CULLEN/FROST BANKERS, INC.
Form 10-Q
July 24, 2013
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United States

Securities and Exchange Commission

Washington, D.C. 20549

Form 10-Q

x **Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**
For the quarterly period ended: June 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: 001-13221

Cullen/Frost Bankers, Inc.

(Exact name of registrant as specified in its charter)

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

(210) 220-4011

(Registrant s telephone number, including area code)

N/A

(Former name, former address and former fiscal year, if changed since last report)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No ¨

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

Large accelerated filer x	Accelerated filer ¨
Non-accelerated filer ¨ (Do not check if a smaller reporting company)	Smaller reporting company ¨

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

As of July 12, 2013, there were 60,393,761 shares of the registrant s Common Stock, $.01 par value, outstanding.

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Cullen/Frost Bankers, Inc.

Quarterly Report on Form 10-Q

June 30, 2013

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Part I. Financial Information

Item 1. Financial Statements (Unaudited)

Cullen/Frost Bankers, Inc.

Consolidated Balance Sheets

(Dollars in thousands, except per share amounts)

	June 30, 2013	December 31, 2012
Assets:		
Cash and due from banks	$ 595,733	$ 790,106
Interest-bearing deposits	2,296,349	2,650,425
Federal funds sold and resell agreements	9,273	84,448
Total cash and cash equivalents	2,901,355	3,524,979
Securities held to maturity, at amortized cost	3,166,692	2,956,381
Securities available for sale, at estimated fair value	6,033,370	6,203,299
Trading account securities	16,777	30,074
Loans, net of unearned discounts	9,232,543	9,223,848
Less: Allowance for loan losses	(93,400)	(104,453)
Net loans	9,139,143	9,119,395
Premises and equipment, net	306,069	315,934
Goodwill	535,509	535,509
Other intangible assets, net	6,539	8,147
Cash surrender value of life insurance policies	139,704	138,005
Accrued interest receivable and other assets	326,356	292,346
Total assets	$ 22,571,514	$ 23,124,069
Liabilities:		
Deposits:		
Non-interest-bearing demand deposits	$ 7,744,676	$ 8,096,937
Interest-bearing deposits	11,333,543	11,400,429
Total deposits	19,078,219	19,497,366
Federal funds purchased and repurchase agreements	549,823	561,061
Junior subordinated deferrable interest debentures	123,712	123,712
Other long-term borrowings	100,000	100,007
Accrued interest payable and other liabilities	291,922	424,441
Total liabilities	20,143,676	20,706,587
Shareholders Equity:		
Preferred stock, par value $0.01 per share; 10,000,000 shares authorized; 6,000,000 Series A shares ($25 liquidation preference) issued at June 30, 2013, none issued at December 31, 2012	144,486	
Common stock, par value $0.01 per share; 210,000,000 shares authorized; 60,236,336 shares issued at June 30, 2013 and 61,479,189 shares issued at December 31, 2012	616	615
Additional paid-in capital	686,920	702,968
Retained earnings	1,524,638	1,475,851
Accumulated other comprehensive income, net of tax	155,602	238,048
Treasury stock, 1,396,128 shares at June 30, 2013, at cost	(84,424)	

Total shareholders equity	2,427,838	2,417,482
Total liabilities and shareholders equity	$ 22,571,514	$ 23,124,069

See Notes to Consolidated Financial Statements.

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Cullen/Frost Bankers, Inc.

Consolidated Statements of Income

(Dollars in thousands, except per share amounts)

	Three Months Ended June 30, 2013	Three Months Ended June 30, 2012	Six Months Ended June 30, 2013	Six Months Ended June 30, 2012
Interest income:				
Loans, including fees	$ 103,316	$ 98,336	$ 205,372	$ 195,687
Securities:				
Taxable	25,485	34,399	52,862	70,465
Tax-exempt	28,690	22,125	56,644	44,628
Interest-bearing deposits	1,498	903	2,851	1,833
Federal funds sold and resell agreements	29	33	51	48
Total interest income	159,018	155,796	317,780	312,661
Interest expense:				
Deposits	3,882	4,547	7,890	9,119
Federal funds purchased and repurchase agreements	29	34	59	68
Junior subordinated deferrable interest debentures	1,690	1,711	3,363	3,385
Other long-term borrowings	236	287	474	1,165
Total interest expense	5,837	6,579	11,786	13,737
Net interest income	153,181	149,217	305,994	298,924
Provision for loan losses	3,575	2,355	9,575	3,455
Net interest income after provision for loan losses	149,606	146,862	296,419	295,469
Non-interest income:				
Trust and investment management fees	22,561	21,279	44,446	41,931
Service charges on deposit accounts	20,044	20,639	40,088	41,433
Insurance commissions and fees	9,266	9,171	22,336	21,548
Interchange and debit card transaction fees	4,268	4,292	8,279	8,409
Other charges, commissions and fees	8,578	7,825	16,333	15,175
Net gain (loss) on securities transactions	6	370	11	(121)
Other	7,786	6,187	18,796	13,367
Total non-interest income	72,509	69,763	150,289	141,742
Non-interest expense:				
Salaries and wages	66,502	62,624	132,967	126,326
Employee benefits	14,629	14,048	32,620	30,749
Net occupancy	12,645	12,213	24,624	24,010
Furniture and equipment	14,986	13,734	29,171	27,154
Deposit insurance	2,835	2,838	5,724	5,335
Intangible amortization	788	994	1,608	2,005
Other	37,373	36,085	78,858	68,997
Total non-interest expense	149,758	142,536	305,572	284,576
Income before income taxes	72,357	74,089	141,136	152,635

Income taxes	12,694	16,027	26,285	33,540
Net income	59,663	58,062	114,851	119,095
Preferred stock dividends	2,688		2,688	
Net income available to common shareholders	$ 56,975	$ 58,062	$ 112,163	$ 119,095
Earnings per common share:				
Basic	$ 0.95	$ 0.94	$ 1.86	$ 1.94
Diluted	0.94	0.94	1.85	1.93

See Notes to Consolidated Financial Statements.

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Cullen/Frost Bankers, Inc.

Consolidated Statements of Comprehensive Income

(Dollars in thousands)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	**2012**	**2013**	**2012**
Net income	$ 59,663	$ 58,062	$ 114,851	$ 119,095
Other comprehensive income (loss), before tax:				
Securities available for sale and transferred securities:				
Change in net unrealized gain/loss during the period	(74,025)	20,968	(95,369)	22,850
Change in net unrealized gain on securities transferred to held to maturity	(9,745)		(18,204)	
Reclassification adjustment for net (gains) losses included in net income	(6)	(370)	(11)	121
Total securities available for sale and transferred securities	(83,776)	20,598	(113,584)	22,971
Defined-benefit post-retirement benefit plans:				
Change in the net actuarial gain/loss	1,639	1,428	3,279	2,657
Derivatives:				
Change in the accumulated gain/loss on effective cash flow hedge derivatives	(33)	(64)	(33)	(491)
Reclassification adjustments for (gains) losses included in net income:				
Interest rate swaps on variable-rate loans	(9,345)	(9,345)	(18,690)	(18,690)
Interest rate swap on junior subordinated deferrable interest debentures	1,103	1,044	2,188	2,077
Total derivatives	(8,275)	(8,365)	(16,535)	(17,104)
Other comprehensive income (loss), before tax	(90,412)	13,661	(126,840)	8,524
Deferred tax expense (benefit) related to other comprehensive income	(31,644)	4,782	(44,394)	2,983
Other comprehensive income (loss), net of tax	(58,768)	8,879	(82,446)	5,541
Comprehensive income	$ 895	$ 66,941	$ 32,405	$ 124,636

See Notes to Consolidated Financial Statements.

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Cullen/Frost Bankers, Inc.

Consolidated Statements of Changes in Shareholders Equity

(Dollars in thousands, except per share amounts)

	Six Months Ended June 30,	
	2013	**2012**
Total shareholders equity at beginning of period	$ 2,417,482	$ 2,283,537
Net income	114,851	119,095
Other comprehensive income (loss)	(82,446)	5,541
Stock option exercises (662,224 shares in 2013 and 140,311 shares in 2012)	34,189	7,211
Stock compensation expense recognized in earnings	4,985	5,398
Tax benefits (deficiencies) related to stock compensation	(73)	(414)
Issuance of preferred stock (6,000,000 shares in 2013)	144,486	
Purchase of treasury stock (1,905,077 shares in 2013)	(115,200)	
Accelerated share repurchase forward contract	(28,800)	
Cash dividends preferred stock (approximately $0.45 per share in 2013)	(2,688)	
Cash dividends common stock ($0.98 per share in 2013 and $0.94 per share in 2012)	(58,948)	(57,757)
Total shareholders equity at end of period	$ 2,427,838	$ 2,362,611

See Notes to Consolidated Financial Statements.

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Cullen/Frost Bankers, Inc.

Consolidated Statements of Cash Flows

(Dollars in thousands)

	Six Months Ended June 30, 2013	Six Months Ended June 30, 2012
Operating Activities:		
Net income	$ 114,851	$ 119,095
Adjustments to reconcile net income to net cash from operating activities:		
Provision for loan losses	9,575	3,455
Deferred tax expense (benefit)	(1,739)	(3,977)
Accretion of loan discounts	(5,790)	(5,663)
Securities premium amortization (discount accretion), net	18,124	9,222
Net (gain) loss on securities transactions	(11)	121
Depreciation and amortization	19,081	18,942
Net loss on sale/write-down of assets/foreclosed assets	3,023	2,598
Stock-based compensation	4,985	5,398
Net tax benefit (deficiency) from stock-based compensation	(448)	(490)
Excess tax benefits from stock-based compensation	(375)	(76)
Earnings on life insurance policies	(1,699)	(2,074)
Net change in:		
Trading account securities	13,297	(2,954)
Accrued interest receivable and other assets	(42,461)	23,261
Accrued interest payable and other liabilities	(163,670)	597
Net cash from operating activities	(33,257)	167,455
Investing Activities:		
Securities held to maturity:		
Purchases	(221,107)	
Maturities, calls and principal repayments	9,723	489
Securities available for sale:		
Purchases	(8,910,706)	(17,060,846)
Sales	8,495,587	15,987,480
Maturities, calls and principal repayments	517,698	401,078
Net change in loans	(26,446)	(501,622)
Net cash paid in acquisitions		(7,199)
Proceeds from sales of premises and equipment	16,301	3,613
Purchases of premises and equipment	(18,520)	(16,032)
Proceeds from sales of repossessed properties	4,081	9,530
Net cash from investing activities	(133,389)	(1,183,509)
Financing Activities:		
Net change in deposits	(419,147)	520,369
Net change in short-term borrowings	(11,238)	(66,177)
Principal payments on long-term borrowings	(7)	(9)
Proceeds from stock option exercises	34,189	7,211
Excess tax benefits from stock-based compensation	375	76
Proceeds from issuance of preferred stock	144,486	
Purchase of treasury stock	(115,200)	
Accelerated stock repurchase agreement	(28,800)	
Cash dividends paid on preferred stock	(2,688)	

Cash dividends paid on common stock	(58,948)	(57,757)
Net cash from financing activities	(456,978)	403,713
Net change in cash and cash equivalents	(623,624)	(612,341)
Cash and equivalents at beginning of period	3,524,979	2,907,592
Cash and equivalents at end of period	$ 2,901,355	$ 2,295,251

See Notes to Consolidated Financial Statements.

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Cullen/Frost Bankers, Inc.

Notes to Consolidated Financial Statements

(Table amounts in thousands, except for share and per share amounts)

Note 1 - Significant Accounting Policies

Nature of Operations. Cullen/Frost Bankers, Inc. (Cullen/Frost) is a financial holding company and a bank holding company headquartered in San Antonio, Texas that provides, through its subsidiaries, a broad array of products and services throughout numerous Texas markets. In addition to general commercial and consumer banking, other products and services offered include trust and investment management, investment banking, insurance, brokerage, leasing, asset-based lending, treasury management and item processing.

Basis of Presentation. The consolidated financial statements in this Quarterly Report on Form 10-Q include the accounts of Cullen/Frost and all other entities in which Cullen/Frost has a controlling financial interest (collectively referred to as the Corporation). All significant intercompany balances and transactions have been eliminated in consolidation. The accounting and financial reporting policies the Corporation follows conform, in all material respects, to accounting principles generally accepted in the United States and to general practices within the financial services industry.

The consolidated financial statements in this Quarterly Report on Form 10-Q have not been audited by an independent registered public accounting firm, but in the opinion of management, reflect all adjustments necessary for a fair presentation of the Corporation s financial position and results of operations. All such adjustments were of a normal and recurring nature. The consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and with the instructions to Form 10-Q adopted by the Securities and Exchange Commission (SEC). Accordingly, the financial statements do not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements and should be read in conjunction with the Corporation s consolidated financial statements, and notes thereto, for the year ended December 31, 2012, included in the Corporation s Annual Report on Form 10-K filed with the SEC on February 8, 2013 (the 2012 Form 10-K). Operating results for the interim periods disclosed herein are not necessarily indicative of the results that may be expected for a full year or any future period.

Use of Estimates. The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements. Actual results could differ from those estimates. The allowance for loan losses, the fair value of stock-based compensation awards, the fair values of financial instruments and the status of contingencies are particularly subject to change.

Cash Flow Reporting. Additional cash flow information was as follows:

	Six Months Ended June 30,	
	2013	**2012**
Cash paid for interest	$ 12,039	$ 16,007
Cash paid for income tax	32,623	27,894
Significant non-cash transactions:		
Loans foreclosed and transferred to other real estate owned and foreclosed assets	2,913	4,697
Deferred gain on sale of building and parking garage	1,120	

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Note 2 - Securities

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

	June 30, 2013				December 31, 2012			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Held to Maturity								
U. S. Treasury	$ 248,386	$ 22,629	$	$ 271,015	$ 248,188	$ 29,859	$	$ 278,047
Residential mortgage-backed securities	10,262	118	109	10,271	10,725	300		11,025
States and political subdivisions	2,907,044	8,864	127,843	2,788,065	2,696,468	15,397	4,993	2,706,872
Other	1,000		2	998	1,000			1,000
Total	$ 3,166,692	$ 31,611	$ 127,954	$ 3,070,349	$ 2,956,381	$ 45,556	$ 4,993	$ 2,996,944
Available for Sale:								
U. S. Treasury	$ 3,021,080	$ 21,643	$	$ 3,042,723	$ 3,020,115	$ 37,806	$	$ 3,057,921
Residential mortgage-backed securities	1,995,296	81,366	1,089	2,075,573	2,382,514	135,514	25	2,518,003
States and political subdivisions	863,754	21,526	6,105	879,175	552,056	39,427		591,483
Other	35,899			35,899	35,892			35,892
Total	$ 5,916,029	$ 124,535	$ 7,194	$ 6,033,370	$ 5,990,577	$ 212,747	$ 25	$ 6,203,299

All mortgage-backed securities included in the above table were issued by U.S. government agencies and corporations. At June 30, 2013, approximately 95.9% of the securities in the Corporation s municipal bond portfolio were issued by political subdivisions or agencies within the State of Texas, of which approximately 76.2% are either guaranteed by the Texas Permanent School Fund, which has a triple A insurer financial strength, or secured by U.S. Treasury securities via defeasance of the debt by the issuers. Securities with limited marketability, such as stock in the Federal Reserve Bank and the Federal Home Loan Bank, are carried at cost and are reported as other available for sale securities in the above table. The carrying value of securities pledged to secure public funds, trust deposits, repurchase agreements and for other purposes, as required or permitted by law was $2.3 billion at June 30, 2013 and $2.7 billion and December 31, 2012.

During the fourth quarter of 2012, the Corporation reclassified certain securities from available for sale to held to maturity. The securities had an aggregate fair value of $2.3 billion with an aggregate net unrealized gain of $165.7 million ($107.7 million, net of tax) on the date of the transfer. The net unamortized, unrealized gain on the transferred securities included in accumulated other comprehensive income in the accompanying balance sheet as of June 30, 2013 totaled $146.8 million ($95.4 million, net of tax). This amount will be amortized out of accumulated other comprehensive income over the remaining life of the underlying securities as an adjustment of the yield on those securities.

As of June 30, 2013, securities, with unrealized losses segregated by length of impairment, were as follows:

	Less than 12 Months		More than 12 Months		Total	
	Estimated Fair Value	Unrealized Losses	Estimated Fair Value	Unrealized Losses	Estimated Fair Value	Unrealized Losses
Held to Maturity						
Residential mortgage-backed securities	$ 7,270	$ 109	$	$	$ 7,270	$ 109
States and political subdivisions	2,424,783	127,843			2,424,783	127,843
Other	998	2			998	2

Total	$ 2,433,051	$ 127,954	$	$	$ 2,433,051	$ 127,954
Available for Sale						
Residential mortgage-backed securities	$ 87,714	$ 1,089	$	$	$ 87,714	$ 1,089
States and political subdivisions	338,904	6,105			338,904	6,105
Total	$ 426,618	$ 7,194	$	$	$ 426,618	$ 7,194

Declines in the fair value of held-to-maturity and available-for-sale securities below their cost that are deemed to be other than temporary are reflected in earnings as realized losses to the extent the impairment is related to credit losses. The amount of the impairment related to other factors is recognized in other comprehensive income. In estimating other-than-temporary impairment losses, management considers, among other things, (i) the length of time and the extent to which the fair value has been less than cost, (ii) the financial condition and near-term prospects of the issuer, and (iii) the intent and ability of the Corporation to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in cost.

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Management has the ability and intent to hold the securities classified as held to maturity in the table above until they mature, at which time the Corporation will receive full value for the securities. Furthermore, as of June 30, 2013, management does not have the intent to sell any of the securities classified as available for sale in the table above and believes that it is more likely than not that the Corporation will not have to sell any such securities before a recovery of cost. Any unrealized losses are largely due to increases in market interest rates over the yields available at the time the underlying securities were purchased. The fair value is expected to recover as the bonds approach their maturity date or repricing date or if market yields for such investments decline. Management does not believe any of the securities are impaired due to reasons of credit quality. Accordingly, as of June 30, 2013, management believes the impairments detailed in the table above are temporary and no impairment loss has been realized in the Corporation s consolidated income statement.

The amortized cost and estimated fair value of securities, excluding trading securities, at June 30, 2013 are presented below by contractual maturity. Expected maturities may differ from contractual maturities because issuers may have the right to call or prepay obligations. Residential mortgage-backed securities and equity securities are shown separately since they are not due at a single maturity date.

	Held to Maturity		Available for Sale	
	Amortized Cost	Estimated Fair Value	Amortized Cost	Estimated Fair Value
Due in one year or less	$ 24,390	$ 24,863	$ 1,512,694	$ 1,514,523
Due after one year through five years	362,850	389,897	1,577,682	1,600,263
Due after five years through ten years	171,543	167,849	517,090	516,034
Due after ten years	2,597,647	2,477,469	277,368	291,078
Residential mortgage-backed securities	10,262	10,271	1,995,296	2,075,573
Equity securities			35,899	35,899
Total	$ 3,166,692	$ 3,070,349	$ 5,916,029	$ 6,033,370

Sales of securities available for sale were as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
Proceeds from sales	$ 3,997,485	$ 6,002,402	$ 8,495,587	$ 15,987,480
Gross realized gains	6	371	11	2,508
Gross realized losses		(1)		(2,629)
Tax (expense) benefit of securities gains/losses	(2)	(130)	(4)	42

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

	June 30, 2013	December 31, 2012
U.S. Treasury	$ 14,489	$ 14,038
States and political subdivisions	2,288	16,036
Total	$ 16,777	$ 30,074

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

	Three Months Ended June 30,	Six Months Ended June 30,

	2013	2012	2013	2012
Net gain on sales transactions	$ 282	$ 299	$ 576	$ 622
Net mark-to-market gains (losses)	(377)	(19)	(380)	(79)
Net gain (loss) on trading account securities	$ (95)	$ 280	$ 196	$ 543

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Note 3 - Loans

Loans were as follows:

	June 30, 2013	Percentage of Total	December 31, 2012	Percentage of Total
Commercial and industrial:				
Commercial	$ 4,292,893	46.5%	$ 4,357,100	47.2%
Leases	304,717	3.3	278,535	3.0
Asset-based	175,007	1.9	192,977	2.1
Total commercial and industrial	4,772,617	51.7	4,828,612	52.3
Commercial real estate:				
Commercial mortgages	2,552,174	27.6	2,495,481	27.1
Construction	588,743	6.4	608,306	6.6
Land	230,351	2.5	216,008	2.3
Total commercial real estate	3,371,268	36.5	3,319,795	36.0
Consumer real estate:				
Home equity loans	318,339	3.4	310,675	3.4
Home equity lines of credit	193,464	2.1	186,522	2.0
1-4 family residential mortgages	33,671	0.4	38,323	0.4
Construction	13,654	0.1	17,621	0.2
Other	226,077	2.5	224,206	2.4
Total consumer real estate	785,205	8.5	777,347	8.4
Total real estate	4,156,473	45.0	4,097,142	44.4
Consumer and other:				
Consumer installment	318,824	3.4	311,310	3.4
Other	6,498	0.1	8,435	0.1
Total consumer and other	325,322	3.5	319,745	3.5
Unearned discounts	(21,869)	(0.2)	(21,651)	(0.2)
Total loans	$ 9,232,543	100.0%	$ 9,223,848	100.0%

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

Commercial and industrial loans are underwritten after evaluating and understanding the borrower s ability to operate profitably and prudently expand its business. Underwriting standards are designed to promote relationship banking rather than transactional banking. Once it is determined that the borrower s management possesses sound ethics and solid business acumen, the Corporation s management examines current and projected cash flows to determine the ability of the borrower to repay their obligations as agreed. Commercial and industrial loans are primarily made based on the identified cash flows of the borrower and secondarily on the underlying collateral provided by the borrower. The cash flows of borrowers, however, may not be as expected and the collateral securing these loans may fluctuate in value. Most commercial and industrial loans are secured by the assets being financed or other business assets such as accounts receivable or inventory and may incorporate a personal guarantee; however, some short-term loans may be made on an unsecured basis. In the case of loans secured by accounts receivable, the availability of funds for the repayment of these loans may be substantially dependent on the ability of the borrower to collect amounts due from its customers.

Commercial real estate loans are subject to underwriting standards and processes similar to commercial and industrial loans, in addition to those of real estate loans. These loans are viewed primarily as cash flow loans and secondarily as loans secured by real estate. Commercial real estate lending typically involves higher loan principal amounts and the repayment of these loans is generally largely dependent on the successful operation of the property securing the loan or the business conducted on the property securing the loan. Commercial real estate loans may be more adversely affected by conditions in the real estate markets or in the general economy. The properties securing the Corporation s commercial real estate portfolio are diverse in terms of type and geographic location. This diversity helps reduce the Corporation s exposure to adverse economic events that affect any single market or industry. Management monitors and evaluates commercial real estate loans based on collateral, geography and risk grade criteria. As a general rule, the Corporation avoids financing single-purpose projects unless other underwriting factors are present to help mitigate risk. The Corporation also utilizes third-party experts to provide insight and guidance about economic conditions and trends affecting market areas it serves. In addition, management tracks the level of owner-occupied commercial real estate loans versus non-owner occupied loans. At June 30, 2013, approximately 56% of the outstanding principal balance of the Corporation s commercial real estate loans were secured by owner-occupied properties.

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

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

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

Concentrations of Credit. Most of the Corporation s lending activity occurs within the State of Texas, including the four largest metropolitan areas of Austin, Dallas/Ft. Worth, Houston and San Antonio, as well as other markets. The majority of the Corporation s loan portfolio consists of commercial and industrial and commercial real estate loans. Other than energy loans, as of June 30, 2013 there were no concentrations of loans related to any single industry in excess of 10% of total loans.

Foreign Loans. The Corporation has U.S. dollar denominated loans and commitments to borrowers in Mexico. The outstanding balance of these loans and the unfunded amounts available under these commitments were not significant at June 30, 2013 or December 31, 2012.

