracts included in accumulated other comprehensive income totaled $2.6 million and $30.6 million ($1.7 million and $19.9 million on an after-tax basis) at September 30, 2014 and December 31, 2013. The remaining deferred gain of $2.6 million ($1.7 million on an after-tax basis) at September 30, 2014 will be recognized in earnings in October 2014.

During 2008, the Corporation entered into an interest rate swap contract on junior subordinated deferrable interest debentures with a total notional amount of $120.0 million. The interest rate swap contract was designated as a hedging instrument in a cash flow hedge with the objective of protecting the quarterly interest payments on the Corporation's $120.0 million of junior subordinated deferrable interest debentures issued to Cullen/Frost Capital Trust II throughout a five-year period beginning in December 2008 and ending in December 2013 from the risk of variability of those payments resulting from changes in the three-month LIBOR interest rate. Under the swap, the Corporation paid a fixed interest rate of 5.47% and received a variable interest rate of three-month LIBOR plus a margin of 1.55% on a total notional amount of $120.0 million, with quarterly settlements. The swap terminated in December 2013.

The Corporation has entered into certain interest rate swap, cap and floor contracts that are not designated as hedging instruments. These derivative contracts relate to transactions in which the Corporation enters into an interest rate swap, cap and/or floor with a customer while at the same time entering into an offsetting interest rate swap, cap and/or floor with another financial institution. In connection with each swap transaction, the Corporation agrees to pay interest to the customer on a notional amount at a variable interest rate and receive interest from the customer on a similar notional amount at a fixed interest rate. At the same time, the Corporation agrees to pay another financial institution the same fixed interest rate on the same notional amount and receive the same variable interest rate on the same notional amount. The transaction allows the Corporation's customer to effectively convert a variable rate loan to a fixed rate. Because the Corporation acts as an intermediary for its customer, changes in the fair value of the underlying derivative contracts for the most part offset each other and do not significantly impact the Corporation's results of operations.

The notional amounts and estimated fair values of interest rate derivative contracts are presented in the following table. The Corporation obtains dealer quotations to value its interest rate derivative contracts designated as hedges of cash flows, while the fair values of other interest rate derivative contracts are estimated utilizing internal valuation models with observable market data inputs.

	September 30, 2014		December 31, 2013	
	Notional Amount	Estimated Fair Value	Notional Amount	Estimated Fair Value
Derivatives designated as hedges of fair value:				
Financial institution counterparties:				
Loan/lease interest rate swaps – assets	$49,992	$870	$50,965	$1,386
Loan/lease interest rate swaps – liabilities	33,235	(3,307)	43,631	(4,191)
Non-hedging interest rate derivatives:				
Financial institution counterparties:				
Loan/lease interest rate swaps – assets	199,592	3,678	195,234	9,573
Loan/lease interest rate swaps – liabilities	625,931	(33,669)	626,980	(32,469)
Loan/lease interest rate caps – assets	73,058	1,253	53,058	1,309
Customer counterparties:				
Loan/lease interest rate swaps – assets	625,931	33,629	626,980	32,426
Loan/lease interest rate swaps – liabilities	199,592	(3,678)	195,234	(9,573)
Loan/lease interest rate caps – liabilities	73,058	(1,253)	53,058	(1,309)

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The weighted-average rates paid and received for interest rate swaps outstanding at September 30, 2014 were as follows:

	Weighted-Average Interest Rate Paid	Interest Rate Received
Interest rate swaps:		
Fair value hedge loan/lease interest rate swaps	2.55 %	0.15 %
Non-hedging interest rate swaps – financial institution counterparties	4.06 %	1.69 %
Non-hedging interest rate swaps – customer counterparties	1.69 %	4.06 %

The weighted-average strike rate for outstanding interest rate caps was 2.99% at September 30, 2014.

Commodity Derivatives. The Corporation enters into commodity swaps and option contracts that are not designated as hedging instruments primarily to accommodate the business needs of its customers. Upon the origination of a commodity swap or option contract with a customer, the Corporation simultaneously enters into an offsetting contract with a third party financial institution to mitigate the exposure to fluctuations in commodity prices.

The notional amounts and estimated fair values of non-hedging commodity swap and option derivative positions outstanding are presented in the following table. The Corporation obtains dealer quotations and uses internal valuation models with observable market data inputs to value its commodity derivative positions.

