

INTERNATIONAL BANCSHARES CORP  
Form 10-Q  
August 11, 2014

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-Q**

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

**For the quarterly period ended June 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 000-09439**

**INTERNATIONAL BANCSHARES CORPORATION**

(Exact name of registrant as specified in its charter)

**Texas**

**74-2157138**

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(State or other jurisdiction of incorporation or organization)

(I.R.S. Employer Identification No.)

1200 San Bernardo Avenue, Laredo, Texas 78042-1359

(Address of principal executive offices)

(Zip Code)

(956) 722-7611

(Registrant's telephone number, including area code)

None

(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 x No o

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Website, 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 x No o

Indicate by check mark if 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.

Large accelerated filer x

Accelerated filer o

Non-accelerated filer o (Do not check if a smaller reporting company)

Smaller reporting company o

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date

Class  
Common Stock, \$1.00 par value

Shares Issued and Outstanding  
66,892,248 shares outstanding at August 5, 2014



## PART I - FINANCIAL INFORMATION

Item 1. Financial Statements

## INTERNATIONAL BANCSHARES CORPORATION AND SUBSIDIARIES

## Consolidated Statements of Condition (Unaudited)

(Dollars in Thousands)

	June 30, 2014	December 31, 2013
<b>Assets</b>		
Cash and cash equivalents	\$ 451,695	\$ 274,785
Investment securities:		
Held-to-maturity (Market value of \$2,400 on June 30, 2014 and \$2,400 on December 31, 2013)	2,400	2,400
Available-for-sale (Amortized cost of \$5,209,023 on June 30, 2014 and \$5,372,594 on December 31, 2013)	5,225,043	5,304,579
Total investment securities	5,227,443	5,306,979
Loans	5,437,515	5,199,235
Less allowance for probable loan losses	(71,537)	(70,161)
Net loans	5,365,978	5,129,074
Bank premises and equipment, net	518,710	504,842
Accrued interest receivable	31,086	30,654
Other investments	409,910	388,563
Identified intangible assets, net	1,057	3,186
Goodwill	282,532	282,532
Other assets	148,056	158,862
Total assets	\$ 12,436,467	\$ 12,079,477

## INTERNATIONAL BANCSHARES CORPORATION AND SUBSIDIARIES

## Consolidated Statements of Condition, continued (Unaudited)

(Dollars in Thousands)

	June 30, 2014	December 31, 2013
<b>Liabilities and Shareholders Equity</b>		
<b>Liabilities:</b>		
Deposits:		
Demand non-interest bearing	\$ 2,881,581	\$ 2,666,510
Savings and interest bearing demand	2,958,745	2,925,612
Time	2,582,313	2,651,303
Total deposits	8,422,639	8,243,425
Securities sold under repurchase agreements	870,065	957,381
Other borrowed funds	1,358,817	1,223,950
Junior subordinated deferrable interest debentures	180,416	190,726
Other liabilities	68,415	39,587
Total liabilities	10,900,352	10,655,069
<b>Shareholders equity:</b>		
Common shares of \$1.00 par value. Authorized 275,000,000 shares; issued 95,766,067 shares on June 30, 2014 and 95,743,592 shares on December 31, 2013	95,766	95,744
Surplus	164,681	163,947
Retained earnings	1,531,624	1,467,000
Accumulated other comprehensive income (loss) (including \$(5,397) and \$(5,646) of comprehensive loss related to other-than-temporary impairment for non-credit related issues)	10,415	(43,774)
	1,802,486	1,682,917
Less cost of shares in treasury, 28,878,612 shares on June 30, 2014 and 28,537,180 December 31, 2013	(266,371)	(258,509)
Total shareholders equity	1,536,115	1,424,408
Total liabilities and shareholders equity	\$ 12,436,467	\$ 12,079,477

See accompanying notes to consolidated financial statements.

## INTERNATIONAL BANCSHARES CORPORATION AND SUBSIDIARIES

## Consolidated Statements of Income (Unaudited)

(Dollars in Thousands, except per share data)

	Three Months Ended		Six Months Ended	
	2014	June 30, 2013	2014	June 30, 2013
Interest income:				
Loans, including fees	\$ 70,036	\$ 64,617	\$ 137,908	\$ 128,151
Investment securities:				
Taxable	26,545	18,601	52,724	39,120
Tax-exempt	2,728	3,085	6,251	6,121
Other interest income	31	21	94	42
Total interest income	99,340	86,324	196,977	173,434
Interest expense:				
Savings deposits	915	956	1,786	1,967
Time deposits	3,019	3,978	6,139	8,423
Securities sold under repurchase agreements	6,088	7,312	12,324	14,880
Other borrowings	564	289	1,120	579
Junior subordinated interest deferrable debentures	1,048	1,165	2,138	2,329
Total interest expense	11,634	13,700	23,507	28,178
Net interest income	87,706	72,624	173,470	145,256
Provision for probable loan losses	3,645	4,342	5,723	11,761
Net interest income after provision for probable loan losses	84,061	68,282	167,747	133,495
Non-interest income:				
Service charges on deposit accounts	22,450	23,507	44,512	47,337
Other service charges, commissions and fees				
Banking	12,090	10,052	22,911	20,035
Non-banking	1,161	1,515	3,060	2,576
Investment securities transactions, net	(379)	7,729	7,729	9,601
Other investments, net	2,309	8,635	11,367	15,632
Other income	3,822	2,996	10,062	4,776
Total non-interest income	\$ 41,453	\$ 46,705	\$ 99,641	\$ 99,957

## INTERNATIONAL BANCSHARES CORPORATION AND SUBSIDIARIES

## Consolidated Statements of Income, continued (Unaudited)

(Dollars in Thousands, except per share data)

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2014	2013	2014	2013
Non-interest expense:				
Employee compensation and benefits	\$ 29,989	\$ 30,764	\$ 60,234	\$ 60,975
Occupancy	7,856	7,180	14,864	14,992
Depreciation of bank premises and equipment	6,054	6,619	12,146	13,244
Professional fees	3,315	3,952	6,927	7,675
Deposit insurance assessments	1,558	1,762	2,997	3,378
Net expense, other real estate owned	830	1,575	1,759	3,364
Amortization of identified intangible assets	1,148	1,158	2,129	2,295
Advertising	1,955	2,023	3,785	3,869
Early termination fee securities sold under repurchase agreements		2,418	11,000	12,303
Impairment charges (Total other-than-temporary impairment losses, \$(74), net of \$(263), \$(953), net of \$(1,370), \$(107), net of \$(386), and \$15, net of \$(712), included in other comprehensive income)	189	417	279	727
Other	15,736	15,846	30,208	31,753
Total non-interest expense	68,630	73,714	146,328	154,575
Income before income taxes	56,884	41,273	121,060	78,877
Provision for income taxes	19,165	13,760	39,695	23,295
Net income	\$ 37,719	\$ 27,513	\$ 81,365	\$ 55,582
Basic earnings per common share:				
Weighted average number of shares outstanding:	66,925,664	67,190,792	67,027,750	67,189,196
Net income	\$ .56	\$ .41	\$ 1.21	\$ .83
Fully diluted earnings per common share:				
Weighted average number of shares outstanding:	67,071,370	67,292,053	67,171,257	67,286,026
Net income	\$ .56	\$ .41	\$ 1.21	\$ .83

See accompanying notes to consolidated financial statements.





## INTERNATIONAL BANCSHARES CORPORATION AND SUBSIDIARIES

## Consolidated Statements of Comprehensive Income (Unaudited)

(Dollars in Thousands)

	Three Months Ended		Six Months Ended	
	2014	June 30, 2013	2014	June 30, 2013
Net income	\$ 37,719	\$ 27,513	\$ 81,365	\$ 55,582
Other comprehensive income (loss), net of tax				
Net unrealized holding gains (losses) on securities available for sale arising during period (tax effects of \$18,168, \$(35,282), \$31,786 and \$(40,425))	33,742	(65,523)	59,032	(75,075)
Reclassification adjustment for losses (gains) on securities available for sale included in net income (tax effects of \$133, \$0, \$(2,705) and \$(3,360))	246		(5,024)	(6,241)
Reclassification adjustment for impairment charges on available for sale securities included in net income (tax effects of \$66, \$146, \$98 and \$254)	123	271	181	473
	34,111	(65,252)	54,189	(80,843)
Comprehensive income (loss)	\$ 71,830	\$ (37,739)	\$ 135,554	\$ (25,261)

See accompanying notes to consolidated financial statements.

## INTERNATIONAL BANCSHARES CORPORATION AND SUBSIDIARIES

## Consolidated Statements of Cash Flows (Unaudited)

(Dollars in Thousands)

	Six Months Ended June 30,	
	2014	2013
Operating activities:		
Net income	\$ 81,365	\$ 55,582
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for probable loan losses	5,723	11,761
Specific reserve, other real estate owned	238	478
Depreciation of bank premises and equipment	12,146	13,244
Gain on sale of bank premises and equipment	(3,957)	(516)
Gain on sale of other real estate owned	(298)	(188)
Accretion of investment securities discounts	(1,714)	(1,812)
Amortization of investment securities premiums	13,549	24,256
Investment securities transactions, net	(7,729)	(9,601)
Impairment charges on available-for-sale investment securities	279	727
Amortization of identified intangible assets	2,129	2,295
Stock based compensation expense	465	221
Earnings from affiliates and other investments	(5,086)	(13,209)
Deferred tax benefit	(2,083)	(3,274)
(Increase) decrease in accrued interest receivable	(432)	323
Net (increase) decrease in other assets	(8,136)	17,281
Net decrease in other liabilities	(4,198)	(4,754)
Net cash provided by operating activities	82,261	92,814
Investing activities:		
Proceeds from sales and calls of available for sale securities	368,296	178,124
Purchases of available for sale securities	(574,029)	(731,384)
Principal collected on mortgage-backed securities	367,999	749,233
Net increase in loans	(244,308)	(141,191)
Purchases of other investments	(5,602)	(637)
Distributions received on other investments	5,288	20,109
Purchases of bank premises and equipment	(28,846)	(16,321)
Proceeds from sales of other real estate owned	6,919	12,582
Proceeds from sale of bank premises and equipment	6,789	535
Net cash (used in) provided by investing activities	(97,494)	71,050

## INTERNATIONAL BANCSHARES CORPORATION AND SUBSIDIARIES

## Consolidated Statements of Cash Flows, continued (Unaudited)

(Dollars in Thousands)

	Six Months Ended June 30,	
	2014	2013
<b>Financing activities:</b>		
Net increase in non-interest bearing demand deposits	\$ 215,071	\$ 147,971
Net increase (decrease) in savings and interest bearing demand deposits	33,133	(33,383)
Net decrease in time deposits	(68,990)	(208,077)
Net decrease in securities sold under repurchase agreements	(87,316)	(104,608)
Net increase in other borrowed funds	134,867	3,431
Purchase of treasury stock	(7,862)	
Repayment of long-term debt	(10,310)	
Proceeds from stock transactions	291	64
Payments of dividends on common stock	(16,741)	(13,438)
Net cash provided by (used in) financing activities	192,143	(208,040)
Decrease in cash and cash equivalents	176,910	(44,176)
Cash and cash equivalents at beginning of period	274,785	283,100
Cash and cash equivalents at end of period	\$ 451,695	\$ 238,924
<b>Supplemental cash flow information:</b>		
Interest paid	\$ 24,365	\$ 29,910
Income taxes paid	53,288	35,171
<b>Non-cash investing and financing activities:</b>		
Net transfer from loans to other real estate owned	(1,681)	(657)

See accompanying notes to consolidated financial statements.