Non-Accrual and Past Due Loans. Loans are considered past due if the required principal and interest payments have not been received as of the date such payments were due. Loans are placed on non-accrual status when, in management s opinion, the borrower may be unable to meet payment obligations as they become due, as well as when required by regulatory provisions. In determining whether or not a borrower may be unable to meet payment obligations for each class of loans, the Corporation considers the borrower s debt service capacity through the analysis of current financial information, if available, and/or current information with regards to the Corporation s collateral position. Regulatory provisions would typically require the placement of a loan on non-accrual status if (i) principal or interest has been in default for a period of 90 days or more unless the loan is both well secured and in the process of collection or (ii) full payment of principal and interest is not expected. Loans may be placed on non-accrual status regardless of whether or not such loans are considered past due. When interest accrual is discontinued, all unpaid accrued interest is reversed. Interest income on non-accrual loans is recognized only to the extent that cash payments are received in excess of principal due. A loan may be returned to accrual status when all the principal and interest amounts contractually due are brought current and future principal and interest amounts contractually due are reasonably assured, which is typically evidenced by a sustained period (at least six months) of repayment performance by the borrower.

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

	June 30, 2013	December 31, 2012
Commercial and industrial:		
Energy	$ 228	$ 1,150
Other commercial	40,790	45,158
Commercial real estate:		
Buildings, land and other	41,615	38,631
Construction	1,015	1,100
Consumer real estate	2,379	2,773
Consumer and other	687	932
Total	$ 86,714	$ 89,744

As of June 30, 2013, non-accrual loans reported in the table above included $3.2 million related to loans that were restructured as troubled debt restructurings during 2013. Had non-accrual loans performed in accordance with their original contract terms, the Corporation would have recognized additional interest income, net of tax, of approximately $591 thousand and $1.2 million for the three and six months ended June 30, 2013, compared to $639 thousand and $1.3 million for the same periods in 2012.

An age analysis of past due loans (including both accruing and non-accruing loans), segregated by class of loans, as of June 30, 2013 was as follows:

	Loans 30-89 Days Past Due	Loans 90 or More Days Past Due	Total Past Due Loans	Current Loans	Total Loans	Accruing Loans 90 or More Days Past Due
Commercial and industrial:						
Energy	$ 397	$ 758	$ 1,155	$ 1,016,182	$ 1,017,337	$ 530
Other commercial	13,841	18,173	32,014	3,723,266	3,755,280	6,570
Commercial real estate:						
Buildings, land and other	15,248	29,484	44,732	2,737,793	2,782,525	430
Construction	5,771	81	5,852	582,891	588,743	81
Consumer real estate	5,989	3,504	9,493	775,712	785,205	3,205
Consumer and other	4,103	485	4,588	320,734	325,322	408
Unearned discounts				(21,869)	(21,869)	
Total	$ 45,349	$ 52,485	$ 97,834	$ 9,134,709	$ 9,232,543	$ 11,224

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

Regulatory guidelines require the Corporation to reevaluate the fair value of collateral supporting impaired collateral dependent loans on at least an annual basis. While the Corporation s policy is to comply with the regulatory guidelines, the Corporation s general practice is to reevaluate the fair value of collateral supporting impaired collateral dependent loans on a quarterly basis. Thus, appraisals are never considered to be outdated, and the Corporation does not need to make any adjustments to the appraised values. The fair value of collateral supporting impaired collateral dependent loans is evaluated by the Corporation s internal appraisal services using a methodology that is consistent with the Uniform Standards of Professional Appraisal Practice. The fair value of collateral supporting impaired collateral dependent construction loans is based on an as is valuation.

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

	Unpaid Contractual Principal Balance	Recorded Investment With No Allowance	Recorded Investment With Allowance	Total Recorded Investment	Related Allowance
June 30, 2013					
Commercial and industrial:					
Energy	$	$	$	$	$
Other commercial	47,024	28,127	8,437	36,564	4,150
Commercial real estate:					
Buildings, land and other	46,772	23,442	14,986	38,428	3,344
Construction	1,460	1,015		1,015	
Consumer real estate	933	802		802	
Consumer and other	403	365		365	
Total	$ 96,592	$ 53,751	$ 23,423	$ 77,174	$ 7,494
December 31, 2012					
Commercial and industrial:					
Energy	$ 1,255	$	$ 1,069	$ 1,069	$ 900
Other commercial	56,784	21,709	19,096	40,805	4,200
Commercial real estate:					
Buildings, land and other	44,652	19,010	17,149	36,159	3,137
Construction	1,497	1,100		1,100	
Consumer real estate	961	864		864	
Consumer and other	428	400		400	
Total	$ 105,577	$ 43,083	$ 37,314	$ 80,397	$ 8,237

The average recorded investment in impaired loans was as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
Commercial and industrial:				
Energy	$	$	$ 356	$
Other commercial	40,331	41,970	40,489	41,090
Commercial real estate:				
Buildings, land and other	37,473	39,055	37,035	39,680
Construction	1,035	1,717	1,057	1,572
Consumer real estate	818	1,928	833	2,109
Consumer and other	375	487	383	509
Total	$ 80,032	$ 85,157	$ 80,153	$ 84,960

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

Troubled debt restructurings during the six months ended June 30, 2013 are set forth in the following table. Amounts represent the aggregate balance of the loans as of their individual restructuring dates. There were no troubled debt restructurings during the six months ended June 30, 2012.

Commercial and industrial:	
Other commercial	$ 2,138
Commercial real estate:	
Buildings, land and other	4,165
	$ 6,303

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The modifications during the six months ended June 30, 2013 primarily related to extending amortization periods, converting the loans to interest only for a limited period of time and/or reducing required collateral. The Corporation did not grant interest-rate concessions on any restructured loan. The modifications did not significantly impact the Corporation s determination of the allowance for loan losses. One loan totaling $169 thousand restructured during 2012 was in excess of 90 days past due as of June 30, 2013. During the six months ended June 30, 2013, the Corporation charged-off $1.1 million related to loans restructured during 2012 and 2013. These charge-offs and the aforementioned past due loan did not significantly impact the Corporation s determination of the allowance for loan losses.

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

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

Grades 1, 2 and 3 These grades include loans to very high credit quality borrowers of investment or near investment grade. These borrowers are generally publicly traded (grades 1 and 2), have significant capital strength, moderate leverage, stable earnings and growth, and readily available financing alternatives. Smaller entities, regardless of strength, would generally not fit in these grades.

Grades 4 and 5 These grades include loans to borrowers of solid credit quality with moderate risk. Borrowers in these grades are differentiated from higher grades on the basis of size (capital and/or revenue), leverage, asset quality and the stability of the industry or market area.

Grades 6, 7 and 8 These grades include pass grade loans to borrowers of acceptable credit quality and risk. Such borrowers are differentiated from Grades 4 and 5 in terms of size, secondary sources of repayment or they are of lesser stature in other key credit metrics in that they may be over-leveraged, under capitalized, inconsistent in performance or in an industry or an economic area that is known to have a higher level of risk, volatility, or susceptibility to weaknesses in the economy.

Grade 9 This grade includes loans on management s watch list and is intended to be utilized on a temporary basis for pass grade borrowers where a significant risk-modifying action is anticipated in the near term.

Grade 10 This grade is for Other Assets Especially Mentioned in accordance with regulatory guidelines. This grade is intended to be temporary and includes loans to borrowers whose credit quality has clearly deteriorated and are at risk of further decline unless active measures are taken to correct the situation.

Grade 11 This grade includes Substandard loans, in accordance with regulatory guidelines, for which the accrual of interest has not been stopped. By definition under regulatory guidelines, a Substandard loan has defined weaknesses which make payment default or principal exposure likely, but not yet certain. Such loans are apt to be dependent upon collateral liquidation, a secondary source of repayment or an event outside of the normal course of business.

Grade 12 This grade includes Substandard loans, in accordance with regulatory guidelines, for which the accrual of interest has been stopped. This grade includes loans where interest is more than 120 days past due and not fully secured and loans where a specific valuation allowance may be necessary, but generally does not exceed 30% of the principal balance.

Grade 13 This grade includes Doubtful loans in accordance with regulatory guidelines. Such loans are placed on non-accrual status and may be dependent upon collateral having a value that is difficult to determine or upon some near-term event which lacks certainty. Additionally, these loans generally have a specific valuation allowance in excess of 30% of the principal balance.

Grade 14 This grade includes Loss loans in accordance with regulatory guidelines. Such loans are to be charged-off or charged-down when payment is acknowledged to be uncertain or when the timing or value of payments cannot be determined. Loss is not intended to imply that the loan or some portion of it will never be paid, nor does it in any way imply that there has been a forgiveness of debt.

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

	June 30, 2013		December 31, 2012	
	Weighted Average Risk Grade	Loans	Weighted Average Risk Grade	Loans
Commercial and industrial:				
Energy				
Risk grades 1-8	5.28	$ 1,009,557	5.24	$ 1,081,725
Risk grade 9	9.00	7,395	9.00	392
Risk grade 10	10.00		10.00	
Risk grade 11	11.00	385	11.00	
Risk grade 12	12.00		12.00	169
Risk grade 13	13.00		13.00	900
Total energy	5.31	$ 1,017,337	5.25	$ 1,083,186
Other commercial				
Risk grades 1-8	5.91	$ 3,481,071	5.81	$ 3,367,443
Risk grade 9	9.00	148,192	9.00	250,508
Risk grade 10	10.00	28,187	10.00	28,440
Risk grade 11	11.00	56,811	11.00	53,797
Risk grade 12	12.00	36,070	12.00	40,603
Risk grade 13	13.00	4,949	13.00	4,635
Total other commercial	6.21	$ 3,755,280	6.21	$ 3,745,426
Commercial real estate:				
Buildings, land and other				
Risk grades 1-8	6.56	$ 2,564,596	6.63	$ 2,460,448
Risk grade 9	9.00	74,938	9.00	92,041
Risk grade 10	10.00	38,397	10.00	42,603
Risk grade 11	11.00	62,929	11.00	77,658
Risk grade 12	12.00	38,321	12.00	35,602
Risk grade 13	13.00	3,344	13.00	3,137
Total commercial real estate	6.86	$ 2,782,525	6.97	$ 2,711,489
Construction				
Risk grades 1-8	6.85	$ 563,561	6.82	$ 579,108
Risk grade 9	9.00	20,977	9.00	23,046
Risk grade 10	10.00	2,490	10.00	4,435
Risk grade 11	11.00	700	11.00	617
Risk grade 12	12.00	1,015	12.00	1,100
Risk grade 13	13.00		13.00	
Total construction	6.95	$ 588,743	6.94	$ 608,306

The Corporation has established maximum loan to value standards to be applied during the origination process of commercial and consumer real estate loans. The Corporation does not subsequently monitor loan-to-value ratios (either individually or on a weighted-average basis) for loans that are subsequently considered to be of a pass grade (grades 9 or better) and/or current with respect to principal and interest payments. As stated above, when an individual commercial real estate loan has a calculated risk grade of 10 or higher, a special assets officer analyzes the loan to determine whether the loan is impaired. At that time, the Corporation reassesses the loan to value position in the loan. If the loan is determined to be collateral dependent, specific allocations of the allowance for loan losses are made for the amount of any collateral deficiency. If a collateral deficiency is ultimately deemed to be uncollectible, the amount is charged-off. These loans and related assessments of collateral position are monitored on an individual, case-by-case basis. The Corporation does not monitor loan-to-value ratios on a weighted-average basis for commercial real estate loans having a calculated risk grade of 10 or higher. Nonetheless, there were three commercial real estate loans having a calculated risk grade of 10 or higher in excess of $5 million as of June 30, 2013, which totaled $31.0 million and had a weighted-average loan-to-value ratio of approximately 75.6%. When an individual consumer real estate loan becomes past due by more than 10 days, the assigned

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relationship manager will begin collection efforts. The Corporation only reassesses the loan to value position in a consumer real estate loan if, during the course of the collections process, it is determined that the loan has become collateral dependent, and any collateral deficiency is recognized as a charge-off to the allowance for loan losses. Accordingly, the Corporation does not monitor loan-to-value ratios on a weighted-average basis for collateral dependent consumer real estate loans.

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

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
Commercial and industrial:				
Energy	$	$	$ (900)	$ 4
Other commercial	(2,883)	(3,180)	(18,510)	(4,855)
Commercial real estate:				
Buildings, land and other	(244)	493	(29)	(1,867)
Construction	116	12	230	22
Consumer real estate	15	(519)	(261)	(285)
Consumer and other	(768)	(694)	(1,158)	(973)
Total	$ (3,764)	$ (3,888)	$ (20,628)	$ (7,954)

In assessing the general economic conditions in the State of Texas, management monitors and tracks the Texas Leading Index (TLI), which is produced by the Federal Reserve Bank of Dallas. The TLI is a single summary statistic that is designed to signal the likelihood of the Texas economy s transition from expansion to recession and vice versa. Management believes this index provides a reliable indication of the direction of overall credit quality. The TLI is a composite of the following eight leading indicators: (i) Texas Value of the Dollar, (ii) U.S. Leading Index, (iii) real oil prices (iv) well permits, (v) initial claims for unemployment insurance, (vi) Texas Stock Index, (vii) Help-Wanted Index and (viii) average weekly hours worked in manufacturing. The TLI totaled 124.5 at May 31, 2013 (most recent date available) and 123.8 at December 31, 2012. A higher TLI value implies more favorable economic conditions.

Allowance for Loan Losses. The allowance for loan losses is a reserve established through a provision for loan losses charged to expense, which represents management s best estimate of probable losses that have been incurred within the existing portfolio of loans. The allowance, in the judgment of management, is necessary to reserve for estimated loan losses and risks inherent in the loan portfolio. The Corporation s allowance for loan loss methodology follows the accounting guidance set forth in U.S. generally accepted accounting principles and the Interagency Policy Statement on the Allowance for Loan and Lease Losses, which was jointly issued by U.S. bank regulatory agencies. In that regard, the Corporation s allowance for loan losses includes allowance allocations calculated in accordance with ASC Topic 310, Receivables and allowance allocations calculated in accordance with ASC Topic 450, Contingencies. Accordingly, the methodology is based on historical loss experience by type of credit and internal risk grade, specific homogeneous risk pools and specific loss allocations, with adjustments for current events and conditions. The Corporation s process for determining the appropriate level of the allowance for loan losses is designed to account for credit deterioration as it occurs. The provision for loan losses reflects loan quality trends, including the levels of and trends related to non-accrual loans, past due loans, potential problem loans, criticized loans and net charge-offs or recoveries, among other factors. The provision for loan losses also reflects the totality of actions taken on all loans for a particular period. In other words, the amount of the provision reflects not only the necessary increases in the allowance for loan losses related to newly identified criticized loans, but it also reflects actions taken related to other loans including, among other things, any necessary increases or decreases in required allowances for specific loans or loan pools.

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

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

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

Historical valuation allowances are calculated based on the historical gross loss experience of specific types of loans and the internal risk grade of such loans at the time they were charged-off. The Corporation calculates historical gross loss ratios for pools of similar loans with similar characteristics based on the proportion of actual charge-offs experienced to the total population of loans in the pool. The historical gross loss ratios are periodically updated based on actual charge-off experience. A historical valuation allowance is established for each pool of similar loans based upon the product of the historical gross loss ratio and the total dollar amount of the loans in the pool. The Corporation s pools of similar loans include similarly risk-graded groups of commercial and industrial loans, commercial real estate loans, consumer real estate loans and consumer and other loans.

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

The environmental adjustment factor is based upon a more qualitative analysis of risk and is calculated through a survey of senior officers who are involved in credit making decisions at a corporate-wide and/or regional level. On a quarterly basis, survey participants rate the degree of various risks utilizing a numeric scale that translates to varying grades of high, moderate or low levels of risk. The results are then input into a risk-weighting matrix to determine an appropriate environmental risk adjustment factor. The various risks that may be considered in the determination of the environmental adjustment factor include, among other things, (i) the experience, ability and effectiveness of the bank s lending management and staff; (ii) the effectiveness of the Corporation s loan policies, procedures and internal controls; (iii) changes in asset quality; (iv) the impact of legislative and governmental influences affecting industry sectors; (v) the effectiveness of the internal loan review function; (vi) the impact of competition on loan structuring and pricing; and (vii) the impact of rising interest rates on portfolio risk. In periods where the surveyed risks are perceived to be higher, the risk-weighting matrix will generally result in a higher environmental adjustment factor, which, in turn will result in higher levels of general valuation allowance allocations. The opposite holds true in periods where the surveyed risks are perceived to be lower.

General valuation allowances also include amounts allocated for loans to borrowers in distressed industries. To determine the amount of the allocation for each loan portfolio segment, management calculates the weighted-average risk grade for all loans to borrowers in distressed industries by loan portfolio segment. A multiple is then applied to the amount by which the weighted-average risk grade for loans to borrowers in distressed industries exceeds the weighted-average risk grade for all pass-grade loans within the loan portfolio segment to derive an allocation factor for loans to borrowers in distressed industries. The amount of the allocation for each loan portfolio segment is the product of this allocation factor and the outstanding balance of pass-grade loans within the identified distressed industries that have a risk grade of 6 or higher. Management identifies potential distressed industries by analyzing industry trends related to delinquencies, classifications

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and charge-offs. At June 30, 2013 and December 31, 2012, contractors were considered to be a distressed industry based on elevated levels of delinquencies, classifications and charge-offs relative to other industries within the Corporation s loan portfolio. Furthermore, the Corporation determined, through a review of borrower financial information that, as a whole, contractors have experienced, among other things, decreased revenues, reduced backlog of work, compressed margins and little, if any, net income.

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

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

	Commercial and Industrial	Commercial Real Estate	Consumer Real Estate	Consumer and Other	Unallocated	Total
June 30, 2013						
Historical valuation allowances	$ 24,910	$ 12,741	$ 2,591	$ 7,896	$	$ 48,138
Specific valuation allowances	4,150	3,344				7,494
General valuation allowances:						
Environmental risk adjustment	4,896	3,073	620	2,041		10,630
Distressed industries	8,005	512				8,517
Excessive industry concentrations	3,705	1,303				5,008
Large relationship concentrations	1,335	944				2,279
Highly-leveraged credit relationships	4,497	761				5,258
Policy exceptions					2,190	2,190
Credit and collateral exceptions					1,707	1,707
Loans not reviewed by concurrence	1,994	2,145	2,178	1,035		7,352
Adjustment for recoveries	(2,678)	(1,250)	(472)	(6,842)		(11,242)
General macroeconomic risk					6,069	6,069
Total	$ 50,814	$ 23,573	$ 4,917	$ 4,130	$ 9,966	$ 93,400
December 31, 2012						
Historical valuation allowances	$ 30,565	$ 15,687	$ 3,013	$ 7,344	$	$ 56,609
Specific valuation allowances	5,100	3,137				8,237
General valuation allowances:						
Environmental risk adjustment	6,593	3,682	684	1,816		12,775
Distressed industries	5,883	1,182				7,065
Excessive industry concentrations	4,291	2,795				7,086
Large relationship concentrations	1,420	981				2,401
Highly-leveraged credit relationships	2,905	699				3,604
Policy exceptions					2,466	2,466
Credit and collateral exceptions					1,635	1,635
Loans not reviewed by concurrence	2,277	2,413	2,411	1,159		8,260
Adjustment for recoveries	(4,870)	(1,230)	(856)	(6,812)		(13,768)
General macroeconomic risk					8,083	8,083
Total	$ 54,164	$ 29,346	$ 5,252	$ 3,507	$ 12,184	$ 104,453

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

The following table details activity in the allowance for loan losses by portfolio segment for the three and six months ended June 30, 2013 and 2012. Allocation of a portion of the allowance to one category of loans does not preclude its availability to absorb losses in other categories.

	Commercial and Industrial	Commercial Real Estate	Consumer Real Estate	Consumer and Other	Unallocated	Total
Three months ended:						
June 30, 2013						
Beginning balance	$ 51,085	$ 24,809	$ 5,148	$ 3,724	$ 8,823	$ 93,589
Provision for loan losses	2,612	(1,108)	(246)	1,174	1,143	3,575
Charge-offs	(3,586)	(415)	(159)	(2,374)		(6,534)
Recoveries	703	287	174	1,606		2,770
Net charge-offs	(2,883)	(128)	15	(768)		(3,764)
Ending balance	$ 50,814	$ 23,573	$ 4,917	$ 4,130	$ 9,966	$ 93,400
June 30, 2012						
Beginning balance	$ 45,869	$ 20,003	$ 3,699	$ 8,715	$ 28,895	$ 107,181
Provision for loan losses	10,786	7,123	2,055	(4,372)	(13,237)	2,355
Charge-offs	(4,474)	(353)	(606)	(2,229)		(7,662)
Recoveries	1,294	858	87	1,535		3,774
Net charge-offs	(3,180)	505	(519)	(694)		(3,888)
Ending balance	$ 53,475	$ 27,631	$ 5,235	$ 3,649	$ 15,658	$ 105,648
Six months ended:						
June 30, 2013						
Beginning balance	$ 54,164	$ 29,346	$ 5,252	$ 3,507	$ 12,184	$ 104,453
Provision for loan losses	16,060	(5,974)	(74)	1,781	(2,218)	9,575
Charge-offs	(20,738)	(681)	(495)	(4,551)		(26,465)
Recoveries	1,328	882	234	3,393		5,837
Net charge-offs	(19,410)	201	(261)	(1,158)		(20,628)
Ending balance	$ 50,814	$ 23,573	$ 4,917	$ 4,130	$ 9,966	$ 93,400
June 30, 2012						
Beginning balance	$ 42,774	$ 20,912	$ 3,540	$ 12,635	$ 30,286	$ 110,147
Provision for loan losses	15,552	8,564	1,980	(8,013)	(14,628)	3,455
Charge-offs	(7,486)	(3,195)	(895)	(4,214)		(15,790)
Recoveries	2,635	1,350	610	3,241		7,836

Net charge-offs	(4,851)	(1,845)	(285)	(973)		(7,954)
Ending balance	$ 53,475	$ 27,631	$ 5,235	$ 3,649	$ 15,658	$ 105,648

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The following table details the amount of the allowance for loan losses allocated to each portfolio segment as of June 30, 2013, December 31, 2012 and June 30, 2012, detailed on the basis of the impairment methodology used by the Corporation.

	Commercial and Industrial	Commercial Real Estate	Consumer Real Estate	Consumer and Other	Unallocated	Total
June 30, 2013						
Loans individually evaluated for impairment	$ 11,330	$ 4,531	$	$	$	$ 15,861
Loans collectively evaluated for impairment	39,484	19,042	4,917	4,130	9,966	77,539
Balance at June 30, 2013	$ 50,814	$ 23,573	$ 4,917	$ 4,130	$ 9,966	$ 93,400
December 31, 2012						
Loans individually evaluated for impairment	$ 13,171	$ 4,366	$	$	$	$ 17,537
Loans collectively evaluated for impairment	40,993	24,980	5,252	3,507	12,184	86,916
Balance at December 31, 2012	$ 54,164	$ 29,346	$ 5,252	$ 3,507	$ 12,184	$ 104,453
June 30, 2012						
Loans individually evaluated for impairment	$ 17,983	$ 2,728	$	$	$	$ 20,711
Loans collectively evaluated for impairment	35,492	24,903	5,235	3,649	15,658	84,937
Balance at June 30, 2012	$ 53,475	$ 27,631	$ 5,235	$ 3,649	$ 15,658	$ 105,648

The Corporation s recorded investment in loans as of June 30, 2013, December 31, 2012 and June 30, 2012 related to each balance in the allowance for loan losses by portfolio segment and detailed on the basis of the impairment methodology used by the Corporation was as follows:

	Commercial and Industrial	Commercial Real Estate	Consumer Real Estate	Consumer and Other	Unearned Discounts	Total
June 30, 2013						
Loans individually evaluated for impairment	$ 126,402	$ 147,196	$ 802	$ 365	$	$ 274,765
Loans collectively evaluated for impairment	4,646,215	3,224,072	784,403	324,957	(21,869)	8,957,778
Ending balance	$ 4,772,617	$ 3,371,268	$ 785,205	$ 325,322	$ (21,869)	$ 9,232,543
December 31, 2012						
Loans individually evaluated for impairment	$ 128,544	$ 165,152	$ 864	$ 400	$	$ 294,960
Loans collectively evaluated for impairment	4,700,068	3,154,643	776,483	319,345	(21,651)	8,928,888
Ending balance	$ 4,828,612	$ 3,319,795	$ 777,347	$ 319,745	$ (21,651)	$ 9,223,848
June 30, 2012						
Loans individually evaluated for impairment	$ 183,964	$ 198,000	$ 1,279	$ 439	$	$ 383,682
Loans collectively evaluated for impairment	4,125,925	2,921,902	760,781	316,564	(19,091)	8,106,081
Ending balance	$ 4,309,889	$ 3,119,902	$ 762,060	$ 317,003	$ (19,091)	$ 8,489,763

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Note 4 - Goodwill and Other Intangible Assets

Goodwill and other intangible assets are presented in the table below.