		September 30, 2014		December 31, 2013	
	Notional Units	Notional Amount	Estimated Fair Value	Notional Amount	Estimated Fair Value
Financial institution counterparties:					
Oil – assets	Barrels	664	$2,228	356	$1,004
Oil – liabilities	Barrels	402	(339)	1,574	(2,704)
Natural gas – assets	MMBTUs	14,410	3,893	14,240	2,903
Natural gas – liabilities	MMBTUs	16,740	(2,236)	22,510	(3,212)
Customer counterparties:					
Oil – assets	Barrels	402	349	1,574	2,818
Oil – liabilities	Barrels	664	(2,174)	356	(991)
Natural gas – assets	MMBTUs	16,800	2,250	22,850	3,301
Natural gas – liabilities	MMBTUs	14,350	(3,800)	13,900	(2,805)

Foreign Currency Derivatives. The Corporation enters into foreign currency forward contracts that are not designated as hedging instruments primarily to accommodate the business needs of its customers. Upon the origination of a foreign currency denominated transaction with a customer, the Corporation simultaneously enters into an offsetting contract with a third party to negate the exposure to fluctuations in foreign currency exchange rates. The Corporation also utilizes foreign currency forward contracts that are not designated as hedging instruments to mitigate the economic effect of fluctuations in foreign currency exchange rates on certain short-term, non-U.S. dollar denominated loans. The notional amounts and fair values of open foreign currency forward contracts were as follows:

		September 30, 2014		December 31, 2013	
	Notional Currency	Notional Amount	Estimated Fair Value	Notional Amount	Estimated Fair Value
Financial institution counterparties:					
Forward contracts – assets	EUR	967	$7	1,175	$5
Forward contracts – assets	CAD	27,571	816	18,886	85
Forward contracts – assets	GBP	501	—	—	—
Forward contracts – liabilities	EUR	—	—	494	(4)
Forward contracts – liabilities	CAD	—	—	14,078	(23)
Customer counterparties:					
Forward contracts – assets	CAD	—	—	14,055	45

Forward contracts – liabilities	CAD	27,528	(773	)	18,859	(58	)

Gains, Losses and Derivative Cash Flows. For fair value hedges, the changes in the fair value of both the derivative hedging instrument and the hedged item are included in other non-interest income or other non-interest expense. The extent that such changes in fair value do not offset represents hedge ineffectiveness. Net cash flows from interest rate swaps on commercial loans/

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leases designated as hedging instruments in effective hedges of fair value are included in interest income on loans. For cash flow hedges, the effective portion of the gain or loss due to changes in the fair value of the derivative hedging instrument is included in other comprehensive income, while the ineffective portion (indicated by the excess of the cumulative change in the fair value of the derivative over that which is necessary to offset the cumulative change in expected future cash flows on the hedge transaction) is included in other non-interest income or other non-interest expense. Net cash flows from interest rate swaps on variable-rate loans designated as hedging instruments in effective hedges of cash flows and the reclassification from other comprehensive income of deferred gains associated with the termination of those hedges are included in interest income on loans. Net cash flows from the interest rate swap on junior subordinated deferrable interest debentures designated as a hedging instrument in an effective hedge of cash flows were included in interest expense on junior subordinated deferrable interest debentures during 2013. For non-hedging derivative instruments, gains and losses due to changes in fair value and all cash flows are included in other non-interest income and other non-interest expense.

Amounts included in the consolidated statements of income related to interest rate derivatives designated as hedges of fair value were as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Commercial loan/lease interest rate swaps:				
Amount of gain (loss) included in interest income on loans	$(493)	$(609)	$(1,548)	$(1,841)
Amount of (gain) loss included in other non-interest expense	12	11	12	17

Amounts included in the consolidated statements of income and in other comprehensive income for the period related to interest rate derivatives designated as hedges of cash flows were as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Interest rate swaps/caps/floors on variable-rate loans:				
Amount reclassified from accumulated other comprehensive income to interest income on loans	$9,345	$9,345	$28,035	$28,035
Interest rate swaps on junior subordinated deferrable interest debentures:				
Amount reclassified from accumulated other comprehensive income to interest expense on junior subordinated deferrable interest debentures	—	1,120	—	3,308
Amount of gain (loss) recognized in other comprehensive income	—	(15)	—	(48)

No ineffectiveness related to interest rate derivatives designated as hedges of cash flows was recognized in the consolidated statements of income during the reported periods. The accumulated net after-tax gain related to effective cash flow hedges included in accumulated other comprehensive income totaled $1.7 million at September 30, 2014 and $19.9 million at December 31, 2013. The Corporation expects that the entire net after-tax gain of $1.7 million related to effective cash flow hedges included in accumulated other comprehensive income at September 30, 2014 will be recognized in earnings in October 2014.

