

INTERNATIONAL BANCSHARES CORP
Form 10-Q
November 06, 2013

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 September 30, 2013

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
67,204,987 shares outstanding at November 1, 2013

PART I - FINANCIAL INFORMATION

Item 1. Financial Statements

INTERNATIONAL BANCSHARES CORPORATION AND SUBSIDIARIES

Consolidated Statements of Condition (Unaudited)

(Dollars in Thousands, except per share amounts)

| | September 30, 2013 | December 31, 2012 |
|---|-----------------------|----------------------|
| Assets | | |
| Cash and due from banks | \$ 302,514 | \$ 283,100 |
| Investment securities: | | |
| Held-to-maturity (Market value of \$2,400 on September 30, 2013 and \$2,400 on December 31, 2012) | 2,400 | 2,400 |
| Available-for-sale (Amortized cost of \$5,470,103 on September 30, 2013 and \$5,423,189 on December 31, 2012) | 5,448,750 | 5,525,015 |
| Total investment securities | 5,451,150 | 5,527,415 |
| Loans | 5,052,161 | 4,775,004 |
| Less allowance for probable loan losses | (67,829) | (58,193) |
| Net loans | 4,984,332 | 4,716,811 |
| Bank premises and equipment, net | 492,375 | 481,287 |
| Accrued interest receivable | 28,983 | 31,034 |
| Other investments | 386,302 | 372,739 |
| Identified intangible assets, net | 4,368 | 7,819 |
| Goodwill | 282,532 | 282,532 |
| Other assets | 144,102 | 179,936 |
| Total assets | \$ 12,076,658 | \$ 11,882,673 |

INTERNATIONAL BANCSHARES CORPORATION AND SUBSIDIARIES

Consolidated Statements of Condition, continued (Unaudited)

(Dollars in Thousands, except per share amounts)

| Liabilities and Shareholders Equity | September 30, 2013 | December 31, 2012 |
|---|-----------------------|----------------------|
| Liabilities: | | |
| Deposits: | | |
| Demand non-interest bearing | \$ 2,651,632 | \$ 2,465,750 |
| Savings and interest bearing demand | 2,759,122 | 2,867,151 |
| Time | 2,702,052 | 2,954,312 |
| Total deposits | 8,112,806 | 8,287,213 |
| Securities sold under repurchase agreements | 1,001,137 | 1,129,679 |
| Other borrowed funds | 1,289,493 | 749,027 |
| Junior subordinated deferrable interest debentures | 190,726 | 190,726 |
| Other liabilities | 67,145 | 90,320 |
| Total liabilities | 10,661,307 | 10,446,965 |
| Shareholders equity: | | |
| Common shares of \$1.00 par value. Authorized 275,000,000 shares; issued 95,736,255 shares on September 30, 2013 and 95,724,517 shares on December 31, 2012 | 95,736 | 95,725 |
| Surplus | 163,744 | 163,287 |
| Retained earnings | 1,428,057 | 1,369,543 |
| Accumulated other comprehensive (loss) income (including \$(5,991) and \$(6,811) of comprehensive loss related to other- than-temporary impairment for non-credit related issues) | (13,677) | 65,662 |
| | 1,673,860 | 1,694,217 |
| Less cost of shares in treasury, 28,537,180 shares on September 30, 2013 and 28,537,180 December 31, 2012 | (258,509) | (258,509) |
| Total shareholders equity | 1,415,351 | 1,435,708 |
| Total liabilities and shareholders equity | \$ 12,076,658 | \$ 11,882,673 |

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 | | Nine Months Ended | |
|--|--------------------|-----------|-------------------|------------|
| | September 30, | | September 30, | |
| | 2013 | 2012 | 2013 | 2012 |
| Interest income: | | | | |
| Loans, including fees | \$ 66,482 | \$ 67,254 | \$ 194,633 | \$ 202,990 |
| Investment securities: | | | | |
| Taxable | 21,821 | 23,388 | 60,941 | 71,128 |
| Tax-exempt | 3,318 | 2,972 | 9,439 | 8,682 |
| Other interest income | 29 | 161 | 71 | 440 |
| Total interest income | 91,650 | 93,775 | 265,084 | 283,240 |
| Interest expense: | | | | |
| Savings deposits | 885 | 1,074 | 2,852 | 4,176 |
| Time deposits | 3,644 | 5,910 | 12,067 | 18,650 |
| Securities sold under repurchase agreements | 7,162 | 8,811 | 22,042 | 29,380 |
| Other borrowings | 454 | 195 | 1,033 | 541 |
| Junior subordinated interest deferrable debentures | 862 | 1,430 | 3,191 | 5,378 |
| Total interest expense | 13,007 | 17,420 | 41,185 | 58,125 |
| Net interest income | 78,643 | 76,355 | 223,899 | 225,115 |
| Provision for probable loan losses | 5,800 | 5,349 | 17,561 | 16,741 |
| Net interest income after provision for probable loan losses | 72,843 | 71,006 | 206,338 | 208,374 |
| Non-interest income: | | | | |
| Service charges on deposit accounts | 25,026 | 23,748 | 72,363 | 69,601 |
| Other service charges, commissions and fees | | | | |
| Banking | 11,327 | 9,492 | 31,362 | 28,980 |
| Non-banking | 2,092 | 2,038 | 4,668 | 4,971 |
| Investment securities transactions, net | | 32,935 | 9,601 | 35,527 |
| Other investments, net | 3,871 | 3,650 | 19,503 | 11,431 |
| Other income | 2,165 | 2,144 | 6,941 | 7,493 |
| Total non-interest income | 44,481 | 74,007 | 144,438 | 158,003 |

INTERNATIONAL BANCSHARES CORPORATION AND SUBSIDIARIES

Consolidated Statements of Income, continued (Unaudited)

(Dollars in Thousands, except per share data)

| | Three Months Ended | | Nine Months Ended | |
|---|--------------------|------------|-------------------|------------|
| | September 30, | | September 30, | |
| | 2013 | 2012 | 2013 | 2012 |
| Non-interest expense: | | | | |
| Employee compensation and benefits | \$ 30,627 | \$ 30,541 | \$ 91,602 | \$ 90,152 |
| Occupancy | 7,604 | 8,032 | 22,596 | 24,873 |
| Depreciation of bank premises and equipment | 6,433 | 6,618 | 19,677 | 20,335 |
| Professional fees | 3,669 | 4,279 | 11,344 | 11,820 |
| Deposit insurance assessments | 1,683 | 2,289 | 5,061 | 5,346 |
| Net expense, other real estate owned | 1,360 | 3,065 | 4,724 | 5,631 |
| Amortization of identified intangible assets | 1,156 | 1,163 | 3,451 | 3,463 |
| Advertising | 1,795 | 1,713 | 5,664 | 5,510 |
| Early termination fee securities sold under repurchase agreements | | 31,550 | 12,303 | 31,550 |
| Impairment charges (Total other-than-temporary impairment losses, \$(13), net of \$(560), \$(402), net of \$(641), \$(27), net of \$(1,273), and \$947, net of \$300, included in other comprehensive loss) | 573 | 239 | 1,300 | 647 |
| Other | 15,327 | 16,955 | 47,080 | 47,351 |
| Total non-interest expense | 70,227 | 106,444 | 224,802 | 246,678 |
| Income before income taxes | 47,097 | 38,569 | 125,974 | 119,699 |
| Provision for income taxes | 15,271 | 12,691 | 38,566 | 37,584 |
| Net income | 31,826 | 25,878 | 87,408 | 82,115 |
| Preferred stock dividends | | 3,845 | | 10,543 |
| Net income available to common shareholders | \$ 31,826 | \$ 22,033 | \$ 87,408 | \$ 71,572 |
| Basic earnings per common share: | | | | |
| Weighted average number of shares outstanding: | 67,197,847 | 67,225,701 | 67,192,112 | 67,246,793 |
| Net income | \$.47 | \$.33 | \$ 1.30 | \$ 1.06 |
| Fully diluted earnings per common share: | | | | |
| Weighted average number of shares outstanding: | 67,333,442 | 67,301,701 | 67,301,863 | 67,326,856 |
| Net income | \$.47 | \$.33 | \$ 1.30 | \$ 1.06 |

See accompanying notes to consolidated financial statements.

INTERNATIONAL BANCSHARES CORPORATION AND SUBSIDIARIES

Consolidated Statements of Comprehensive Income (Unaudited)

(Dollars in Thousands)

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|--|-------------------------------------|-----------|------------------------------------|-----------|
| | 2013 | 2012 | 2013 | 2012 |
| Net income | \$ 31,826 | \$ 25,878 | \$ 87,408 | \$ 82,115 |
| Other comprehensive income, net of tax | | | | |
| Net unrealized holding gains (losses) on securities available for Sale arising during period (tax effects of \$609, \$10,897, \$(39,816) and \$11,292) | 1,132 | 20,238 | (73,943) | 20,971 |
| Reclassification adjustment for gains on securities available for sale included in net income (tax effects of \$0, \$(11,527), \$(3,360) and \$(12,434)) | | (21,408) | (6,241) | (23,093) |
| Reclassification adjustment for impairment charges on available for sale securities included in net income (tax effects of \$201, \$84, \$455 and \$226) | 372 | 155 | 845 | 421 |
| | 1,504 | (1,015) | (79,339) | (1,701) |
| Comprehensive income | \$ 33,330 | \$ 24,863 | \$ 8,069 | \$ 80,414 |

See accompanying notes to consolidated financial statements.