	June 30, 2013	December 31, 2012
Goodwill	$ 535,509	$ 535,509
Other intangible assets:		
Core deposits	$ 4,115	$ 5,296
Customer relationship	1,944	2,262
Non-compete agreements	480	589
	$ 6,539	$ 8,147

The estimated aggregate future amortization expense for intangible assets remaining as of June 30, 2013 is as follows:

Remainder of 2013	$ 1,507
2014	2,271
2015	1,489
2016	777
2017	215
Thereafter	280
	$ 6,539

Note 5 - Deposits

Deposits were as follows:

	June 30, 2013	Percentage of Total	December 31, 2012	Percentage of Total
Non-interest-bearing demand deposits:				
Commercial and individual	$ 7,057,425	37.0%	$ 7,186,105	36.9%
Correspondent banks	323,992	1.7	436,381	2.2
Public funds	363,259	1.9	474,451	2.4
Total non-interest-bearing demand deposits	7,744,676	40.6	8,096,937	41.5
Interest-bearing deposits:				
Private accounts:				
Savings and interest checking	3,495,530	18.3	3,812,712	19.6
Money market accounts	6,438,506	33.8	6,127,256	31.4
Time accounts of $100,000 or more	523,944	2.7	514,346	2.6
Time accounts under $100,000	448,905	2.4	464,641	2.4
Total private accounts	10,906,885	57.2	10,918,955	56.0
Public funds:				
Savings and interest checking	233,107	1.2	287,391	1.5
Money market accounts	42,548	0.2	50,600	0.3

Time accounts of $100,000 or more	146,300	0.8	140,191	0.7
Time accounts under $100,000	4,703		3,292	
Total public funds	426,658	2.2	481,474	2.5
Total interest-bearing deposits	11,333,543	59.4	11,400,429	58.5
Total deposits	$ 19,078,219	100.0%	$ 19,497,366	100.0%

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

	June 30, 2013	December 31, 2012
Deposits from the Certificate of Deposit Account Registry Service (CDARS) deposits	$ 701	$ 2,723
Deposits from foreign sources (primarily Mexico)	766,265	799,504

Note 6 - Commitments and Contingencies

Financial Instruments with Off-Balance-Sheet Risk. In the normal course of business, the Corporation enters into various transactions, which, in accordance with generally accepted accounting principles are not included in its consolidated balance sheets. The Corporation enters into these transactions to meet the financing needs of its customers. These transactions include commitments to extend credit and standby letters of credit, which involve, to varying degrees, elements of credit risk and interest rate risk in excess of the amounts recognized in the consolidated balance sheets. The Corporation minimizes its exposure to loss under these commitments by subjecting them to credit approval and monitoring procedures.

The Corporation enters into contractual commitments to extend credit, normally with fixed expiration dates or termination clauses, at specified rates and for specific purposes. Substantially all of the Corporation s commitments to extend credit are contingent upon customers maintaining specific credit standards at the time of loan funding. Standby letters of credit are written conditional commitments issued by the Corporation to guarantee the performance of a customer to a third party. In the event the customer does not perform in accordance with the terms of the agreement with the third party, the Corporation would be required to fund the commitment. The maximum potential amount of future payments the Corporation could be required to make is represented by the contractual amount of the commitment. If the commitment were funded, the Corporation would be entitled to seek recovery from the customer. The Corporation s policies generally require that standby letter of credit arrangements contain security and debt covenants similar to those contained in loan agreements.

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

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

	June 30, 2013	December 31, 2012
Commitments to extend credit	$ 6,169,000	$ 5,710,448
Standby letters of credit	216,595	186,049
Deferred standby letter of credit fees	1,246	1,412

Lease Commitments. The Corporation leases certain office facilities and office equipment under operating leases. Rent expense for all operating leases totaled $6.2 million and $12.0 million during the three and six months ended June 30, 2013 and $5.6 million and $11.0 million during the three and six months ended June 30, 2012. There has been no significant change in the future minimum lease payments payable by the Corporation since December 31, 2012. See the 2012 Form 10-K for information regarding these commitments.

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

Note 7 - Capital and Regulatory Matters

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

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

Cullen/Frost s and Frost Bank s Tier 1 capital consists of shareholders equity excluding unrealized gains and losses on securities available for sale, the accumulated gain or loss on effective cash flow hedging derivatives, the net actuarial gain/loss on the Corporation s defined benefit post-retirement benefit plans, goodwill and other intangible assets. Tier 1 capital for Cullen/Frost also includes $144.7 million of 5.375% non-cumulative perpetual preferred stock and $120 million of trust preferred securities issued by its unconsolidated subsidiary trust.

Cullen/Frost s and Frost Bank s total capital is comprised of Tier 1 capital for each entity plus a permissible portion of the allowance for loan losses. The Corporation s aggregate $100 million of floating rate subordinated notes are not included in Tier 1 capital but the permissible portion (which decreases 20% per year during the final five years of the term of the notes) totaling $60 million at June 30, 2013 and $80 million at December 31, 2012, is included in total capital of Cullen/Frost.

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

As further discussed below, in July 2013, Cullen/Frost s and Frost Bank s primary federal regulator, the Federal Reserve, published final rules establishing a new comprehensive capital framework for U.S. banking organizations which will become effective on January 1, 2015 (subject to a phase-in period).

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

	Actual		Minimum Required for Capital Adequacy Purposes		Required to be Considered Well Capitalized	
	Capital Amount	Ratio	Capital Amount	Ratio	Capital Amount	Ratio
June 30, 2013						
Total Capital to Risk-Weighted Assets						
Cullen/Frost	$ 2,011,267	15.39%	$ 1,045,233	8.00%	$ 1,306,541	10.00%
Frost Bank	1,767,524	13.54	1,044,199	8.00	1,305,249	10.00
Tier 1 Capital to Risk-Weighted Assets						
Cullen/Frost	1,857,867	14.22	522,616	4.00	783,925	6.00
Frost Bank	1,674,124	12.83	522,099	4.00	783,149	6.00
Leverage Ratio						
Cullen/Frost	1,857,867	8.60	864,342	4.00	1,080,427	5.00
Frost Bank	1,674,124	7.75	863,558	4.00	1,079,448	5.00
December 31, 2012						
Total Capital to Risk-Weighted Assets						
Cullen/Frost	$ 1,947,974	15.11%	$ 1,031,526	8.00%	$ 1,289,408	10.00%
Frost Bank	1,730,444	13.43	1,030,878	8.00	1,288,597	10.00
Tier 1 Capital to Risk-Weighted Assets						
Cullen/Frost	1,763,521	13.68	515,763	4.00	773,645	6.00
Frost Bank	1,625,991	12.62	515,439	4.00	773,158	6.00
Leverage Ratio						
Cullen/Frost	1,763,521	8.28	851,483	4.00	1,064,354	5.00
Frost Bank	1,625,991	7.64	850,954	4.00	1,063,693	5.00

Management believes that, as of June 30, 2013, Cullen/Frost and its bank subsidiary, Frost Bank, were well capitalized based on the ratios presented above.

Cullen/Frost and Frost Bank are subject to the regulatory capital requirements administered by the Federal Reserve, and, for Frost Bank, the Federal Deposit Insurance Corporation (FDIC). Regulatory authorities can initiate certain mandatory actions if Cullen/Frost or Frost Bank fail to meet the minimum capital requirements, which could have a direct material effect on the Corporation s financial statements. Management believes, as of June 30, 2013, that Cullen/Frost and Frost Bank meet all capital adequacy requirements to which they are subject.

Trust Preferred Securities. In accordance with the applicable accounting standard related to variable interest entities, the accounts of the Corporation s wholly owned subsidiary trust, Cullen/Frost Capital Trust II, have not been included in the Corporation s consolidated financial statements. However, the $120.0 million in trust preferred securities issued by this subsidiary trust have been included in the Tier 1 capital of Cullen/Frost for regulatory capital purposes pursuant to guidance from the Federal Reserve. As more fully discussed below, new rules related to the implementation of the Basel III capital framework will require the phase-out of certain hybrid securities, such as trust preferred securities, as Tier 1 capital of bank holding companies beginning January 1, 2015.

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Preferred Stock. On February 15, 2013, the Corporation issued and sold 6,000,000 shares, or $150 million in aggregate liquidation preference, of it s 5.375% Non-Cumulative Perpetual Preferred Stock, Series A, par value $0.01 and liquidation preference $25 per share (Series A Preferred Stock). Dividends on the Series A Preferred stock, if declared, accrue and are payable quarterly, in arrears, at a rate of 5.375%. The Series A Preferred Stock qualifies as Tier 1 capital for the purposes of the regulatory capital calculations. The net proceeds from the issuance and sale of the Series A Preferred Stock, after deducting underwriting discount and commissions, and the payment of expenses, were approximately $144.5 million. The net proceeds from the offering were used to fund the accelerated share repurchase further discussed below.

Accelerated Share Repurchase. Concurrent with the issuance and sale of the Series A Preferred Stock, on February 15, 2013, the Corporation entered into an accelerated share repurchase agreement (the ASR agreement) with Goldman, Sachs & Co. (Goldman Sachs). Under the ASR agreement, the Corporation paid $144 million to Goldman Sachs and received from Goldman Sachs approximately 1.9 million shares of the Corporation s common stock, representing approximately 80% of the estimated total number of shares to be repurchased. Goldman Sachs borrowed such shares delivered to the Corporation from stock lenders, and during the term of the ASR agreement, will purchase shares in the open market to return to those stock lenders. Final settlement of the ASR agreement is expected to occur in the third quarter of 2013. Upon final settlement, the Corporation expects to receive the balance of the shares repurchased under the ASR agreement. The specific number of shares that the Corporation ultimately will repurchase will be based on the volume-weighted-average price per share of the Corporation s common stock during the repurchase period, subject to other adjustments pursuant to the terms and conditions of the ASR agreement. At settlement, under certain circumstances, Goldman Sachs may be required to deliver additional shares of the Corporation s common stock to the Corporation, or, under certain circumstances, the Corporation may be required to deliver shares of the Corporation s common stock or the Corporation may elect to make a cash payment to Goldman Sachs. The terms of the ASR agreement are subject to adjustment if the Corporation were to enter into or announce certain types of transactions. Furthermore, during the term of the ASR agreement, and subject to certain limited exceptions, the Corporation may only make repurchases of Cullen/Frost common stock with the consent of Goldman Sachs.

The ASR agreement is part of a stock repurchase program that was authorized by the Corporation s board of directors in December 2012 to buy up to $150 million of the Corporation s common stock. The Corporation accounted for the repurchase as two separate transactions: (i) as shares of common stock acquired in a treasury stock transaction recorded on the acquisition date; and (ii) as a forward contract indexed to the Corporation s common stock that is classified as equity and reported as a component of additional paid in capital.

Dividend Restrictions. In the ordinary course of business, Cullen/Frost is dependent upon dividends from Frost Bank to provide funds for the payment of dividends to shareholders and to provide for other cash requirements. Banking regulations may limit the amount of dividends that may be paid. Approval by regulatory authorities is required if the effect of dividends declared would cause the regulatory capital of Frost Bank to fall below specified minimum levels. Approval is also required if dividends declared exceed the net profits for that year combined with the retained net profits for the preceding two years. Under the foregoing dividend restrictions and while maintaining its well capitalized status, at June 30, 2013, Frost Bank could pay aggregate dividends of up to $243.3 million to Cullen/Frost without prior regulatory approval.

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

Basel III Capital Rules. In July 2013, the Cullen/Frost s and Frost Bank s primary federal regulator, the Federal Reserve, published final rules (the Basel III Capital Rules) establishing a new comprehensive capital framework for U.S. banking organizations. The rules implement the Basel Committee s December 2010 framework known as Basel III for strengthening international capital standards as well as certain provisions of the Dodd-Frank Act. The Basel III Capital Rules substantially revise the risk-based capital requirements applicable to bank holding companies and depository institutions, including Cullen/Frost and Frost Bank, compared to the current U.S. risk-based capital rules. The Basel III Capital Rules define the components of capital and address other issues affecting the numerator in banking institutions regulatory capital ratios. The Basel III Capital Rules also address risk weights and other issues affecting the denominator in banking institutions regulatory capital ratios and replace the existing risk-weighting approach, which was derived from the Basel I capital accords of the Basel Committee, with a more risk-sensitive approach based, in part, on the standardized approach in the Basel Committee s 2004 Basel II capital accords. The Basel III Capital Rules also implement the requirements of Section 939A of the Dodd-Frank Act to remove references to credit ratings from the federal banking agencies rules. The Basel III Capital Rules are effective for Cullen/Frost and Frost Bank on January 1, 2015 (subject to a phase-in period).

The Basel III Capital Rules, among other things, (i) introduce a new capital measure called Common Equity Tier 1 (CET1), (ii) specify that Tier 1 capital consist of CET1 and Additional Tier 1 capital instruments meeting specified requirements, (iii) define CET1 narrowly by requiring that most deductions/adjustments to regulatory capital measures be made to CET1 and not to the other components of capital and (iv) expand the scope of the deductions/adjustments as compared to existing regulations.

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When fully phased in on January 1, 2019, the Basel III Capital Rules will require Cullen/Frost and Frost Bank to maintain (i) a minimum ratio of CET1 to risk-weighted assets of at least 4.5%, plus a 2.5% capital conservation buffer (which is added to the 4.5% CET1 ratio as that buffer is phased in, effectively resulting in a minimum ratio of CET1 to risk-weighted assets of at least 7% upon full implementation), (ii) a minimum ratio of Tier 1 capital to risk-weighted assets of at least 6.0%, plus the capital conservation buffer (which is added to the 6.0% Tier 1 capital ratio as that buffer is phased in, effectively resulting in a minimum Tier 1 capital ratio of 8.5% upon full implementation), (iii) a minimum ratio of Total capital (that is, Tier 1 plus Tier 2) to risk-weighted assets of at least 8.0%, plus the capital conservation buffer (which is added to the 8.0% total capital ratio as that buffer is phased in, effectively resulting in a minimum total capital ratio of 10.5% upon full implementation) and (iv) a minimum leverage ratio of 4%, calculated as the ratio of Tier 1 capital to average assets (as compared to a current minimum leverage ratio of 3% for banking organizations that either have the highest supervisory rating or have implemented the appropriate federal regulatory authority s risk-adjusted measure for market risk).

The Basel III Capital Rules also provides for a countercyclical capital buffer that is applicable to only certain covered institutions and is not expected to have any current applicability to Cullen/Frost or Frost Bank.

The aforementioned capital conservation buffer is designed to absorb losses during periods of economic stress. Banking institutions with a ratio of CET1 to risk-weighted assets above the minimum but below the conservation buffer (or below the combined capital conservation buffer and countercyclical capital buffer, when the latter is applied) will face constraints on dividends, equity repurchases and compensation based on the amount of the shortfall.

Under the Basel III Capital Rules, the initial minimum capital ratios as of January 1, 2015 will be as follows:

4.5% CET1 to risk-weighted assets.

6.0% Tier 1 capital to risk-weighted assets.

8.0% Total capital to risk-weighted assets.

The Basel III Capital Rules provide for a number of deductions from and adjustments to CET1. These include, for example, the requirement that mortgage servicing rights, deferred tax assets dependent upon future taxable income and significant investments in non-consolidated financial entities be deducted from CET1 to the extent that any one such category exceeds 10% of CET1 or all such categories in the aggregate exceed 15% of CET1. Under current capital standards, the effects of accumulated other comprehensive income items included in capital are excluded for the purposes of determining regulatory capital ratios. Under the Basel III Capital Rules, the effects of certain accumulated other comprehensive items are not excluded; however, non-advanced approaches banking organizations, including Cullen/Frost and Frost Bank, may make a one-time permanent election to continue to exclude these items. Cullen/Frost and Frost Bank expect to make this election in order to avoid significant variations in the level of capital depending upon the impact of interest rate fluctuations on the fair value of the Corporation s securities portfolio. The Basel III Capital Rules also preclude certain hybrid securities, such as trust preferred securities, as Tier 1 capital of bank holding companies, subject to phase-out. As a result, beginning in 2015, only 25% of the Corporation s trust preferred securities will be included in Tier 1 capital and in 2016, none of the Corporation s trust preferred securities will be included in Tier 1 capital. Trust preferred securities no longer included in the Corporation s Tier 1 capital may nonetheless be included as a component of Tier 2 capital on a permanent basis without phase-out.

Implementation of the deductions and other adjustments to CET1 will begin on January 1, 2015 and will be phased-in over a 4-year period (beginning at 40% on January 1, 2015 and an additional 20% per year thereafter). The implementation of the capital conservation buffer will begin on January 1, 2016 at the 0.625% level and be phased in over a four-year period (increasing by that amount on each subsequent January 1, until it reaches 2.5% on January 1, 2019).

With respect to Frost Bank, the Basel III Capital Rules also revise the prompt corrective action regulations pursuant to Section 38 of the Federal Deposit Insurance Act, by (i) introducing a CET1 ratio requirement at each level (other than critically undercapitalized), with the required CET1 ratio being 6.5% for well-capitalized status; (ii) increasing the minimum Tier 1 capital ratio requirement for each category (other than critically undercapitalized), with the minimum Tier 1 capital ratio for well-capitalized status being 8% (as compared to the current 6%); and (iii) eliminating the current provision that provides that a bank with a composite supervisory rating of 1 may have a 3% leverage ratio and still be adequately capitalized. The Basel III Capital Rules do not change the total risk-based capital requirement for any prompt corrective action category.

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The Basel III Capital Rules prescribe a standardized approach for risk weightings that expand the risk-weighting categories from the current four Basel I-derived categories (0%, 20%, 50% and 100%) to a much larger and more risk-sensitive number of categories, depending on the nature of the assets, generally ranging from 0% for U.S. government and agency securities, to 600% for certain equity exposures, and resulting in higher risk weights for a variety of asset categories. Specifics changes to current rules impacting the Corporation s determination of risk-weighted assets include, among other things:

- Applying a 150% risk weight instead of a 100% risk weight for certain high volatility commercial real estate acquisition, development and construction loans.

- Assigning a 150% risk weight to exposures (other than residential mortgage exposures) that are 90 days past due.

- Providing for a 20% credit conversion factor for the unused portion of a commitment with an original maturity of one year or less that is not unconditionally cancellable (currently set at 0%).

- Providing for a risk weight, generally not less than 20% with certain exceptions, for securities lending transactions based on the risk weight category of the underlying collateral securing the transaction.

- Providing for a 100% risk weight for claims on securities firms.

- Eliminating the current 50% cap on the risk weight for OTC derivatives.

In addition, the Basel III Capital Rules provide more advantageous risk weights for derivatives and repurchase-style transactions cleared through a qualifying central counterparty and increase the scope of eligible guarantors and eligible collateral for purposes of credit risk mitigation.

Management believes that, as of June 30, 2013, Cullen/Frost and Frost Bank would meet all capital adequacy requirements under the Basel III Capital Rules on a fully phased-in basis as if such requirements were currently in effect. The Basel III Capital Rules adopted in July 2013 do not address the proposed liquidity coverage ratio test and net stable funding ratio test called for by the Basel III liquidity framework. See the section captioned Supervision and Regulation in Item 1. Business of the Corporation s 2012 Form 10-K for more information on these topics.

Note 8 - Derivative Financial Instruments

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

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

The Corporation has entered into certain interest rate swap contracts that are matched to specific fixed-rate commercial loans or leases that the Corporation has entered into with its customers. These contracts have been designated as hedging instruments to hedge the risk of changes in the fair value of the underlying commercial loan/lease due to changes in interest rates. The related contracts are structured so that the notional amounts reduce over time to generally match the expected amortization of the underlying loan/lease.

In October 2007, the Corporation entered into three interest rate swap contracts on variable-rate loans with a total notional amount of $1.2 billion. The interest rate swap contracts were designated as hedging instruments in cash flow hedges with the objective of protecting the overall cash flows from the Corporation s monthly interest receipts on a rolling portfolio of $1.2 billion of variable-rate loans outstanding throughout the 84-month period beginning in October 2007 and ending in October 2014 from the risk of variability of those cash flows such that the yield on the underlying loans would remain constant. As more fully discussed in the 2012 Form 10-K, the Corporation terminated portions of the hedges and settled portions of the interest rate swap contracts during November 2009 and terminated the remaining portions of the hedges and settled the remaining portions of the interest rate swap contracts during November 2010. The deferred accumulated gain applicable to the settled interest rate swap contracts included in accumulated other comprehensive income totaled $49.3 million and $68.0 million ($32.0 million and $44.2 million on an after-tax basis) at June 30, 2013 and December 31, 2012. The remaining deferred gain of $49.3 million ($32.0 million on an after-tax basis) at June 30, 2013 will be recognized ratably in earnings through October 2014.

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

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

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

	June 30, 2013		December 31, 2012	
	Notional Amount	Estimated Fair Value	Notional Amount	Estimated Fair Value
Derivatives designated as hedges of fair value:				
Financial institution counterparties:				
Loan/lease interest rate swaps assets	$ 52,235	$ 1,214	$ 14,748	$ 24
Loan/lease interest rate swaps liabilities	55,405	(5,091)	84,577	(7,186)
Derivatives designated as hedges of cash flows:				
Financial institution counterparties:				
Interest rate swap on junior subordinated deferrable interest debentures	120,000	(2,201)	120,000	(4,365)
Non-hedging interest rate derivatives:				
Financial institution counterparties:				
Loan/lease interest rate swaps assets	212,361	6,610		
Loan/lease interest rate swaps liabilities	542,431	(40,051)	797,311	(60,994)
Loan/lease interest-rate caps assets	53,058	1,122	30,000	12
Customer counterparties:				
Loan/lease interest rate swaps assets	542,431	39,967	797,311	60,854
Loan/lease interest rate swaps liabilities	212,361	(6,610)		
Loan/lease interest-rate caps liabilities	53,058	(1,122)	30,000	(12)

The weighted-average rates paid and received for interest rate swaps outstanding at June 30, 2013 were as follows:

	Weighted-Average	
	Interest Rate Paid	Interest Rate Received
Interest rate swaps:		
Fair value hedge loan/lease interest rate swaps	2.57%	0.19%
Cash flow hedge interest rate swaps on junior subordinated deferrable interest debentures	5.47	1.82
Non-hedging interest rate swaps financial institution counterparties	4.48	1.81
Non-hedging interest rate swaps customer counterparties	1.81	4.48

The weighted-average strike rate for outstanding interest rate caps was 2.89% at June 30, 2013.

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

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

		June 30, 2013		December 31, 2012	
	Notional Units	Notional Amount	Estimated Fair Value	Notional Amount	Estimated Fair Value
Financial institution counterparties:					
Oil assets	Barrels	673	$ 1,389	464	$ 2,188
Oil liabilities	Barrels	607	(965)	402	(1,590)
Natural gas assets	MMBTUs	10,600	3,435	120	19
Natural gas liabilities	MMBTUs	5,470	(829)	120	(24)
Customer counterparties:					
Oil assets	Barrels	387	595	402	1,636
Oil liabilities	Barrels	567	(1,309)	464	(2,139)
Natural gas assets	MMBTUs	5,796	1,236	120	24
Natural gas liabilities	MMBTUs	10,600	(3,330)	120	(19)

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

		June 30, 2013		December 31, 2012	
	Notional Currency	Notional Amount	Estimated Fair Value	Notional Amount	Estimated Fair Value
Financial institution counterparties:					
Forward contracts assets	EUR	1,077	$ 2	1,093	$ 3
Forward contracts assets	CAD	19,573	588		
Customer counterparties:					
Forward contracts liabilities	CAD	19,552	(567)		

Gains, Losses and Derivative Cash Flows. For fair value hedges, the changes in the fair value of both the derivative hedging instrument and the hedged item are included in other non-interest income or other non-interest expense. The extent that such changes in fair value do not offset represents hedge ineffectiveness. Net cash flows from interest rate swaps on commercial loans/leases designated as hedging instruments in effective hedges of fair value are included in interest income on loans. For cash flow hedges, the effective portion of the gain or loss due to changes in the fair value of the derivative hedging instrument is included in other comprehensive income, while the ineffective portion (indicated by the excess of the cumulative change in the fair value of the derivative over that which is necessary to offset the cumulative change in expected future cash flows on the hedge transaction) is included in other non-interest income or other non-interest expense. Net cash flows from interest rate swaps on variable-rate loans designated as hedging instruments in effective hedges of cash flows and the reclassification from other comprehensive income of deferred gains associated with the termination of those hedges are included in interest income on loans. Net cash flows from the interest rate swap on junior subordinated deferrable interest debentures designated as a hedging instrument in an effective hedge of cash flows are included in interest expense on junior subordinated deferrable interest debentures. For non-hedging derivative instruments, gains and losses due to changes in fair value and all cash flows are included in other non-interest income and other non-interest expense.