**INTERNATIONAL BANCSHARES CORPORATION AND SUBSIDIARIES**

**Notes to Consolidated Financial Statements**

**(Unaudited)**

**Note 1 - Basis of Presentation**

The accounting and reporting policies of International Bancshares Corporation ( Corporation ) and Subsidiaries (the Corporation and Subsidiaries collectively referred to herein as the Company ) conform to accounting principles generally accepted in the United States of America and to general practices within the banking industry. The consolidated financial statements include the accounts of the Corporation and its wholly-owned subsidiaries, International Bank of Commerce, Laredo ( IBC ), Commerce Bank, International Bank of Commerce, Zapata, International Bank of Commerce, Brownsville and the Corporation s wholly-owned non-bank subsidiaries, IBC Subsidiary Corporation, IBC Life Insurance Company, IBC Trading Company, IBC Capital Corporation and Premier Tierra Holdings, Inc. All significant inter-company balances and transactions have been eliminated in consolidation. The consolidated financial statements are unaudited, but include all adjustments, which, in the opinion of management, are necessary for a fair presentation of the results of the periods presented. All such adjustments were of a normal and recurring nature. It is suggested that these financial statements be read in conjunction with the financial statements and the notes thereto in the Company s latest Annual Report on Form 10-K. The consolidated statement of condition at December 31, 2013 has been derived from the audited financial statements at that date but does not include all of the information and footnotes required by accounting principles generally accepted in the United States of America for complete financial statements. Certain reclassifications have been made to make prior periods comparable. Operating results for the six months ended June 30, 2014 are not necessarily indicative of the results for the year ending December 31, 2014, or any future period.

The Company operates as one segment. The operating information used by the Company s chief executive officer for purposes of assessing performance and making operating decisions about the Company is the consolidated statements presented in this report. The Company has four active operating subsidiaries, namely, the bank subsidiaries, otherwise known as International Bank of Commerce, Laredo, Commerce Bank, International Bank of Commerce, Zapata and International Bank of Commerce, Brownsville. The Company applies the provision of ASC Topic 280, Segment Reporting, in determining its reportable segments and related disclosures.

The Company has evaluated all events or transactions that occurred through the date the Company issued these financial statements. During this period, the Company did not have any material recognizable or non-recognizable subsequent events.

**Note 2 Fair Value Measurements**

ASC Topic 820, Fair Value Measurements and Disclosures ( ASC 820 ) defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. ASC 820 applies to all financial instruments that are being measured and reported on a fair value basis. ASC 820 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date; it also establishes a fair value hierarchy that prioritizes the inputs used in valuation methodologies into the following three levels:

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- Level 1 Inputs Unadjusted quoted prices in active markets for identical assets or liabilities.
- Level 2 Inputs Observable inputs other than Level 1 prices, such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities.
- Level 3 Inputs Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities. Level 3 assets and liabilities include financial instruments whose value is determined using pricing models, discounted cash flow methodologies, or other valuation techniques, as well as instruments for which the determination of fair value requires significant management judgment or estimation.

A description of the valuation methodologies used for instruments measured at fair value, as well as the general classification of such instruments pursuant to the valuation hierarchy is set forth below.

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The following table represents financial instruments reported on the consolidated balance sheets at their fair value on a recurring basis as of June 30, 2014 by level within the fair value measurement hierarchy:

	Fair Value Measurements at Reporting Date Using (Dollars in Thousands)			
	Assets/Liabilities Measured at Fair Value June 30, 2014	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
<i>Measured on a recurring basis:</i>				
Assets:				
Available for sale securities				
Residential mortgage-backed securities	\$ 4,927,862	\$	\$ 4,901,866	\$ 25,996
States and political subdivisions	268,095		268,095	
Other	29,086	29,086		
Total	\$ 5,225,043	\$ 29,086	\$ 5,169,961	\$ 25,996

The following table represents financial instruments reported on the consolidated balance sheets at their fair value on a recurring basis as of December 31, 2013 by level within the fair value measurement hierarchy:

	Fair Value Measurements at Reporting Date Using (Dollars in Thousands)			
	Assets/Liabilities Measured at Fair Value December 31, 2013	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
<i>Measured on a recurring basis:</i>				
Assets:				
Available for sale securities				
Residential mortgage-backed securities	\$ 5,027,701	\$	\$ 4,999,849	\$ 27,852
States and political subdivisions	248,410		248,410	
Other	28,468	28,468		
Total	\$ 5,304,579	\$ 28,468	\$ 5,248,259	\$ 27,852

Investment securities available-for-sale are classified within level 2 and level 3 of the valuation hierarchy, with the exception of certain equity investments that are classified within level 1. For investments classified as level 2 in the fair value hierarchy, the Company obtains fair value measurements for investment securities from an independent pricing service. The fair value measurements consider observable data that may include dealer quotes, market spreads, cash flows, the U.S. Treasury yield curve, live trading levels, trade execution data, market consensus prepayment speeds, credit information and the bond's terms and conditions, among other things. Investment securities classified as level 3 are non-agency mortgage-backed securities. The non-agency mortgage-backed securities held by the Company are traded in inactive markets and markets that have experienced significant decreases in volume and level of activity, as evidenced by few recent transactions, a significant decline or absence of new issuances, price quotations that are not based on comparable securities transactions and wide bid-ask spreads among other factors. As a result of the inability to use quoted market prices to determine fair value for these securities, the Company determined that fair value, as determined by level 3 inputs in the fair value hierarchy, is more appropriate for financial reporting and more consistent with the expected performance of the investments. For the investments classified within level 3 of the fair value hierarchy, the Company used a discounted cash flow model to determine fair value. Inputs in the model included both historical performance and expected future performance based on information currently available.



Assumptions used in the discounted cash flow model as of June 30, 2014 and December 31, 2013, were applied separately to those portions of the bond where the underlying residential mortgage loans had been performing under original contract terms for at least the prior 24 months and those where the underlying residential mortgages had not been meeting the original contractual obligation for the same period. Unobservable inputs included in the model are estimates on future principal prepayment rates, and default and loss severity rates. For that portion of the bond where the underlying residential mortgage had been meeting the original contract terms for at least 24 months, the Company used the following estimates in the model: (i) a voluntary prepayment rate of 7%, (ii) a 1% default rate, (iii) a loss severity rate of 25%, and (iv) a discount rate of 13%. The assumptions used in the model for the rest of the bond included the following estimates: (i) a voluntary prepayment rate of 2 %, (ii) a default rate of 4.5%, (iii) a loss severity rate that started at 60% for the first year (2012) then declines by 5% for the following five years (2013, 2014, 2015, 2016 and 2017) and remains at 25% thereafter (2018 and beyond), and (iv) a discount rate of 13%. The estimates used in the model to determine fair value are based on observable historical data of the underlying collateral. The model anticipates that the housing market will gradually improve and that the underlying collateral will eventually all perform in accordance with the original contract terms on the bond. Should the number of loans in the underlying collateral that default and go into foreclosure or the severity of the losses in the underlying collateral significantly change, the results of the model would be impacted. The Company will continue to evaluate the actual historical performance of the underlying collateral and will modify the assumptions used in the model as necessary.

The following table presents a reconciliation of activity for such mortgage-backed securities on a net basis (Dollars in Thousands):

Balance at December 31, 2013	\$	27,852
Principal paydowns		(1,962)
Total unrealized gains (losses) included in:		
Other comprehensive income		386
Impairment realized in earnings		(279)
Balance at June 30, 2014	\$	25,996

Certain financial instruments are measured at fair value on a nonrecurring basis. They are not measured at fair value on an ongoing basis but are subject to fair value adjustments in certain circumstances (for example, when there is evidence of impairment).



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The following table represents financial instruments measured at fair value on a non-recurring basis as of and for the period ended June 30, 2014 by level within the fair value measurement hierarchy:

	Fair Value Measurements at Reporting Date Using (Dollars in Thousands)				
	Assets/Liabilities Measured at Fair Value June 30, 2014	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Net Provision During Six Month Period
<i>Measured on a non-recurring basis:</i>					
Assets:					
Impaired loans	\$ 24,223	\$	\$	\$ 24,223	\$ 4,363
Other real estate owned	6,352			6,352	238

The following table represents financial instruments measured at fair value on a non-recurring basis as of and for the year ended December 31, 2013 by level within the fair value measurement hierarchy:

	Fair Value Measurements at Reporting Date Using (Dollars in Thousands)				
	Assets/Liabilities Measured at Fair Value December 31, 2013	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Net Provision During Twelve Month Period
<i>Measured on a non-recurring basis:</i>					
Assets:					
Impaired loans	\$ 28,391	\$	\$	\$ 28,391	\$ 13,229
Other real estate owned	16,329			16,329	1,204

The Company's assets measured at fair value on a non-recurring basis are limited to impaired loans and other real estate owned. Impaired loans are classified within level 3 of the valuation hierarchy. The fair value of impaired loans is derived in accordance with FASB ASC 310,

Receivables. Impaired loans are primarily comprised of collateral-dependent commercial loans. The fair value of impaired loans is based on the fair value of the collateral, as determined through either an appraisal or evaluation process. The basis for the Company's appraisal and appraisal review process is based on regulatory guidelines and strives to comply with all regulatory appraisal laws, regulations and the Uniform Standards of Professional Appraisal Practice. Understanding that as the primary sources of loan repayments decline, the secondary repayment source comes into play and correctly evaluating the fair value of that secondary source, the collateral, becomes even more important. As part of the weekly credit quality meetings and the determination of the loan loss provision, obsolete appraisals are identified. Appraisals are considered for each type of impaired collateral dependent loan and new or updated appraisals may be obtained as warranted after evaluation of any material deterioration in the performance of the project or changes in project specifications, the economic conditions for the geographic area where the property is located, a change in the use of the property, differences between the current property conditions and the conditions assumed in prior appraisals or evaluations, or, if it is an income producing property, changes in the cash flow on the property. All appraisals and evaluations



are as is (the property's highest and best use) valuations based on the current conditions of the property/project at that point in time. The determination of the fair value of the collateral is based on the net realizable value, which is the appraised value less any closing costs, when applicable. Impaired loans are remeasured and reported at fair value through a specific valuation allowance allocation of the allowance for probable loan losses based upon the fair value of the underlying collateral. As of June 30, 2014, the Company had \$64,092,000 of impaired commercial collateral dependent loans, of which \$29,544,000 had an appraisal or evaluation performed within the immediately preceding twelve months. As of December 31, 2013, the Company had \$64,585,000 of impaired commercial collateral dependent loans, of which \$50,346,000 had an appraisal or evaluation performed within the immediately preceding twelve months.