INTERNATIONAL BANCSHARES CORPORATION AND SUBSIDIARIES

Consolidated Statements of Cash Flows (Unaudited)

(Dollars in Thousands)

| | Nine Months Ended September 30, | |
|---|------------------------------------|-------------|
| | 2013 | 2012 |
| Operating activities: | | |
| Net income | \$ 87,408 | \$ 82,115 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Provision for probable loan losses | 17,561 | 16,741 |
| Specific reserve, other real estate owned | 478 | 2,032 |
| Depreciation of bank premises and equipment | 19,677 | 20,335 |
| Gain on sale of bank premises and equipment | (626) | (734) |
| Gain on sale of other real estate owned | (201) | (239) |
| Accretion of investment securities discounts | (2,844) | (2,346) |
| Amortization of investment securities premiums | 35,666 | 20,290 |
| Investment securities transactions, net | (9,601) | (35,527) |
| Impairment charges on available-for-sale investment securities | 1,300 | 647 |
| Amortization of identified intangible assets | 3,451 | 3,463 |
| Stock based compensation expense | 322 | 366 |
| Earnings from affiliates and other investments | (16,085) | (8,836) |
| Deferred tax (benefit) expense | (2,325) | 2,267 |
| Decrease in accrued interest receivable | 2,051 | 1,516 |
| Net decrease (increase) in other assets | 16,624 | (271) |
| Net increase in other liabilities | 7,535 | 16,793 |
| Net cash provided by operating activities | 160,391 | 118,612 |
| Investing activities: | | |
| Proceeds from maturities of held-to-maturity securities | | 1,125 |
| Proceeds from sales and calls of available for sale securities | 178,124 | 1,279,963 |
| Purchases of available for sale securities | (1,274,574) | (2,383,774) |
| Principal collected on mortgage-backed securities | 1,025,015 | 955,550 |
| Net (increase) decrease in loans | (285,453) | 86,501 |
| Purchases of other investments | (1,637) | (2,956) |
| Distributions received on other investments | 4,159 | 8,845 |
| Purchases of bank premises and equipment | (30,792) | (23,650) |
| Proceeds from sales of other real estate owned | 19,303 | 25,643 |
| Proceeds from sale of bank premises and equipment | 653 | 3,795 |
| Net cash used in investing activities | (365,202) | (48,958) |

INTERNATIONAL BANCSHARES CORPORATION AND SUBSIDIARIES

Consolidated Statements of Cash Flows, continued (Unaudited)

(Dollars in Thousands)

| | Nine Months Ended September 30, | |
|--|------------------------------------|------------|
| | 2013 | 2012 |
| Financing activities: | | |
| Net increase in non-interest bearing demand deposits | \$ 185,882 | \$ 182,477 |
| Net decrease in savings and interest bearing demand deposits | (108,029) | (22,938) |
| Net decrease in time deposits | (252,260) | (114,460) |
| Net decrease in securities sold under repurchase agreements | (128,542) | (175,017) |
| Net increase in other borrowed funds | 540,466 | 120,900 |
| Purchase of treasury stock | | (1,092) |
| Redemption of senior preferred shares | | (40,000) |
| Proceeds from stock transactions | 146 | 43 |
| Payments of dividends on common stock | (13,438) | (13,450) |
| Payments of dividends on preferred stock | | (7,911) |
| Net cash provided by (used in) financing activities | 224,225 | (71,448) |
| Increase (decrease) in cash and cash equivalents | 19,414 | (1,794) |
| Cash and cash equivalents at beginning of period | 283,100 | 261,885 |
| Cash and cash equivalents at end of period | \$ 302,514 | \$ 260,091 |
| Supplemental cash flow information: | | |
| Interest paid | \$ 43,405 | \$ 60,651 |
| Income taxes paid | 45,480 | 22,271 |
| Non-cash investing and financing activities: | | |
| Accrued dividends, preferred shares | | 1,100 |
| Dividends declared, not yet paid on common stock | 15,456 | 13,445 |
| Net transfer from loans to other real estate owned | (371) | 55,694 |
| Purchases of available-for-sale securities not yet settled | | 442,240 |

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, 2012 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.

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 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 assets and liabilities reported on the consolidated balance sheets at their fair value on a recurring basis as of September 30, 2013 by level within the fair value measurement hierarchy:

| | Fair Value Measurements at Reporting Date Using (in thousands) | | | |
|--|--|---|--|--|
| | Assets/Liabilities Measured at Fair Value September 30, 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 | \$ 5,172,186 | \$ | \$ 5,143,187 | \$ 28,999 |
| States and political subdivisions | 247,731 | | 247,731 | |
| Other | 28,833 | 28,833 | | |
| Total | \$ 5,448,750 | \$ 28,833 | \$ 5,390,918 | \$ 28,999 |

The following table represents assets and liabilities reported on the consolidated balance sheets at their fair value on a recurring basis as of December 31, 2012 by level within the fair value measurement hierarchy:

| | | | | |
|---------------------------------------|--------------|-----------|--------------|-----------|
| <i>Measured on a recurring basis:</i> | | | | |
| Available for sale securities | | | | |
| States and political subdivisions | 238,675 | | 238,675 | |
| Total | \$ 5,525,015 | \$ 21,136 | \$ 5,471,019 | \$ 32,860 |

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 September 30, 2013 and December 31, 2012 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, 2012 | \$ | 32,860 |
| Principal paydowns | | (3,833) |
| Total unrealized gains (losses) included in: | | |
| Other comprehensive loss | | 1,272 |
| Impairment realized in earnings | | (1,300) |
| Balance at September 30, 2013 | \$ | 28,999 |

Certain assets and liabilities 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 assets measured at fair value on a non-recurring basis as of and for the period ended September 30, 2013 by level within the fair value measurement hierarchy:

| | Fair Value Measurements at Reporting Date Using (in thousands) | | | | Net Provision During Period Nine Months ended September 30, 2013 |
|---|--|--|---|--|--|
| | Assets/Liabilities Measured at Fair Value September 30, 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 non-recurring basis:</i> | | | | | |
| Assets: | | | | | |
| Impaired loans | \$ 29,159 | \$ | \$ | \$ 29,159 | \$ 11,048 |
| Other real estate owned | 11,656 | | | 11,656 | 478 |

The following table represents assets measured at fair value on a non-recurring basis as of and for the year ended December 31, 2012 by level within the fair value measurement hierarchy:

| | Fair Value Measurements at Reporting Date Using (in thousands) | | | | Net Provision During Period Twelve Months ended December 31, 2012 |
|---|---|--|---|--|--|
| | Assets/Liabilities Measured at Fair Value December 31, 2012 | 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 non-recurring basis:</i> | | | | | |
| Assets: | | | | | |
| Impaired loans | \$ 11,981 | \$ | \$ | \$ 11,981 | \$ 295 |
| Other real estate owned | 18,749 | | | 18,749 | |

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 an appraisal 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. New or

updated appraisals may be obtained as warranted after evaluation of any material deterioration in the performance of the project, the conditions for the geographic area where the property is located, the property type, differences between the current property conditions and the conditions assumed in prior appraisals or evaluations, or changes in project specifications. 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 September 30, 2013, the Company had \$87,914,000 of impaired commercial collateral dependent loans, of which \$70,548,000 had an appraisal or evaluation performed within the last twelve months. As of December 31, 2012, the Company had \$73,646,000 of impaired commercial collateral dependent loans, of which \$48,856,000 had an appraisal or evaluation performed within the last 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 nine months ended September 30, 2013 and the twelve months ended December 31, 2012, respectively the Company recorded \$237,000 and \$10,450,000 in charges to the allowance for probable loan losses in connection with loans transferred to other real estate owned. For the nine months ended September 30, 2013 and twelve months ended December 31, 2012, respectively, the Company recorded \$ 478,000 and \$0 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 September 30, 2013 and December 31, 2012 are outlined below.

Cash and Due From Banks and Federal Funds Sold

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

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 September 30, 2013, and December 31, 2012, the carrying amount of

fixed rate performing loans was \$1,207,154,000 and \$1,189,585,000 respectively, and the estimated fair value was \$1,152,663,000 and \$1,126,228,000, 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 September 30, 2013 and December 31, 2012. 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 September 30, 2013 and December 31, 2012, the carrying amount of time deposits was \$2,702,052,000 and \$2,954,312,000, respectively, and the estimated fair value was \$2,695,908,000 and \$2,962,190,000, 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 September 30, 2013 and December 31, 2012. 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 September 30, 2013 and December 31, 2012, respectively, the carrying amount of long-term repurchase agreements was \$710,000,000 and \$800,000,000 and the estimated fair value was \$799,005,000 and \$932,007,000, 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 September 30, 2013 and December 31, 2012.