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
Commercial loan/lease interest rate swaps:				
Amount of gain (loss) included in interest income on loans	$ (609)	$ (648)	$ (1,232)	$ (1,315)
Amount of (gain) loss included in other non-interest expense	(9)	5	6	17

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
Interest rate swaps/caps/floors on variable-rate loans:				
Amount reclassified from accumulated other comprehensive income to interest income on loans	$ 9,345	$ 9,345	$ 18,690	$ 18,690
Interest rate swaps on junior subordinated deferrable interest debentures:				
Amount reclassified from accumulated other comprehensive income to interest expense on junior subordinated deferrable interest debentures	1,103	1,044	2,188	2,077
Amount of gain (loss) recognized in other comprehensive income	(33)	(64)	(33)	(491)

No ineffectiveness related to interest rate derivatives designated as hedges of cash flows was recognized in the consolidated statements of income during the reported periods. The accumulated net after-tax gain related to effective cash flow hedges included in accumulated other comprehensive income totaled $30.8 million at June 30, 2013 and $41.6 million at December 31, 2012. The Corporation currently expects approximately $10.9 million of the net after-tax gain related to effective cash flow hedges included in accumulated other comprehensive income at June 30, 2013 will be reclassified into earnings during 2013, with the remaining amount expected to be classified into earnings in 2014. This amount represents management s best estimate given current expectations about market interest rates and volumes related to loan pools underlying the terminated cash flow hedges. Because actual market interest rates and volumes related to loan pools underlying the terminated cash flow hedges may differ from management s expectations, there can be no assurance as to the ultimate amount that will be reclassified into earnings during 2013.

As stated above, the Corporation enters into non-hedge related derivative positions primarily to accommodate the business needs of its customers. Upon the origination of a derivative contract with a customer, the Corporation simultaneously enters into an offsetting derivative contract with a third party. The Corporation recognizes immediate income based upon the difference in the bid/ask spread of the underlying transactions with its customers and the third party. Because the Corporation acts only as an intermediary for its customer, subsequent changes in the fair value of the underlying derivative contracts for the most part offset each other and do not significantly impact the Corporation s results of operations.

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
Non-hedging interest rate derivatives:				
Other non-interest income	$ 67	$ 197	$ 185	$ 979
Other non-interest expense	(37)	10	(55)	(37)
Non-hedging commodity derivatives:				
Other non-interest income	89	27	256	64
Non-hedging foreign currency derivatives:				

Other non-interest income	21	5	73	5

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

The Corporation s credit exposure relating to interest rate swaps, commodity swaps/options and foreign currency forward contracts with bank customers was approximately $40.2 million at June 30, 2013. This credit exposure is partly mitigated as transactions with customers are generally secured by the collateral, if any, securing the underlying transaction being hedged. The Corporation s credit exposure, net of collateral pledged, relating to interest rate swaps, commodity swaps/options and foreign currency forward contracts with upstream financial institution counterparties was $493 thousand at June 30, 2013. Collateral levels for upstream financial institution counterparties are monitored and adjusted as necessary. See Note 9 Balance Sheet Offsetting for additional information regarding the Corporation s credit exposure with upstream financial institution counterparties.

The aggregate fair value of securities posted as collateral by the Corporation related to derivative contracts totaled $32.2 million at June 30, 2013. At such date, the Corporation also had $1.3 million in cash collateral on deposit with other financial institution counterparties.

Note 9 - Balance Sheet Offsetting

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

Information about financial instruments that are eligible for offset in the consolidated balance sheet as of June 30, 2013 is presented in the following tables.

	Gross Amount Recognized	Gross Amount Offset	Net Amount Recognized
June 30, 2013			
Financial assets:			
Derivatives:			
Loan/lease interest rate swaps and caps	$ 8,946	$	$ 8,946
Commodity swaps and options	4,824		4,824
Foreign currency forward contracts	590		590
Total derivatives	14,360		14,360
Resell agreements	4,898		4,898
	$ 19,258	$	$ 19,258
Financial liabilities:			
Derivatives:			
Loan/lease interest rate swaps	$ 45,142	$	$ 45,142
Interest rate swap on junior subordinated deferrable interest debentures	2,201		2,201
Commodity swaps and options	1,794		1,794
Foreign currency forward contracts			

Total derivatives	49,137		49,137
Repurchase agreements	549,073		549,073
	$ 598,210	$	$ 598,210

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	Net Amount Recognized	Gross Amounts Not Offset Financial Instruments	Collateral	Net Amount
June 30, 2013				
Financial assets:				
Derivatives:				
Counterparty A	$ 2,425	$ (2,425)	$	$
Counterparty B	6,045	(6,045)		
Counterparty C	3,437	(3,437)		
Other counterparties	2,453	(1,960)		493
Total derivatives	14,360	(13,867)		493
Resell agreements	4,898		(4,898)	
Total	$ 19,258	$ (13,867)	$ (4,898)	$ 493
Financial liabilities:				
Derivatives:				
Counterparty A	$ 23,412	$ (2,425)	$ (19,708)	$ 1,279
Counterparty B	7,458	(6,045)		1,413
Counterparty C	11,888	(3,437)	(8,451)	
Other counterparties	6,379	(1,960)	(2,935)	1,484
Total derivatives	49,137	(13,867)	(31,094)	4,176
Repurchase agreements	549,073		(549,073)	
Total	$ 598,210	$ (13,867)	$ (580,167)	$ 4,176

Information about financial instruments that are eligible for offset in the consolidated balance sheet as of December 31, 2012 is presented in the following tables.

	Gross Amount Recognized	Gross Amount Offset	Net Amount Recognized
December 31, 2012			
Financial assets:			
Derivatives:			
Loan/lease interest rate swaps and caps	$ 36	$	$ 36
Commodity swaps and options	2,207		2,207
Foreign currency forward contracts	3		3
Total derivatives	2,246		2,246
Resell agreements	4,898		4,898
	$ 7,144	$	$ 7,144
Financial liabilities:			
Derivatives:			
Loan/lease interest rate swaps	$ 68,180	$	$ 68,180
Interest rate swap on junior subordinated deferrable interest debentures	4,365		4,365
Commodity swaps and options	1,614		1,614
Total derivatives	74,159		74,159
Repurchase agreements	559,461		559,461

	$	633,620	$		$	633,620

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	Net Amount Recognized	Gross Amounts Not Offset: Financial Instruments	Gross Amounts Not Offset: Collateral	Net Amount
December 31, 2012				
Financial assets:				
Derivatives:				
Counterparty A	$ 4	$ (4)	$	$
Counterparty B	2,033	(2,033)		
Counterparty C	189	(189)		
Other counterparties	20	(17)		3
Total derivatives	2,246	(2,243)		3
Resell agreements	4,898		(4,898)	
Total	$ 7,144	$ (2,243)	$ (4,898)	$ 3
Financial liabilities:				
Derivatives:				
Counterparty A	$ 33,999	$ (4)	$ (33,778)	$ 217
Counterparty B	14,374	(2,033)	(11,318)	1,023
Counterparty C	13,807	(189)	(13,618)	
Other counterparties	11,979	(17)	(10,059)	1,903
Total derivatives	74,159	(2,243)	(68,773)	3,143
Repurchase agreements	559,461		(559,461)	
Total	$ 633,620	$ (2,243)	$ (628,234)	$ 3,143

Note 10 - Earnings Per Common Share

Earnings per common share is computed using the two-class method. Basic earnings per common share is computed by dividing net earnings allocated to common stock by the weighted-average number of common shares outstanding during the applicable period, excluding outstanding participating securities. Participating securities include non-vested stock awards/stock units and deferred stock units, though no actual shares of common stock related to non-vested stock units and deferred stock units have been issued. Non-vested stock awards/stock units and deferred stock units are considered participating securities because holders of these securities receive non-forfeitable dividends at the same rate as holders of the Corporation s common stock. Diluted earnings per common share is computed using the weighted-average number of shares determined for the basic earnings per common share computation plus the dilutive effect of stock compensation using the treasury stock method.

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

	Three Months Ended June 30, 2013	Three Months Ended June 30, 2012	Six Months Ended June 30, 2013	Six Months Ended June 30, 2012
Net income	$ 59,663	$ 58,062	$ 114,851	$ 119,095
Less: Preferred stock dividends	2,688		2,688	
Net income available to common shareholders	56,975	58,062	112,163	119,095
Less: Earnings allocated to participating securities	209	185	407	376
Net earnings allocated to common stock	$ 56,766	$ 57,877	$ 111,756	$ 118,719
Distributed earnings allocated to common stock	$ 30,058	$ 29,424	$ 58,733	$ 57,575

Undistributed earnings allocated to common stock	26,708	28,453	53,023	61,144
Net earnings allocated to common stock	$ 56,766	$ 57,877	$ 111,756	$ 118,719
Weighted-average shares outstanding for basic earnings per common share	60,010,527	61,290,792	60,299,939	61,245,959
Dilutive effect of stock compensation	664,597	344,044	628,961	338,732
Weighted-average shares outstanding for diluted earnings per common share	60,675,124	61,634,836	60,928,900	61,584,691

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Note 11 - Stock-Based Compensation

A combined summary of activity in the Corporation s active stock plans is presented in the following table.

	Shares Available for Grant	Director Deferred Stock Units Outstanding	Non-Vested Stock Awards/Stock Units Outstanding Number of Shares	Non-Vested Stock Awards/Stock Units Outstanding Weighted-Average Grant-Date Fair Value	Stock Options Outstanding Number of Shares	Stock Options Outstanding Weighted-Average Exercise Price
Balance, January 1, 2013	1,157,413	27,724	188,560	$ 51.67	5,513,516	$ 51.94
Authorized	2,293,660					
Granted	(5,500)	5,500				
Stock options exercised					(662,224)	51.63
Stock awards vested						
Forfeited	30,375				(30,375)	51.32
Cancelled/expired						
Balance, June 30, 2013	3,475,948	33,224	188,560	$ 51.67	4,820,917	$ 51.99

Shares issued in connection with stock compensation awards are issued from available treasury shares. If no treasury shares are available, new shares are issued from available authorized shares. Shares issued in connection with stock compensation awards along with other related information were as follows:

	Three Months Ended June 30, 2013	Three Months Ended June 30, 2012	Six Months Ended June 30, 2013	Six Months Ended June 30, 2012
New shares issued from available authorized shares		31,511	153,275	132,671
Issued from available treasury stock	266,799		508,949	7,640
Total	266,799	31,511	662,224	140,311
Proceeds from stock option exercises	$ 13,743	$ 1,669	$ 34,189	$ 7,211

Stock-based compensation expense is recognized ratably over the requisite service period for all awards. Stock-based compensation expense was as follows:

	Three Months Ended June 30, 2013	Three Months Ended June 30, 2012	Six Months Ended June 30, 2013	Six Months Ended June 30, 2012
Stock options	$ 1,968	$ 2,158	$ 3,966	$ 4,359
Non-vested stock awards/stock units	345	355	689	709
Deferred stock units	330	330	330	330
Total	$ 2,643	$ 2,843	$ 4,985	$ 5,398

Unrecognized stock-based compensation expense at June 30, 2013 was as follows:

Stock options	$ 13,374
Non-vested stock awards/stock units	2,245
Total	$ 15,619

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Note 12 - Defined Benefit Plans

The components of the combined net periodic expense for the Corporation s defined benefit pension plans were as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
Expected return on plan assets, net of expenses	$ (2,772)	$ (2,603)	$ (5,544)	$ (5,206)
Interest cost on projected benefit obligation	1,836	1,950	3,671	3,900
Net amortization and deferral	1,639	1,428	3,279	2,657
Net periodic cost (benefit)	$ 703	$ 775	$ 1,406	$ 1,351

The Corporation s non-qualified defined benefit pension plan is not funded. No contributions to the qualified defined benefit pension plan were made during the six months ended June 30, 2013. The Corporation does not expect to make any contributions to the qualified defined benefit plan during the remainder of 2013.

Note 13 - Income Taxes

Income tax expense was as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
Current income tax expense	$ 12,315	$ 17,465	$ 28,024	$ 37,517
Deferred income tax expense (benefit)	379	(1,438)	(1,739)	(3,977)
Income tax expense, as reported	$ 12,694	$ 16,027	$ 26,285	$ 33,540
Effective tax rate	17.5%	21.6%	18.6%	22.0%

Net deferred tax liabilities totaled $65.9 million at June 30, 2013 and $112.1 million at December 31, 2012. No valuation allowance was recorded against deferred tax assets at June 30, 2013 as management believes it is more likely than not that all of the deferred tax assets will be realized because they were supported by recoverable taxes paid in prior years. There were no unrecognized tax benefits during any of the reported periods. Interest and/or penalties related to income taxes are reported as a component of income tax expense. Such amounts were not significant during the reported periods.

The Corporation files income tax returns in the U.S. federal jurisdiction. The Company is no longer subject to U.S. federal income tax examinations by tax authorities for years before 2009.

Note 14 - Other Comprehensive Income (Loss)

The before and after tax amounts allocated to each component of other comprehensive income (loss) are presented in the following table. Reclassification adjustments related to securities available for sale are included in net gain (loss) on securities transactions in the accompanying consolidated statements of income. The change in the net actuarial gain/loss on defined-benefit post-retirement benefit plans is included in the computation of net periodic pension expense (see Note 12 Defined Benefit Plans). Reclassification adjustments related to interest rate swaps on variable-rate loans are included in interest income and fees on loans in the accompanying consolidated statements of income. Reclassification adjustments related to the interest rate swap on junior subordinated deferrable interest debentures are included in interest expense on junior subordinated deferrable interest debentures in the accompanying consolidated statements of income.

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	Three Months Ended June 30, 2013			Three Months Ended June 30, 2012		
	Before Tax Amount	Tax Expense, (Benefit)	Net of Tax Amount	Before Tax Amount	Tax Expense, (Benefit)	Net of Tax Amount
Securities available for sale and transferred securities:						
Change in net unrealized gain/loss during the period	$ (74,025)	$ (25,909)	$ (48,116)	$ 20,968	$ 7,340	$ 13,628
Change in net unrealized gain on securities transferred to held to maturity	(9,745)	(3,411)	(6,334)			
Reclassification adjustment for net (gains) losses included in net income	(6)	(2)	(4)	(370)	(130)	(240)
Total securities available for sale and transferred securities	(83,776)	(29,322)	(54,454)	20,598	7,210	13,388
Defined-benefit post-retirement benefit plans:						
Change in the net actuarial gain/loss	1,639	574	1,065	1,428	500	928
Derivatives:						
Change in the accumulated gain/loss on effective cash flow hedge derivatives	(33)	(12)	(21)	(64)	(23)	(41)
Reclassification adjustments for (gains) losses included in net income:						
Interest rate swaps on variable-rate loans	(9,345)	(3,270)	(6,075)	(9,345)	(3,270)	(6,075)
Interest rate swap on junior subordinated deferrable interest debentures	1,103	386	717	1,044	365	679
Total derivatives	(8,275)	(2,896)	(5,379)	(8,365)	(2,928)	(5,437)
Total other comprehensive income (loss)	$ (90,412)	$ (31,644)	$ (58,768)	$ 13,661	$ 4,782	$ 8,879

	Six Months Ended June 30, 2013			Six Months Ended June 30, 2012		
	Before Tax Amount	Tax Expense, (Benefit)	Net of Tax Amount	Before Tax Amount	Tax Expense, (Benefit)	Net of Tax Amount
Securities available for sale and transferred securities:						
Change in net unrealized gain/loss during the period	$ (95,369)	$ (33,379)	$ (61,990)	$ 22,850	$ 7,998	$ 14,852
Change in net unrealized gain on securities transferred to held to maturity	(18,204)	(6,372)	(11,832)			
Reclassification adjustment for net (gains) losses included in net income	(11)	(4)	(7)	121	42	79
Total securities available for sale and transferred securities	(113,584)	(39,755)	(73,829)	22,971	8,040	14,931
Defined-benefit post-retirement benefit plans:						
Change in the net actuarial gain/loss	3,279	1,148	2,131	2,657	930	1,727
Derivatives:						
Change in the accumulated gain/loss on effective cash flow hedge derivatives	(33)	(12)	(21)	(491)	(173)	(318)
Reclassification adjustments for (gains) losses included in net income:						
Interest rate swaps on variable-rate loans	(18,690)	(6,541)	(12,149)	(18,690)	(6,541)	(12,149)
Interest rate swap on junior subordinated deferrable interest debentures	2,188	766	1,422	2,077	727	1,350
Total derivatives	(16,535)	(5,787)	(10,748)	(17,104)	(5,987)	(11,117)
Total other comprehensive income (loss)	$ (126,840)	$ (44,394)	$ (82,446)	$ 8,524	$ 2,983	$ 5,541

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Activity in accumulated other comprehensive income (loss), net of tax, was as follows:

	Securities Available For Sale	Defined Benefit Plans	Derivatives	Accumulated Other Comprehensive Income
Balance January 1, 2013	$ 245,539	$ (49,071)	$ 41,580	$ 238,048
Other comprehensive income (loss) before reclassifications	(73,822)	2,131	(21)	(71,712)
Amounts reclassified from accumulated other comprehensive income (loss)	(7)		(10,727)	(10,734)
Net other comprehensive income (loss) during period	(73,829)	2,131	(10,748)	(82,446)
Balance June 30, 2013	$ 171,710	$ (46,940)	$ 30,832	$ 155,602
Balance January 1, 2012	$ 227,052	$ (42,958)	$ 63,640	$ 247,734
Other comprehensive income (loss) before reclassifications	14,852	1,727	(318)	16,261
Amounts reclassified from accumulated other comprehensive income (loss)	79		(10,799)	(10,720)
Net other comprehensive income (loss) during period	14,931	1,727	(11,117)	5,541
Balance June 30, 2012	$ 241,983	$ (41,231)	$ 52,523	$ 253,275

Note 15 Operating Segments

The Corporation is managed under a matrix organizational structure whereby its two primary operating segments, Banking and Frost Wealth Advisors overlap a regional reporting structure. The regions are primarily based upon geographic location and include Austin, Corpus Christi, Dallas, Fort Worth, Houston, Rio Grande Valley, San Antonio and Statewide. The Corporation is primarily managed based on the line of business structure. In that regard, all regions have the same lines of business, which have the same product and service offerings, have similar types and classes of customers and utilize similar service delivery methods. Pricing guidelines for products and services are the same across all regions. The regional reporting structure is primarily a means to scale the lines of business to provide a local, community focus for customer relations and business development.

Banking and Frost Wealth Advisors are delineated by the products and services that each segment offers. The Banking operating segment includes both commercial and consumer banking services, Frost Securities, Inc. and Frost Insurance Agency. Commercial banking services are provided to corporations and other business clients and include a wide array of lending and cash management products. Consumer banking services include direct lending and depository services. Frost Insurance Agency provides insurance brokerage services to individuals and businesses covering corporate and personal property and casualty products, as well as group health and life insurance products and human resources consulting services. Frost Securities, Inc. provides advisory and private equity services to middle market companies. The Frost Wealth Advisors operating segment includes fee-based services within private trust, retirement services, and financial management services, including personal wealth management and brokerage services. A third operating segment, Non-Banks, is for the most part the parent holding company, as well as certain other insignificant non-bank subsidiaries of the parent that, for the most part, have little or no activity. The parent company s principal activities include the direct and indirect ownership of the Corporation s banking and non-banking subsidiaries and the issuance of debt and equity. Its principal source of revenue is dividends from its subsidiaries.

The accounting policies of each reportable segment are the same as those of the Corporation except for the following items, which impact the Banking and Frost Wealth Advisors segments: (i) expenses for consolidated back-office operations and general overhead-type expenses such as executive administration, accounting and internal audit are allocated to operating segments based on estimated uses of those services, (ii) income tax expense for the individual segments is calculated essentially at the statutory rate, and (iii) the parent company records the tax expense or benefit necessary to reconcile to the consolidated total.

The Corporation uses a match-funded transfer pricing process to assess operating segment performance. The process helps the Corporation to (i) identify the cost or opportunity value of funds within each business segment, (ii) measure the profitability of a particular business segment by relating appropriate costs to revenues, (iii) evaluate each business segment in a manner consistent with its economic impact on consolidated earnings, and (iv) enhance asset and liability pricing decisions.

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Summarized operating results by segment were as follows:

	Banking	Frost Wealth Advisors	Non-Banks	Consolidated
Revenues from (expenses to) external customers:				
Three months ended:				
June 30, 2013	$ 198,206	$ 28,259	$ (775)	$ 225,690
June 30, 2012	193,634	26,598	(1,252)	218,980
Six months ended:				
June 30, 2013	$ 402,466	$ 55,482	$ (1,665)	$ 456,283
June 30, 2012	389,907	52,595	(1,836)	440,666
Net income (loss):				
Three months ended:				
June 30, 2013	$ 56,582	$ 4,263	$ (1,182)	$ 59,663
June 30, 2012	55,984	4,228	(2,150)	58,062
Six months ended:				
June 30, 2013	$ 110,135	$ 7,501	$ (2,785)	$ 114,851
June 30, 2012	114,274	7,619	(2,798)	119,095

Note 16 Fair Value Measurements

The fair value of an asset or liability is the price that would be received to sell that asset or paid to transfer that liability in an orderly transaction occurring in the principal market (or most advantageous market in the absence of a principal market) for such asset or liability. In estimating fair value, the Corporation utilizes valuation techniques that are consistent with the market approach, the income approach and/or the cost approach. Such valuation techniques are consistently applied. Inputs to valuation techniques include the assumptions that market participants would use in pricing an asset or liability. ASC Topic 820 establishes a fair value hierarchy for valuation inputs that gives the highest priority to quoted prices in active markets for identical assets or liabilities and the lowest priority to unobservable inputs. The fair value hierarchy is as follows:

Level 1 Inputs Unadjusted quoted prices in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date.

Level 2 Inputs Inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly or indirectly. These might include quoted prices for similar assets or liabilities in active markets, quoted prices for identical or similar assets or liabilities in markets that are not active, inputs other than quoted prices that are observable for the asset or liability (such as interest rates, volatilities, prepayment speeds, credit risks, etc.) or inputs that are derived principally from or corroborated by market data by correlation or other means.

Level 3 Inputs Unobservable inputs for determining the fair values of assets or liabilities that reflect an entity s own assumptions about the assumptions that market participants would use in pricing the assets or liabilities.

In general, fair value is based upon quoted market prices, where available. If such quoted market prices are not available, fair value is based upon internally developed models that primarily use, as inputs, observable market-based parameters. Valuation adjustments may be made to ensure that financial instruments are recorded at fair value. These adjustments may include amounts to reflect counterparty credit quality and the Corporation s creditworthiness, among other things, as well as unobservable parameters. Any such valuation adjustments are applied consistently over time. The Corporation s valuation methodologies may produce a fair value calculation that may not be indicative of net realizable value or reflective of future fair values. While management believes the Corporation s valuation methodologies are appropriate and consistent with other market participants, the use of different methodologies or assumptions to determine the fair value of certain financial instruments could result in a different estimate of fair value at the reporting date. Furthermore, the reported fair value amounts have not been comprehensively revalued since the presentation dates, and therefore, estimates of fair value after the balance sheet date may differ significantly from the amounts presented herein. A more detailed description of the valuation methodologies used for assets and liabilities measured at fair value is set forth below. Transfers between levels of the fair value hierarchy are recognized on the actual date of the event or circumstances that caused the transfer, which generally coincides with the Corporation s monthly and/or quarterly valuation process.

Financial Assets and Financial Liabilities: Financial assets and financial liabilities measured at fair value on a recurring basis include the following:

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Securities Available for Sale. U.S. Treasury securities are reported at fair value utilizing Level 1 inputs. Other securities classified as available for sale are reported at fair value utilizing Level 2 inputs. For these securities, the Corporation obtains fair value measurements 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.