Other real estate owned is comprised of real estate acquired by foreclosure and deeds in lieu of foreclosure. Other real estate owned is carried at the lower of the recorded investment in the property or its fair value less estimated costs to sell such property (as determined by independent appraisal) within level 3 of the fair value hierarchy. Prior to foreclosure, the value of the underlying loan is written down to the fair value of the real estate to be acquired by a charge to the allowance for probable loan losses, if necessary. The fair value is reviewed periodically and subsequent write downs are made accordingly through a charge to operations. Other real estate owned is included in other assets on the consolidated financial statements. For the six months ended June 30, 2014 and the twelve months ended December 31, 2013, respectively the Company recorded \$174,000 and \$402,000 in charges to the allowance for probable loan losses in connection with loans transferred to other real estate owned. For the six months ended June 30, 2014 and twelve months ended December 31, 2013, respectively, the Company recorded \$238,000 and \$1,204,000 in adjustments to fair value in connection with other real estate owned.

The fair value estimates, methods, and assumptions for the Company's financial instruments at June 30, 2014 and December 31, 2013 are outlined below.

#### *Cash and Cash Equivalents*

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

#### *Time Deposits with Banks*

The carrying amounts of time deposits with banks approximate fair value.

#### *Investment Securities Held-to-Maturity*

The carrying amounts of investments held-to-maturity approximate fair value.

#### *Investment Securities*

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For investment securities, which include U.S. Treasury securities, obligations of other U.S. government agencies, obligations of states and political subdivisions and mortgage pass through and related securities, fair values are from an independent pricing service. The fair value measurements consider observable data that may include dealer quotes, market spreads, cash flows, the U.S. Treasury yield curve, live trading levels, trade execution data, market consensus prepayment speeds, credit information and the bond's terms and conditions, among other things. See disclosures of fair value of investment securities in Note 6.

### *Loans*

Fair values are estimated for portfolios of loans with similar financial characteristics. Loans are segregated by type such as commercial, real estate and consumer loans as outlined by regulatory reporting guidelines. Each category is segmented into fixed and variable interest rate terms and by performing and non-performing categories.

For variable rate performing loans, the carrying amount approximates the fair value. For fixed rate performing loans, except residential mortgage loans, the fair value is calculated by discounting scheduled cash flows through the estimated maturity using estimated market discount rates that reflect the credit and interest rate risk inherent in the loan. For performing residential mortgage loans, fair value is estimated by discounting contractual cash flows adjusted for prepayment estimates using discount rates based on secondary market sources or the primary origination market. Fixed rate performing loans are within Level 3 of the fair value hierarchy. At June 30, 2014, and December 31, 2013, the carrying amount of fixed rate performing loans was \$1,289,469,000 and \$1,243,252,000 respectively, and the estimated fair value was \$1,237,981,000 and \$1,196,916,000, respectively.

*Accrued Interest*

The carrying amounts of accrued interest approximate fair value.

*Deposits*

The fair value of deposits with no stated maturity, such as non-interest bearing demand deposit accounts, savings accounts and interest bearing demand deposit accounts, was equal to the amount payable on demand as of June 30, 2014 and December 31, 2013. The fair value of time deposits is based on the discounted value of contractual cash flows. The discount rate is based on currently offered rates. Time deposits are within Level 3 of the fair value hierarchy. At June 30, 2014 and December 31, 2013, the carrying amount of time deposits was \$2,582,313,000 and \$2,651,303,000, respectively, and the estimated fair value was \$2,580,859,000 and \$2,648,452,000, respectively.

*Securities Sold Under Repurchase Agreements*

Securities sold under repurchase agreements include both short and long-term maturities. Due to the contractual terms of the short-term instruments, the carrying amounts approximated fair value at June 30, 2014 and December 31, 2013. The fair value of the long-term instruments is based on established market spreads using option adjusted spread methodology. Long-term repurchase agreements are within level 3 of the fair value hierarchy. At June 30, 2014 and December 31, 2013, respectively, the carrying amount of long-term repurchase agreements was \$610,000,000 and \$710,000,000 and the estimated fair value was \$673,150,200 and \$792,215,500, respectively.

*Junior Subordinated Deferrable Interest Debentures*

The Company currently has floating rate junior subordinated deferrable interest debentures outstanding. Due to the contractual terms of the floating rate junior subordinated deferrable interest debentures, the carrying amounts approximated fair value at June 30, 2014 and December 31, 2013.

*Other Borrowed Funds*

The company currently has short and long-term borrowings issued from the Federal Home Loan Bank ( FHLB ). Due to the contractual terms of the short-term borrowings, the carrying amounts approximated fair value at June 30, 2014 and December 31, 2013. The fair value of the long-term borrowings is based on established market spreads for similar types of borrowings. The long-term borrowings are included in Level 2 of the fair value hierarchy. At June 30, 2014 and December 31, 2013, the carrying amount of the long-term FHLB borrowings was \$6,316,000, and \$8,951,000, respectively, and the estimated fair value was \$6,589,000 and \$8,950,000, respectively.

*Commitments to Extend Credit and Letters of Credit*

Commitments to extend credit and fund letters of credit are principally at current interest rates, and, therefore, the carrying amount approximates fair value.

*Limitations*

Fair value estimates are made at a point in time, based on relevant market information and information about the financial instrument. These estimates do not reflect any premium or discount that could result from offering for sale at one time the Company's entire holdings of a particular financial instrument. Because no market exists for a significant portion of the Company's financial instruments, fair value estimates are based on judgments regarding future expected loss experience, current economic conditions, risk characteristics of various financial instruments and other factors. These estimates are subjective in nature and involve uncertainties and matters of significant judgment and therefore cannot be determined with precision. Changes in assumptions could significantly affect the estimates.

Fair value estimates are based on existing on-and off-statement of condition financial instruments without attempting to estimate the value of anticipated future business and the value of assets and liabilities that are not considered financial instruments. Other significant assets and liabilities that are not considered financial assets or liabilities include the bank premises and equipment and core deposit value. In addition, the tax ramifications related to the effect of fair value estimates have not been considered in the above estimates.

**Note 3 Loans**

A summary of loans, by loan type at June 30, 2014 and December 31, 2013 is as follows:

	June 30, 2014	December 31, 2013
	(Dollars in Thousands)	
Commercial, financial and agricultural	\$ 3,000,427	\$ 2,894,779
Real estate mortgage	860,867	847,692
Real estate construction	1,324,207	1,208,508
Consumer	62,885	66,414
Foreign	189,129	181,842
<b>Total loans</b>	<b>\$ 5,437,515</b>	<b>\$ 5,199,235</b>

**Note 4 - Allowance for Probable Loan Losses**

The allowance for probable loan losses primarily consists of the aggregate loan loss allowances of the bank subsidiaries. The allowances are established through charges to operations in the form of provisions for probable loan losses. Loan losses or recoveries are charged or credited directly to the allowances. The allowance for probable loan losses of each bank subsidiary is maintained at a level considered appropriate by management, based on estimated probable losses in the loan portfolio. The allowance for probable loan losses is derived from the following elements: (i) allowances established on specific impaired loans, which are based on a review of the individual characteristics of each loan, including the customer's ability to repay the loan, the underlying collateral values, and the industry in which the customer operates, (ii) allowances based on actual historical loss experience for similar types of loans in the Company's loan portfolio, and (iii) allowances based on general economic conditions, changes in the mix of loans, company resources, border risk and credit quality indicators, among other things. All segments of the loan portfolio continue to be impacted by the prolonged economic downturn. Loans secured by real estate could be impacted negatively by the continued economic environment and resulting decrease in collateral values. Consumer loans may be impacted by continued and prolonged unemployment rates.

The Company's management continually reviews the allowance for loan losses of the bank subsidiaries using the amounts determined from the allowances established on specific impaired loans, the allowance established on quantitative historical loss percentages, and the allowance based on qualitative data to establish an appropriate amount to maintain in the Company's allowance for loan losses. Should any of the factors considered by management in evaluating the adequacy of the allowance for probable loan losses change, the Company's estimate of probable loan losses could also change, which could affect the level of future provisions for probable loan losses. While the calculation of the allowance for probable loan losses utilizes management's best judgment and all information available, the adequacy of the allowance is dependent on a variety of factors beyond the Company's control, including, among other things, the performance of the entire loan portfolio, the economy, changes in interest rates and the view of regulatory authorities towards loan classifications.

The loan loss provision is determined using the following methods. On a weekly basis, loan past due reports are reviewed by the credit quality committee to determine if a loan has any potential problems and if a loan should be placed on the Company's internal classified report. Additionally, the Company's credit department reviews the majority of the Company's loans for proper internal classification purposes regardless of whether they are past due and segregates any loans with potential problems for further review. The credit department will discuss the potential problem loans with the servicing loan officers to determine any relevant issues that were not discovered in the evaluation. Also, an analysis of loans that is provided through examinations by regulatory authorities is considered in the review process. After the above analysis is completed, the Company will determine if a loan should be placed on an internal classified report because of issues related to the analysis of the

credit, credit documents, collateral and/or payment history.



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A summary of the transactions in the allowance for probable loan losses by loan class is as follows:

	Quarter Ended June 30, 2014							Foreign	Total
	Domestic								
Commercial	Commercial real estate: other construction & land development	Commercial real estate: farmland & commercial	Commercial real estate: multifamily	Residential: first lien	Residential: junior lien	Consumer	Foreign		
Balance at March 31,	\$ 27,923	\$ 13,475	\$ 18,934	\$ 819	\$ 3,524	\$ 3,968	\$ 748	\$ 1,017	\$ 70,408
Losses charge to allowance	(2,379)	(399)	(170)		(103)	(7)	(222)	(47)	(3,327)
Recoveries credited to allowance	620	21	35		1	67	67		811
Net (losses) gains charged to allowance	(1,759)	(378)	(135)		(102)	60	(155)	(47)	(2,516)
Provision (credit) charged to operations	1,842	(91)	739	(33)	299	708	113	68	3,645
Balance at June 30,	\$ 28,006	\$ 13,006	\$ 19,538	\$ 786	\$ 3,721	\$ 4,736	\$ 706	\$ 1,038	\$ 71,537

	Quarter Ended June 30, 2013							Foreign	Total
	Domestic								
Commercial	Commercial real estate: other construction & land development	Commercial real estate: farmland & commercial	Commercial real estate: multifamily	Residential: first lien	Residential: junior lien	Consumer	Foreign		
Balance at March 31,	\$ 20,926	\$ 11,053	\$ 20,651	\$ 609	\$ 3,868	\$ 4,011	\$ 820	\$ 1,030	\$ 62,968
Losses charge to allowance	(2,663)	(120)	(1)		(27)	(140)	(105)		(3,056)
Recoveries credited to allowance	557	13	128		4	30	60	5	797
Net (losses) gains charged to allowance	(2,106)	(107)	127		(23)	(110)	(45)	5	(2,259)
Provision (credit) charged to operations	1,856	678	1,605	14	10	146	22	11	4,342
Balance at June 30,	\$ 20,676	\$ 11,624	\$ 22,383	\$ 623	\$ 3,855	\$ 4,047	\$ 797	\$ 1,046	\$ 65,051