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 September 30, 2013 and December 31, 2012. 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

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of the fair value hierarchy. At September 30, 2013 and December 31, 2012, the carrying amount of the long-term FHLB borrowings was \$8,993,000, and \$6,527,000, respectively, and the estimated fair value was \$8,993,000 and \$7,073,000, 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 September 30, 2013 and December 31, 2012 is as follows:

| | September 30, 2013 | December 31, 2012 |
|--|------------------------|----------------------|
| | (Dollars in Thousands) | |
| Commercial, financial and agricultural | \$ 2,841,022 | \$ 2,525,380 |
| Real estate mortgage | 837,326 | 838,467 |
| Real estate construction | 1,119,342 | 1,147,669 |
| Consumer | 67,422 | 74,514 |
| Foreign | 187,049 | 188,974 |
| Total loans | \$ 5,052,161 | \$ 4,775,004 |

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

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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

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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.

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

| | Quarter ended September 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 June 30, | \$ 20,676 | \$ 11,624 | \$ 22,383 | \$ 623 | \$ 3,855 | \$ 4,047 | \$ 797 | \$ 1,046 | \$ 65,051 |
| Losses charge to allowance | (3,540) | (2) | | | (22) | (149) | (130) | (2) | (3,845) |
| Recoveries credited to allowance | 658 | 10 | 9 | | 45 | 80 | 21 | | 823 |
| Net losses charged to allowance | (2,882) | 8 | 9 | | 23 | (69) | (109) | (2) | (3,022) |
| Provision (credit) charged to operations | 3,370 | (10) | 1,549 | 112 | 186 | 404 | 124 | 65 | 5,800 |
| Balance at September 30, | \$ 21,164 | \$ 11,622 | \$ 23,941 | \$ 735 | \$ 4,064 | \$ 4,382 | \$ 812 | \$ 1,109 | \$ 67,829 |

| | Quarter ended September 30, 2012 | | | | | | | 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 June 30, | \$ 24,688 | \$ 13,242 | \$ 20,551 | \$ 803 | \$ 3,987 | \$ 4,410 | \$ 1,476 | \$ 1,221 | \$ 70,378 |
| Losses charge to allowance | (3,521) | (3) | (1) | | (63) | (282) | (159) | (7) | (4,036) |
| Recoveries credited to allowance | 821 | 13 | 32 | | 4 | 62 | 58 | | 990 |
| Net losses charged to allowance | (2,700) | 10 | 31 | | (59) | (220) | (101) | (7) | (3,046) |
| Provision (credit) charged to operations | 3,312 | 44 | 1,138 | (27) | 272 | 626 | 31 | (47) | 5,349 |
| Balance at September 30, | \$ 25,300 | \$ 13,296 | \$ 21,720 | \$ 776 | \$ 4,200 | \$ 4,816 | \$ 1,406 | \$ 1,167 | \$ 72,681 |

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| | Nine Months Ended September 30, 2013 | | | | | | | Foreign | | Total |
|--|--------------------------------------|---|---|-------------------------------------|-------------------------|--------------------------|----------|----------|-----------|-------|
| | Domestic | | | | | | | Foreign | | |
| | Commercial | Commercial real estate: other construction & land development | Commercial real estate: farmland & commercial | Commercial real estate: multifamily | Residential: first lien | Residential: junior lien | Consumer | | | |
| 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 | (8,866) | (250) | (61) | | (221) | (544) | (446) | (22) | (10,410) | |
| Recoveries credited to allowance | 1,909 | 36 | 150 | | 54 | 204 | 127 | 5 | 2,485 | |
| Net losses charged to allowance | (6,957) | (214) | 89 | | (167) | (340) | (319) | (17) | (7,925) | |
| Provision (credit) charged to operations | 16,489 | (884) | 1,972 | 41 | (159) | 274 | (158) | (14) | 17,561 | |
| Balance at September 30, | \$ 21,164 | \$ 11,622 | \$ 23,941 | \$ 735 | \$ 4,064 | \$ 4,382 | \$ 812 | \$ 1,109 | \$ 67,829 | |

| | Nine Months Ended September 30, 2012 | | | | | | | Foreign | | Total |
|--|--------------------------------------|---|---|-------------------------------------|-------------------------|--------------------------|----------|----------|-----------|-------|
| | Domestic | | | | | | | Foreign | | |
| | Commercial | Commercial real estate: other construction & land development | Commercial real estate: farmland & commercial | Commercial real estate: multifamily | Residential: first lien | Residential: junior lien | Consumer | | | |
| Balance at December 31, | \$ 26,617 | \$ 19,940 | \$ 24,227 | \$ 1,003 | \$ 4,562 | \$ 4,760 | \$ 1,724 | \$ 1,359 | \$ 84,192 | |
| Losses charge to allowance | (10,009) | (7,574) | (12,477) | | (129) | (993) | (595) | (12) | (31,789) | |
| Recoveries credited to allowance | 2,823 | 225 | 163 | | 7 | 168 | 151 | | 3,537 | |
| Net losses charged to allowance | (7,186) | (7,349) | (12,314) | | (122) | (825) | (444) | (12) | (28,252) | |
| Provision (credit) charged to operations | 5,869 | 705 | 9,807 | (227) | (240) | 881 | 126 | (180) | 16,741 | |
| Balance at September 30, | \$ 25,300 | \$ 13,296 | \$ 21,720 | \$ 776 | \$ 4,200 | \$ 4,816 | \$ 1,406 | \$ 1,167 | \$ 72,681 | |

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 September 30, 2013 and December 31, 2012:

| | September 30, 2013 | | | |
|---|--|------------------|--|------------------|
| | Loans individually evaluated for impairment | | Loans collectively evaluated for impairment | |
| | (Dollars in Thousands) | | | |
| | Recorded Investment | Allowance | Recorded Investment | Allowance |
| Domestic | | | | |
| Commercial | \$ 35,231 | \$ 10,741 | \$ 982,923 | \$ 10,423 |
| Commercial real estate: other construction & land development | 36,304 | 852 | 1,083,038 | 10,770 |
| Commercial real estate: farmland & commercial | 17,038 | 3,404 | 1,705,918 | 20,537 |
| Commercial real estate: multifamily | 314 | | 99,598 | 735 |
| Residential: first lien | 4,984 | | 438,905 | 4,064 |
| Residential: junior lien | 3,219 | | 390,218 | 4,382 |
| Consumer | 1,481 | | 65,941 | 812 |
| Foreign | 455 | | 186,594 | 1,109 |
| Total | \$ 99,026 | \$ 14,997 | \$ 4,953,135 | \$ 52,832 |

| | December 31, 2012 | | | |
|---|--|-----------------|--|------------------|
| | Loans individually evaluated for impairment | | Loans collectively evaluated for impairment | |
| | (Dollars in Thousands) | | | |
| | Recorded Investment | Allowance | Recorded Investment | Allowance |
| Domestic | | | | |
| Commercial | \$ 32,768 | \$ 1,477 | \$ 736,342 | \$ 10,155 |
| Commercial real estate: other construction & land development | 28,660 | 539 | 1,119,009 | 12,181 |
| Commercial real estate: farmland & commercial | 13,945 | 2,730 | 1,659,377 | 19,150 |
| Commercial real estate: multifamily | 353 | | 82,595 | 694 |
| Residential: first lien | 3,656 | | 453,075 | 4,390 |
| Residential: junior lien | 1,850 | | 379,886 | 4,448 |
| Consumer | 1,326 | | 73,188 | 1,289 |
| Foreign | 447 | | 188,527 | 1,140 |
| Total | \$ 83,005 | \$ 4,746 | \$ 4,691,999 | \$ 53,447 |

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The table below provides additional information on loans accounted for on a non-accrual basis by loan class at September 30, 2013 and December 31, 2012:

| | September 30, 2013 | December 31, 2012 |
|---|------------------------|-------------------|
| | (Dollars in Thousands) | |
| Domestic | | |
| Commercial | \$ 34,450 | \$ 31,929 |
| Commercial real estate: other construction & land development | 34,053 | 26,410 |
| Commercial real estate: farmland & commercial | 14,775 | 11,681 |
| Commercial real estate: multifamily | 314 | 353 |
| Residential: first lien | 1,234 | 1,175 |
| Residential: junior lien | 1,576 | 175 |
| Consumer | 37 | 45 |
| Foreign | 13 | |
| Total non-accrual loans | \$ 86,452 | \$ 71,768 |