As stated above, the Corporation enters into non-hedge related derivative positions primarily to accommodate the business needs of its customers. Upon the origination of a derivative contract with a customer, the Corporation simultaneously enters into an offsetting derivative contract with a third party. The Corporation recognizes immediate income based upon the difference in the bid/ask spread of the underlying transactions with its customers and the third party. Because the Corporation acts only as an intermediary for its customer, subsequent changes in the fair value of

the underlying derivative contracts for the most part offset each other and do not significantly impact the Corporation’s results of operations.

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Amounts included in the consolidated statements of income related to non-hedging interest rate, commodity and foreign currency derivative instruments are presented in the table below.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Non-hedging interest rate derivatives:				
Other non-interest income	$414	$54	$1,279	$239
Other non-interest expense	(5)	(28)	(3)	(83)
Non-hedging commodity derivatives:				
Other non-interest income	7	75	100	331
Non-hedging foreign currency derivatives:				
Other non-interest income	43	30	118	103

Counterparty Credit Risk. Derivative contracts involve the risk of dealing with both bank customers and institutional derivative counterparties and their ability to meet contractual terms. Institutional counterparties must have an investment grade credit rating and be approved by the Corporation's Asset/Liability Management Committee. The Corporation's credit exposure on interest rate swaps is limited to the net favorable value and interest payments of all swaps by each counterparty, while the Corporation's credit exposure on commodity swaps/options and foreign currency forward contracts is limited to the net favorable value of all contracts by each counterparty. Credit exposure may be reduced by the amount of collateral pledged by the counterparty. There are no credit-risk-related contingent features associated with any of the Corporation's derivative contracts. Certain derivative contracts with upstream financial institution counterparties may be terminated with respect to a party in the transaction, if such party does not have at least a minimum level rating assigned to either its senior unsecured long-term debt or its deposit obligations by certain third-party rating agencies.

The Corporation's credit exposure relating to interest rate swaps, commodity swaps/options and foreign currency forward contracts with bank customers was approximately $33.7 million at September 30, 2014. This credit exposure is partly mitigated as transactions with customers are generally secured by the collateral, if any, securing the underlying transaction being hedged. The Corporation's credit exposure, net of collateral pledged, relating to interest rate swaps, commodity swaps/options and foreign currency forward contracts with upstream financial institution counterparties was approximately $6.1 million at September 30, 2014. This amount was mostly related to excess collateral posted by the Corporation to counterparties. Collateral levels for upstream financial institution counterparties are monitored and adjusted as necessary. See Note 10 – Balance Sheet Offsetting for additional information regarding the Corporation's credit exposure with upstream financial institution counterparties.

The aggregate fair value of securities posted as collateral by the Corporation related to derivative contracts totaled $32.4 million at September 30, 2014.

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Note 10 - Balance Sheet Offsetting

Certain financial instruments, including resell and repurchase agreements, securities lending arrangements and derivatives, may be eligible for offset in the consolidated balance sheet and/or subject to master netting arrangements or similar agreements. The Corporation’s derivative transactions with upstream financial institution counterparties are generally executed under International Swaps and Derivative Association (“ISDA”) master agreements which include “right of set-off” provisions. In such cases there is generally a legally enforceable right to offset recognized amounts and there may be an intention to settle such amounts on a net basis. Nonetheless, the Corporation does not generally offset such financial instruments for financial reporting purposes.

Information about financial instruments that are eligible for offset in the consolidated balance sheet as of September 30, 2014 is presented in the following tables.