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	Six Months Ended June 30, 2014							Foreign	
	Domestic							Foreign	Total
	Commercial	Commercial real estate: other construction & land development	Commercial real estate: farmland & commercial	Commercial real estate: multifamily	Residential: first lien	Residential: junior lien	Consumer	Foreign	Total
Balance at December 31,	\$ 22,433	\$ 12,541	\$ 24,467	\$ 776	\$ 3,812	\$ 4,249	\$ 750	\$ 1,133	\$ 70,161
Losses charge to allowance	(4,860)	(399)	(170)		(130)	(153)	(409)	(50)	(6,171)
Recoveries credited to allowance	1,416	52	58		5	100	147	46	1,824
Net losses charged to allowance	(3,444)	(347)	(112)		(125)	(53)	(262)	(4)	(4,347)
Provision (credit) charged to operations	9,017	812	(4,817)	10	34	540	218	(91)	5,723
Balance at June 30,	\$ 28,006	\$ 13,006	\$ 19,538	\$ 786	\$ 3,721	\$ 4,736	\$ 706	\$ 1,038	\$ 71,537

	Six Months Ended June 30, 2013							Foreign	
	Domestic							Foreign	Total
	Commercial	Commercial real estate: other construction & land development	Commercial real estate: farmland & commercial	Commercial real estate: multifamily	Residential: first lien	Residential: junior lien	Consumer	Foreign	Total
Balance at December 31,	\$ 11,632	\$ 12,720	\$ 21,880	\$ 694	\$ 4,390	\$ 4,448	\$ 1,289	\$ 1,140	\$ 58,193
Losses charge to allowance	(5,326)	(248)	(61)		(199)	(395)	(316)	(20)	(6,565)
Recoveries credited to allowance	1,251	26	141		9	124	106	5	1,662
Net (losses) gains charged to allowance	(4,075)	(222)	80		(190)	(271)	(210)	(15)	(4,903)
Provision (credit) charged to operations	13,119	(874)	423	(71)	(345)	(130)	(282)	(79)	11,761
Balance at June 30,	\$ 20,676	\$ 11,624	\$ 22,383	\$ 623	\$ 3,855	\$ 4,047	\$ 797	\$ 1,046	\$ 65,051

The allowance for probable loan losses is a reserve established through a provision for probable loan losses charged to expense, which represents management's best estimate of probable loan losses when evaluating loans (i) individually or (ii) collectively.



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The table below provides additional information on the balance of loans individually or collectively evaluated for impairment and their related allowance, by loan class as of June 30, 2014 and December 31, 2013:

	June 30, 2014			
	Loans individually evaluated for impairment		Loans collectively evaluated for impairment	
	(Dollars in Thousands)			
	Recorded Investment	Allowance	Recorded Investment	Allowance
Domestic				
Commercial	\$ 38,072	\$ 16,368	\$ 1,114,058	\$ 11,638
Commercial real estate: other construction & land development	11,520	1,119	1,312,687	11,887
Commercial real estate: farmland & commercial	14,464	2,441	1,729,852	17,097
Commercial real estate: multifamily	266		103,715	786
Residential: first lien	5,689		407,915	3,721
Residential: junior lien	3,110		444,153	4,736
Consumer	1,363		61,522	706
Foreign	424		188,705	1,038
<b>Total</b>	<b>\$ 74,908</b>	<b>\$ 19,928</b>	<b>\$ 5,362,607</b>	<b>\$ 51,609</b>

	December 31, 2013			
	Loans individually evaluated for impairment		Loans collectively evaluated for impairment	
	(Dollars in Thousands)			
	Recorded Investment	Allowance	Recorded Investment	Allowance
Domestic				
Commercial	\$ 34,183	\$ 12,234	\$ 1,008,459	\$ 10,199
Commercial real estate: other construction & land development	13,976	852	1,194,532	11,689
Commercial real estate: farmland & commercial	16,038	2,916	1,734,001	21,551
Commercial real estate: multifamily	295		101,803	776
Residential: first lien	6,153		432,309	3,812
Residential: junior lien	3,206		406,024	4,249
Consumer	1,606		64,808	750
Foreign	436		181,406	1,133
<b>Total</b>	<b>\$ 75,893</b>	<b>\$ 16,002</b>	<b>\$ 5,123,342</b>	<b>\$ 54,159</b>

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The table below provides additional information on loans accounted for on a non-accrual basis by loan class at June 30, 2014 and December 31, 2013:

	June 30, 2014	December 31, 2013
	(Dollars in Thousands)	
Domestic		
Commercial	\$ 38,011	\$ 34,110
Commercial real estate: other construction & land development	9,267	11,726
Commercial real estate: farmland & commercial	12,200	13,775
Commercial real estate: multifamily	266	295
Residential: first lien	698	1,266
Residential: junior lien	1,554	1,576
Consumer	39	75
Total non-accrual loans	\$ 62,035	\$ 62,823

Impaired loans are those loans where it is probable that all amounts due according to contractual terms of the loan agreement will not be collected. The Company has identified these loans through its normal loan review procedures. Impaired loans are measured based on (1) the present value of expected future cash flows discounted at the loan's effective interest rate; (2) the loan's observable market price; or (3) the fair value of the collateral if the loan is collateral dependent. Substantially all of the Company's impaired loans are measured at the fair value of the collateral. In limited cases the Company may use other methods to determine the level of impairment of a loan if such loan is not collateral dependent.

The following tables detail key information regarding the Company's impaired loans by loan class at June 30, 2014 and December 31, 2013:

	June 30, 2014				December 31, 2013			
	Recorded Investment	Unpaid Principal Balance	Related Allowance	Quarter to Date Average Recorded Investment	Interest Recognized	Year to Date Average Recorded Investment	Interest Recognized	
	(Dollars in Thousands)							
Loans with Related Allowance								
Domestic								
Commercial	\$ 17,686	\$ 17,685	\$ 16,368	\$ 17,685	\$ 17,486	\$ 17,486	\$ 17,486	\$ 17,486
Commercial real estate: other construction & land development	6,895	6,904	1,119	6,896	6,897	6,897	6,897	6,897
Commercial real estate: farmland & commercial	5,943	6,262	2,441	6,374	23	6,499	46	46
Total impaired loans with related allowance	\$ 30,524	\$ 30,851	\$ 19,928	\$ 30,955	\$ 23	\$ 30,882	\$ 46	\$ 46

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	June 30, 2014					
	Recorded Investment	Unpaid Principal Balance	Quarter to Date		Year to Date	
			Average Recorded Investment	Interest Recognized	Average Recorded Investment	Interest Recognized
			(Dollars in Thousands)			
Loans with No Related Allowance						
Domestic						
Commercial	\$ 20,386	\$ 20,436	\$ 20,347	\$ 1	\$ 18,704	\$ 2
Commercial real estate: other construction & land development	4,625	4,676	5,226	19	6,014	37
Commercial real estate: farmland & commercial	8,521	9,896	8,854		8,755	
Commercial real estate: multifamily	266	266	270		278	
Residential: first lien	5,689	5,810	6,057	64	6,172	127
Residential: junior lien	3,110	3,130	3,114	24	3,124	47
Consumer	1,363	1,365	1,369	1	1,406	2
Foreign	424	424	426	5	429	9
Total impaired loans with no related allowance	\$ 44,384	\$ 46,003	\$ 45,663	\$ 114	\$ 44,882	\$ 224

	December 31, 2013				
	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Recognized
			(Dollars in Thousands)		
Loans with Related Allowance					
Domestic					
Commercial	\$ 17,178	\$ 17,177	\$ 12,234	\$ 18,019	\$ 38
Commercial real estate: other construction & land development	6,818	6,825	852	6,058	
Commercial real estate: farmland & commercial	7,259	10,697	2,916	7,167	92
Total impaired loans with related allowance	\$ 31,255	\$ 34,699	\$ 16,002	\$ 31,244	\$ 130

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	December 31, 2013		Year to Date	
	Recorded Investment	Unpaid Principal Balance (Dollars in Thousands)	Average Recorded Investment	Interest Recognized
<b>Loans with No Related Allowance</b>				
Domestic				
Commercial	\$ 17,005	\$ 17,023	\$ 16,778	\$ 2
Commercial real estate: other construction & land development	7,158	7,187	18,164	74
Commercial real estate: farmland & commercial	8,779	9,949	7,313	
Commercial real estate: multifamily	295	295	322	
Residential: first lien	6,153	6,258	4,860	179
Residential: junior lien	3,206	3,226	2,347	99
Consumer	1,606	1,612	1,380	1
Foreign	436	436	452	19
Total impaired loans with no related allowance	\$ 44,638	\$ 45,986	\$ 51,616	\$ 374

The following tables detail key information regarding the Company's average recorded investment in impaired loans and interest recognized on impaired loans by loan class at June 30, 2013:

	June 30, 2013			
	Quarter to Date		Year to Date	
	Average Recorded Investment	Interest Recognized	Average Recorded Investment	Interest Recognized
(Dollars in Thousands)				
<b>Loans with Related Allowance</b>				
Domestic				
Commercial	\$ 18,174	\$ 10	\$ 18,184	\$ 21
Commercial real estate: other construction & land development	3,969		4,820	
Commercial real estate: farmland & commercial	6,879	23	6,666	46
Total impaired loans with related allowance	\$ 29,022	\$ 33	\$ 29,670	\$ 67



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June 30, 2013

	Quarter to Date		Year to Date	
	Average Recorded Investment	Interest Recognized (Dollars in Thousands)	Average Recorded Investment	Interest Recognized
Loans with No Related Allowance				
Domestic				
Commercial	\$ 17,309	\$	\$ 16,475	\$
Commercial real estate: other construction & land development	20,217	18	20,451	37
Commercial real estate: farmland & commercial	6,579		5,793	
Commercial real estate: multifamily	329		337	
Residential: first lien	4,605	39	4,222	72
Residential: junior lien	1,713	24	1,722	49
Consumer	1,236		1,241	
Foreign	455	5	456	9
Total impaired loans with no related allowance	\$ 52,443	\$ 86	\$ 50,697	\$ 167

A portion of the impaired loans have adequate collateral and credit enhancements not requiring a related allowance for loan loss. The level of impaired loans is reflective of the economic weakness that has been created by the financial crisis and the subsequent economic downturn. Management is confident the Company's loss exposure regarding these credits will be significantly reduced due to the Company's long-standing practices that emphasize secured lending with strong collateral positions and guarantor support. Management is likewise confident the reserve for probable loan losses is adequate. The Company has no direct exposure to sub-prime loans in its loan portfolio, but the sub-prime crisis has affected the credit markets on a national level, and as a result, the Company has experienced an increasing amount of impaired loans; however, management's decision to place loans in this category does not necessarily mean that the Company will experience significant losses from these loans or significant increases in impaired loans from these levels.