The Corporation reviews the prices supplied by the independent pricing service, as well as their underlying pricing methodologies, for reasonableness and to ensure such prices are aligned with traditional pricing matrices. In general, the Corporation does not purchase investment portfolio securities that are esoteric or that have a complicated structure. The Corporation s entire portfolio consists of traditional investments, nearly all of which are U.S. Treasury obligations, federal agency bullet or mortgage pass-through securities, or general obligation or revenue based municipal bonds. Pricing for such instruments is fairly generic and is easily obtained. From time to time, the Corporation will validate, on a sample basis, prices supplied by the independent pricing service by comparison to prices obtained from third-party sources or derived using internal models.

Trading Securities. U.S. Treasury securities and exchange-listed common stock are reported at fair value utilizing Level 1 inputs. Other securities classified as trading are reported at fair value utilizing Level 2 inputs in the same manner as described above for securities available for sale.

Derivatives. Derivatives are generally reported at fair value utilizing Level 2 inputs, except for foreign currency contracts, which are reported at fair value utilizing Level 1 inputs. The Corporation obtains dealer quotations and utilizes internally developed valuation models to value the swap related to its junior subordinated deferrable interest debentures and commodity swaps/options. The Corporation utilizes internally developed valuation models and/or third-party models with observable market data inputs to validate the valuations provided by the dealers. Though there has never been a significant discrepancy in the valuations, should such a significant discrepancy arise, the Corporation would obtain price verification from a third-party dealer. The Corporation utilizes internal valuation models with observable market data inputs to estimate fair values of customer interest rate swaps, caps and floors. The Corporation also obtains dealer quotations for these derivatives for comparative purposes to assess the reasonableness of the model valuations. In cases where significant credit valuation adjustments are incorporated into the estimation of fair value, reported amounts are considered to have been derived utilizing Level 3 inputs.

For purposes of potential valuation adjustments to its derivative positions, the Corporation evaluates the credit risk of its counterparties as well as that of the Corporation. Accordingly, the Corporation has considered factors such as the likelihood of default by the Corporation and its counterparties, its net exposures, and remaining contractual life, among other things, in determining if any fair value adjustments related to credit risk are required. Counterparty exposure is evaluated by netting positions that are subject to master netting arrangements, as well as considering the amount of collateral securing the position. The Corporation reviews its counterparty exposure on a regular basis, and, when necessary, appropriate business actions are taken to adjust the exposure. The Corporation also utilizes this approach to estimate its own credit risk on derivative liability positions. To date, the Corporation has not realized any significant losses due to a counterparty s inability to pay any net uncollateralized position. The change in value of derivative assets and derivative liabilities attributable to credit risk was not significant during the reported periods.

The following table summarizes financial assets and financial liabilities measured at fair value on a recurring basis as of June 30, 2013 and December 31, 2012, segregated by the level of the valuation inputs within the fair value hierarchy utilized to measure fair value:

	Level 1 Inputs	Level 2 Inputs	Level 3 Inputs	Total Fair Value
June 30, 2013				
Securities available for sale:				
U.S. Treasury	$ 3,042,723	$	$	$ 3,042,723
Residential mortgage-backed securities		2,075,573		2,075,573
States and political subdivisions		879,175		879,175
Other		35,899		35,899
Trading account securities:				
U.S. Treasury	14,489			14,489
States and political subdivisions		2,288		2,288
Derivative assets:				
Interest rate swaps, caps and floors		48,677	236	48,913

Commodity swaps and options		6,655	6,655
Foreign currency forward contracts	590		590
Derivative liabilities:			
Interest rate swaps, caps and floors		55,075	55,075
Commodity swaps and options		6,433	6,433
Foreign currency forward contracts	567		567

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	Level 1 Inputs	Level 2 Inputs	Level 3 Inputs	Total Fair Value
December 31, 2012				
Securities available for sale:				
U.S. Treasury	$ 3,057,921	$	$	$ 3,057,921
Residential mortgage-backed securities		2,518,003		2,518,003
States and political subdivisions		591,483		591,483
Other		35,892		35,892
Trading account securities:				
U.S. Treasury	14,038			14,038
States and political subdivisions		16,036		16,036
Derivative assets:				
Interest rate swaps, caps and floors		60,535	355	60,890
Commodity swaps and options		3,867		3,867
Foreign currency forward contracts	3			3
Derivative liabilities:				
Interest rate swaps, caps and floors		72,557		72,557
Commodity swaps and options		3,772		3,772

Derivative assets, measured at fair value on a recurring basis using significant unobservable (Level 3) inputs during the reported periods consist of interest rate swaps sold to loan customers. The significant unobservable (Level 3) inputs used in the fair value measurement of these interest rate swaps sold to loan customers primarily relate to the probability of default and loss severity in the event of default. The probability of default is determined by the underlying risk grade of the loan (see Note 3 Loans) underlying the interest rate swap in that the probability of default increases as a loan s risk grade deteriorates, while the loss severity is estimated through an analysis of the collateral supporting both the underlying loan and interest rate swap. Generally, a change in the assumption used for the probability of default is accompanied by a directionally similar change in the assumption used for the loss severity. As of June 30, 2013, the weighted-average risk grade of loans underlying interest rate swaps measured at fair value using significant unobservable (Level 3) inputs was 11.1. The loss severity in the event of default on the interest rate swaps ranged from 20% to 50%, with the weighted-average loss severity being 24.3%. A reconciliation the beginning and ending balances of derivative assets measured at fair value on a recurring basis using significant unobservable (Level 3) inputs is not presented as such amounts were not significant during the reported periods.

Certain financial assets and financial liabilities are measured at fair value on a nonrecurring basis; that is, the instruments 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). Financial assets measured at fair value on a non-recurring basis during the reported periods include certain impaired loans reported at the fair value of the underlying collateral if repayment is expected solely from the collateral. Collateral values are estimated using Level 2 inputs based on observable market data, typically in the case of real estate collateral, or Level 3 inputs based on customized discounting criteria, typically in the case of non-real estate collateral such as inventory, accounts receivable, equipment or other business assets.

The following table presents impaired loans that were remeasured and reported at fair value through a specific valuation allowance allocation of the allowance for loan losses based upon the fair value of the underlying collateral during the reported periods.

	Six Months Ended June 30, 2013		Six Months Ended June 30, 2012	
	Level 2	Level 3	Level 2	Level 3
Carrying value of impaired loans before allocations	$	$	$ 11,078	$
Specific valuation allowance allocations			(2,732)	
Fair value	$	$	$ 8,346	$

The significant unobservable (Level 3) inputs used in the fair value measurement of collateral for collateral-dependent impaired loans included in the above table primarily relate to customized discounting criteria applied to the customer s reported amount of collateral. The amount of the collateral discount depends upon the marketability of the underlying collateral. As the Corporation s primary objective in the event of default would be to monetize the collateral to settle the outstanding balance of the loan, less marketable collateral would receive a larger discount. During the reported periods, collateral discounts ranged from 20% in the case of accounts receivable collateral to 50% in the case of inventory collateral.

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Non-Financial Assets and Non-Financial Liabilities: The Corporation has no non-financial assets or non-financial liabilities measured at fair value on a recurring basis. Certain non-financial assets measured at fair value on a non-recurring basis include foreclosed assets (upon initial recognition or subsequent impairment), non-financial assets and non-financial liabilities measured at fair value in the second step of a goodwill impairment test, and intangible assets and other non-financial long-lived assets measured at fair value for impairment assessment. Non-financial assets measured at fair value on a non-recurring basis during the reported periods include certain foreclosed assets which, upon initial recognition, were remeasured and reported at fair value through a charge-off to the allowance for loan losses and certain foreclosed assets which, subsequent to their initial recognition, were remeasured at fair value through a write-down included in other non-interest expense. The fair value of a foreclosed asset is estimated using Level 2 inputs based on observable market data or Level 3 inputs based on customized discounting criteria. During the reported periods, all fair value measurements for foreclosed assets utilized Level 2 inputs.

The following table presents foreclosed assets that were remeasured and reported at fair value during the reported periods:

	Six Months Ended June 30, 2013	Six Months Ended June 30, 2012
Foreclosed assets remeasured at initial recognition:		
Carrying value of foreclosed assets prior to remeasurement	$ 3,489	$ 5,856
Charge-offs recognized in the allowance for loan losses	(576)	(1,159)
Fair value	$ 2,913	$ 4,697
Foreclosed assets remeasured subsequent to initial recognition:		
Carrying value of foreclosed assets prior to remeasurement	$ 3,852	$ 9,210
Write-downs included in other non-interest expense	(657)	(1,321)
Fair value	$ 3,195	$ 7,889

Charge-offs recognized upon loan foreclosures are generally offset by general or specific allocations of the allowance for loan losses and generally do not, and did not during the reported periods, significantly impact the Corporation s provision for loan losses. Regulatory guidelines require the Corporation to reevaluate the fair value of other real estate owned on at least an annual basis. The Corporation s policy is to comply with the regulatory guidelines. Accordingly, appraisals are never considered to be outdated, and the Corporation does not make any adjustments to the appraised values.

FASB ASC Topic 825 requires disclosure of the fair value of financial assets and financial liabilities, including those financial assets and financial liabilities that are not measured and reported at fair value on a recurring basis or non-recurring basis. A detailed description of the valuation methodologies used in estimating the fair value of financial instruments is set forth in the 2012 Form 10-K.

The estimated fair values of financial instruments that are reported at amortized cost in the Corporation s consolidated balance sheets, segregated by the level of the valuation inputs within the fair value hierarchy utilized to measure fair value, were as follows:

	June 30, 2013		December 31, 2012	
	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
Financial assets:				
Level 2 inputs:				
Cash and cash equivalents	$ 2,901,355	$ 2,901,355	$ 3,524,979	$ 3,524,979
Securities held to maturity	3,166,692	3,070,349	2,956,381	2,996,944
Cash surrender value of life insurance policies	139,704	139,704	138,005	138,005
Accrued interest receivable	95,334	95,334	82,529	82,529
Level 3 inputs:				
Loans, net	9,139,143	9,262,790	9,119,395	9,212,159

Financial liabilities:				
Level 2 inputs:				
Deposits	19,078,219	19,078,952	19,497,366	19,498,518
Federal funds purchased and repurchase agreements	549,823	549,823	561,061	561,061
Junior subordinated deferrable interest debentures	123,712	123,712	123,712	123,712
Subordinated notes payable and other borrowings	100,000	90,185	100,007	89,596
Accrued interest payable	1,551	1,551	1,804	1,804

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Under ASC Topic 825, entities may choose to measure eligible financial instruments at fair value at specified election dates. The fair value measurement option (i) may be applied instrument by instrument, with certain exceptions, (ii) is generally irrevocable and (iii) is applied only to entire instruments and not to portions of instruments. Unrealized gains and losses on items for which the fair value measurement option has been elected must be reported in earnings at each subsequent reporting date. During the reported periods, the Corporation had no financial instruments measured at fair value under the fair value measurement option.

Note 17 - Accounting Standards Updates

ASU 2011-11, Balance Sheet (Topic 210) Disclosures about Offsetting Assets and Liabilities. ASU 2011-11 amends Topic 210, Balance Sheet, to require an entity to disclose both gross and net information about financial instruments, such as sales and repurchase agreements and reverse sale and repurchase agreements and securities borrowing/lending arrangements, and derivative instruments that are eligible for offset in the statement of financial position and/or subject to a master netting arrangement or similar agreement. ASU No. 2013-01, Balance Sheet (Topic 210) Clarifying the Scope of Disclosures about Offsetting Assets and Liabilities, clarifies that ordinary trade receivables are not within the scope of ASU 2011-11. ASU 2011-11, as amended by ASU 2013-01, became effective for the Corporation on January 1, 2013. See Note 9 Balance Sheet Offsetting for applicable disclosures.

ASU 2012-02, Intangibles Goodwill and Other (Topic 350) Testing Indefinite-Lived Intangible Assets for Impairment. ASU 2012-02 gives entities the option to first assess qualitative factors to determine whether the existence of events or circumstances leads to a determination that it is more likely than not that an indefinite-lived intangible asset is impaired. If, after assessing the totality of events or circumstances, an entity determines it is more likely than not that an indefinite-lived intangible asset is impaired, then the entity must perform the quantitative impairment test. If, under the quantitative impairment test, the carrying amount of the intangible asset exceeds its fair value, an entity should recognize an impairment loss in the amount of that excess. Permitting an entity to assess qualitative factors when testing indefinite-lived intangible assets for impairment results in guidance that is similar to the goodwill impairment testing guidance in ASU 2011-08. ASU 2012-02 became effective for the Corporation on January 1, 2013 and did not have a significant impact on the Corporation s financial statements.

ASU 2012-06, Business Combinations (Topic 805) Subsequent Accounting for an Indemnification Asset Recognized at the Acquisition Date as a Result of a Government-Assisted Acquisition of a Financial Institution (a consensus of the FASB Emerging Issues Task Force). ASU 2012-06 clarifies the applicable guidance for subsequently measuring an indemnification asset recognized as a result of a government-assisted acquisition of a financial institution. Under ASU 2012-06, when a reporting entity recognizes an indemnification asset as a result of a government-assisted acquisition of a financial institution and, subsequently, a change in the cash flows expected to be collected on the indemnification asset occurs (as a result of a change in cash flows expected to be collected on the assets subject to indemnification), the reporting entity should subsequently account for the change in the measurement of the indemnification asset on the same basis as the change in the assets subject to indemnification. Any amortization of changes in value should be limited to the contractual term of the indemnification agreement (that is, the lesser of the term of the indemnification agreement and the remaining life of the indemnified assets). ASU 2012-06 became effective for the Corporation on January 1, 2013 and did not have a significant impact on the Corporation s financial statements.

ASU 2013-02, Comprehensive Income (Topic 220) Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income. ASU 2013-02 amends recent guidance related to the reporting of comprehensive income to enhance the reporting of reclassifications out of accumulated other comprehensive income. ASU 2013-02 became effective for the Corporation on January 1, 2013 and did not have a significant impact on the Corporation s financial statements. See Note 14 Other Comprehensive Income (Loss).

ASU 2013-08, Financial Services Investment Companies (Topic 946) Amendments to the Scope, Measurement and Disclosure Requirements. ASU 2013-08 clarifies the characteristics of investment companies and sets forth a new approach for determining whether a company is an investment company. The fundamental characteristics of an investment company include (i) the company obtains funds from investors and provides the investors with investment management services; (ii) the company commits to its investors that its business purpose and only substantive activities are investing the funds for returns solely from capital appreciation, investment income, or both; and (iii) the company or its affiliates do not obtain or have the objective of obtaining returns or benefits from an investee or its affiliates that are not normally attributable to ownership interests or that are other than capital appreciation or investment income. ASU 2013-08 also sets forth the scope, measurement and disclosure requirements for investment companies. ASU 2013-08 is effective for the Corporation on January 1, 2014 and is not expected to have a significant impact on the Corporation s financial statements.

ASU 2013-10, Derivatives and Hedging (Topic 815) Inclusion of the Fed Funds Effective Swap Rate (or Overnight Index Swap Rate) as a Benchmark Interest Rate for Hedge Accounting Purposes. ASU 2013-10 permits the Fed Funds Effective Swap Rate (or Overnight Index Swap Rate) to be used as a U.S. benchmark interest rate for hedge accounting purposes under Topic 815, in addition to interest rates on direct Treasury obligations of the U.S. government and the London Interbank Offered Rate (LIBOR). ASU 2013-10 is effective prospectively for qualifying new or redesignated hedging relationships entered into on or after July 17, 2013 and is not expected to have a significant impact on the Corporation s financial statements.

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Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations

Financial Review

Cullen/Frost Bankers, Inc.

The following discussion should be read in conjunction with the Corporation s consolidated financial statements, and notes thereto, for the year ended December 31, 2012, included in the 2012 Form 10-K. Operating results for the three and six months ended June 30, 2013 are not necessarily indicative of the results for the year ending December 31, 2013 or any future period.

Dollar amounts in tables are stated in thousands, except for per share amounts.

Forward-Looking Statements and Factors that Could Affect Future Results

Certain statements contained in this Quarterly Report on Form 10-Q that are not statements of historical fact constitute forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995 (the Act), notwithstanding that such statements are not specifically identified as such. In addition, certain statements may be contained in the Corporation s future filings with the SEC, in press releases, and in oral and written statements made by or with the approval of the Corporation that are not statements of historical fact and constitute forward-looking statements within the meaning of the Act. Examples of forward-looking statements include, but are not limited to: (i) projections of revenues, expenses, income or loss, earnings or loss per share, the payment or nonpayment of dividends, capital structure and other financial items; (ii) statements of plans, objectives and expectations of Cullen/Frost or its management or Board of Directors, including those relating to products or services; (iii) statements of future economic performance; and (iv) statements of assumptions underlying such statements. Words such as believes , anticipates , expects , intends , targeted , continue , remain , will , should , may and other simi intended to identify forward-looking statements but are not the exclusive means of identifying such statements.

Forward-looking statements involve risks and uncertainties that may cause actual results to differ materially from those in such statements. Factors that could cause actual results to differ from those discussed in the forward-looking statements include, but are not limited to:

Local, regional, national and international economic conditions and the impact they may have on the Corporation and its customers and the Corporation s assessment of that impact.

Volatility and disruption in national and international financial markets.

Government intervention in the U.S. financial system.

Changes in the mix of loan geographies, sectors and types or the level of non-performing assets and charge-offs.

Changes in estimates of future reserve requirements based upon the periodic review thereof under relevant regulatory and accounting requirements.

The effects of and changes in trade and monetary and fiscal policies and laws, including the interest rate policies of the Federal Reserve Board.

Inflation, interest rate, securities market and monetary fluctuations.

The effect of changes in laws and regulations (including laws and regulations concerning taxes, banking, securities and insurance) with which the Corporation and its subsidiaries must comply.

The soundness of other financial institutions.

Political instability.

Impairment of the Corporation s goodwill or other intangible assets.

Acts of God or of war or terrorism.

The timely development and acceptance of new products and services and perceived overall value of these products and services by users.

Changes in consumer spending, borrowings and savings habits.

Changes in the financial performance and/or condition of the Corporation s borrowers.

Technological changes.

Acquisitions and integration of acquired businesses.

The ability to increase market share and control expenses.

The Corporation s ability to attract and retain qualified employees.

Changes in the competitive environment in the Corporation s markets and among banking organizations and other financial service providers.

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 standard setters.

Changes in the reliability of the Corporation s vendors, internal control systems or information systems.

Changes in the Corporation s liquidity position.

Changes in the Corporation s organization, compensation and benefit plans.

The costs and effects of legal and regulatory developments including the resolution of legal proceedings or regulatory or other governmental inquiries and the results of regulatory examinations or reviews.

Greater than expected costs or difficulties related to the integration of new products and lines of business.

The Corporation s success at managing the risks involved in the foregoing items.

Forward-looking statements speak only as of the date on which such statements are made. The Corporation undertakes no obligation to update any forward-looking statement to reflect events or circumstances after the date on which such statement is made, or to reflect the occurrence of unanticipated events.

Application of Critical Accounting Policies and Accounting Estimates

The accounting and reporting policies followed by the Corporation conform, in all material respects, to accounting principles generally accepted in the United States and to general practices within the financial services industry. The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. While the Corporation bases estimates on historical experience, current information and other factors deemed to be relevant, actual results could differ from those estimates.

The Corporation considers accounting estimates to be critical to reported financial results if (i) the accounting estimate requires management to make assumptions about matters that are highly uncertain and (ii) different estimates that management reasonably could have used for the accounting estimate in the current period, or changes in the accounting estimate that are reasonably likely to occur from period to period, could have a material impact on the Corporation s financial statements. Accounting policies related to the allowance for loan losses are considered to be critical, as these policies involve considerable subjective judgment and estimation by management.

For additional information regarding critical accounting policies, refer to Note 1 - Summary of Significant Accounting Policies in the notes to consolidated financial statements and the sections captioned Application of Critical Accounting Policies and Accounting Estimates and Allowance for Loan Losses in Management s Discussion and Analysis of Financial Condition and Results of Operations included in the 2012 Form 10-K. There have been no significant changes in the Corporation s application of critical accounting policies related to the allowance for loan losses since December 31, 2012.

Overview

A discussion of the Corporation s results of operations is presented below. Certain reclassifications have been made to make prior periods comparable. Taxable-equivalent adjustments are the result of increasing income from tax-free loans and securities by an amount equal to the taxes that would be paid if the income were fully taxable based on a 35% federal income tax rate, thus making tax-exempt asset yields comparable to taxable asset yields.

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Results of Operations

Net income available to common shareholders totaled $57.0 million, or $0.94 diluted per common share, and $112.2 million, or $1.85 diluted per commons share, for the three and six months ended June 30, 2013 compared to $58.1 million, or $0.94 diluted per common share, and $119.1 million, or $1.93 diluted per common share, for the three and six months ended June 30, 2012, respectively.

Selected income statement data and other selected data for the comparable periods was as follows:

	Three Months Ended		Six Months Ended	
	June 30, 2013	June 30, 2012	June 30, 2013	June 30, 2012
Taxable-equivalent net interest income	$ 173,966	$ 163,972	$ 346,767	$ 328,679
Taxable-equivalent adjustment	20,785	14,755	40,773	29,755
Net interest income	153,181	149,217	305,994	298,924
Provision for loan losses	3,575	2,355	9,575	3,455
Net interest income after provision for loan losses	149,606	146,862	296,419	295,469
Non-interest income	72,509	69,763	150,289	141,742
Non-interest expense	149,758	142,536	305,572	284,576
Income before income taxes	72,357	74,089	141,136	152,635
Income taxes	12,694	16,027	26,285	33,540
Net income	59,663	58,062	114,851	119,095
Preferred stock dividends	2,688		2,688	
Net income available to common shareholders	$ 56,975	$ 58,062	$ 112,163	$ 119,095
Earnings per common share basic	$ 0.95	$ 0.94	$ 1.86	$ 1.94
Earnings per common share diluted	0.94	0.94	1.85	1.93
Dividends per common share	0.50	0.48	0.98	0.94
Return on average assets	1.03%	1.14%	1.02%	1.19%
Return on average common equity	9.93	9.95	9.71	10.27
Average shareholders equity to average total assets	11.00	11.51	10.97	11.57

Net income available to common shareholders decreased $1.1 million, or 1.9%, for the three months ended June 30, 2013 and decreased $6.9 million, or 5.8%, for the six months ended June 30, 2013 compared to the same periods in 2012. The decrease during the three months ended June 30, 2013 was primarily the result of a $7.2 million increase in non-interest expense, $2.7 million related to preferred stock dividends and a $1.2 million increase in the provision for loan losses partly offset by a $4.0 million increase in net interest income, a $3.3 million decrease in income tax expense and a $2.7 million increase in non-interest income. The decrease during the six months ended June 30, 2013 was primarily the result of a $21.0 million increase in non-interest expense, a $6.1 million increase in the provision for loan losses and $2.7 million related to preferred stock dividends partly offset by an $8.5 million increase in non-interest income, a $7.3 million decrease in income tax expense and a $7.1 million increase in net interest income.

Details of the changes in the various components of net income are further discussed below.

Net Interest Income

Net interest income is the difference between interest income on earning assets, such as loans and securities, and interest expense on liabilities, such as deposits and borrowings, which are used to fund those assets. Net interest income is the Corporation s largest source of revenue, representing 67.1% of total revenue during the first six months of 2013. Net interest margin is the ratio of taxable-equivalent net interest income to average earning assets for the period. The level of interest rates and the volume and mix of earning assets and interest-bearing liabilities impact net interest income and net interest margin.

The Federal Reserve influences the general market rates of interest, including the deposit and loan rates offered by many financial institutions. The Corporation s loan portfolio is significantly affected by changes in the prime interest rate. The prime interest rate, which is the rate offered on loans to borrowers with strong credit, remained at 3.25% for the entire year in 2012 and through the second quarter of 2013. The Corporation s loan portfolio is also impacted, to a lesser extent, by changes in the London Interbank Offered Rate (LIBOR). At June 30, 2013, the one-month and three-month U.S. dollar LIBOR rates were 0.20% and 0.27%, respectively, while at June 30, 2012, the one-month and three-month U.S. dollar LIBOR rates were 0.25% and 0.46%, respectively. The intended federal funds rate, which is the cost of immediately available overnight funds, remained at zero to 0.25% for the entire year in 2012 and through the second quarter of 2013.