	Gross Amount Recognized	Gross Amount Offset	Net Amount Recognized
September 30, 2014			
Financial assets:			
Derivatives:			
Loan/lease interest rate swaps and caps	$5,801	$—	$5,801
Commodity swaps and options	6,121	—	6,121
Foreign currency forward contracts	823	—	823
Total derivatives	12,745	—	12,745
Resell agreements	4,898	—	4,898
Total	$17,643	$—	$17,643
Financial liabilities:			
Derivatives:			
Loan/lease interest rate swaps	$36,976	$—	$36,976
Commodity swaps and options	2,575	—	2,575
Foreign currency forward contracts	—	—	—
Total derivatives	39,551	—	39,551
Repurchase agreements	576,040	—	576,040
Total	$615,591	$—	$615,591

		Gross Amounts Not Offset		
	Net Amount Recognized	Financial Instruments	Collateral	Net Amount
September 30, 2014				
Financial assets:				
Derivatives:				
Counterparty A	$1,493	$(1,493)	$—	$—
Counterparty B	5,140	(5,140)	—	—
Counterparty C	2,157	(2,157)	—	—
Other counterparties	3,955	(3,474)	(212)	269
Total derivatives	12,745	(12,264)	(212)	269
Resell agreements	4,898	—	(4,898)	—
Total	$17,643	$(12,264)	$(5,110)	$269
Financial liabilities:				
Derivatives:				
Counterparty A	$17,875	$(1,493)	$(15,943)	$439
Counterparty B	7,146	(5,140)	(2,006)	—
Counterparty C	7,440	(2,157)	(5,283)	—
Other counterparties	7,090	(3,474)	(3,302)	314
Total derivatives	39,551	(12,264)	(26,534)	753

Repurchase agreements	576,040	—	(576,040)	—
Total	$615,591	$(12,264)	$(602,574)	$753

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Information about financial instruments that are eligible for offset in the consolidated balance sheet as of December 31, 2013 is presented in the following tables.

	Gross Amount Recognized	Gross Amount Offset	Net Amount Recognized
December 31, 2013			
Financial assets:			
Derivatives:			
Loan/lease interest rate swaps and caps	$12,268	$—	$12,268
Commodity swaps and options	3,907	—	3,907
Foreign currency forward contracts	90	—	90
Total derivatives	16,265	—	16,265
Resell agreements	7,898	—	7,898
Total	$24,163	$—	$24,163
Financial liabilities:			
Derivatives:			
Loan/lease interest rate swaps	$36,660	$—	$36,660
Commodity swaps and options	5,916	—	5,916
Foreign currency forward contracts	27	—	27
Total derivatives	42,603	—	42,603
Repurchase agreements	668,053	—	668,053
Total	$710,656	$—	$710,656

		Gross Amounts Not Offset		
	Net Amount Recognized	Financial Instruments	Collateral	Net Amount
December 31, 2013				
Financial assets:				
Derivatives:				
Counterparty A	$3,342	$(3,342)	$—	$—
Counterparty B	8,196	(8,196)	—	—
Counterparty C	1,187	(1,187)	—	—
Other counterparties	3,540	(2,099)	(1,360)	81
Total derivatives	16,265	(14,824)	(1,360)	81
Resell agreements	7,898	—	(7,898)	—
Total	$24,163	$(14,824)	$(9,258)	$81
Financial liabilities:				
Derivatives:				
Counterparty A	$18,615	$(3,342)	$(15,167)	$106
Counterparty B	9,054	(8,196)	(613)	245
Counterparty C	10,870	(1,187)	(9,683)	—
Other counterparties	4,064	(2,099)	(1,549)	416
Total derivatives	42,603	(14,824)	(27,012)	767
Repurchase agreements	668,053	—	(668,053)	—
Total	$710,656	$(14,824)	$(695,065)	$767

Note 11 - Earnings Per Common Share

Earnings per common share is computed using the two-class method. Basic earnings per common share is computed by dividing net earnings allocated to common stock by the weighted-average number of common shares outstanding during the applicable period, excluding outstanding participating securities. Participating securities include non-vested stock awards/stock units and deferred stock units, though no actual shares of common stock related to non-vested stock units and deferred stock units have been issued. Non-vested stock awards/stock units and deferred stock units

are considered participating securities because holders of these securities receive non-forfeitable dividends at the same rate as holders of the Corporation's common stock. Diluted earnings per common share is computed using the weighted-average number of shares determined for the basic earnings per common share computation plus the dilutive effect of stock compensation using the treasury stock method.

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The following table presents a reconciliation of net income available to common shareholders, net earnings allocated to common stock and the number of shares used in the calculation of basic and diluted earnings per common share.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Net income	$77,615	$60,444	$205,273	$175,295
Less: Preferred stock dividends	2,016	2,015	6,047	4,703
Net income available to common shareholders	75,599	58,429	199,226	170,592
Less: Earnings allocated to participating securities	286	214	758	621
Net earnings allocated to common stock	$			