Management of the Company recognizes the risks associated with these impaired loans. However, management's decision to place loans in this category does not necessarily mean that losses will occur. In the current environment, troubled loan management can be protracted because of the legal and process problems that delay the collection of an otherwise collectable loan. Additionally, management believes that the collateral related to these impaired loans and/or the secondary support from guarantors mitigates the potential for losses from impaired loans. It is also important to note that even though the economic conditions in Texas and Oklahoma are weakened, we believe these markets are continuing to improve and continue to be in a position to recover better than many other areas of the country. Loans accounted for as troubled debt restructuring, which are included in impaired loans, were not significant and totaled \$21,974,000 and \$20,358,000 as of June 30, 2014 and December 31, 2013, respectively.

The bank subsidiaries charge off that portion of any loan which management considers to represent a loss as well as that portion of any other loan which is classified as a loss by bank examiners. Commercial and industrial or real estate loans are generally considered by management to represent a loss, in whole or part, when an exposure beyond any collateral coverage is apparent and when no further collection of the loss portion is anticipated based on the borrower's financial condition and general economic conditions in the borrower's industry. Generally, unsecured consumer loans are charged-off when 90 days past due.

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While management of the Company considers that it is generally able to identify borrowers with financial problems reasonably early and to monitor credit extended to such borrowers carefully, there is no precise method of predicting loan losses. The determination that a loan is likely to be uncollectible and that it should be wholly or partially charged-off as a loss is an exercise of judgment. Similarly, the determination of the adequacy of the allowance for probable loan losses can be made only on a subjective basis. It is the judgment of the Company's management that the allowance for probable loan losses at June 30, 2014 was adequate to absorb probable losses from loans in the portfolio at that date.

The following table presents information regarding the aging of past due loans by loan class at June 30, 2014 and December 31, 2013:

	30 Days	59 Days	60 Days	89 Days	90 Days or Greater	June 30, 2014 90 Days or Greater & Still Accruing	Total Past Due	Current	Total Portfolio					
	(Dollars in Thousands)													
Domestic														
Commercial	\$	14,276	\$	852	\$	42,266	\$	8,038	\$	57,394	\$	1,094,736	\$	1,152,130
Commercial real estate:														
other construction & land development		1,212		870		8,229		6		10,311		1,313,896		1,324,207
Commercial real estate: farmland & commercial		10,949		4,628		9,383		1,370		24,960		1,719,356		1,744,316
Commercial real estate: multifamily		581				266		847				103,134		103,981
Residential: first lien		4,425		2,625		2,589		2,026		9,639		403,965		413,604
Residential: junior lien		896		232		2,222		696		3,350		443,913		447,263
Consumer		941		457		827		789		2,225		60,660		62,885
Foreign		3,326		55		158		158		3,539		185,590		189,129
Total past due loans	\$	36,606	\$	9,719	\$	65,940	\$	13,083	\$	112,265	\$	5,325,250	\$	5,437,515

	December 31, 2013													
	30 Days		60 Days		90 Days or Greater		90 Days or Greater & Still Accruing		Total Past Due	Current	Total Portfolio			
	(Dollars in Thousands)													
Domestic														
Commercial	\$	4,240	\$	538	\$	36,066	\$	2,051	\$	40,844	\$	1,001,798	\$	1,042,642
Commercial real estate: other construction & land development		1,042				9,942		62		10,984		1,197,524		1,208,508
Commercial real estate: farmland & commercial		6,216		520		6,990		417		13,726		1,736,313		1,750,039
Commercial real estate: multifamily		39		142		295				476		101,622		102,098
Residential: first lien		4,758		3,046		4,541		3,518		12,345		426,117		438,462
Residential: junior lien		606		198		1,900		368		2,704		406,526		409,230
Consumer		1,523		469		803		781		2,795		63,619		66,414
Foreign		1,467		417						1,884		179,958		181,842
Total past due loans	\$	19,891	\$	5,330	\$	60,537	\$	7,197	\$	85,758	\$	5,113,477	\$	5,199,235

The Company's internal classified report is segregated into the following categories: (i) Special Review Credits, (ii) Watch List - Pass Credits, or (iii) Watch List - Substandard Credits. The loans placed in the Special Review Credits category reflect the Company's opinion that the loans reflect potential weakness which require monitoring on a more frequent basis. The Special Review Credits are reviewed and discussed on a regular basis with the credit department and the lending staff to determine if a change in category is warranted. The loans placed in the Watch List - Pass Credits category reflect the Company's opinion that the credit contains weaknesses which represent a greater degree of risk, which warrant extra attention. The Watch List - Pass Credits are reviewed and discussed on a regular basis with the credit department and the lending staff to determine if a change in category is warranted. The loans placed in the Watch List - Substandard Credits classification are considered to be potentially inadequately protected by the current sound worth and debt service capacity of the borrower or of any pledged collateral. These credit obligations, even if apparently protected by collateral value, have shown defined weaknesses related to adverse financial, managerial, economic, market or political conditions which may jeopardize repayment of principal and interest. Furthermore, there is the possibility that some future loss could be sustained by the Company if such weaknesses are not corrected. For loans that are classified as impaired, management evaluates these credits in accordance with the provisions of ASC 310-10, Receivables, and, if deemed necessary, a specific reserve is allocated to the credit. The specific reserve allocated under ASC 310-10, is based on (i) the present value of expected future cash flows discounted at the loan's effective interest rate; (ii) the loan's observable market price; or (iii) the fair value of the collateral if the loan is collateral dependent. Substantially all of the Company's loans evaluated as impaired under ASC 310-10 are measured using the fair value of collateral method. In limited cases, the Company may use other methods to determine the specific reserve of a loan under ASC 310-10 if such loan is not collateral dependent.

The allowance based on historical loss experience on the Company's remaining loan portfolio, which includes the Special Review Credits, Watch List - Pass Credits, and Watch List - Substandard Credits is determined by segregating the remaining loan portfolio into certain categories such as commercial loans, installment loans, international loans, loan concentrations and overdrafts. Installment loans are then further segregated by number of days past due. A historical loss percentage, adjusted for (i) management's evaluation of changes in lending policies and procedures, (ii) current economic conditions in the market area served by the Company, (iii) other risk factors, (iv) the effectiveness of the internal loan review function, (v) changes in loan portfolios, and (vi) the composition and concentration of credit volume is applied to each category. Each category is then added together to determine the allowance allocated under ASC 450-20.

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A summary of the loan portfolio by credit quality indicator by loan class at June 30, 2014 and December 31, 2013 is as follows:

	June 30, 2014				
	Pass	Special Review	Watch List - Pass (Dollars in Thousands)	Watch List - Substandard	Watch List - Impaired
<b>Domestic</b>					
Commercial	\$ 1,058,402	\$ 1,017	\$ 2,270	\$ 52,369	\$ 38,072
Commercial real estate: other construction & land development	1,257,444	344	10,835	44,064	11,520
Commercial real estate: farmland & commercial	1,627,979	9,264	20,646	71,963	14,464
Commercial real estate: multifamily	102,887			828	266
Residential: first lien	407,780	114		21	5,689
Residential: junior lien	443,702			451	3,110
Consumer	61,522				1,363
Foreign	188,399			306	424
<b>Total</b>	<b>\$ 5,148,115</b>	<b>\$ 10,739</b>	<b>\$ 33,751</b>	<b>\$ 170,002</b>	<b>\$ 74,908</b>

	December 31, 2013				
	Pass	Special Review	Watch List - Pass (Dollars in Thousands)	Watch List - Substandard	Watch List - Impaired
<b>Domestic</b>					
Commercial	\$ 955,522	\$ 2,270	\$ 4,389	\$ 46,278	\$ 34,183
Commercial real estate: other construction & land development	1,167,295	14,247	9,318	3,672	13,976
Commercial real estate: farmland & commercial	1,635,179	56,438	21,912	20,472	16,038
Commercial real estate: multifamily	100,948			855	295
Residential: first lien	432,067	122		120	6,153
Residential: junior lien	405,731			293	3,206
Consumer	64,808				1,606
Foreign	180,837			569	436
<b>Total</b>	<b>\$ 4,942,387</b>	<b>\$ 73,077</b>	<b>\$ 35,619</b>	<b>\$ 72,259</b>	<b>\$ 75,893</b>

The increase in the watch-list substandard category can be attributed primarily to a loan relationship that deteriorated in the first six months of 2014. The majority of the relationship had previously been included in the special review category at December 31, 2013.

**Note 5 Stock Options**

On April 5, 2012, the Board of Directors adopted the 2012 International Bancshares Corporation Stock Option Plan (the 2012 Plan ). There are 800,000 shares available for stock option grants under the 2012 Plan. Under the 2012 Plan, both qualified incentive stock options ( ISOs ) and non-qualified stock options ( NQSOs ) may be granted. Options granted may be exercisable for a period of up to 10 years from the date of grant, excluding ISOs granted to 10% shareholders, which may be exercisable for a period of up to only five years. As of June 30, 2014, 206,750 shares were available for future grants under the 2012 Plan.

A summary of option activity under the stock option plans for the six months ended June 30, 2014 is as follows:

	Number of Options	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (Years)	Aggregate Intrinsic Value (\$) (Dollars in Thousands)
Options outstanding at December 31, 2013	515,143	\$ 15.98		
Plus: Options granted	549,750	21.42		
Less:				
Options exercised	22,475	12.95		
Options expired				
Options forfeited	14,025	17.77		
Options outstanding at June 30, 2014	1,028,393	18.93	5.79	\$ 8,303
Options fully vested and exercisable at June 30, 2014	248,636	\$ 17.49	2.24	\$ 2,369

Stock-based compensation expense included in the consolidated statements of income for the three and six months ended June 30, 2014 was approximately \$304,000 and \$465,000, respectively. Stock-based compensation expense included in the consolidated statements of income for the three and six months ended June 30, 2013 was approximately \$107,000 and \$221,000, respectively. As of June 30, 2014, there was approximately \$4,527,000 of total unrecognized stock-based compensation cost related to non-vested options granted under the Company plans that will be recognized over a weighted average period of 2.5 years.

**Note 6 - Investment Securities**

The Company classifies debt and equity securities into one of three categories: held-to maturity, available-for-sale, or trading. Such securities are reassessed for appropriate classification at each reporting date. Securities classified as held-to-maturity are carried at amortized cost for financial statement reporting, while securities classified as available-for-sale and trading are carried at their fair value. Unrealized holding gains and losses are included in net income for those securities classified as trading, while unrealized holding gains and losses related to those securities classified as available-for-sale are excluded from net income and reported net of tax as other comprehensive income (loss) and accumulated other comprehensive income (loss) until realized, or in the case of losses, when deemed other than temporary.