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 September 30, 2013 and December 31, 2012:

| | | | September 30, 2013 | | | | | |
|---|---------------------|--------------------------|--------------------|-----------------------------|---------------------|-----------------------------|---------------------|--|
| | Recorded Investment | Unpaid Principal Balance | Related Allowance | Average Recorded Investment | Interest Recognized | Average Recorded Investment | Interest Recognized | |
| (Dollars in Thousands) | | | | | | | | |
| Loans with Related Allowance | | | | | | | | |
| Domestic | | | | | | | | |
| Commercial | \$ 17,880 | \$ 17,880 | \$ 10,741 | \$ 17,884 | \$ 9 | \$ 17,898 | \$ 29 | |
| Commercial real estate: other construction & land development | 6,819 | 6,825 | 852 | 6,821 | | 5,804 | | |
| Commercial real estate: farmland & commercial | 7,751 | 11,133 | 3,404 | 7,771 | 23 | 7,034 | 69 | |
| Total impaired loans with related allowance | \$ 32,450 | \$ 35,838 | \$ 14,997 | \$ 32,476 | \$ 32 | \$ 30,736 | \$ 98 | |

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| | Recorded Investment | Unpaid Principal Balance | September 30, 2013 Quarter to Date | | Year to Date | |
|---|---------------------|--------------------------|---|---------------------|-----------------------------|---------------------|
| | | | Average Recorded Investment (Dollars in Thousands) | Interest Recognized | Average Recorded Investment | Interest Recognized |
| Loans with No Related Allowance | | | | | | |
| Domestic | | | | | | |
| Commercial | \$ 17,351 | \$ 17,993 | \$ 17,238 | \$ | \$ 16,915 | \$ |
| Commercial real estate: other construction & land development | 29,485 | 29,542 | 22,414 | 17 | 20,788 | 53 |
| Commercial real estate: farmland & commercial | 9,287 | 10,289 | 8,775 | | 6,787 | |
| Commercial real estate: multifamily | 314 | 314 | 316 | | 330 | |
| Residential: first lien | 4,984 | 5,117 | 4,878 | 45 | 4,441 | 117 |
| Residential: junior lien | 3,219 | 3,238 | 2,731 | 25 | 2,059 | 74 |
| Consumer | 1,481 | 1,486 | 1,458 | | 1,313 | |
| Foreign | 455 | 457 | 457 | 5 | 456 | 14 |
| Total impaired loans with no related allowance | \$ 66,576 | \$ 68,436 | \$ 58,267 | \$ 92 | \$ 53,089 | \$ 258 |

| | Recorded Investment | Unpaid Principal Balance | December 31, 2012 | | Year to Date | |
|---|---------------------|--------------------------|---|-----------------------------|---------------------|--------|
| | | | Related Allowance (Dollars in Thousands) | Average Recorded Investment | Interest Recognized | |
| Loans with Related Allowance | | | | | | |
| Domestic | | | | | | |
| Commercial | \$ 1,633 | \$ 1,679 | \$ 1,477 | \$ 21,126 | \$ | \$ 39 |
| Commercial real estate: other construction & land development | 3,671 | 3,671 | 539 | 6,608 | | |
| Commercial real estate: farmland & commercial | 6,678 | 9,923 | 2,730 | 7,342 | | 92 |
| Total impaired loans with related allowance | \$ 11,982 | \$ 15,273 | \$ 4,746 | \$ 35,076 | \$ | \$ 131 |

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| | December 31, 2012 | | Year to Date | |
|---|---------------------|--|-----------------------------|---------------------|
| | Recorded Investment | Unpaid Principal Balance (Dollars in Thousands) | Average Recorded Investment | Interest Recognized |
| Loans with No Related Allowance | | | | |
| Domestic | | | | |
| Commercial | \$ 31,135 | \$ 31,170 | \$ 2,996 | \$ 4 |
| Commercial real estate: other construction & land development | 24,989 | 25,160 | 39,449 | 141 |
| Commercial real estate: farmland & commercial | 7,267 | 9,340 | 16,536 | 8 |
| Commercial real estate: multifamily | 353 | 353 | 381 | |
| Residential: first lien | 3,656 | 3,984 | 2,876 | 60 |
| Residential: junior lien | 1,850 | 1,944 | 1,939 | 104 |
| Consumer | 1,326 | 1,330 | 1,193 | |
| Foreign | 447 | 447 | 166 | 6 |
| Total impaired loans with no related allowance | \$ 71,023 | \$ 73,728 | \$ 65,536 | \$ 323 |

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 September 30, 2012:

| | September 30, 2012 | | | |
|---|-----------------------------|---------------------|-----------------------------|---------------------|
| | Quarter to Date | | Year to Date | |
| | Average Recorded Investment | Interest Recognized | Average Recorded Investment | Interest Recognized |
| | (Dollars in Thousands) | | | |
| Loans with Related Allowance | | | | |
| Domestic | | | | |
| Commercial | \$ 22,729 | \$ 10 | \$ 22,517 | \$ 29 |
| Commercial real estate: other construction & land development | 3,671 | | 23,479 | |
| Commercial real estate: farmland & commercial | 7,117 | 23 | 11,518 | 69 |
| Residential: first lien | 198 | | 202 | |
| Total impaired loans with related allowance | \$ 33,715 | \$ 33 | \$ 57,716 | \$ 98 |

| | September 30, 2012 | | | |
|---|-----------------------------------|--|-----------------------------------|------------------------|
| | 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 | \$ 840 | \$ 1 | \$ 538 | \$ 3 |
| Commercial real estate: other construction & land development | 26,689 | 23 | 27,632 | 122 |
| Commercial real estate: farmland & commercial | 14,069 | | 14,850 | 8 |
| Commercial real estate: multifamily | 374 | | 388 | |
| Residential: first lien | 2,957 | 15 | 2,485 | 31 |
| Residential: junior lien | 1,836 | 25 | 1,958 | 79 |
| Consumer | 1,271 | | 1,149 | |
| Foreign | 92 | | 61 | 1 |
| Total impaired loans with no related allowance | \$ 48,128 | \$ 64 | \$ 49,061 | \$ 244 |

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 improving and better positioned to recover 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 \$20,275,000 and \$29,395,000 as of September 30, 2013 and December 31, 2012, 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.

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 September 30, 2013 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 September 30, 2013 and December 31, 2012:

| | September 30, 2012 | | September 30, 2013 | | September 30, 2013 | | September 30, 2013 | | | | | | | |
|---------------------------------------|------------------------|---------|--------------------|---------|--------------------|-------------------------------------|--------------------|---------|-----------------|---------|----|-----------|----|-----------|
| | 30 Days | 59 Days | 60 Days | 89 Days | 90 Days or Greater | 90 Days or greater & still accruing | Total Past due | Current | Total Portfolio | | | | | |
| | (Dollars in Thousands) | | | | | | | | | | | | | |
| Domestic | | | | | | | | | | | | | | |
| Commercial | \$ | 4,319 | \$ | 1,054 | \$ | 35,379 | \$ | 1,227 | \$ | 40,752 | \$ | 977,402 | \$ | 1,018,154 |
| Commercial real estate: | | | | | | | | | | | | | | |
| other construction & land development | | 1,916 | | 292 | | 32,593 | | 38 | | 34,801 | | 1,084,541 | | 1,119,342 |
| Commercial real estate: | | | | | | | | | | | | | | |
| farmland & commercial | | 7,436 | | 297 | | 9,122 | | 1,728 | | 16,855 | | 1,706,101 | | 1,722,956 |
| Commercial real estate: | | | | | | | | | | | | | | |
| multifamily | | 418 | | | | 314 | | | | 732 | | 99,180 | | 99,912 |
| Residential: first lien | | 6,538 | | 3,060 | | 8,612 | | 7,751 | | 18,210 | | 425,679 | | 443,889 |
| Residential: junior lien | | 1,060 | | 175 | | 1,758 | | 216 | | 2,993 | | 390,444 | | 393,437 |
| Consumer | | 1,615 | | 385 | | 708 | | 685 | | 2,708 | | 64,714 | | 67,422 |
| Foreign | | 1,912 | | 148 | | 215 | | 202 | | 2,275 | | 184,774 | | 187,049 |
| Total past due loans | \$ | 25,214 | \$ | 5,411 | \$ | 88,701 | \$ | 11,847 | \$ | 119,326 | \$ | 4,932,835 | \$ | 5,052,161 |