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The Corporation s balance sheet has historically been asset sensitive, meaning that earning assets generally reprice more quickly than interest-bearing liabilities. Therefore, the Corporation s net interest margin was likely to increase in sustained periods of rising interest rates and decrease in sustained periods of declining interest rates. During the fourth quarter of 2007, in an effort to make the Corporation s balance sheet less sensitive to changes in interest rates, the Corporation entered into various interest rate swaps which effectively converted certain variable-rate loans into fixed-rate instruments for a period of time. During the fourth quarter of 2008, the Corporation also entered into an interest rate swap which effectively converted variable-rate debt into fixed-rate debt for a period of time. As a result of these actions, the Corporation s balance sheet was more interest-rate neutral and changes in interest rates had a less significant impact on the Corporation s net interest margin than would have otherwise been the case. During the fourth quarter of 2009, a portion of the interest rate swaps on variable-rate loans were terminated, while the remaining interest rate swaps on variable-rate loans were terminated during the fourth quarter of 2010. These actions increased the asset sensitivity of the Corporation s balance sheet. The deferred accumulated after-tax gain applicable to the settled interest rate contracts included in accumulated other comprehensive income totaled $49.3 million ($32.0 million on an after-tax basis) at June 30, 2013. The remaining deferred gain of $49.3 million ($32.0 million on an after-tax basis) will be recognized ratably in earnings through October 2014. See Note 8 -Derivative Financial Instruments in the accompanying notes to consolidated financial statements included elsewhere in this report for additional information related to these interest rate swaps.

The Corporation is primarily funded by core deposits, with non-interest-bearing demand deposits historically being a significant source of funds. This lower-cost funding base is expected to have a positive impact on the Corporation s net interest income and net interest margin in a rising interest rate environment. The Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act) repealed the federal prohibitions on the payment of interest on demand deposits, thereby permitting depository institutions to pay interest on business transaction and other accounts beginning July 21, 2011. Although the ultimate impact of this legislation on the Corporation has not yet been determined, the Corporation may begin to incur interest costs associated with demand deposits in the future as market conditions warrant. See Item 3. Quantitative and Qualitative Disclosures About Market Risk elsewhere in this report for information about the expected impact of this legislation on the Corporation s sensitivity to interest rates. Further analysis of the components of the Corporation s net interest margin is presented below.

The following table presents the changes in taxable-equivalent net interest income and identifies the changes due to differences in the average volume of earning assets and interest-bearing liabilities and the changes due to changes in the average interest rate on those assets and liabilities. The changes in net interest income due to changes in both average volume and average interest rate have been allocated to the average volume change or the average interest rate change in proportion to the absolute amounts of the change in each. The comparison also includes, where applicable, an additional change factor that shows the effect of the difference in the number of days in each period, as further discussed below.

	Quarter to Date June 30, 2013 vs. June 30, 2012	Year to Date June 30, 2013 vs. June 30, 2012
Due to changes in average volumes	$ 18,316	$ 27,158
Due to changes in average interest rates	(8,322)	(7,264)
Due to difference in the number days in each of the comparable periods		(1,806)
Total change	$ 9,994	$ 18,088

Taxable-equivalent net interest income for the three months ended June 30, 2013 increased $10.0 million, or 6.1%, while taxable-equivalent net interest income for the six months ended June 30, 2013 increased $18.1 million, or 5.5%, compared to the same periods in 2012, respectively. The increase during the three months ended June 30, 2013 was primarily related to an increase in the average volume of interest-earning assets partly offset by a decrease in the net interest margin. Taxable-equivalent net interest income for the first six months of 2013 included 181 days compared to 182 days for the first six months of 2012 as a result of leap year. The additional day added approximately $1.8 million to taxable-equivalent net interest income during the first six months of 2012. Excluding the impact of the additional day during 2012 results in an effective increase in taxable-equivalent net interest income of approximately $19.9 million during the first six months of 2013, which was primarily related to an increase in the average volume of interest-earning assets partly offset by a decrease in the net interest margin. The average volume of interest-earning assets for the three and six months ended June 30, 2012 increased $1.9 billion and $2.1 billion compared to the same periods in 2012. Over the same time frame, the net interest margin decreased 18 basis points from 3.61% during the three months ended June 30, 2012 to 3.43% during the three months ended June 30, 2013 and decreased 23 basis points from 3.67% during the six months ended June 30, 2012 to 3.44% during the six months ended June 30, 2013. The decrease in the net interest margin during the comparable periods was partly due to

an increase in the relative proportion of average interest-earning assets invested in lower-yielding, interest-bearing deposits during 2013 compared to 2012 while the relative proportion of average interest-earning assets invested in higher-yielding securities decreased. The net interest margin was also negatively impacted by a decrease in the average yield on loans, as further discussed below. The average yield on interest-earning assets decreased 26 basis points from 3.82% in the first six months of 2012 to 3.56% in the first six months of 2013 while the average cost of funds decreased 5 basis points from 0.25% in the first six months of 2012 to 0.20% in the first six months of 2013. The average yield on interest-earning assets is primarily impacted by changes in market interest rates as well as changes in the volume and relative mix of interest-earning assets. As stated above, market interest rates have remained at historically low levels during the reported periods. The effect of lower average market interest rates during the reported periods on the average yield on average interest-earning assets was partly limited by the aforementioned interest rate swaps on variable-rate loans.

The average volume of loans during the first six months of 2013 increased $999.4 million compared to the same period in 2012. Loans made up approximately 44.8% of average interest-earning assets during the first six months of 2013 compared to 44.5% during the first six months of 2012. The average yield on loans was 4.59% during the first six months of 2013 compared to 4.90% during the first six months of 2012. Loans generally have significantly higher yields compared to securities, interest-bearing deposits and federal funds sold and resell agreements and, as such, have a more positive effect on the net interest margin.

The average volume of securities increased $84.9 million during the first six months of 2013 compared to the same period in 2012. Securities made up approximately 44.1% of average interest-earning assets during the first six months of 2013 compared to 48.6% during the first six months of 2012. The average yield on securities was 3.34% in the first six months of 2013 compared to 3.32% in the first six months of 2012. Despite a significant decrease in market rates for investment securities during the comparable periods, the average yield on securities increased 2 basis points during the first six months of 2013 compared to the first six months of 2012 as the Corporation increased the relative proportion of investments held in higher-yielding, tax-exempt municipal securities. The relative proportion of higher-yielding, tax-exempt municipal securities totaled 36.4% of average securities during the first six months of 2013 compared to 25.1% during the first six months of 2012. The average yield on taxable securities was 1.90% in the first six months of 2013 compared to 2.17% in first six months of 2012, while the average taxable-equivalent yield on tax-exempt securities was 5.82% in the first six months of 2013 compared to 6.94% in first six months of 2012.

Average federal funds sold, resell agreements and interest-bearing deposits during the first six months of 2013 increased $1.0 billion compared to the same period in 2012. Federal funds sold, resell agreements and interest-bearing deposits made up approximately 11.1% of average interest-earning assets during the first six months of 2013 compared to 6.9% during the first six months of 2012. The combined average yield on federal funds sold, resell agreements and interest-bearing deposits was 0.26% during the first six months of 2013 compared to 0.30% during the first six months of 2012. The increase in average federal funds sold, resell agreements and interest-bearing deposits compared to the first six months of 2012 was primarily related to excess liquidity from deposit growth.

Average deposits increased $2.1 billion during the first six months of 2013 compared to the first six months of 2012. Average interest-bearing deposits for the first six months of 2013 increased $1.3 billion compared to the same period in 2012, while average non-interest-bearing deposits for the first six months of 2013 increased $827.7 million compared to the same period in 2012. The ratio of average interest-bearing deposits to total average deposits was 60.3% during both the first six months of 2013 and 2012. The average cost of deposits is primarily impacted by changes in market interest rates as well as changes in the volume and relative mix of interest-bearing deposits. The average cost of interest-bearing deposits and total deposits was 0.14% and 0.08% during the first six months of 2013 compared to 0.18% and 0.11% during the same period in 2012. The decrease in the average cost of interest-bearing deposits during the comparable periods was primarily the result of decreases in interest rates offered on certain deposit products due to decreases in average market interest rates and decreases in renewal interest rates on maturing certificates of deposit given the current low interest rate environment. Additionally, the relative proportion of higher-cost certificates of deposit to total average interest-bearing deposits decreased from 6.2% during the first six months of 2012, to 5.3% during the first six months of 2013.

The Corporation s net interest spread, which represents the difference between the average rate earned on earning assets and the average rate paid on interest-bearing liabilities, was 3.36% during the first six months of 2013 compared to 3.57% during the first six months of 2012. The net interest spread, as well as the net interest margin, will be impacted by future changes in short-term and long-term interest rate levels, as well as the impact from the competitive environment. A discussion of the effects of changing interest rates on net interest income is set forth in Item 3. Quantitative and Qualitative Disclosures About Market Risk included elsewhere in this report.

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The Corporation s hedging policies permit the use of various derivative financial instruments, including interest rate swaps, swaptions, caps and floors, to manage exposure to changes in interest rates. Details of the Corporation s derivatives and hedging activities are set forth in Note 8 - Derivative Financial Instruments in the accompanying notes to consolidated financial statements included elsewhere in this report. Information regarding the impact of fluctuations in interest rates on the Corporation s derivative financial instruments is set forth in Item 3. Quantitative and Qualitative Disclosures About Market Risk included elsewhere in this report.

Provision for Loan Losses

The provision for loan losses is determined by management as the amount to be added to the allowance for loan losses after net charge-offs have been deducted to bring the allowance to a level which, in management s best estimate, is necessary to absorb probable losses within the existing loan portfolio. The provision for loan losses totaled $3.6 million and $9.6 million for the three and six months ended June 30, 2013 compared to $2.4 million and $3.5 million for the three and six months ended June 30, 2012. The increase in the provision for loan losses during the three and six months ended June 30, 2013 compared to the three and six months ended June 30, 2012 was impacted by a $15.0 million charge-off related to a single commercial and industrial loan relationship during the first quarter of 2013. See the section captioned Allowance for Loan Losses elsewhere in this discussion for further analysis of the provision for loan losses.

Non-Interest Income

The components of non-interest income were as follows:

	Three Months Ended		Six Months Ended	
	June 30, 2013	June 30, 2012	June 30, 2013	June 30, 2012
Trust and investment management fees	$ 22,561	$ 21,279	$ 44,446	$ 41,931
Service charges on deposit accounts	20,044	20,639	40,088	41,433
Insurance commissions and fees	9,266	9,171	22,336	21,548
Interchange and debit card transaction fees	4,268	4,292	8,279	8,409
Other charges, commissions and fees	8,578	7,825	16,333	15,175
Net gain (loss) on securities transactions	6	370	11	(121)
Other	7,786	6,187	18,796	13,367
Total	$ 72,509	$ 69,763	$ 150,289	$ 141,742

Total non-interest income for the three and six months ended June 30, 2013 increased $2.7 million, or 3.9%, and $8.5 million, or 6.0%, compared to the same periods in 2012. Changes in the components of non-interest income are discussed below.

Trust and Investment Management Fees. Trust and investment management fees for the three and six months ended June 30, 2013 increased $1.3 million, or 6.0%, and $2.5 million, or 6.0%, compared to the same periods in 2012. Trust investment fees are the most significant component of trust and investment management fees, making up approximately 67% of total trust and investment management fees for the first six months of 2013. Investment and other custodial account fees are generally based on the market value of assets within a trust account. Volatility in the equity and bond markets impacts the market value of trust assets and the related trust investment fees.

The increase in trust and investment management fee income during the three months ended June 30, 2013 compared to the same period in 2012 was primarily the result of an increase in trust investment fees (up $1.2 million) and securities lending income (up $138 thousand) partially offset by a decrease in estate fees (down $192 thousand). Estate fees are transactional in nature and can vary from quarter to quarter. The increase in trust and investment management fee income during the six months ended June 30, 2013 compared to the same period in 2012 was primarily the result of an increase in trust investment fees (up $2.5 million), securities lending income (up $410 thousand) and custody fees (up $139 thousand) partially offset by a decrease in estate fees (down $722 thousand). The increase in trust investment fees in the three and six months ended June 30, 2013 compared to the prior year periods was partly due to higher average equity valuations during 2013 and an increase in the number of accounts.

At June 30, 2013, assets held in accounts maintained by Frost Wealth Advisors were primarily composed of equity securities (44.2% of assets), fixed income securities (41.0% of assets) and cash equivalents (9.3% of assets). The estimated fair value of these assets was $26.3 billion (including managed assets of $11.1 billion and custody assets of $15.2 billion) at June 30, 2013, compared to $26.2 billion (including managed assets of $10.9 billion and custody assets of $15.3 billion) at December 31, 2012 and $26.1 billion (including managed assets of $10.5 billion and custody assets of $15.6 billion) at June 30, 2012.

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Service Charges on Deposit Accounts. Service charges on deposit accounts for the three and six months ended June 30, 2013 decreased $595 thousand, or 2.9%, and $1.3 million, or 3.2%, compared to the same periods in 2012. The decreases were primarily due to decreases in service charges on commercial accounts (down $313 thousand and $856 thousand during the three and six months ended June 30, 2013, respectively) and decreases in overdraft/insufficient funds charges on both consumer and commercial accounts (down $311 thousand and $549 thousand on a combined basis during the three and six months ended June 30, 2013, respectively). Overdraft/insufficient funds charges totaled $7.9 million ($6.2 million consumer and $1.7 million commercial) during the three months ended June 30, 2013 compared to $8.2 million ($6.5 million consumer and $1.7 million commercial) during the same period in 2012. Overdraft/insufficient funds charges totaled $15.9 million ($12.4 million consumer and $3.5 million commercial) during the six months ended June 30, 2013 compared to $16.4 million ($13.0 million consumer and $3.4 million commercial) during the six months ended June 30, 2012.

Insurance Commissions and Fees. Insurance commissions and fees for the three and six months ended June 30, 2013 increased $95 thousand, or 1.0%, and $788 thousand, or 3.7%, compared to the same periods in 2012. The increase during the three months ended June 30, 2013 was related to an increase in commission income (up $203 thousand) partially offset by a decrease in contingent commissions (down $109 thousand). The increase during the six months ended June 30, 2013 included increases in commission income (up $458 thousand) and contingent commissions (up $329 thousand). The increases in commission income resulted from normal variation in the market demand for insurance products.

Insurance commissions and fees include contingent commissions totaling $357 thousand and $3.1 million during the three and six months ended June 30, 2013 and $466 thousand and $2.8 million during the three and six months ended June 30, 2012. Contingent commissions primarily consist of amounts received from various property and casualty insurance carriers related to the loss performance of insurance policies previously placed. Such commissions are seasonal in nature and are generally received during the first quarter of each year. These commissions totaled $2.1 million and $2.0 million during the six months ended June 30, 2013 and 2012. Contingent commissions also include amounts received from various benefit plan insurance companies related to the volume of business generated and/or the subsequent retention of such business. These benefit plan related commissions totaled $354 thousand and $1.0 million during the three and six months ended June 30, 2013 and $417 thousand and $803 thousand during the three and six months ended June 30, 2012.

Interchange and Debit Card Transaction Fees. Interchange and debit card transaction fees consist of income from Visa check card usage, point of sale income from PIN-based debit card transactions and ATM service fees. Interchange and debit card transaction fees for the three and six months ended June 30, 2013 decreased $24 thousand, or 0.6%, and $130 thousand, or 1.5%, compared to the three and six months ended June 30, 2012.

Federal Reserve rules applicable to financial institutions that have assets of $10 billion or more provide that the maximum permissible interchange fee for an electronic debit transaction is the sum of 21 cents per transaction and 5 basis points multiplied by the value of the transaction. An upward adjustment of no more than 1 cent to an issuer s debit card interchange fee is allowed if the card issuer develops and implements policies and procedures reasonably designed to achieve certain fraud-prevention standards.

Other Charges, Commissions and Fees. Other charges, commissions and fees for the three and six months ended June 30, 2013 increased $753 thousand, or 9.6%, and $1.2 million, or 7.6%, compared to the same periods in 2012. The increase in other charges, commissions and fees during the three months ended June 30, 2013 included increases in income from the sale of mutual funds (up $497 thousand), income related to the sale of annuities (up $348 thousand) and loan processing fees (up $221 thousand). These increases were partly offset by a decrease in income related to letter of credit fees (down $165 thousand) and human resources consulting revenue (down $113 thousand). The increase in other charges, commissions and fees during the six months ended June 30, 2013 included increases in income from the sale of mutual funds (up $889 thousand), income related to the sale of annuities (up $544 thousand), loan processing fees (up $427 thousand) and referral fees from the Corporation s merchant services payment processor (up $210 thousand). These increases were partly offset by decreases in other service charges (down $474 thousand), investment banking fees related to corporate advisory services (down $176 thousand) and human resources consulting revenue (down $149 thousand).

Net Gain/Loss on Securities Transactions. During the six months ended June 30, 2013, the Corporation sold available-for-sale securities with an amortized cost totaling $8.5 billion and realized a net gain of $11 thousand on those sales. These securities were primarily purchased during 2013 and subsequently sold in connection with the Corporation s tax planning strategies related to the Texas franchise tax. The gross proceeds from the sales of these securities outside of Texas are included in total revenues/receipts from all sources reported for Texas franchise tax purposes, which results in a reduction in the overall percentage of revenues/receipts apportioned to Texas and subjected to taxation under the Texas franchise tax.

During the six months ended June 30, 2012, the Corporation realized a net loss of $121 thousand on the sale of available-for-sale securities. In January 2012, the Corporation purchased $996.4 million of U.S. Treasury securities utilizing excess liquidity as a defensive strategy to lock in the yield on those funds in case the Federal Reserve lowered the rate paid on funds deposited in the Federal Reserve account. Shortly thereafter, U.S. Treasury prices rallied and the Corporation sold the

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securities, realizing a $2.1 million gain, and concurrently purchased $998.4 million of U.S. Treasury securities having a shorter term to maturity. In March 2012, U.S. Treasury yields increased and the Corporation sold the aforementioned position in U.S. Treasury securities and recognized a $2.6 million loss. The proceeds were concurrently reinvested in U.S. Treasury securities that had a similar yield to the original, longer-term position purchased in January 2012, but with a shorter term to maturity. During the second quarter of 2012, the Corporation sold a municipal security with an amortized cost totaling $5.6 million and realized a $367 thousand gain on the sale. During the first six months of 2012, the Corporation also sold available-for-sale securities with an amortized cost totaling $14.0 billion and realized a net gain of $2 thousand on those sales. These securities were primarily purchased during 2012 and subsequently sold in connection with the Corporation s aforementioned tax planning strategies related to the Texas franchise tax.

Other Non-Interest Income. Other non-interest income increased $1.6 million, or 25.8% and increased $5.4 million, or 40.6%, for the three and six months ended June 30, 2013 compared to the same periods in 2012. Other non-interest income during the three months ended June 30, 2013 included increases in sundry income from various miscellaneous items (up $952 thousand), mineral interest income related to bonus, rental and shut-in payments and oil and gas royalties received from severed mineral interests on property owned by Main Plaza Corporation, a wholly owned non-banking subsidiary of the Corporation (up $533 thousand), gain on sale of assets (up $526 thousand) and income from customer foreign currency transactions (up approximately $191 thousand). The increase from the aforementioned items was partly offset by decreases in income from securities trading and customer derivative transactions (down $428 thousand) and earnings on the cash surrender value of life insurance policies (down $200 thousand). Other non-interest income during the six months ended June 30, 2013 included increases in gains on the sale of assets/foreclosed assets (up $5.0 million), sundry income from various miscellaneous items (up $1.5 million) and income from customer foreign currency transactions (up approximately $412 thousand). The increase from the aforementioned items was partly offset by a decrease in income from securities trading and customer derivative transactions (down $881 thousand), mineral interest income (down $392 thousand) and earnings on the cash surrender value of life insurance policies (down $376 thousand). During the first quarter of 2013, the Corporation realized a $5.6 million gain related to the sale of a building and parking garage. The Corporation leased back portions of the building through the third quarter of 2013 and the first quarter of 2015. As a result, a portion of the gain was deferred and only $4.5 million of the total $5.6 million gain has been recognized during the six months ended June 30, 2013. The remaining deferred portion of the gain, which totaled $1.1 million, at June 30, 2013 will be recognized ratably over the lease periods. The Corporation also recognized a $251 thousand gain related to the sale of another building during the second quarter of 2013. During the second quarter of 2013, sundry income from various miscellaneous items included a $1.8 million reversal of an accrual related to an acquisition contingency and $312 thousand related to a distribution from a limited partnership investment.

Non-Interest Expense

The components of non-interest expense were as follows:

	Three Months Ended		Six Months Ended	
	June 30, 2013	June 30, 2012	June 30, 2013	June 30, 2012
Salaries and wages	$ 66,502	$ 62,624	$ 132,967	$ 126,326
Employee benefits	14,629	14,048	32,620	30,749
Net occupancy	12,645	12,213	24,624	24,010
Furniture and equipment	14,986	13,734	29,171	27,154
Deposit insurance	2,835	2,838	5,724	5,335
Intangible amortization	788	994	1,608	2,005
Other	37,373	36,085	78,858	68,997
Total	$ 149,758	$ 142,536	$ 305,572	$ 284,576

Total non-interest expense for the three and six months ended June 30, 2013 increased $7.2 million, or 5.1%, and $21.0 million, or 7.4%, compared to the same periods in 2012. Changes in the components of non-interest expense are discussed below.

Salaries and Wages. Salaries and wages for the three and six months ended June 30, 2013 increased $3.9 million, or 6.2%, and $6.6 million, or 5.3%, compared to the same periods in 2012. These increases were primarily related to normal annual merit and market increases and increases in incentive compensation partly offset by decreases in stock-based compensation expense and increases in cost deferrals related to lending activity.

Employee Benefits. Employee benefits expense for the three and six months ended June 30, 2013 increased $581 thousand, or 4.1%, and $1.9 million, or 6.1%, compared to the same periods in 2012. The increase during the three months ended June 30, 2013 was primarily related to increases in expenses related to the Corporation s 401(k) and profit sharing plans (up

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$332 thousand) and payroll taxes (up $253 thousand). The increase during the six months ended June 30, 2013 was primarily related to increases in expenses related to the Corporation s 401(k) and profit sharing plans (up $1.2 million) and payroll taxes (up $717 thousand) partly offset by a decrease in expenses related to the Corporation s defined benefit retirement plans (down $143 thousand).

The Corporation s defined benefit retirement and restoration plans were frozen effective as of December 31, 2001 and were replaced by a profit sharing plan. Management believes these actions helped to reduce the volatility in retirement plan expense. However, the Corporation still has funding obligations related to the defined benefit and restoration plans and could recognize retirement expense related to these plans in future years, which would be dependent on the return earned on plan assets, the level of interest rates and employee turnover.

Net Occupancy. Net occupancy expense for the three and six months ended June 30, 2013 increased $432 thousand, or 3.5%, and $614 thousand, or 2.6%, compared to the same periods in 2012. The increases were primarily related to increases in lease expense (up $484 thousand and $854 thousand during the three and six months ended June 30, 2013, respectively), decreases in rental income (down $219 thousand and $351 thousand during the three and six months ended June 30, 2013, respectively) and increases in depreciation on leasehold improvements (up $104 thousand and $223 thousand during the three and six months ended June 30, 2013, respectively). These items were partly offset by decreases in service contracts expense (down $212 thousand and $131 thousand during the three and six months ended June 30, 2013, respectively), building depreciation (down $109 thousand and $178 thousand during the three and six months ended June 30, 2013, respectively) and property taxes (down $103 thousand and $190 thousand during the three and six months ended June 30, 2013, respectively), among other things.

Furniture and Equipment. Furniture and equipment expense for the three and six months ended June 30, 2013 increased $1.3 million, or 9.1%, and $2.0 million, or 7.4%, compared to the same periods in 2012. The increase during the three months ended June 30, 2013 was primarily related to increases in service contracts expense (up $310 thousand), software amortization (up $270 thousand), software maintenance (up $260 thousand) and repairs expense (up $149 thousand). The increase during the six months ended June 30, 2013 was primarily related to increases in software maintenance (up $687 thousand), service contracts expense (up $425 thousand), software amortization (up $354 thousand) and repairs expense (up $268 thousand).