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The amortized cost and estimated fair value by type of investment security at June 30, 2014 are as follows:

	Amortized Cost	Gross Unrealized Gains	Held to Maturity Gross Unrealized Losses (Dollars in Thousands)	Estimated Fair Value	Carrying Value
Other securities	\$ 2,400	\$	\$	\$ 2,400	\$ 2,400
Total investment securities	\$ 2,400	\$	\$	\$ 2,400	\$ 2,400

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	Amortized Cost	Gross Unrealized Gains	Available for Sale Gross Unrealized Losses (Dollars in Thousands)	Estimated Fair Value	Carrying Value (1)
Residential mortgage-backed securities	\$ 4,923,587	\$ 58,667	\$ (54,391)	\$ 4,927,863	\$ 4,927,863
Obligations of states and political subdivisions	257,361	16,550	(5,817)	268,094	268,094
Equity securities	28,075	1,252	(241)	29,086	29,086
Total investment securities	\$ 5,209,023	\$ 76,469	\$ (60,449)	\$ 5,225,043	\$ 5,225,043

(1) Included in the carrying value of residential mortgage-backed securities are \$1,646,495 of mortgage-backed securities issued by Ginnie Mae, \$3,255,372 of mortgage-backed securities issued by Fannie Mae and Freddie Mac and \$25,996 issued by non-government entities

The amortized cost and estimated fair value by type of investment security at December 31, 2013 are as follows:

	Amortized Cost	Gross Unrealized Gains	Held to Maturity Gross Unrealized Losses (Dollars in Thousands)	Estimated Fair Value	Carrying Value
Other securities	\$ 2,400	\$	\$	\$ 2,400	\$ 2,400
Total investment securities	\$ 2,400	\$	\$	\$ 2,400	\$ 2,400

	Amortized Cost	Gross Unrealized Gains	Available for Sale Gross Unrealized Losses (Dollars in Thousands)	Estimated Fair Value	Carrying Value (1)
Residential mortgage-backed securities	\$ 5,096,165	\$ 56,110	\$ (124,574)	\$ 5,027,701	\$ 5,027,701
Obligations of states and political subdivisions	248,354	8,063	(8,007)	248,410	248,410
Equity securities	28,075	931	(538)	28,468	28,468
Total investment securities	\$ 5,372,594	\$ 65,104	\$ (133,119)	\$ 5,304,579	\$ 5,304,579

(1) Included in the carrying value of residential mortgage-backed securities are \$1,799,807 of mortgage-backed securities issued by Ginnie Mae, \$3,200,042 of mortgage-backed securities issued by Fannie Mae and Freddie Mac and \$27,852 issued by non-government entities

The amortized cost and estimated fair value of investment securities at June 30, 2014, by contractual maturity, are shown below. Expected maturities will differ from contractual maturities because borrowers may have the right to prepay obligations with or without prepayment penalties.

	Held to Maturity		Available for Sale	
	Amortized Cost	Estimated Fair Value	Amortized Cost	Estimated Fair Value
	(Dollars in Thousands)			
Due in one year or less	\$ 1,200	\$ 1,200	\$	\$

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Due after one year through five years	1,200	1,200		
Due after five years through ten years			719	797
Due after ten years			256,642	267,297
Residential mortgage-backed securities			4,923,587	4,927,863
Equity securities			28,075	29,086
Total investment securities	\$ 2,400	\$ 2,400	\$ 5,209,023	\$ 5,225,043



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Residential mortgage-backed securities are securities issued by Freddie Mac, Fannie Mae, Ginnie Mae or non-government entities. Investments in residential mortgage-backed securities issued by Ginnie Mae are fully guaranteed by the U.S. Government. Investments in mortgage-backed securities issued by Freddie Mac and Fannie Mae are not fully guaranteed by the U.S. Government, however, the Company believes that the quality of the bonds is similar to other AAA rated bonds with limited credit risk, particularly given the placement of Fannie Mae and Freddie Mac into conservatorship by the federal government in early September 2008 and because securities issued by others that are collateralized by residential mortgage-backed securities issued by Fannie Mae or Freddie Mac are rated consistently as AAA rated securities.

The amortized cost and fair value of available for sale investment securities pledged to qualify for fiduciary powers, to secure public monies as required by law, repurchase agreements and short-term fixed borrowings was \$2,520,425,000 and \$2,535,969,000 at June 30, 2014.

Proceeds from the sale of securities available-for-sale were \$110,020,000 and \$368,296,000 for the three and six months ended June 30, 2014, which included \$110,020,000 and \$367,641,000 of mortgage-backed securities. Gross gains of \$1,371,000 and \$9,479,000 and gross losses of \$1,750,000 and \$1,750,000 were realized on the sales for the three and six months ended June 30, 2014, respectively. Proceeds from the sale of securities available-for-sale were \$0 and \$178,124,000 for the three and six months ended June 30, 2013, which included \$0 and \$177,623,000 of mortgage-backed securities. Gross gains of \$0 and \$9,601,000 and gross losses of \$0 and \$0 were realized on the sales for the three and six months ended June 30, 2013, respectively.

Gross unrealized losses on investment securities and the fair value of the related securities, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position at June 30, 2014, were as follows:

	Less than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
(Dollars in Thousands)						
Available for sale:						
Residential mortgage-backed securities	\$ 219,141	\$ (755)	\$ 2,240,363	\$ (53,636)	\$ 2,459,504	\$ (54,391)
Obligations of states and political subdivisions	4,740	(216)	40,487	(5,601)	45,227	(5,817)
Other equity securities			10,509	(241)	10,509	(241)
	\$ 223,881	\$ (971)	\$ 2,291,359	\$ (59,478)	\$ 2,515,240	\$ (60,449)

Gross unrealized losses on investment securities and the fair value of the related securities, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, at December 31, 2013 were as follows:

	Less than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
(Dollars in Thousands)						
Available for sale:						
Residential mortgage-backed securities	\$ 2,459,565	\$ (98,022)	\$ 420,262	\$ (26,552)	\$ 2,879,827	\$ (124,574)
Obligations of states and political subdivisions	55,327	(3,025)	14,292	(4,982)	69,619	(8,007)
Equity securities	19,462	(538)			19,462	(538)
	\$ 2,534,354	\$ (101,585)	\$ 434,554	\$ (31,534)	\$ 2,968,908	\$ (133,119)



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The unrealized losses on investments in residential mortgage-backed securities are primarily caused by changes in market interest rates. Residential mortgage-backed securities are primarily securities issued by Freddie Mac, Fannie Mae and Ginnie Mae. The contractual cash obligations of the securities issued by Ginnie Mae are fully guaranteed by the U.S. Government. The contractual cash obligations of the securities issued by Freddie Mac and Fannie Mae are not fully guaranteed by the U.S. Government; however, the Company believes that the quality of the bonds is similar to other AAA rated bonds with limited credit risk, particularly given the placement of Fannie Mae and Freddie Mac into conservatorship by the federal government in early September 2008 and because securities issued by others that are collateralized by residential mortgage-backed securities issued by Fannie Mae or Freddie Mac are rated consistently as AAA rated securities. The decrease in fair value on residential mortgage-backed securities issued by Freddie Mac, Fannie Mae and Ginnie Mae is due to market interest rates. The Company has no intent to sell such mortgage-backed securities, and will more than likely not be required to sell such securities before a market price recovery or maturity of the securities; therefore, it is the conclusion of the Company that the investments in residential mortgage-backed securities issued by Freddie Mac, Fannie Mae and Ginnie Mae are not considered other-than-temporarily impaired. In addition, the Company has a small investment in non-agency residential mortgage-backed securities that have strong credit backgrounds and include additional credit enhancements to protect the Company from losses arising from high foreclosure rates. These securities have additional market volatility beyond economically induced interest rate events. It is the conclusion of the Company that the investments in non-agency residential mortgage-backed securities are other-than-temporarily impaired due to both credit and other than credit issues. Impairment charges of \$189,000 (\$122,900, after tax) and \$279,000 (\$181,300, after tax) were recorded for the three and six months ended June 30, 2014, respectively. Impairment charges of \$417,000 (\$271,000, after tax) and \$727,000 (\$473,000, after tax) were recorded for the three and six months ended June 30, 2013, respectively. The impairment charge represents the credit related impairment on the securities.

The unrealized losses on investments in other securities are caused by fluctuations in market interest rates. The underlying cash obligations of the securities are guaranteed by the entity underwriting the debt instrument. It is the belief of the Company that the entity issuing the debt will honor its interest payment schedule, as well as the full debt at maturity. The securities are purchased by the Company for their economic value. The decrease in fair value is primarily due to market interest rates and not other factors, and because the Company has no intent to sell and will more than likely not be required to sell before a market price recovery or maturity of the securities, it is the conclusion of the Company that the investments are not considered other-than-temporarily impaired.

The following table presents a reconciliation of credit-related impairment charges on available-for-sale investments recognized in earnings for the three months ended June 30, 2014 (Dollars in Thousands):

Balance at March 31, 2014	\$	11,896
Impairment charges recognized during period		189
Balance at June 30, 2014	\$	12,085

The following table presents a reconciliation of credit-related impairment charges on available-for-sale investments recognized in earnings for the six months ended June 30, 2014 (Dollars in Thousands):

Balance at December 31, 2013	\$	11,806
Impairment charges recognized during period		279
Balance at June 30, 2014	\$	12,085

The following table presents a reconciliation of credit-related impairment charges on available-for-sale investment recognized in earnings for the three months ended June 30, 2013 (Dollars in Thousands):

Balance at March 31, 2013	\$	10,742
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Impairment charges recognized during period		417
Balance at June 30, 2013	\$	11,159

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The following table presents a reconciliation of credit-related impairment charges on available-for-sale investment recognized in earnings for the six months ended June 30, 2013 (Dollars in Thousands):

Balance at December 31, 2012	\$	10,432
Impairment charges recognized during period		727
Balance at June 30, 2013	\$	11,159

### Note 7 Other Borrowed Funds

Other borrowed funds include Federal Home Loan Bank borrowings, which are short-term and long-term borrowings issued by the FHLB of Dallas at the market price offered at the time of funding. These borrowings are secured by residential mortgage-backed investment securities and a portion of the Company's loan portfolio. At June 30, 2014, other borrowed funds totaled \$1,358,817,000, an increase of 11.0% from \$1,223,950,000 at December 31, 2013.

### Note 8 Junior Subordinated Interest Deferrable Debentures

The Company has formed seven statutory business trusts under the laws of the State of Delaware, for the purpose of issuing trust preferred securities. The seven statutory business trusts formed by the Company (the Trusts) have each issued Capital and Common Securities and invested the proceeds thereof in an equivalent amount of junior subordinated debentures (the Debentures) issued by the Company. As of June 30, 2014 and December 31, 2013, the principal amount of debentures outstanding totaled \$180,416,000 and \$190,726,000, respectively. On February 11, 2014, the Company bought back the capital securities of IB Capital Trust VII from the holder of the securities for a price that reflected an approximate six percent discount from the redemption price of the securities and thereby retired the \$10,310,000 of related Junior Subordinated Deferrable Interest Debentures related to IB Capital Trust VII.

The Debentures are subordinated and junior in right of payment to all present and future senior indebtedness (as defined in the respective indentures) of the Company, and are *pari passu* with one another. The interest rate payable on, and the payment terms of the Debentures are the same as the distribution rate and payment terms of the respective issues of Capital and Common Securities issued by the Trusts. The Company has fully and unconditionally guaranteed the obligations of each of the Trusts with respect to the Capital and Common Securities. The Company has the right, unless an Event of Default (as defined in the Indentures) has occurred and is continuing, to defer payment of interest on the Debentures for up to twenty consecutive quarterly periods on Trusts VI, VIII, IX, X, XI and XII. If interest payments on any of the Debentures are deferred, distributions on both the Capital and Common Securities related to that Debenture would also be deferred. The redemption prior to maturity of any of the Debentures may require the prior approval of the Federal Reserve and/or other regulatory bodies. In February 2014, the Company redeemed all of the outstanding Capital and Common Securities issued by Trust VII.