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| | December 31, 2012 | | | | | | | | | | | | | |
|---|------------------------|--------|-------|--------|------------|--------|-----------|--------|----|--------|----|-----------|----|-----------|
| | 30 59 | | 60 89 | | 90 Days or | | 90 Days | | | | | | | |
| | Days | | Days | | Greater | | or | | | | | | | |
| | | | | | | | greater | | | | | | | |
| | | | | | | | & still | | | | | | | |
| | | | | | | | accruing | | | | | | | |
| | | | | | | | Total | | | | | | | |
| | | | | | | | Past | | | | | | | |
| | | | | | | | due | | | | | | | |
| | | | | | | | Current | | | | | | | |
| | | | | | | | Total | | | | | | | |
| | | | | | | | Portfolio | | | | | | | |
| | (Dollars in Thousands) | | | | | | | | | | | | | |
| Domestic | | | | | | | | | | | | | | |
| Commercial | \$ | 4,393 | \$ | 471 | \$ | 3,386 | \$ | 2,689 | \$ | 8,250 | \$ | 760,860 | \$ | 769,110 |
| Commercial real estate: other construction & land development | | 1,107 | | 2,300 | | 24,225 | | 497 | | 27,632 | | 1,120,037 | | 1,147,669 |
| Commercial real estate: farmland & commercial | | 3,127 | | 21,272 | | 2,310 | | 929 | | 26,709 | | 1,646,613 | | 1,673,322 |
| Commercial real estate: multifamily | | 685 | | | | 353 | | | | 1,038 | | 81,910 | | 82,948 |
| Residential: first lien | | 4,305 | | 2,510 | | 10,645 | | 9,657 | | 17,460 | | 439,271 | | 456,731 |
| Residential: junior lien | | 2,035 | | 410 | | 259 | | 115 | | 2,704 | | 379,032 | | 381,736 |
| Consumer | | 1,598 | | 404 | | 915 | | 882 | | 2,917 | | 71,597 | | 74,514 |
| Foreign | | 2,257 | | 1,005 | | 264 | | 264 | | 3,526 | | 185,448 | | 188,974 |
| Total past due loans | \$ | 19,507 | \$ | 28,372 | \$ | 42,357 | \$ | 15,033 | \$ | 90,236 | \$ | 4,684,768 | \$ | 4,775,004 |

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 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 September 30, 2013 and December 31, 2012 is as follows:

| | September 30, 2013 | | | | | |
|---|------------------------|-------------------|----------------------|-----------------------------|--------------------------|--|
| | Pass | Special Review | Watch List - Pass | Watch List - Substandard | Watch List - Impaired | |
| | (Dollars in Thousands) | | | | | |
| Domestic | | | | | | |
| Commercial | \$ 911,393 | \$ 8,244 | \$ 16,623 | \$ 46,663 | \$ 35,231 | |
| Commercial real estate: other construction & land development | 1,044,439 | 25,064 | 9,164 | 4,371 | 36,304 | |
| Commercial real estate: farmland & commercial | 1,558,965 | 101,674 | 19,698 | 25,581 | 17,038 | |
| Commercial real estate: multifamily | 99,598 | | | | 314 | |
| Residential: first lien | 433,944 | 119 | | 4,842 | 4,984 | |
| Residential: junior lien | 389,920 | | | 298 | 3,219 | |
| Consumer | 65,937 | | | 4 | 1,481 | |
| Foreign | 183,900 | 2,080 | | 614 | 455 | |
| Total | \$ 4,688,096 | \$ 137,181 | \$ 45,485 | \$ 82,373 | \$ 99,026 | |

| | December 31, 2012 | | | | | |
|---|------------------------|-------------------|----------------------|-----------------------------|--------------------------|--|
| | Pass | Special Review | Watch List - Pass | Watch List - Substandard | Watch List - Impaired | |
| | (Dollars in Thousands) | | | | | |
| Domestic | | | | | | |
| Commercial | \$ 675,263 | \$ 4,278 | \$ 16,535 | \$ 40,266 | \$ 32,768 | |
| Commercial real estate: other construction & land development | 1,038,749 | 55,079 | 2,614 | 22,567 | 28,660 | |
| Commercial real estate: farmland & commercial | 1,486,572 | 109,144 | 46,316 | 17,345 | 13,945 | |
| Commercial real estate: multifamily | 82,542 | | 53 | | 353 | |
| Residential: first lien | 446,218 | 519 | | 6,338 | 3,656 | |
| Residential: junior lien | 378,000 | 77 | 309 | 1,500 | 1,850 | |
| Consumer | 73,188 | | | | 1,326 | |
| Foreign | 188,499 | | 28 | | 447 | |
| Total | \$ 4,369,031 | \$ 169,097 | \$ 65,855 | \$ 88,016 | \$ 83,005 | |

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 September 30, 2013, 749,000 shares were available for future grants under the 2012 Plan.

A summary of option activity under the stock option plans for the nine months ended September 30, 2013 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, 2012 | 794,877 | \$ 19.03 | | |
| Plus: Options granted | 8,500 | 21.33 | | |
| Less: | | | | |
| Options exercised | 11,738 | 12.36 | | |
| Options expired | 22,343 | 23.50 | | |
| Options forfeited | 20,600 | 17.88 | | |
| Options outstanding at September 30, 2013 | 748,969 | 19.06 | 3.18 | \$ 3,386 |
| Options fully vested and exercisable at September 30, 2013 | 426,476 | 22.74 | 1.34 | 991 |

Stock-based compensation expense included in the consolidated statements of income for the three and nine months ended September 30, 2013 was approximately \$101,000 and \$322,000, respectively. Stock-based compensation expense included in the consolidated statements of income for the three and nine months ended September 30, 2012 was approximately \$113,000 and \$366,000, respectively. As of September 30, 2013, there was approximately \$900,000 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 1.85 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 September 30, 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 |

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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 | \$ 5,197,331 | \$ 70,436 | \$ (95,581) | \$ 5,172,186 | \$ 5,172,186 |
| Obligations of states and political subdivisions | 244,697 | 9,758 | (6,724) | 247,731 | 247,731 |
| Equity securities | 28,075 | 1,041 | (283) | 28,833 | 28,833 |
| Total investment securities | \$ 5,470,103 | \$ 81,235 | \$ (102,588) | \$ 5,448,750 | \$ 5,448,750 |

(1) Included in the carrying value of residential mortgage-backed securities are \$1,894,858 of mortgage-backed securities issued by Ginnie Mae, \$3,248,329 of mortgage-backed securities issued by Fannie Mae and Freddie Mac and \$28,999 issued by non-government entities

The amortized cost and estimated fair value by type of investment security at December 31, 2012 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 | \$ 5,186,652 | \$ 94,585 | \$ (16,033) | \$ 5,265,204 | \$ 5,265,204 |
| Obligations of states and political subdivisions | 216,962 | 23,504 | (1,791) | 238,675 | 238,675 |
| Equity securities | 19,575 | 1,581 | (20) | 21,136 | 21,136 |
| Total investment securities | \$ 5,423,189 | \$ 119,670 | \$ (17,844) | \$ 5,525,015 | \$ 5,525,015 |

(1) Included in the carrying value of residential mortgage-backed securities are \$2,035,742 of mortgage-backed securities issued by Ginnie Mae, \$3,196,602 of mortgage-backed securities issued by Fannie Mae and Freddie Mac and \$32,860 issued by non-government entities

The amortized cost and estimated fair value of investment securities at September 30, 2013, 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 | \$ 1,325 | \$ 1,325 | \$ | \$ |

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| | | | | |
|--|----------|----------|--------------|--------------|
| Due after one year through five years | 1,075 | 1,075 | | |
| Due after five years through ten years | | | 697 | 744 |
| Due after ten years | | | 244,000 | 246,987 |
| Residential mortgage-backed securities | | | 5,197,331 | 5,172,186 |
| Equity securities | | | 28,075 | 28,833 |
| Total investment securities | \$ 2,400 | \$ 2,400 | \$ 5,470,103 | \$ 5,448,750 |

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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 \$2,070,772,000 and \$2,106,076,000 at September 30, 2013.

Proceeds from the sale of securities available-for-sale were \$0 and \$178,124,000 for the three and nine months ended September 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 nine months ended September 30, 2013, respectively. Proceeds from the sale of securities available-for-sale were \$1,207,581,000 and \$1,279,963,000 for the three and nine months ended September 30, 2012, which included \$1,205,556,000 and \$1,237,071,000 of mortgage-backed securities. Gross gains of \$32,935,000 and \$35,528,000 and gross losses of \$0 and \$(1,000) were realized on the sales for the three and nine months ended September 30, 2012, 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 September 30, 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 | \$ 2,599,415 | \$ (84,205) | \$ 94,376 | \$ (11,376) | \$ 2,693,791 | \$ (95,581) |
| Obligations of states and political subdivisions | 51,800 | (2,859) | 12,044 | (3,865) | 63,844 | (6,724) |
| Other equity securities | 10,470 | (279) | 71 | (4) | 10,541 | (283) |
| | \$ 2,661,685 | \$ (87,343) | \$ 106,491 | \$ (15,245) | \$ 2,768,176 | \$ (102,588) |

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, 2012 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 | \$ 738,492 | \$ (5,476) | \$ 32,860 | \$ (10,557) | \$ 771,352 | \$ (16,033) |
| Obligations of states and political subdivisions | 5,117 | (114) | 10,437 | (1,677) | 15,554 | (1,791) |
| Equity securities | | | 56 | (20) | 56 | (20) |
| | \$ 743,609 | \$ (5,590) | \$ 43,353 | \$ (12,254) | \$ 786,962 | \$ (17,844) |