Deposit Insurance. Deposit insurance expense totaled $2.8 million and $5.7 million for the three and six months ended June 30, 2013 compared to $2.8 million and $5.3 million for the three and six months ended June 30, 2012. The increase in deposit insurance expense during the first six months of 2013 compared to the same period in 2012 was primarily related to an increase in assets, partly offset by the impact of a decrease in the assessment rate.

Intangible Amortization. Intangible amortization is primarily related to core deposit intangibles and, to a lesser extent, intangibles related to customer relationships and non-compete agreements. Intangible amortization for the three and six months ended June 30, 2013 decreased $206 thousand, or 20.7% and $397 thousand, or 19.8% compared to the same periods in 2012. The decreases in amortization expense are primarily the result of the completion of amortization of certain intangible assets and a reduction in the annual amortization rate of certain intangible assets as the Corporation uses an accelerated amortization approach which results in higher amortization rates during the earlier years of the useful lives of intangible assets.

Other Non-Interest Expense. Other non-interest expense for the three and six months ended June 30, 2013 increased $1.3 million, or 3.6%, and $9.9 million, or 14.3%, compared to the same periods in 2012. Components of other non-interest expense with significant increases during the three months ended June 30, 2013 included advertising/promotions expense (up $985 thousand), partly due to increased promotions for mobile banking products; ATM expense (up $857 thousand), related to a branding arrangement entered into in 2012 that more than doubled the number of ATM machines; and professional services expense (up $659 thousand). The increases in the aforementioned items were partly offset by decreases in losses on the sale/write-down of assets/foreclosed assets (down $1.2 million), sundry losses from various miscellaneous items (down $941 thousand) and regulatory examination fees (down $310 thousand). Losses on the sale/write-down of assets/foreclosed assets included a $700 thousand non-recurring write-down of certain equipment assets in 2012. The increase during the six months ended June 30, 2013 was primarily related to the write-down of certain land and other assets totaling $7.2 million during the first quarter of 2013. Approximately $6.2 million of this amount was related to the write-down of certain long-term bank-owned property in downtown San Antonio that was recently made available for sale. Additionally, other components of other non-interest expense with significant increases during the six months ended June 30, 2013 included ATM expense (up $1.7 million), professional services expense (up $983 thousand), fraud losses (up $610 thousand), donations expense (up $490 thousand), advertising/promotions expense (up $452 thousand) and Visa check card expense (up $433 thousand). The increases in the aforementioned items were partly offset by decreases in regulatory examination fees (down $625 thousand), amortization of net deferred costs related to loan commitments (down $539 thousand) and sundry losses from various miscellaneous items (down $427 thousand).

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Results of Segment Operations

The Corporation s operations are managed along two primary operating segments: Banking and Frost Wealth Advisors. A description of each business and the methodologies used to measure financial performance is described in Note 15 - Operating Segments in the accompanying notes to consolidated financial statements included elsewhere in this report. Net income (loss) available to common shareholders by operating segment is presented below:

	Three Months Ended		Six Months Ended	
	June 30, 2013	June 30, 2012	June 30, 2013	June 30, 2012
Banking	$ 56,582	$ 55,984	$ 110,135	$ 114,274
Frost Wealth Advisors	4,263	4,228	7,501	7,619
Non-Banks	(1,182)	(2,150)	(2,785)	(2,798)
Consolidated net income	$ 59,663	$ 58,062	$ 114,851	$ 119,095

Banking

Net income for the three and six months ended June 30, 2013 increased $598 thousand, or 1.1%, and decreased $4.1 million, or 3.6%, compared to the same periods in 2012. The increase during the three months ended June 30, 2013 was primarily the result of a $4.3 million increase in net interest income, a $3.6 million decrease in income tax expense and a $306 thousand increase in non-interest income partly offset by a $6.4 million increase in non-interest expense and a $1.2 million increase in the provision for loan losses. The decrease during the six months ended June 30, 2013 was primarily the result of a $17.8 million increase in non-interest expense and a $6.1 million increase in the provision for loan losses partly offset by a $7.2 million increase in net interest income, a $7.2 million decrease in income tax expense and a $5.3 million increase in non-interest income.

Net interest income for the three and six months ended June 30, 2013 increased $4.3 million, or 2.9%, and $7.2 million, or 2.4%, compared to the same periods in 2012. The increase primarily resulted from an increase in the average volume of interest-earning assets partly offset by a decrease in the net interest margin. Net interest income included an additional day of interest accrual in the first six months of 2012 due to leap year. See the analysis of net interest income included in the section captioned Net Interest Income included elsewhere in this discussion.

The provision for loan losses for the three and six months ended June 30, 2013 totaled $3.6 million and $9.6 million compared to $2.4 million and $3.5 million for the same periods in 2012. The increase during the six months ended June 30, 2013 was impacted by a $15.0 million charge-off related to a single commercial and industrial loan relationship during the first quarter of 2013. See the analysis of the provision for loan losses included in the section captioned Allowance for Loan Losses included elsewhere in this discussion.

Non-interest income for the three and six months ended June 30, 2013 increased $306 thousand, or 0.7%, and $5.3 million, or 5.9%, compared to the same periods in 2012. The increase during the three months ended June 30, 2013 was primarily related to an increase in other non-interest income partly offset by a decreases in service charges on deposits and net gains on securities transaction). The increase in other-non-interest income was partly related to the reversal of an accrual related to an acquisition contingency, a distribution from a limited partnership investment and gain related to the sale of a building during the second quarter of 2013. The increase during the six months ended June 30, 2013 was primarily due to increases in other non-interest income and insurance commissions and fees partly offset by a decreases in service charges on deposits. In addition to the aforementioned items impacting other non-interest income, during the first quarter of 2013, the Banking segment realized a $5.6 million gain related to the sale of a building and parking garage. The Banking segment leased back portions of the building through the third quarter of 2013 and the first quarter of 2015. As a result, a portion of the gain was deferred and only $4.5 million of the total $5.6 million gain has been recognized as a component of other non-interest income during the six months ended June 30, 2013. The increase in insurance commissions and fees during the six months ended June 30, 2013 was primarily due to increases in commission income and contingent commissions. The decreases in services charges on deposit accounts during the three and six months ended June 30, 2013 were primarily due to decreases in service charges on commercial accounts. See the analysis of these items included in the section captioned Non-Interest Income included elsewhere in this discussion.

Non-interest expense for the three months and six months ended June 30, 2013 increased $6.4 million, or 5.3%, and increased $17.8 million, or 7.4%, compared to the same periods in 2012. The increase during the three months ended June 30, 2013 was primarily due to increases in salaries and wages and employee benefits, other non-interest expense and furniture and equipment expense. The increase during the six months ended June 30, 2013 was primarily due to increases in other non-interest expense, salaries and wages and employee benefits and furniture and equipment expense. The increase in other non-interest expense during the six months ended June 30, 2013 was primarily related to the write-down of certain land and other assets totaling $7.2 million during the first quarter of 2013. Approximately $6.2 million of this amount was related to the write-down of certain long-term bank-owned property in downtown San Antonio that was recently made available for sale. Other non-interest expense during the three and six months ended June 30, 2013 was also impacted by increases in ATM expense, advertising/promotions expense and professional services expense, among other things. The increases in salaries and wages during the three and six months ended June 30, 2013 were primarily related to normal annual merit and market increases and increases in incentive compensation partly offset by decreases in stock-based compensation expense and increases in cost deferrals related to lending activity. The increases in furniture and equipment expense during the three and six months ended June 30, 2013 were primarily due to increases in software maintenance, service contract expenses, software amortization and repairs expense. The increases in employee benefits expense were primarily related to increases in expenses related to the Corporation s 401(k) and profit sharing plans and an increase in payroll taxes. See the analysis of these items included in the section captioned Non-Interest Expense included elsewhere in this discussion.

Frost Insurance Agency, which is included in the Banking operating segment, had gross commission revenues of $9.3 million and $22.5 million during the three and six months ended June 30, 2013 and $9.2 million and $21.7 million during the three and six months ended June 30, 2012. The increase during the three months ended June 30, 2013 was related to an increase in commission income. The increase during the six months ended June 30, 2013 was related to an increase in commission income and, to a lesser extent, contingent commissions. See the analysis of insurance commissions and fees included in the section captioned Non-Interest Income included elsewhere in this discussion. Frost Insurance Agency also had consulting revenues totaling $364 thousand and $713 thousand during the three and six months ended June 30, 2013 and $477 thousand and $862 thousand during the three and six months ended June 30, 2012. Consulting revenues are reported as a component of other charges, commissions and fees and were primarily related to the acquisition of Stone Partners during the first quarter of 2012.

Frost Wealth Advisors

Net income for the three and six months ended June 30, 2013 increased $35 thousand, or 0.8%, and decreased $118 thousand, or 1.5%, compared to the same periods in 2012. The increase during the three months ended June 30, 2013 was primarily due to a $2.0 million increase in non-interest income mostly offset by a $1.6 million increase in non-interest expense and a $372 thousand decrease in net interest income. The decrease during the six months ended June 30, 2013 was primarily due to a $3.1 million increase in non-interest expense and an $832 thousand decrease in net interest income mostly offset by a $3.7 million increase in non-interest income.

Net interest income for the three and six months ended June 30, 2013 decreased $372 thousand, or 18.5%, and $832 thousand, or 20.4%, compared to the same periods in 2012. The decrease in net interest income was partly due to a decrease in the funds transfer price received for providing those funds.

Non-interest income for the three and six months ended June 30, 2013 increased $2.0 million, or 8.3%, and $3.7 million, or 7.7%, compared to the same periods in 2012. The increases during the three and six months ended June 30, 2013 were primarily due to increases in trust and investment management fees (up $1.3 million during the three months ended June 30, 2013 and $2.5 million during the six months ended June 30, 2013) and other charges, commissions and fees (up $800 thousand during the three months ended June 30, 2013 and $1.3 million during the six months ended June 30, 2013).

Trust and investment management fee income is the most significant income component for Frost Wealth Advisors. Investment fees are the most significant component of trust and investment management fees, making up approximately 67% of total trust and investment management fees for the first six months of 2013. Investment and other custodial account fees are generally based on the market value of assets within a trust account. Volatility in the equity and bond markets impacts the market value of trust assets and the related investment fees. The increase in trust and investment management fee income during the three months ended June 30, 2013 compared to the same period in 2012 was primarily the result of an increase in trust investment fees and securities lending income partly offset by a decrease in estate fees. The increase in trust and investment management fee income during the six months ended June 30, 2013 compared to the same period in 2012 was primarily the result of an increase in trust investment fees, securities lending income and custody fees partly offset by a decrease in estate fees. See the analysis of trust and investment management fees included in the section captioned Non-Interest Income included elsewhere in this discussion.

The increases in other charges, commissions and fees during the three and six months ended June 30, 2013 compared to the same periods in 2012 was primarily due to increases in income related to sale of mutual funds and annuities.

Non-interest expense for the three and six months ended June 30, 2013 increased $1.6 million, or 8.0%, and $3.1 million, or 7.5%, compared to the same periods in 2012. The increases were primarily due to a increases in salaries and wages (up $956 thousand and $1.8 million, respectively), other non-interest expense (up $472 thousand and $851 thousand, respectively) and employee benefits (up $141 thousand and $404 thousand, respectively). The increases in salaries and wages

were primarily related to normal annual merit and market increases. The increases in other non-interest expense were related to increases in various miscellaneous categories of expense and overhead cost allocations. The increases in employee benefits were related to increases in payroll taxes and 401(k) plan expenses and, during the six months ended June 30, 2013, profit sharing plan expenses.

Non-Banks

The Non-Banks segment had a net loss of $1.2 million and $2.8 million for the three and six months ended June 30, 2013 compared to a net loss of $2.2 million and $2.8 million for the same periods in 2012. The decrease in the net loss during the three months ended June 30, 2013 was primarily due to a $773 thousand decrease in non-interest expense, a $407 thousand increase in non-interest income and a $70 thousand decrease in net interest expense partly offset by a $282 thousand increase in income tax expense. During the second quarter of 2012, non-interest expense included a $700 thousand non-recurring write-down of certain equipment assets. The increase in non-interest income was primarily related to an increase in mineral interest income related to bonus, rental and shut-in payments and oil and gas royalties received from severed mineral interests on property owned by Main Plaza Corporation, a wholly-owned non-banking subsidiary of the Corporation. During the six months ended June 30, 2013, a $690 thousand decrease in net interest expense was for the most part offset by a $519 thousand decrease in non-interest income and a $150 thousand increase in non-interest expense. The decrease in net interest expense was related to a decrease in the interest rate paid on the Corporation s $100 million fixed-to-floating rate subordinated notes, which changed to a floating interest rate during the first quarter of 2012. The decrease in non-interest income was primarily related to decreased mineral interest income. The increase in non-interest expense was partly related to a $923 thousand write-off of certain premises and equipment assets during the first quarter of 2013.

Income Taxes

The Corporation recognized income tax expense of $12.7 million and $26.3 million, for an effective tax rate of 17.5% and 18.6% for the three and six months ended June 30, 2013 compared to $16.0 million and $33.5 million, for an effective tax rate of 21.6% and 22.0% for the three and six months ended June 30, 2012. The effective income tax rates differed from the U.S. statutory rate of 35% during the comparable periods primarily due to the effect of tax-exempt income from loans, securities and life insurance policies. The decrease in the effective tax rate during 2013 was partly related to an increase in the relative proportion of tax-exempt income.

Average Balance Sheet

Average assets totaled $22.2 billion for the six months ended June 30, 2013 representing an increase of $2.1 billion, or 10.2%, compared to average assets for the same period in 2012. The increase was primarily reflected in earning assets, which increased $2.1 billion, or 11.4%, during the first six months of 2013 compared to the first six months of 2012. The increase in earning assets was primarily due to a $1.0 billion increase in average interest-bearing deposits, a $999.4 million increase in average loans and an $84.9 million increase in average securities. The growth in average interest-earning assets was primarily funded by an increase in deposits. Total deposits averaged $18.7 billion for the first six months of 2013, increasing $2.1 billion, or 12.7%, compared to the same period in 2012. Average interest-bearing accounts totaled 60.3% of average total deposits during the first six months of both 2013 and 2012.

Loans

Loans were as follows as of the dates indicated:

	June 30, 2013	Percentage of Total	December 31, 2012	Percentage of Total
Commercial and industrial:				
Commercial	$ 4,292,893	46.5%	$ 4,357,100	47.2%
Leases	304,717	3.3	278,535	3.0
Asset-based	175,007	1.9	192,977	2.1
Total commercial and industrial	4,772,617	51.7	4,828,612	52.3
Commercial real estate:				
Commercial mortgages	2,552,174	27.6	2,495,481	27.1
Construction	588,743	6.4	608,306	6.6
Land	230,351	2.5	216,008	2.3
Total commercial real estate	3,371,268	36.5	3,319,795	36.0
Consumer real estate:				
Home equity loans	318,339	3.4	310,675	3.4
Home equity lines of credit	193,464	2.1	186,522	2.0
1-4 family residential mortgages	33,671	0.4	38,323	0.4
Construction	13,654	0.1	17,621	0.2
Other	226,077	2.5	224,206	2.4
Total consumer real estate	785,205	8.5	777,347	8.4
Total real estate	4,156,473	45.0	4,097,142	44.4
Consumer and other:				
Consumer installment	318,824	3.4	311,310	3.4
Other	6,498	0.1	8,435	0.1
Total consumer and other	325,322	3.5	319,745	3.5
Unearned discounts	(21,869)	(0.2)	(21,651)	(0.2)
Total loans	$ 9,232,543	100.0%	$ 9,223,848	100.0%

Loans increased $8.7 million, or 0.1%, compared to December 31, 2012. The majority of the Corporation s loan portfolio is comprised of commercial and industrial loans and real estate loans. Commercial and industrial loans made up 51.7% and 52.3% of total loans at June 30, 2013 and December 31, 2012, respectively, while real estate loans made up 45.0% and 44.4% of total loans, respectively, at those dates. Real estate loans include both commercial and consumer balances.

Commercial and industrial loans decreased $56.0 million, or 1.2%, during the first six months of 2013. The Corporation s commercial and industrial loans are a diverse group of loans to small, medium and large businesses. The purpose of these loans varies from supporting seasonal working capital needs to term financing of equipment. While some short-term loans may be made on an unsecured basis, most are secured by the assets being financed with collateral margins that are consistent with the Corporation s loan policy guidelines. The commercial and industrial loan portfolio also includes the commercial lease and asset-based lending portfolios as well as purchased shared national credits (SNC s) which are discussed in more detail below.

Purchased shared national credits are participations purchased from upstream financial organizations and tend to be larger in size than the Corporation s originated portfolio. The Corporation s purchased SNC portfolio totaled $615.6 million at June 30, 2013, decreasing $12.4 million, or 2.0%, from $628.0 million at December 31, 2012. At June 30, 2013, 51.4% of outstanding purchased SNCs was related to the energy industry. The remaining purchased SNCs were diversified throughout various other industries, with no other single industry exceeding 10% of the total purchased SNC portfolio. Additionally, almost all of the outstanding balance of purchased SNCs was included in the commercial and industrial portfolio, with the remainder included in the real estate categories. SNC participations are originated in the normal course of business to meet the needs of the Corporation s customers. As a matter of policy, the Corporation generally only participates in SNCs for companies headquartered in or which have significant operations within the Corporation s market areas. In addition, the Corporation must have direct access to the company s management, an existing banking relationship or the expectation of broadening the relationship with other banking products and services within the following 12 to 24 months. SNCs are reviewed at least quarterly for credit quality and business development successes.

Real estate loans increased $59.3 million, or 1.4%, during the first six months of 2013. Real estate loans include both commercial and consumer balances. Commercial real estate loans totaled $3.4 billion at June 30, 2013 and represented 81.1% of total real estate loans. The majority of this portfolio consists of commercial real estate mortgages, which includes both

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permanent and intermediate term loans. The Corporation s primary focus for its commercial real estate portfolio has been growth in loans secured by owner-occupied properties. These loans are viewed primarily as cash flow loans and secondarily as loans secured by real estate. Consequently, these loans must undergo the analysis and underwriting process of a commercial and industrial loan, as well as that of a real estate loan.

The consumer loan portfolio, including all consumer real estate and consumer installment loans, totaled $1.1 billion at both June 30, 2013 and December 31, 2012. Consumer real estate loans, increased $7.9 million, or 1.0%, from December 31, 2012. Combined, home equity loans and lines of credit made up 65.2% and 64.0% of the consumer real estate loan total at June 30, 2013 and December 31, 2012, respectively. The Corporation offers home equity loans up to 80% of the estimated value of the personal residence of the borrower, less the value of existing mortgages and home improvement loans. In general, the Corporation no longer originates 1-4 family mortgage loans, however, from time to time, the Corporation may invest in such loans to meet the needs of its customers. Consumer installment loans, increased $7.5 million, or 2.4%, from December 31, 2012. The consumer installment loan portfolio primarily consists of automobile loans, unsecured revolving credit products, personal loans secured by cash and cash equivalents, and other similar types of credit facilities

Non-Performing Assets

Non-performing assets and accruing past due loans are presented in the table below. Troubled debt restructurings on non-accrual status are reported as non-accrual loans. Troubled debt restructurings on accrual status are reported separately.

	June 30, 2013	December 31, 2012
Non-accrual loans:		
Commercial and industrial	$ 41,018	$ 46,308
Commercial real estate	42,630	39,731
Consumer real estate	2,379	2,773
Consumer and other	687	932
Total non-accrual loans	86,714	89,744
Restructured loans	1,900	
Foreclosed assets:		
Real estate	13,047	15,152
Other		350
Total foreclosed assets	13,047	15,502
Total non-performing assets	$ 101,661	$ 105,246
Ratio of non-performing assets to:		
Total loans and foreclosed assets	1.10%	1.14%
Total assets	0.45	0.46
Accruing past due loans:		
30 to 89 days past due	$ 39,676	$ 35,969
90 or more days past due	11,224	6,994
Total accruing past due loans	$ 50,900	$ 42,963
Ratio of accruing past due loans to total loans:		
30 to 89 days past due	0.43%	0.39%
90 or more days past due	0.12	0.08
Total accruing past due loans	0.55%	0.47%

Non-performing assets include non-accrual loans, troubled debt restructurings and foreclosed assets. Non-performing assets at June 30, 2013 decreased $3.6 million from December 31, 2012. The level of non-performing assets during the comparable periods is reflective of weaker economic conditions which began in the latter part of 2008, although the level of classified assets has trended downward since the first quarter of 2012. Non-accrual commercial and industrial loans included two credit relationships in excess of $5 million totaling $12.8 million at June 30, 2013 and three credit relationships in excess of $5 million totaling $27.8 million at December 31, 2012. Non-accrual real estate loans primarily consist of land development, 1-4 family residential construction credit relationships and loans secured by office buildings and religious facilities. Non-accrual commercial real estate loans included two credit relationships in excess of $5 million totaling $18.2 million at both June 30, 2013 and December 31, 2012. Approximately $3.5 million and $15.0 million of the non-accrual commercial and industrial loans at June 30, 2013 and December 31, 2012, respectively, and $12.6 million of the non-accrual commercial real estate loans at both June 30, 2013 and December 31, 2012 pertained to the same customer.

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Generally, loans are placed on non-accrual status if principal or interest payments become 90 days past due and/or management deems the collectibility of the principal and/or interest to be in question, as well as when required by regulatory requirements. Once interest accruals are discontinued, accrued but uncollected interest is charged to current year operations. Subsequent receipts on non-accrual loans are recorded as a reduction of principal, and interest income is recorded only after principal recovery is reasonably assured. Classification of a loan as non-accrual does not preclude the ultimate collection of loan principal or interest.

Foreclosed assets represent property acquired as the result of borrower defaults on loans. Foreclosed assets are recorded at estimated fair value, less estimated selling costs, at the time of foreclosure. Regulatory guidelines require the Corporation to reevaluate the fair value of foreclosed assets on at least an annual basis. The Corporation s policy is to comply with the regulatory guidelines. Write-downs are provided for subsequent declines in value and are included in other non-interest expense along with other expenses related to maintaining the properties. Write-downs of foreclosed assets totaled $657 thousand and $1.3 million, during the six months ended June 30, 2013 and 2012, respectively. There were no significant concentrations of any properties, to which the aforementioned write-downs relate, in any single geographic region.

Potential problem loans consist of loans that are performing in accordance with contractual terms but for which management has concerns about the ability of an obligor to continue to comply with repayment terms because of the obligor s potential operating or financial difficulties. Management monitors these loans closely and reviews their performance on a regular basis. At June 30, 2013 and December 31, 2012, the Corporation had $7.8 million and $10.7 million in loans of this type which are not included in either of the non-accrual or 90 days past due loan categories. At June 30, 2013, potential problem loans consisted of four credit relationships. Of the total outstanding balance at June 30, 2013, 38.6% related to a customer in the health care industry, 25.7% related to a customer in manufacturing and 21.7% related to a customer in commercial real estate. Weakness in these companies operating performance has caused the Corporation to heighten the attention given to these credits.

Allowance for Loan Losses

The allowance for loan losses is a reserve established through a provision for loan losses charged to expense, which represents management s best estimate of probable losses that have been incurred within the existing portfolio of loans. The allowance, in the judgment of management, is necessary to reserve for estimated loan losses and risks inherent in the loan portfolio. The Corporation s allowance for loan loss methodology includes allowance allocations calculated in accordance with ASC Topic 310, Receivables and allowance allocations calculated in accordance with ASC Topic 450, Contingencies. Accordingly, the methodology is based on historical loss experience by type of credit and internal risk grade, specific homogeneous risk pools and specific loss allocations, with adjustments for current events and conditions. The Corporation s process for determining the appropriate level of the allowance for loan losses is designed to account for credit deterioration as it occurs. The provision for loan losses reflects loan quality trends, including the levels of and trends related to non-accrual loans, past due loans, potential problem loans, classified and criticized loans and net charge-offs or recoveries, among other factors. The provision for loan losses also reflects the totality of actions taken on all loans for a particular period. In other words, the amount of the provision reflects not only the necessary increases in the allowance for loan losses related to newly identified criticized loans, but it also reflects actions taken related to other loans including, among other things, any necessary increases or decreases in required allowances for specific loans or loan pools. See Note 3 - Loans in the accompanying notes to consolidated financial statements included elsewhere in this report for further details regarding the Corporation s methodology for estimating the appropriate level of the allowance for loan losses.