For financial reporting purposes, the Trusts are treated as investments of the Company and not consolidated in the consolidated financial statements. Although the Capital Securities issued by each of the Trusts are not included as a component of shareholders' equity on the consolidated statement of condition, the Capital Securities are treated as capital for regulatory purposes. Specifically, under applicable regulatory guidelines, the Capital Securities issued by the Trusts qualify as Tier 1 capital up to a maximum of 25% of Tier 1 capital on an aggregate basis. Any amount that exceeds the 25% threshold would qualify as Tier 2 capital. At June 30, 2014 and December 31, 2013, the total \$180,416,000 and \$190,726,000, respectively, of the Capital Securities outstanding qualified as Tier 1 capital.



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The following table illustrates key information about each of the Capital and Common Securities and their interest rate at June 30, 2014:

	<b>Junior Subordinated Deferrable Interest Debentures (In Thousands)</b>	<b>Repricing Frequency</b>	<b>Interest Rate</b>	<b>Interest Rate Index</b>	<b>Maturity Date</b>	<b>Optional Redemption Date(1)</b>
Trust VI	\$ 25,774	Quarterly	3.67%	LIBOR + 3.45	November 2032	February 2008
Trust VIII	25,774	Quarterly	3.28%	LIBOR + 3.05	October 2033	October 2008
Trust IX	41,238	Quarterly	1.85%	LIBOR + 1.62	October 2036	October 2011
Trust X	34,021	Quarterly	1.88%	LIBOR + 1.65	February 2037	February 2012
Trust XI	32,990	Quarterly	1.85%	LIBOR + 1.62	July 2037	July 2012
Trust XII	20,619	Quarterly	1.68%	LIBOR + 1.45	September 2037	September 2012
	<b>\$ 180,416</b>					

(1) The Capital Securities may be redeemed in whole or in part on any interest payment date after the Optional Redemption Date.

### Note 9 Common Stock and Dividends

The Company had outstanding 216,000 shares of Series A cumulative perpetual preferred stock (the Senior Preferred Stock), issued to the US Treasury under the Company's participation in the Troubled Asset Relief Program Capital Purchase Program (the TARP Capital Purchase Program). The Company redeemed all of the Senior Preferred Stock in 2012. In conjunction with the purchase of the Senior Preferred Stock, the US Treasury received a warrant (the Warrant) to purchase 1,326,238 shares of the Company's common stock (the Warrant Shares) at \$24.43 per share, which would represent an aggregate common stock investment in the Company on exercise of the warrant in full equal to 15% of the Senior Preferred Stock investment. The term of the Warrant is ten years and was immediately exercisable. The Warrant is included as a component of Tier 1 capital. On June 12, 2013, the U. S. Treasury sold the Warrant to a third party. As of June 30, 2014, the Warrant is still outstanding, but expires on December 23, 2018 with no value if not exercised before that date.

The Company paid cash dividends to the common shareholders of \$.25 per share on April 18, 2014 to all holders of record on April 1, 2014. The Company paid cash dividends to the common shareholders of \$.20 per share on April 20, 2013 to all holders of record on April 1, 2013 and \$.23 per share on October 15, 2013 to all holders of record on September 30, 2013, respectively.

In April 2009, following receipt of the Treasury Department's consent, the Board of Directors re-established a formal stock repurchase program that authorized the repurchase of up to \$40 million of common stock within the following twelve months and on March 7, 2014, the Board of Directors extended the repurchase program and again authorized the repurchase of up to \$40 million of common stock during the twelve month period commencing on April 9, 2014, which repurchase cap the Board is inclined to increase over time. Stock repurchases may be made from time to time, on the open market or through private transactions. Shares repurchased in this program will be held in treasury for reissue for various corporate purposes, including employee stock option plans. As of August 5, 2014, a total of 8,184,725 shares had been repurchased under all programs at a cost of \$245,397,000.





**Note 10 - Commitments and Contingent Liabilities**

The Company is involved in various legal proceedings that are in various stages of litigation. Some of these actions allege lender liability claims on a variety of theories and claim substantial actual and punitive damages. The Company has determined, based on discussions with its counsel that any material loss in such actions, individually or in the aggregate, is remote or the damages sought, even if fully recovered, would not be considered material to the consolidated financial position, results of operations or cash flows of the Company. However, many of these matters are in various stages of proceedings and further developments could cause management to revise its assessment of these matters.

**Note 11 Capital Ratios**

The Company had a Tier 1 capital to average total asset (leverage) ratio of 11.81% and 11.61%, risk-weighted Tier 1 capital ratio of 19.45% and 19.33% and risk-weighted total capital ratio of 20.47% and 20.36% at June 30, 2014 and December 31, 2013, respectively. The identified intangibles and goodwill of \$283,589,000 as of June 30, 2014, recorded in connection with the acquisitions made by the Company, are deducted from the sum of core capital elements when determining the capital ratios of the Company. Under applicable regulatory guidelines, the Capital Securities issued by the Trusts qualify as Tier 1 capital up to a maximum of 25% of tier 1 capital on an aggregate basis. Any amount that exceeds the 25% threshold qualifies as Tier 2 capital. As of June 30, 2014, the total of \$180,416,000 of the Capital Securities outstanding qualified as Tier 1 capital. The Company actively monitors the regulatory capital ratios to ensure that the Company's bank subsidiaries are well capitalized under the regulatory framework.

**Item 2 - Management's Discussion and Analysis of Financial Condition and Results of Operations**

The following discussion should be read in conjunction with the Company's consolidated financial statements, and notes thereto, for the year-ended December 31, 2013, included in the Company's 2013 Form 10-K. Operating results for the six months ended June 30, 2014 are not necessarily indicative of the results for the year ending December 31, 2014, or any future period.

**Special Cautionary Notice Regarding Forward Looking Information**

Certain matters discussed in this report, excluding historical information, include forward-looking statements, within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, and are subject to the safe harbor created by these sections. Although the Company believes such forward-looking statements are based on reasonable assumptions, no assurance can be given that every objective will be reached. The words estimate, expect, intend, believe and project, as well as other words or expressions of a similar meaning are intended to identify forward-looking statements. Readers are cautioned not to place undue reliance on forward-looking statements, which speak only as of the date of this report. Such statements are based on current expectations, are inherently uncertain, are subject to risks and should be viewed with caution. Actual results and experience may differ materially from the forward-looking statements as a result of many factors.

Risk factors that could cause actual results to differ materially from any results that are projected, forecasted, estimated or budgeted by the Company in forward-looking statements include, among others, the following possibilities:

- Local, regional, national and international economic business conditions and the impact they may have on the Company, the Company's customers, and such customers' ability to transact profitable business with the Company, including the ability of its borrowers to repay their loans according to their terms or a change in the value of the related collateral.
- Volatility and disruption in national and international financial markets.
- Government intervention in the U.S. financial system.
- The Company relies, in part, on external financing to fund the Company's operations from the FHLB, the Fed and other sources and the unavailability of such funding sources in the future could adversely impact the Company's growth strategy, prospects and performance.
- Changes in consumer spending, borrowings and savings habits.
- Changes in interest rates and market prices, which could reduce the Company's net interest margins, asset valuations and expense expectations, including, without limitation, the repeal of federal prohibitions on the payment of interest on demand deposits.

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- Changes in the capital markets utilized by the Company and its subsidiaries, including changes in the interest rate environment that may reduce margins.
- Changes in state and/or federal laws and regulations to which the Company and its subsidiaries, as well as their customers, competitors and potential competitors, are subject, including, without limitation, the impact of the Consumer Financial Protection Bureau as a new regulator of financial institutions, changes in the accounting, tax and regulatory treatment of trust preferred securities, as well as changes in banking, tax, securities, insurance, employment, environmental and immigration laws and regulations and the risk of litigation that may follow.
- Changes in U.S. Mexico trade, including, without limitation, reductions in border crossings and commerce resulting from the Homeland Security Programs called US-VISIT, which is derived from Section 110 of the Illegal Immigration Reform and Immigrant Responsibility Act of 1996.
- The reduction of deposits from nonresident alien individuals due to the new IRS rules requiring U.S. financial institutions to report to the IRS deposit interest payments made to nonresident alien individuals.
- The loss of senior management or operating personnel.
- Increased competition from both within and outside the banking industry.
- The timing, impact and other uncertainties of the Company's potential future acquisitions including the Company's ability to identify suitable potential future acquisition candidates, the success or failure in the integration of their operations and the Company's ability to maintain its current branch network and to enter new markets successfully and capitalize on growth opportunities.
- Changes in the Company's ability to pay dividends on its Common Stock.
- Changes in estimates of future reserve requirements based upon periodic review thereof under relevant regulatory and accounting requirements.
- Additions to the Company's loan loss allowance as a result of changes in local, national or international conditions which adversely affect the Company's customers, including, without limitation, lower real estate values or environmental liability risks associated with foreclosed properties.
- Greater than expected costs or difficulties related to the development and integration of new products and lines of business.
- Increased labor costs and effects related to health care reform and other laws, regulations and legal developments impacting labor costs.
- Impairment of carrying value of goodwill could negatively impact our earnings and capital.
- Changes in the soundness of other financial institutions with which the Company interacts.
- Political instability in the United States or Mexico.
- Technological changes or system failure or breaches of our network security could subject us to increased operating costs as well as litigation and other liabilities.
- Acts of war or terrorism.
- Natural disasters.

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- Reduced earnings resulting from the write down of the carrying value of securities held in our securities available-for-sale portfolio following a determination that the securities are other-than-temporarily impaired.
- The effect of changes in accounting policies and practices as may be adopted by the regulatory agencies, as well as the Public Company Accounting Oversight Board, the Financial Accounting Standards Board and other accounting standards setters.
- The costs and effects of regulatory developments, including the resolution of regulatory or other governmental inquiries and the results of regulatory examinations or reviews.
- The effect of final rules amending Regulation E that prohibit financial institutions from charging consumer fees for paying overdrafts on ATM and one-time debit card transactions, unless the consumer consents or opts-in to the overdraft service for those types of transactions, as well as the effect of any other regulatory or legal developments that limit overdraft services.
- The reduction of income and possible increase in required capital levels related to the adoption of new legislation, including, without limitation, the Dodd-Frank Regulatory Reform Act (the Dodd-Frank Act ) and the implementing rules and regulations, including the Federal Reserve s rule that establishes debit card interchange fee standards and prohibits network exclusivity arrangements and routing restrictions that is negatively affecting interchange revenue from debit card transactions as well as revenue from consumer services.
- The possible increase in required capital levels related to the implementation of capital and liquidity rules of the federal banking agencies that address or are impacted by the Basel III capital and liquidity standards.
- The enhanced due diligence burden imposed on banks related to the banks inability to rely on credit ratings under Dodd-Frank which may result in a limitation on the types of securities certain banks will be able to purchase as a result of the due diligence burden.

- The Company's success at managing the risks involved in the foregoing items, or a failure or circumvention of the Company's internal controls and risk management, policies and procedures.