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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. Investments in 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 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 \$573,000 (\$372,000, after tax) and \$1,300,000 (\$845,000, after tax) were recorded for the three and nine months ended September 30, 2013. Impairment charges of \$239,000 (\$155,000, after tax) and \$647,000 (\$421,000, after tax) were recorded for the three and nine months ended September 30, 2012. 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 September 30, 2013 (Dollars in Thousands):

| | | |
|---|----|--------|
| Balance at June 30, 2013 | \$ | 11,159 |
| Impairment charges recognized during period | | 573 |
| Balance at September 30, 2013 | \$ | 11,732 |

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

| | | |
|---|----|--------|
| Balance at December 31, 2012 | \$ | 10,432 |
| Impairment charges recognized during period | | 1,300 |
| Balance at September 30, 2013 | \$ | 11,732 |

The following table presents a reconciliation of credit-related impairment charges on available-for-sale investment recognized in earnings for the three months ended September 30, 2012 (Dollars in Thousands):

| | | |
|--------------------------|----|-------|
| Balance at June 30, 2012 | \$ | 9,801 |
|--------------------------|----|-------|

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| | | |
|---|----|--------|
| Impairment charges recognized during period | | 239 |
| Balance at September 30, 2012 | \$ | 10,040 |

The following table presents a reconciliation of credit-related impairment charges on available-for-sale investment recognized in earnings for the nine months ended September 30, 2012 (Dollars in Thousands):

| | | |
|---|----|--------|
| Balance at December 31, 2011 | \$ | 9,393 |
| Impairment charges recognized during period | | 647 |
| Balance at September 30, 2012 | \$ | 10,040 |

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 September 30, 2013, other borrowed funds totaled \$1,289,493,000, an increase of 72.2% from \$749,027,000 at December 31, 2012. The increase in other borrowed funds is a result of purchases of available-for-sale securities.

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 September 30, 2013 and December 31, 2012, the principal amount of debentures outstanding totaled \$190,726,000.

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, VII, 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.

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 September 30, 2013 and December 31, 2012, the total \$190,726,000 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 September 30, 2013:

| | Junior Subordinated Deferrable Interest Debentures (In Thousands) | Repricing Frequency | Interest Rate | Interest Rate Index | Maturity Date | Optional Redemption Date(1) |
|------------|--|--------------------------------|----------------------|--------------------------------|----------------------|--|
| Trust VI | \$ 25,774 | Quarterly | 3.71% | LIBOR + 3.45 | November 2032 | February 2008 |
| Trust VII | 10,310 | Quarterly | 3.52% | LIBOR + 3.25 | April 2033 | April 2008 |
| Trust VIII | 25,774 | Quarterly | 3.32% | LIBOR + 3.05 | October 2033 | October 2008 |
| Trust IX | 41,238 | Quarterly | 1.89% | LIBOR + 1.62 | October 2036 | October 2011 |
| Trust X | 34,021 | Quarterly | 1.92% | LIBOR + 1.65 | February 2037 | February 2012 |
| Trust XI | 32,990 | Quarterly | 1.89% | LIBOR + 1.62 | July 2037 | July 2012 |
| Trust XII | 20,619 | Quarterly | 1.71% | LIBOR + 1.45 | September 2037 | September 2012 |
| | \$ 190,726 | | | | | |

(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 September 30, 2013, none of the Warrant had been exercised.

The Company paid cash dividends to the common shareholders of \$.20 per share on April 19, 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. Cash dividends of \$.20 per share were paid to common shareholders on April 20, and October 15, 2012 to all holders of record on April 2 and September 28, 2012, 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 February 28, 2013, 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, 2013, 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 November 1, 2013, a total of 7,843,293 shares had been repurchased under all programs at a cost of \$237,536,000.

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 11.53% and 10.86%, risk-weighted Tier 1 capital ratio of 19.37% and 19.65% and risk-weighted total capital ratio of 20.40% and 20.60% at September 30, 2013 and December 31, 2012, respectively. The identified intangibles and goodwill of \$286,900,000 as of September 30, 2013, 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 September 30, 2013, the total of \$190,726,000 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, 2012, included in the Company's 2012 Form 10-K. Operating results for the nine months ended September 30, 2013 are not necessarily indicative of the results for the year ending December 31, 2013, 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:

- Government intervention in the U.S. financial system, and the free enterprise system in general.
- 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.
- 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.
- Changes in the capital markets utilized by the Company and its subsidiaries, including changes in the interest rate environment that may reduce margins.

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- 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.
- 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.
- 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.

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- 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 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 and liquidity 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 216 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

| | September 30, 2013 | December 31, 2012 | Percent Increase (Decrease) |
|----------------------|------------------------|-------------------|--------------------------------|
| | (Dollars in Thousands) | | |
| Assets | \$ 12,076,658 | \$ 11,882,673 | 1.6% |
| Net loans | 4,984,332 | 4,716,811 | 5.7 |
| Deposits | 8,112,806 | 8,287,213 | (2.1) |
| Other borrowed funds | 1,289,493 | 749,027 | 72.2 |

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| | | | |
|--|-----------|-----------|--------|
| Junior subordinated deferrable interest debentures | 190,726 | 190,726 | |
| Shareholders' equity | 1,415,351 | 1,435,708 | (1.4)% |

Consolidated Statements of Income Information

| | Three Months Ended September 30, (Dollars in Thousands) | | | Percent Increase (Decrease) | Nine Months Ended September 30, (Dollars in Thousands) | | | Percent Increase (Decrease) |
|--|---|-----------|--------|-----------------------------------|--|--------|--|-----------------------------------|
| | 2013 | 2012 | | | 2013 | 2012 | | |
| Interest income | \$ 91,650 | \$ 93,775 | (2.3)% | \$ 265,084 | \$ 283,240 | (6.4)% | | |
| Interest expense | 13,007 | 17,420 | (25.3) | 41,185 | 58,125 | (29.1) | | |
| Net interest income | 78,643 | 76,355 | 3.0 | 223,899 | 225,115 | (.5) | | |
| Provision for probable loan losses | 5,800 | 5,349 | 8.4 | 17,561 | 16,741 | 4.9 | | |
| Non-interest income | 44,481 | 74,007 | (39.9) | 144,438 | 158,003 | (8.6) | | |
| Non-interest expense | 70,227 | 106,444 | (34.0) | 224,802 | 246,678 | (8.9) | | |
| Net income available to common shareholders | 31,826 | 22,033 | 44.4 | 87,408 | 71,572 | 22.1 | | |
| Per common share: | | | | | | | | |
| Basic | \$.47 | \$.33 | 42.4% | \$ 1.30 | \$ 1.06 | 22.6% | | |
| Diluted | .47 | .33 | 42.4 | 1.30 | 1.06 | 22.6 | | |

Net Income

Net income available to common shareholders for the three months ended September 30, 2013 increased by 44.4% and net income available to common shareholders for the nine months ended September 30, 2013 increased by 22.1% when compared to the same period in 2012. Net income for the nine months ended September 30, 2013 was positively affected by the repayment of the TARP funds in the fourth quarter of 2012 which eliminated the continued payment of dividends on the Senior Preferred Stock that had been held by the U.S. Treasury, as well as the sale of available-for-sale investment securities totaling \$6.2 million, net of tax. The securities sales were a result of the Company re-positioning a portion of the investment portfolio. Net income for the same period was negatively impacted by a charge of \$8.0 million, net of tax, as a result of the Company's lead bank subsidiary's early termination of a portion of its long-term repurchase agreements in order to help manage its long-term funding costs. Net income was also negatively impacted by narrowing interest margins caused by slow loan demand, although loan demand is slightly improving, and declining yields in the bond markets. Net income also continues to be negatively affected by the burden of increasing compliance costs arising from the Dodd-Frank Act and heightened regulatory oversight.

Net Interest Income

| | Three Months Ended September 30, (in Thousands) | | | Percent Increase (Decrease) | Nine Months Ended September 30, (in Thousands) | | | Percent Increase (Decrease) |
|---|---|-----------|--|-----------------------------------|--|------------|--|-----------------------------------|
| | 2013 | 2012 | | | 2013 | 2012 | | |
| Interest income: | | | | | | | | |
| Loans, including fees | \$ 66,482 | \$ 67,254 | | (1.1)% | \$ 194,633 | \$ 202,990 | | (4.1)% |
| Investment securities: | | | | | | | | |
| Taxable | 21,821 | 23,388 | | (6.7) | 60,941 | 71,128 | | (14.3) |
| Tax-exempt | 3,318 | 2,972 | | 11.6 | 9,439 | 8,682 | | 8.7 |
| Other interest income | 29 | 161 | | (82.0) | 71 | 440 | | (83.9) |
| Total interest income | 91,650 | 93,775 | | (2.3) | 265,084 | 283,240 | | (6.4) |
| Interest expense: | | | | | | | | |
| Savings deposits | 885 | 1,074 | | (17.6) | 2,852 | 4,176 | | (31.7) |
| Time deposits | 3,644 | 5,910 | | (38.3) | 12,067 | 18,650 | | (35.3) |
| Securities sold under repurchase agreements | 7,162 | 8,811 | | (18.7) | 22,042 | 29,380 | | (25.0) |
| Other borrowings | 454 | 195 | | 132.8 | 1,033 | 541 | | 90.9 |
| Junior subordinated interest deferrable debentures | 862 | 1,430 | | (39.7) | 3,191 | 5,378 | | (40.7) |
| Total interest expense | 13,007 | 17,420 | | (25.3) | 41,185 | 58,125 | | (29.1) |
| Net interest income | \$ 78,643 | \$ 76,355 | | 3.0% | \$ 223,899 | \$ 225,115 | | (.5)% |

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. 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 41 for the September 30, 2013 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 September 30, (in Thousands) | | | Percent Increase (Decrease) | Nine Months Ended September 30, (in Thousands) | | | Percent Increase (Decrease) |
|---|---|------------------|----------------|-----------------------------------|--|---------------|--|-----------------------------------|
| | 2013 | 2012 | | | 2013 | 2012 | | |
| Service charges on deposit accounts | \$ 25,026 | \$ 23,748 | 5.4% | \$ 72,363 | \$ 69,601 | 4.0% | | |
| Other service charges, commissions and fees | | | | | | | | |
| Banking | 11,327 | 9,492 | 19.3 | 31,362 | 28,980 | 8.2 | | |
| Non-banking | 2,092 | 2,038 | 2.6 | 4,668 | 4,971 | (6.1) | | |
| Investment securities transactions, net | | 32,935 | (100.0) | 9,601 | 35,527 | (73.0) | | |
| Other investments, net | 3,871 | 3,650 | 6.1 | 19,503 | 11,431 | 70.6 | | |
| Other income | 2,165 | 2,144 | 1.0 | 6,941 | 7,493 | (7.4) | | |
| Total non-interest income | \$ 44,481 | \$ 74,007 | (39.9)% | \$ 144,438 | \$ 158,003 | (8.6)% | | |

Total non-interest income decreased 8.6% for the nine months ended September 30, 2013 from the same period of 2012. Investment securities transactions increased for the nine months ended September 30, 2013 primarily due to the sale of residential mortgage-backed securities as a result of the Company re-positioning of a portion of its investment portfolio. Other investments income for the nine months ended September 30, 2013 was positively impacted due to the sale of assets in a partnership where the holding company held an equity position resulting in income of \$5.5 million.

Non-Interest Expense

| | Three Months Ended September 30, (in Thousands) | | | Percent Increase (Decrease) | Nine Months Ended September 30, (in Thousands) | | | Percent Increase (Decrease) |
|---|---|-----------|--------|-----------------------------------|--|--------|--|-----------------------------------|
| | 2013 | 2012 | | | 2013 | 2012 | | |
| Employee compensation and benefits | \$ 30,627 | \$ 30,541 | .3% | \$ 91,602 | \$ 90,152 | 1.6% | | |
| Occupancy | 7,604 | 8,032 | (5.3) | 22,596 | 24,873 | (9.2) | | |
| Depreciation of bank premises and equipment | 6,433 | 6,618 | (2.8) | 19,677 | 20,335 | (3.2) | | |
| Professional fees | 3,669 | 4,279 | (14.3) | 11,344 | 11,820 | (4.0) | | |
| Deposit insurance assessments | 1,683 | 2,289 | (26.5) | 5,061 | 5,346 | (5.3) | | |
| Net expense, other real estate owned | 1,360 | 3,065 | (55.6) | 4,724 | 5,631 | (16.1) | | |
| Amortization of identified intangible assets | 1,156 | 1,163 | (0.6) | 3,451 | 3,463 | (.3) | | |
| Advertising | 1,795 | 1,713 | 4.8 | 5,664 | 5,510 | 2.8 | | |
| Early termination fee securities sold under repurchase agreements | | 31,550 | (100) | 12,303 | 31,550 | (61.0) | | |
| Impairment charges (Total other-than- temporary | 573 | 239 | 139.7 | 1,300 | 647 | 100.9 | | |

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impairment losses, \$(13), net
of \$(560), \$(402), net of
\$(641), \$(27), net of
\$(1,273) and \$947, net of
\$300 included in other
comprehensive income)

| | | | | | | |
|----------------------------|-----------|------------|---------|------------|------------|--------|
| Other | 15,327 | 16,955 | (9.6) | 47,080 | 47,351 | (.6) |
| Total non-interest expense | \$ 70,227 | \$ 106,444 | (34.0)% | \$ 224,802 | \$ 246,678 | (8.9)% |

Non-interest expense decreased 34.0% for the three months ended September 30, 2013 and 8.9% for the nine months ended September 30, 2013 compared to the same periods of 2012. Non-interest expense for the nine months ended September 30, 2013 was negatively impacted by a charge of \$12.3 million recorded by the Company's lead bank subsidiary. 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 16.6% to \$67,829,000 at September 30, 2013 from \$58,193,000 at December 31, 2012. The change is primarily driven by the addition of a specific reserve of approximately \$10,000,000 on a previously identified impaired commercial loan that further deteriorated during the nine months ended September 30, 2013, offset by a decrease in the general reserve due to the stability of general economic factors used in the calculation. The provision for probable loan losses charged to expense increased 4.9% to \$17,561,000 for the nine months ended September 30, 2013 from \$16,741,000 for the same period in 2012. The allowance for probable loan losses was 1.3% and 1.2% of total loans at September 30, 2013 and December 31, 2012, respectively.

Investment Securities

Mortgage-backed securities are securities primarily issued by the Federal Home Loan Mortgage Corporation (Freddie Mac), Federal National Mortgage Association (Fannie Mae), and the Government National Mortgage Association (Ginnie Mae). Investments in residential mortgage-backed securities issued by Ginnie Mae are fully guaranteed by the U.S. Government. Investments in residential 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.

Loans

Net loans increased 5.7% to \$4,984,332,000 at September 30, 2013, from \$4,716,811,000 at December 31, 2012. The increase in loans can be attributed to improved opportunities for loan growth.

Deposits

Deposits decreased by 2.1% to \$8,112,806,000 at September 30, 2013, from \$8,287,213,000 at December 31, 2012. The Company is still experiencing a substantial amount of competition for deposits at higher than market rates. As a result, the Company has attempted to maintain certain deposit relationships but has allowed certain deposits to leave as the result of aggressive pricing.

Other Borrowed Funds

Other borrowed funds increased by 72.2% to \$1,289,493,000 at September 30, 2013, from \$749,027,000 at December 31, 2012. The increase in other borrowed funds is a result of purchases of available-for-sale securities.

Foreign Operations

On September 30, 2013, the Company had \$12,076,658,000 of consolidated assets, of which approximately \$187,049,000, or 1.6%, was related to loans outstanding to borrowers domiciled in foreign countries, compared to \$188,974,000, or 1.6%, at December 31, 2012. Of the \$187,049,000, 91.1 % is directly or indirectly secured by U.S. assets, certificates of deposits and real estate; 8.4% is secured by foreign real estate; and .5% is unsecured.

Critical Accounting Policies

The Company has established various accounting policies which govern the application of accounting principles in the preparation of the Company's consolidated financial statements. The significant accounting policies are described in the notes to the consolidated financial statements. Certain accounting policies involve significant subjective judgments and assumptions by management which have a material impact on the carrying value of certain assets and liabilities; management considers such accounting policies to be critical accounting policies.

The Company considers its Allowance for Probable Loan Losses as a policy critical to the sound operations of the bank subsidiaries. The allowance for probable loan losses 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 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. See also discussion regarding the allowance for probable loan losses and provision for probable loan losses included in the results of operations and Provision and Allowance for Probable Loan Losses included in Notes 1 and 4 of the notes to Consolidated Financial Statements in the Company's latest Annual Report on Form 10-K for further information regarding the Company's provision and allowance for probable loan losses policy.

Liquidity and Capital Resources

The maintenance of adequate liquidity provides the Company's bank subsidiaries with the ability to meet potential depositor withdrawals, provide for customer credit needs, maintain adequate statutory reserve levels and take full advantage of high-yield investment opportunities as they arise. Liquidity is afforded by access to financial markets and by holding appropriate amounts of liquid assets. The Company's bank subsidiaries derive their liquidity largely from deposits of individuals and business entities. Deposits from persons and entities domiciled in Mexico comprise a stable portion of the deposit base of the Company's bank subsidiaries. Other important funding sources for the Company's bank subsidiaries during 2013 and 2012 were borrowings from FHLB, securities sold under repurchase agreements and large certificates of deposit, requiring management to closely monitor its asset/liability mix in terms of both rate sensitivity and maturity distribution. Primary liquidity of the Company and its subsidiaries has been maintained by means of increased investment in shorter-term securities, certificates of deposit and repurchase agreements. As in the past, the Company will continue to monitor the volatility and cost of funds in an attempt to match maturities of rate-sensitive assets and liabilities and respond accordingly to anticipated fluctuations in interest rates over reasonable periods of time.