Forward-looking statements speak only as of the date on which such statements are made. It is not possible to foresee or identify all such factors. The Company makes no commitment to update any forward-looking statement, or to disclose any facts, events or circumstances after the date hereof that may affect the accuracy of any forward-looking statement, unless required by law.

## Overview

The Company, which is headquartered in Laredo, Texas, with 217 facilities and more than 315 ATMs, provides banking services for commercial, consumer and international customers of South, Central and Southeast Texas and the State of Oklahoma. The Company is one of the largest independent commercial bank holding companies headquartered in Texas. The Company, through its bank subsidiaries, is in the business of gathering funds from various sources and investing those funds in order to earn a return. The Company either directly or through a bank subsidiary owns two insurance agencies, a liquidating subsidiary, a broker/dealer and a fifty percent interest in an investment banking unit that owns a broker/dealer. The Company's primary earnings come from the spread between the interest earned on interest-bearing assets and the interest paid on interest-bearing liabilities. In addition, the Company generates income from fees on products offered to commercial, consumer and international customers.

The Company is very active in facilitating trade along the United States border with Mexico. The Company does a large amount of business with customers domiciled in Mexico. Deposits from persons and entities domiciled in Mexico comprise a large and stable portion of the deposit base of the Company's bank subsidiaries. The Company also serves the growing Hispanic population through the Company's facilities located throughout South, Central and Southeast Texas and the State of Oklahoma.

Expense control is an essential element in the Company's long-term profitability. As a result, the Company monitors the efficiency ratio, which is a measure of non-interest expense to net interest income plus non-interest income closely. As the Company adjusts to regulatory changes related to Dodd-Frank, the Company's efficiency ratio may suffer because the additional regulatory compliance costs are expected to increase non-interest expense. The Company monitors this ratio over time to assess the Company's efficiency relative to its peers. The Company uses this measure as one factor in determining if the Company is accomplishing its long-term goals of providing superior returns to the Company's shareholders.

**Results of Operations****Summary**

## Consolidated Statements of Condition Information

	June 30, 2014	December 31, 2013	Percent Increase (Decrease)
	(Dollars in Thousands)		
Assets	\$ 12,436,467	\$ 12,079,477	3.0%
Net loans	5,365,978	5,129,074	4.6
Deposits	8,422,639	8,243,425	2.2
Other borrowed funds	1,358,817	1,223,950	11.0
Junior subordinated deferrable interest debentures	180,416	190,726	(5.4)%
Shareholders' equity	1,536,115	1,424,408	7.8%

## Consolidated Statements of Income Information

	Three Months Ended June 30, (Dollars in Thousands)			Percent Increase (Decrease)	Six Months Ended June 30, (Dollars in Thousands)			Percent Increase (Decrease)
	2014	2013			2014	2013		
Interest income	\$ 99,340	\$ 86,324	15.1%	\$ 137,908	\$ 173,434	(20.5)%		
Interest expense	11,634	13,700	(15.1)	23,507	28,178	(16.6)		
Net interest income	87,706	72,624	20.8	173,470	145,256	19.4		
Provision for probable loan losses	3,645	4,342	(16.1)	5,723	11,761	(51.3)		
Non-interest income	41,453	46,705	(11.2)	99,641	99,957	(.3)		
Non-interest expense	68,630	73,714	(6.9)	146,328	154,575	(5.3)		
Net income	37,719	27,513	37.1	81,365	55,582	46.4		
<b>Per common share:</b>								
Basic	\$ .56	\$ .41	36.6%	\$ 1.21	\$ .83	45.8%		
Diluted	.56	.41	36.6	1.21	.83	45.8		

**Net Income**

Net income for the three months ended June 30, 2014 increased by 37.1% when compared to the same period in 2013. Net income for the three and six months ended June 30, 2014 was positively impacted by an increase in the Company's net interest margin, as well as a 51.3% decrease in the provision for probable loan losses for the six months ended June 30, 2014. The increase in the net interest margin can be primarily attributed to increased levels of interest income arising from the repositioning of the investment portfolio the Company undertook in 2013, an increase in loans outstanding, and a decrease in interest expense on securities sold under repurchase agreements arising from the early termination of some of the long-term repurchase agreements by the lead bank subsidiary.



**Net Interest Income**

	Three Months Ended June 30, (Dollars in Thousands)			Percent Increase (Decrease)	Six Months Ended June 30, (Dollars in Thousands)			Percent Increase (Decrease)
	2014	2013			2014	2013		
Interest income:								
Loans, including fees	\$ 70,036	\$ 64,617		8.4%	\$ 137,908	\$ 128,151		7.6%
Investment securities:								
Taxable	26,545	18,601		42.7	57,724	39,120		47.6
Tax-exempt	2,728	3,085		(11.6)	6,251	6,121		2.1
Other interest income	31	21		47.6	94	42		123.8
Total interest income	99,340	86,324		15.1	196,977	173,434		13.6
Interest expense:								
Savings deposits	915	956		(4.3)	1,786	1,967		(9.2)
Time deposits	3,019	3,978		(24.1)	6,139	8,423		(27.1)
Securities sold under repurchase agreements	6,088	7,312		(16.7)	12,324	14,880		(17.2)
Other borrowings	564	289		95.2	1,120	579		93.4
Junior subordinated interest deferrable debentures	1,048	1,165		(10.0)	2,138	2,329		(8.2)
Total interest expense	11,634	13,700		(15.1)	23,507	28,178		(16.6)
Net interest income	\$ 87,706	\$ 72,624		20.8%	\$ 173,470	\$ 145,256		19.4%

Net interest income is the spread between income on interest earning assets, such as loans and securities, and the interest expense on liabilities used to fund those assets, such as deposits, repurchase agreements and funds borrowed. As part of its strategy to manage interest rate risk, the Company strives to manage both assets and liabilities so that interest sensitivities match. One method of calculating interest rate sensitivity is through gap analysis. A gap is the difference between the amount of interest rate sensitive assets and interest rate sensitive liabilities that re-price or mature in a given time period. Positive gaps occur when interest rate sensitive assets exceed interest rate sensitive liabilities, and negative gaps occur when interest rate sensitive liabilities exceed interest rate sensitive assets. A positive gap position in a period of rising interest rates should have a positive effect on net interest income as assets will re-price faster than liabilities. Conversely, net interest income should contract somewhat in a period of falling interest rates. Management can quickly change the Company's interest rate position at any given point in time as market conditions dictate. Additionally, interest rate changes do not affect all categories of assets and liabilities equally or at the same time. Analytical techniques employed by the Company to supplement gap analysis include simulation analysis to quantify interest rate risk exposure. The gap analysis prepared by management is reviewed by the Investment Committee of the Company twice a year (see table on page 40 for the June 30, 2014 gap analysis). Management currently believes that the Company is properly positioned for interest rate changes; however if management determines at any time that the Company is not properly positioned, it will strive to adjust the interest rate sensitive assets and liabilities in order to manage the effect of interest rate changes.



**Non-Interest Income**

	Three Months Ended June 30, (Dollars in Thousands)		Percent Increase (Decrease)	Six Months Ended June 30, (Dollars in Thousands)		Percent Increase (Decrease)
	2014	2013		2014	2013	
Service charges on deposit accounts	\$ 22,450	\$ 23,507	(4.5)%	\$ 44,512	\$ 47,337	(6.0)%
Other service charges, commissions and fees						
Banking	12,090	10,052	20.3	22,911	20,035	14.4
Non-banking	1,161	1,515	(23.4)	3,060	2,576	18.8
Investment securities transactions, net	(379)		100.0	7,729	9,601	(19.5)
Other investments, net	2,309	8,635	(73.3)	11,367	15,632	(27.3)
Other income	3,822	2,996	27.6	10,062	4,776	110.7
Total non-interest income	\$ 41,453	\$ 46,705	(11.2)%	\$ 99,641	\$ 99,957	(.3)%

Total non-interest income decreased .3% for the six months ended June 30, 2014 from the same period of 2013. The increase in other income for the six months ended June 20, 2014 can be primarily attributed to the sale of property originally held by the bank subsidiaries resulting in a net gain of approximately \$2,900,000, and the discount recorded in connection with the buyback of \$10.3 million of the outstanding capital securities issued by one of the statutory business trusts formed by the Company in the amount of approximately \$600,000, which were recorded in the first quarter of 2014. The decrease in other investment income for the six months ended June 30, 2014 compared to the same period of 2013 can be attributed to the sale of a partnership where the holding company held an equity position resulting in income of \$5.5 million and recorded in the second quarter of 2013.

**Non-Interest Expense**

	Three Months Ended June 30, (Dollars in Thousands)		Percent Increase (Decrease)	Six Months Ended June 30, (Dollars in Thousands)		Percent Increase (Decrease)
	2014	2013		2014	2013	
Employee compensation and benefits	\$ 29,989	\$ 30,764	(2.5)%	\$ 60,234	\$ 60,975	(1.2)%
Occupancy	7,856	7,180	9.4	14,864	14,992	(0.9)
Depreciation of bank premises and equipment	6,054	6,619	(8.5)	12,146	13,244	(8.3)
Professional fees	3,315	3,952	(16.1)	6,927	7,675	(9.7)
Deposit insurance assessments	1,558	1,762	(11.6)	2,997	3,378	(11.3)
Net expense, other real estate owned	830	1,575	(47.3)	1,759	3,364	(47.7)
Amortization of identified intangible assets	1,148	1,158	(0.9)	2,129	2,295	(7.2)
Advertising	1,955	2,023	(3.4)	3,785	3,869	(2.2)
Early termination fee securities sold under repurchase agreements		2,418	(100)	11,000	12,303	(10.6)
Impairment charges (Total other-than-temporary impairment losses, \$(953), net of \$(1,370), \$(301), net of \$(523), \$15, net of \$(712) and \$1,349, net of \$941 included in other comprehensive income)	189	417	(54.7)	279	727	(61.6)
Other	15,736	15,846	(0.7)	30,208	31,753	(4.9)
<b>Total non-interest expense</b>	<b>\$ 68,630</b>	<b>\$ 73,714</b>	<b>(6.9)%</b>	<b>\$ 146,328</b>	<b>\$ 154,575</b>	<b>(5.3)%</b>

Non-interest expense decreased 6.9% for the three months ended June 30, 2014 and 5.3% for the six months ended June 30, 2014 compared to the same periods of 2013. Included in total non-interest expense for the six months ended June 30, 2014 and 2013 are charges of \$11.0 million and \$12.3 million, respectively. The lead bank subsidiary terminated a portion of its long-term repurchase agreements outstanding in order to help manage its long-term funding costs.

**Financial Condition****Allowance for Probable Loan Losses**

The allowance for probable loan losses increased 2.0% to \$71,537,000 at June 30, 2014 from \$70,161,000 at December 31, 2013. The provision for probable loan losses charged to expense decreased 51.3% to \$5,723,000 for the six months ended June 30, 2014 from \$11,761,000 for the same period in 2013. The allowance for probable loan losses was 1.3% of total loans at June 30, 2014 and December 31, 2013, respectively.

**Investment Securities**

Mortgage-backed