The Company maintains an adequate level of capital as a margin of safety for its depositors and shareholders. At September 30, 2013, shareholders' equity was \$1,415,351,000 compared to \$1,435,708,000 at December 31, 2012, a decrease of \$20,358,000, or 1.4%. The decrease is primarily due to an increase in other comprehensive loss and the payment of cash dividends to shareholders, offset by the retention of earnings.

The Company had a leverage ratio of 11.53% and 10.86%, risk-weighted Tier 1 capital ratio of 19.37% and 19.65% and risk-weighted total capital ratio of 20.40% and 20.60% at September 30, 2013 and December 31, 2012, respectively. The identified intangibles and goodwill of \$286,900,000 as of September 30, 2013, recorded in connection with the Company's acquisitions, are deducted from the sum of core capital elements when determining the capital ratios of the Company.

As in the past, the Company will continue to monitor the volatility and cost of funds in an attempt to match maturities of rate-sensitive assets and liabilities, and respond accordingly to anticipate fluctuations in interest rates by adjusting the balance between sources and uses of funds as deemed appropriate. The net-interest rate sensitivity as of September 30, 2013 is illustrated in the table entitled Interest Rate Sensitivity. This information reflects the balances of assets and liabilities for which rates are subject to change. A mix of assets and liabilities that are roughly equal in volume and re-pricing characteristics represents a matched interest rate sensitivity position. Any excess of assets or liabilities results in an interest rate sensitivity gap.

The Company undertakes an interest rate sensitivity analysis to monitor the potential risk on future earnings resulting from the impact of possible future changes in interest rates on currently existing net asset or net liability positions. However, this type of analysis is as of a point-in-time position, when in fact that position can quickly change as market

conditions, customer needs, and management strategies change. Thus, interest rate changes do not affect all categories of asset and liabilities equally or at the same time. As indicated in the table, the Company is liability sensitive during the early time periods and asset sensitive in the longer periods. The Company's Asset and Liability Committee semi-annually reviews the consolidated position along with simulation and duration models, and makes adjustments as needed to control the Company's interest rate risk position. The Company uses modeling of future events as a primary tool for monitoring interest rate risk.

Interest Rate Sensitivity

(Dollars in Thousands)

| September 30, 2013 | 3 Months or Less | Over 3 Months to 1 Year | Rate/Maturity Over 1 Year to 5 Years | Over 5 Years | Total |
|--|---------------------|----------------------------|---|----------------------|----------------------|
| Rate sensitive assets | | | | | |
| Investment securities | \$ 415,509 | \$ 1,484,748 | \$ 3,303,162 | \$ 247,731 | \$ 5,451,150 |
| Loans, net of non-accruals | 3,797,996 | 226,747 | 261,371 | 679,595 | 4,965,709 |
| Total earning assets | \$ 4,213,505 | \$ 1,711,495 | \$ 3,564,533 | \$ 927,326 | \$ 10,416,859 |
| Cumulative earning assets | \$ 4,213,505 | \$ 5,925,000 | \$ 9,489,533 | \$ 10,416,859 | |
| Rate sensitive liabilities | | | | | |
| Time deposits | \$ 1,133,718 | \$ 1,266,363 | \$ 301,915 | \$ 56 | \$ 2,702,052 |
| Other interest bearing deposits | 2,759,122 | | | | 2,759,122 |
| Securities sold under repurchase agreements | 358,856 | 31,265 | 611,016 | | 1,001,137 |
| Other borrowed funds | 1,280,500 | | | 8,993 | 1,289,493 |
| Junior subordinated deferrable interest debentures | 190,726 | | | | 190,726 |
| Total interest bearing liabilities | \$ 5,722,922 | \$ 1,297,628 | \$ 912,931 | \$ 9,049 | \$ 7,942,530 |
| Cumulative sensitive liabilities | \$ 5,722,922 | \$ 7,020,550 | \$ 7,933,481 | \$ 7,942,530 | |
| Repricing gap | \$ (1,509,417) | \$ 413,867 | \$ 2,651,602 | \$ 918,277 | \$ 2,474,329 |
| Cumulative repricing gap | (1,509,417) | (1,095,550) | 1,556,052 | 2,474,329 | |
| Ratio of interest-sensitive assets to liabilities | .74 | 1.32 | 3.90 | 102.48 | 1.31 |
| Ratio of cumulative, interest- sensitive assets to liabilities | .74 | .84 | 1.20 | 1.31 | |

Item 3. Quantitative and Qualitative Disclosures about Market Risk

During the first nine months of 2013, there were no material changes in market risk exposures that affected the quantitative and qualitative disclosures regarding market risk presented under the caption "Liquidity and Capital Resources" located on pages 18 through 24 of the Company's 2012 Annual Report as filed as an exhibit to the Company's Form 10-K for the year ended December 31, 2012.

Item 4. Controls and Procedures

Disclosure Controls and Procedures

The Company maintains disclosure controls and procedures designed to ensure that information required to be disclosed in reports filed under the Securities Exchange Act of 1934, as amended, is recorded, processed, summarized and reported within specified time periods. As of the end of the period covered by this Quarterly Report on Form 10-Q, the Company's principal executive officer and principal financial officer evaluated, with the participation of the Company's management, the effectiveness of the Company's disclosure controls and procedures (as defined in Exchange Act rules 13a-15(e) and 15d-15(e)). Based on the evaluation, which disclosed no material weaknesses, the Company's principal executive officer and principal financial officer concluded that the Company's disclosure controls and procedures were effective as of the end of the period covered by this report.

Internal Control Over Financial Reporting

There were no changes in the Company's internal control over financial reporting that occurred during the Company's most recent fiscal quarter that have materially affected or are reasonably likely to materially affect the Company's internal control over financial reporting.

PART II - OTHER INFORMATION

Item 1. Legal Proceedings

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 or results of operations 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.

1A. Risk Factors

There were no material changes in the risk factors as previously disclosed in Item 1A to Part I of the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2012.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

From time to time, the Company's Board of Directors has authorized stock repurchase plans. In April 2009, the Board of Directors 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 February 28, 2013, 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, 2013, 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. During the second quarter, the Company's Board of Directors adopted a Rule 10b5-1 plan and intends to adopt additional Rule 10b5-1 trading plans that will allow the Company to purchase its shares of common stock during certain trading blackout periods when the Company ordinarily would not be in the market due to trading restrictions in its internal trading policy. Shares repurchased in this program will be held in treasury for reissue for various corporate purposes, including employee stock option plans. As of November 1, 2013, a total of 7,843,293 shares had been repurchased under all repurchase programs at a cost of \$237,536,000. The Company is not obligated to repurchase shares under its stock purchase program or to enter into additional Rule 10b5-1 plans; however, during the term of a 10b5-1 Plan, purchases of common stock are automatic to the extent the conditions of the 10b5-1 Plan's trading instructions are met. The timing, actual number and value of shares purchased will depend on many factors, including the Company's cash flow and the liquidity and price performance of its shares of common stock.

Except for repurchases in connection with the administration of an employee benefit plan in the ordinary course of business and consistent with past practices, common stock repurchases are only conducted under publicly announced repurchase programs approved by the Board of Directors. The following table includes information about common stock share repurchases for the quarter ended September 30, 2013.

| | Total Number of Shares Purchased | Average Price Paid Per Share | Shares Purchased as Part of a Publicly- Announced Program | Approximate Dollar Value of Shares Available for Repurchase (1) |
|--------------------------------|---|---|--|--|
| July 1 July 31, 2013 | | | | \$ 40,000,000 |
| August 1 August 31, 2013 | | | | 40,000,000 |
| September 1 September 30, 2013 | | | | 40,000,000 |

(1) The repurchase program was extended on February 28, 2013 and allows for the repurchase of up to an additional \$40,000,000 of treasury stock through April 9, 2014.

Item 6. Exhibits

The following exhibits are filed as a part of this Report:

31(a) Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

31(b) Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

32(a) Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

32(b) Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

101++ Interactive Data File

++ Attached as Exhibit 101 to this report are the following documents formatted in XBRL (Extensible Business Reporting Language): (i) the Condensed Consolidated Statement of Earnings for the three and nine months ended September 30, 2013 and 2012, (ii) the Condensed Consolidated Balance Sheet as of September 30, 2013 and December 31, 2012, and (iii) the Condensed Consolidated Statement of Cash Flows for the nine months ended September 30, 2013 and 2012. Users of this data are advised pursuant to Rule 406T of Regulation S-T that this interactive data file is deemed not filed or part of a registration statement or prospectus for purposes of sections 11 or 12 of the Securities Act of 1933, is deemed not filed for purposes of section 18 of the Securities and Exchange Act of 1934, and otherwise is not subject to liability under these sections.

SIGNATURES

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

INTERNATIONAL BANCSHARES CORPORATION

Date: November 6, 2013

/s/ Dennis E. Nixon
Dennis E. Nixon
President

Date: November 6, 2013

/s/ Imelda Navarro
Imelda Navarro
Treasurer