The table below provides, as of the dates indicated, an allocation of the allowance for loan losses by loan type; however, allocation of a portion of the allowance to one category of loans does not preclude its availability to absorb losses in other categories:

	June 30, 2013	December 31, 2012
Commercial and industrial	$ 50,814	$ 54,164
Commercial real estate	23,573	29,346
Consumer real estate	4,917	5,252
Consumer and other	4,130	3,507
Unallocated	9,966	12,184
Total	$ 93,400	$ 104,453

The reserve allocated to commercial and industrial loans at June 30, 2013 decreased $3.4 million compared to December 31, 2012. The decrease was primarily related to decreases in historical valuation allowances due to decreases in the historical loss allocation factors applied to certain categories of non-classified and classified commercial and industrial loans. The decrease was also partly related to a decrease in the environmental risk adjustment. Although the environmental risk adjustment factor at June 30, 2013 increased compared to December 31, 2012, the dollar amount of the environmental risk adjustment decreased $1.7 million from $6.6 million at December 31, 2012 to $4.9 million at June 30, 2013 as a result of the aforementioned decreases in the base historical loss allocation factors to which the environmental risk adjustment factor is applied. The reserve allocated to commercial and industrial loans at June 30, 2013 compared to December 31, 2012 was also impacted by an increase in the reserve allocation for distressed industries, a decrease in the adjustment for recoveries and an increase in the reserve allocated for highly leveraged credit relationships. The distressed industries allocation related to commercial and industrial loans increased $2.1 million from $5.9 million at December 31, 2012 to $8.0 million at June 30, 2013. The increase was primarily related to an increase in the volume of loans to contractors combined with an increase in the spread by which the weighted-average risk grade of this portfolio exceeds the weighted-average risk grade of the commercial and industrial loan portfolio as a whole. The adjustment for recoveries decreased $2.2 million from $4.9 million at December 31, 2012 to $2.7 million at June 30, 2013 primarily due to the lower level of recoveries experienced in the first six months of 2013 relative to the trailing four quarters. The reserve allocated for highly leveraged credit relationships increased $1.6 million from $2.9 million at December 31, 2012 to $4.5 million at June 30, 2013 primarily due to an increase in the volume of such credit relationships.

Classified commercial and industrial loans (loans having a risk grade of 11, 12 or 13) totaled $98.2 million at June 30, 2013 compared to $100.1 million at December 31, 2012. Specific allocations of the allowance for loan losses related to commercial and industrial loans totaled $4.2 million at June 30, 2013 compared to $5.1 million at December 31, 2012.

The reserve allocated to commercial real estate loans at June 30, 2013 decreased $5.8 million compared to December 31, 2012. The decrease was mostly related to decreases in the historical valuation allowances related to pass and watch grade commercial real estate loans due to decreases in the historical loss allocation factors applied to such loans. The reserve allocated to commercial real estate loans at June 30, 2013 compared to December 31, 2012 was also partly impacted by a decrease in the allocation for excessive industry concentrations (down $1.5 million), a decrease in the reserve allocation for distressed industries (down $670 thousand) and a decrease in the environmental risk adjustment (down $609 thousand).

Classified commercial real estate loans totaled $106.3 million at June 30, 2013 compared to $118.1 million at December 31, 2012. Specific allocations of the allowance for loan losses related to commercial real estate loans totaled $3.3 million at June 30, 2013 compared to $3.1 million at December 31, 2012. The environmental adjustment factor resulted in additional general valuation allowances for commercial real estate loans totaling $3.1 million at June 30, 2013 and $3.7 million at December 31, 2012. The distressed industries allocation related to commercial real estate loans totaled $512 thousand at June 30, 2013 and $1.2 million at December 31, 2012.

The reserve allocated to consumer real estate loans at June 30, 2013 decreased $335 thousand compared to December 31, 2012 as decreases in historical valuation allowances as well as decreases in the allocation for loans that did not undergo a separate, independent concurrence review during the underwriting process and the environmental risk adjustment were partly offset by a decrease in the adjustment for recoveries.

The reserve allocated to consumer and other loans at June 30, 2013 increased $623 thousand compared to December 31, 2012. The increase was primarily related to an increase in the historical valuation allowance due to an increase in the historical loss allocation factor applied to consumer and other loans and an increase in the environmental risk adjustment. The increase from these items was partly offset by a decrease in the allocation for loans that did not undergo a separate, independent concurrence review during the underwriting process and an increase in the adjustment for recoveries.

The unallocated portion of the allowance for loan losses represents general valuation allowances that are not allocated to specific loan portfolio segments. See Note 3 Loans in the accompanying notes to consolidated financial statements for information regarding the components of the unallocated portion of the allowance. The unallocated portion of the allowance for loan losses at June 30, 2013 decreased $2.2 million compared to December 31, 2012. This decrease was primarily due to a decrease in the allocation for general macroeconomic risk (down $2.0 million) and a decrease in the allocation for loans with policy exceptions (down $276 thousand) partly offset by an increase in the allocation for credit and/or collateral exceptions that exceed specified risk grades (up $72 thousand). The decrease in the allocation for general macroeconomic risk is reflective of improving trends in certain components of the Texas Leading Index and, aside from a $15.0 million charge-off discussed below related to a single customer relationship which was not considered to be indicative of a decline in the overall credit quality of the Corporation s loan portfolio, the trend in net charge-offs has continued to improve. The overall level of classified commercial and industrial and commercial real estate loans decreased approximately $13.7 million, or 6.3%, at June 30, 2013 compared to December 31, 2012 while the overall weighted-average risk grades of these portfolios decreased slightly to 6.37% at June 30, 2013 from 6.39% at December 31, 2012.

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Activity in the allowance for loan losses is presented in the following table.

	Three Months Ended		Six Months Ended	
	June 30, 2013	June 30, 2012	June 30, 2013	June 30, 2012
Balance at beginning of period	$ 93,589	$ 107,181	$ 104,453	$ 110,147
Provision for loan losses	3,575	2,355	9,575	3,455
Charge-offs:				
Commercial and industrial	(3,586)	(4,474)	(20,738)	(7,486)
Commercial real estate	(415)	(353)	(681)	(3,195)
Consumer real estate	(159)	(606)	(495)	(895)
Consumer and other	(2,374)	(2,229)	(4,551)	(4,214)
Total charge-offs	(6,534)	(7,662)	(26,465)	(15,790)
Recoveries:				
Commercial and industrial	703	1,294	1,328	2,635
Commercial real estate	287	858	882	1,350
Consumer real estate	174	87	234	610
Consumer and other	1,606	1,535	3,393	3,241
Total recoveries	2,770	3,774	5,837	7,836
Net charge-offs	(3,764)	(3,888)	(20,628)	(7,954)
Balance at end of period	$ 93,400	$ 105,648	$ 93,400	$ 105,648
Ratio of allowance for loan losses to:				
Total loans	1.01%	1.24%	1.01%	1.24%
Non-accrual loans	1.08	114.52	1.08	114.52
Ratio of annualized net charge-offs to average total loans	0.16	0.19	0.45	0.20

The provision for loan losses increased $1.2 million, or 51.8%, during the three months ended June 30, 2013 and increased $6.1 million, or 177.1%, during the six months ended June 30, 2013 compared to the same periods in 2012. During the first six months of 2013, the Corporation recognized a $15.0 million charge-off related to a single commercial and industrial loan relationship. The loan was not past due or previously considered to be a non-performing, impaired or potential problem loan; however, in April 2013, the borrower entered into bankruptcy proceedings. The level of the provision for loan losses during the first six months of 2013 was impacted by this charge-off. Net charge-offs during the three months ended June 30, 2013 decreased $124 thousand while net charge-offs during the six months ended June 30, 2013 increased $12.7 million, compared in each case, to the same periods in 2012. Excluding the $15.0 million charge-off related to a single commercial and industrial loan relationship, net charge-offs would have been $5.6 million, or 0.12% of average loans (on an annualized basis) during the first six months of 2013. This compares to net charge-offs of $7.9 million, or 0.20% of average loans (on an annualized basis) during the first six months of 2012, evidencing the otherwise positive trend in net charge-offs and the overall credit quality of the Corporation s loan portfolio.

The ratio of the allowance for loan losses to total loans decreased 12 basis points from 1.13% at December 31, 2012 to 1.01% at June 30, 2013. Management believes the recorded amount of the allowance for loan losses is appropriate based upon management s best estimate of probable losses that have been incurred within the existing portfolio of loans. Should any of the factors considered by management in evaluating the appropriate level of the allowance for loan losses change, the Corporation s estimate of probable loan losses could also change, which could affect the level of future provisions for loan losses.

Capital and Liquidity

Capital. Shareholders equity totaled $2.4 billion at both June 30, 2013 and December 31, 2012. In addition to net income of $114.9 million, other sources of capital during the six months ended June 30, 2013 included $144.5 million related to newly issued preferred stock, $34.2 million in proceeds from stock option exercises and $5.0 million related to stock-based compensation. Uses of capital during the six months ended June 30, 2013 included $144.0 million related to an accelerated share repurchase program, $61.6 million of dividends paid on preferred and common stock, other comprehensive loss, net of tax, of $82.4 million and tax deficiencies related to stock option exercises of $73 thousand.

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The accumulated other comprehensive income/loss component of shareholders equity totaled a net, after-tax, unrealized gain of $155.6 million at June 30, 2013 compared to a net, after-tax, unrealized gain of $238.0 million at December 31, 2012. The decrease was primarily due to a combined $73.8 million net after-tax decrease in the net unrealized gain on securities available for sale and securities transferred to held to maturity and a $10.7 million net after-tax decrease in the accumulated net gain on effective cash flow hedges partly offset by a $2.1 million net after-tax decrease in the net actuarial loss of the Corporation s defined benefit post-retirement benefit plans.

Under current regulatory requirements, amounts reported as accumulated other comprehensive income/loss related to securities available for sale and securities transferred to held to maturity, effective cash flow hedges and defined benefit post-retirement benefit plans do not increase or reduce regulatory capital and are not included in the calculation of risk-based capital and leverage ratios. Regulatory agencies for banks and bank holding companies utilize capital guidelines designed to measure Tier 1 and total capital and take into consideration the risk inherent in both on-balance sheet and off-balance sheet items. See Note 7 Capital and Regulatory Matters in the accompanying notes to consolidated financial statements included elsewhere in this report.

On February 15, 2013, the Corporation issued and sold 6,000,000 shares, or $150 million in aggregate liquidation preference, of its 5.375% Non-Cumulative Perpetual Preferred Stock, Series A, par value $0.01 and liquidation preference $25 per share (Series A Preferred Stock). The net proceeds from the offering were used to fund an accelerated share repurchase. See Note 7 Capital and Regulatory Matters in the accompanying notes to consolidated financial statements included elsewhere in this report.

The Corporation paid quarterly dividends of $0.48 and $0.50 per common share during the first and second quarters of 2013 and quarterly dividends of $0.46 and $0.48 per common share during the first and second quarters of 2012. This equates to a dividend payout ratio of 52.1% and 53.0% during the first and second quarters of 2013 and 46.3% and 50.8% during the first and second quarters of 2012. Under the terms of the Series A Preferred Stock, the ability of the Corporation to declare or pay dividends on, or purchase, redeem or otherwise acquire, shares of its common stock or any securities of the Corporation that rank junior to the Series A Preferred Stock is subject to certain restrictions in the event that the Corporation does not declare and pay dividends on the Series A Preferred Stock for the most recent dividend period.

From time to time, the Corporation s board of directors has authorized stock repurchase plans. Stock repurchase plans allow the Corporation to proactively manage its capital position and return excess capital to shareholders. Shares purchased under such plans also provide the Corporation with shares of common stock necessary to satisfy obligations related to stock compensation awards. The aforementioned accelerated share repurchase is part of a stock repurchase program that was authorized by the Corporation s board of directors in December 2012 to buy up to $150 million of the Corporation s common stock. During the first quarter of 2013, 1,905,077 shares were repurchased under the stock repurchase plan. See Part II, Item 2 - Unregistered Sales of Equity Securities and Use of Proceeds, included elsewhere in this report, for details of stock repurchases during the quarter.

Basel III Capital Rules. In July 2013, the Corporation s primary federal regulator, the Federal Reserve, published final rules (the Basel III Capital Rules) establishing a new comprehensive capital framework for U.S. banking organizations. The rules implement the Basel Committee s December 2010 framework known as Basel III for strengthening international capital standards as well as certain provisions of the Dodd-Frank Act. The Basel III Capital Rules substantially revise the risk-based capital requirements applicable to bank holding companies and depository institutions, including Cullen/Frost and Frost Bank, compared to the current U.S. risk-based capital rules. The Basel III Capital Rules define the components of capital and address other issues affecting the numerator in banking institutions regulatory capital ratios. The Basel III Capital Rules also address risk weights and other issues affecting the denominator in banking institutions regulatory capital ratios and replace the existing risk-weighting approach, which was derived from Basel I capital accords of the Basel Committee, with a more risk-sensitive approach based, in part, on the standardized approach in the Basel Committee s 2004 Basel II capital accords. The Basel III Capital Rules also implement the requirements of Section 939A of the Dodd-Frank Act to remove references to credit ratings from the federal banking agencies rules. The Basel III Capital Rules are effective for Cullen/Frost and Frost Bank on January 1, 2015 (subject to a phase-in period). Management believes that, as of June 30, 2013, Cullen/Frost and Frost Bank would meet all capital adequacy requirements under the Basel III Capital Rules on a fully phased-in basis if such requirements were currently effective. See Note 7 Capital and Regulatory Matters for additional information regarding the Basel III Capital Rules.

Liquidity. Liquidity measures the ability to meet current and future cash flow needs as they become due. The liquidity of a financial institution reflects its ability to meet loan requests, to accommodate possible outflows in deposits and to take advantage of interest rate market opportunities. The ability of a financial institution to meet its current financial obligations is a function of its balance sheet structure, its ability to liquidate assets and its access to alternative sources of funds. The objective of the Corporation s liquidity management is to manage cash flow and liquidity reserves so that they are adequate to fund the Corporation s operations and to meet obligations and other commitments on a timely basis and at a reasonable cost. The Corporation seeks to achieve this objective and ensure that funding needs are met by maintaining an appropriate

level of liquid funds through asset/liability management, which includes managing the mix and time to maturity of financial assets and financial liabilities on the Corporation s balance sheet. The Company s liquidity position is enhanced by its ability to raise additional funds as needed in the wholesale markets.

Asset liquidity is provided by liquid assets which are readily marketable or pledgeable or which will mature in the near future. Liquid assets include cash, interest-bearing deposits in banks, securities available for sale, maturities and cash flow from securities held to maturity, and federal funds sold and resell agreements.

Liability liquidity is provided by access to funding sources which include core deposits and correspondent banks in the Corporation s natural trade area that maintain accounts with and sell federal funds to Frost Bank, as well as federal funds purchased and repurchase agreements from upstream banks and deposits obtained through financial intermediaries.

The liquidity position of the Corporation is continuously monitored and adjustments are made to the balance between sources and uses of funds as deemed appropriate. Liquidity risk management is an important element in the Corporation s asset/liability management process. The Corporation regularly models liquidity stress scenarios to assess potential liquidity outflows or funding problems resulting from economic disruptions, volatility in the financial markets, unexpected credit events or other significant occurrences deemed problematic by management. These scenarios are incorporated into the Corporation s contingency funding plan, which provides the basis for the identification of the Corporation s liquidity needs. As of June 30, 2013, management is not aware of any events that are reasonably likely to have a material adverse effect on the Corporation s liquidity, capital resources or operations. In addition, management is not aware of any regulatory recommendations regarding liquidity, including the Basel III liquidity framework, which, if implemented, would have a material adverse effect on the Corporation.

Since Cullen/Frost is a holding company and does not conduct operations, its primary sources of liquidity are dividends upstreamed from Frost Bank and borrowings from outside sources. Banking regulations may limit the amount of dividends that may be paid by Frost Bank. See Note 7 Capital and Regulatory Matters in the accompanying notes to consolidated financial statements included elsewhere in this report regarding such dividends. At June 30, 2013, Cullen/Frost had liquid assets, including cash and resell agreements, totaling $277.1 million, which included $1.3 million in cash collateral on deposit with other financial institution counterparties to interest rate swap transactions.

Accounting Standards Updates

See Note 17 - Accounting Standards Updates in the accompanying notes to consolidated financial statements included elsewhere in this report for details of recently issued accounting pronouncements and their expected impact on the Corporation s financial statements.

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Consolidated Average Balance Sheets and Interest Income Analysis - Quarter To Date

(Dollars in thousands - taxable-equivalent basis)

	June 30, 2013			June 30, 2012		
	Average Balance	Interest Income/ Expense	Yield/ Cost	Average Balance	Interest Income/ Expense	Yield/ Cost
Assets:						
Interest-bearing deposits	$ 2,309,653	$ 1,498	0.26%	$ 1,380,380	$ 903	0.26%
Federal funds sold and resell agreements	24,302	29	0.48	33,039	33	0.40
Securities:						
Taxable	5,619,568	25,485	1.86	6,705,624	34,399	2.11
Tax-exempt	3,307,588	48,001	5.86	2,218,519	35,440	6.94
Total securities	8,927,156	73,486	3.36	8,924,143	69,839	3.27
Loans, net of unearned discounts	9,207,289	104,790	4.56	8,267,721	99,776	4.85
Total Earning Assets and Average Rate Earned	20,468,400	179,803	3.55	18,605,283	170,551	3.75
Cash and due from banks	552,237			551,863		
Allowance for loan losses	(93,847)			(107,697)		
Premises and equipment, net	306,625			324,350		
Accrued interest and other assets	998,754			1,027,443		
Total Assets	$ 22,232,169			$ 20,401,242		
Liabilities:						
Non-interest-bearing demand deposits:						
Commercial and individual	$ 6,795,334			$ 6,116,737		
Correspondent banks	304,613			323,003		
Public funds	352,387			389,461		
Total non-interest-bearing demand deposits	7,452,334			6,829,201		
Interest-bearing deposits:						
Private accounts						
Savings and interest checking	3,529,731	375	0.04	2,944,130	416	0.06
Money market deposit accounts	6,394,561	2,709	0.17	5,716,406	3,020	0.21
Time accounts	981,273	642	0.26	1,028,597	959	0.37
Public funds	413,095	156	0.15	363,332	152	0.17
Total interest-bearing deposits	11,318,660	3,882	0.14	10,052,465	4,547	0.18
Total deposits	18,770,994			16,881,666		
Federal funds purchased and repurchase agreements	514,221	29	0.02	621,114	34	0.02
Junior subordinated deferrable interest debentures	123,712	1,690	5.46	123,712	1,711	5.53
Subordinated notes payable and other notes	100,000	236	0.94	100,000	287	1.15
Federal Home Loan Bank advances				18		6.00
Total Interest-Bearing Funds and Average Rate Paid	12,056,593	5,837	0.19	10,897,309	6,579	0.24
Accrued interest and other liabilities	278,292			327,559		
Total Liabilities	19,787,219			18,054,069		

Shareholders Equity	2,444,950		2,347,173	
Total Liabilities and Shareholders Equity	$ 22,232,169		$ 20,401,242	
Net interest income		$ 173,966		$ 163,972
Net interest spread		3.36%		3.51%
Net interest income to total average earning assets		3.43%		3.61%

For these computations: (i) average balances are presented on a daily average basis, (ii) information is shown on a taxable-equivalent basis assuming a 35% tax rate, (iii) average loans include loans on non-accrual status, and (iv) average securities include unrealized gains and losses on securities available for sale while yields are based on average amortized cost.

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Consolidated Average Balance Sheets and Interest Income Analysis-Year-to-Date

(Dollars in thousands - taxable-equivalent basis)

	June 30, 2013			June 30, 2012		
	Average Balance	Interest Income/ Expense	Yield/ Cost	Average Balance	Interest Income/ Expense	Yield/ Cost
Assets:						
Interest-bearing deposits	$ 2,255,128	$ 2,851	0.25%	$ 1,240,624	$ 1,833	0.30%
Federal funds sold and resell agreements	20,341	51	0.51	23,530	48	0.41
Securities:						
Taxable	5,727,489	52,862	1.90	6,685,501	70,465	2.17
Tax-exempt	3,280,537	94,485	5.82	2,237,643	71,463	6.94
Total securities	9,008,026	147,347	3.34	8,923,144	141,928	3.32
Loans, net of unearned discounts	9,158,225	208,304	4.59	8,158,845	198,607	4.90
Total Earning Assets and Average Rate Earned	20,441,720	358,553	3.56	18,346,143	342,416	3.82
Cash and due from banks	565,899			564,899		
Allowance for loan losses	(99,472)			(109,742)		
Premises and equipment, net	311,955			323,590		
Accrued interest and other assets	1,002,519			1,035,844		
Total Assets	$ 22,222,621			$ 20,160,734		
Liabilities:						
Non-interest-bearing demand deposits:						
Commercial and individual	$ 6,759,181			$ 5,879,952		
Correspondent banks	319,940			326,721		
Public funds	362,615			407,412		
Total non-interest-bearing demand deposits	7,441,736			6,614,085		
Interest-bearing deposits:						
Private accounts						
Savings and interest checking	3,533,484	753	0.04	2,899,312	841	0.06
Money market deposit accounts	6,347,703	5,442	0.17	5,699,535	5,989	0.21
Time accounts	988,181	1,381	0.28	1,036,803	1,985	0.39
Public funds	436,104	314	0.15	389,645	304	0.16
Total interest-bearing deposits	11,305,472	7,890	0.14	10,025,295	9,119	0.18
Total deposits	18,747,208			16,639,380		
Federal funds purchased and repurchase agreements	523,416	59	0.02	627,208	68	0.02
Junior subordinated deferrable interest debentures	123,712	3,363	5.44	123,712	3,385	5.47
Subordinated notes payable and other notes	100,000	474	0.95	100,000	1,164	2.33
Federal Home Loan Bank advances	2		6.00	21	1	6.00
Total Interest-Bearing Funds and Average Rate Paid	12,052,602	11,786	0.20	10,876,236	13,737	0.25
Accrued interest and other liabilities	290,341			338,275		
Total Liabilities	19,784,679			17,828,596		

Shareholders Equity	2,437,942		2,332,138	
Total Liabilities and Shareholders Equity	$ 22,222,621		$ 20,160,734	
Net interest income		$ 346,767		$ 328,679
Net interest spread		3.36%		3.57%
Net interest income to total average earning assets		3.44%		3.67%

For these computations: (i) average balances are presented on a daily average basis, (ii) information is shown on a taxable-equivalent basis assuming a 35% tax rate, (iii) average loans include loans on non-accrual status, and (iv) average securities include unrealized gains and losses on securities available for sale while yields are based on average amortized cost.

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Item 3. Quantitative and Qualitative Disclosures About Market Risk

The disclosures set forth in this item are qualified by the section captioned Forward-Looking Statements and Factors that Could Affect Future Results included in Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations of this report and other cautionary statements set forth elsewhere in this report.

Refer to the discussion of market risks included in Item 7A. Quantitative and Qualitative Disclosures About Market Risk in the 2012 Form 10-K. There has been no significant change in the types of market risks faced by the Corporation since December 31, 2012.

The Corporation utilizes an earnings simulation model as the primary quantitative tool in measuring the amount of interest rate risk associated with changing market rates. The model quantifies the effects of various interest rate scenarios on projected net interest income and net income over the next 12 months. The model measures the impact on net interest income relative to a base case scenario of hypothetical fluctuations in interest rates over the next 12 months. These simulations incorporate assumptions regarding balance sheet growth and mix, pricing and the repricing and maturity characteristics of the existing and projected balance sheet. The impact of interest rate derivatives, such as interest rate swaps, caps and floors, is also included in the model. Other interest rate-related risks such as prepayment, basis and option risk are also considered.

For modeling purposes, as of June 30, 2013, the model simulations projected that a 100 basis point increase in interest rates would result in a negative variance in net interest income of 0.4% and a 200 basis point increase in interest rates would result in a positive variance in net interest income of 0.4%, relative to the base case over the next 12 months, while a decrease in interest rates of 25 basis points would result in a negative variance in net interest income of 2.5% relative to the base case over the next 12 months. The June 30, 2013 model simulations were impacted by the assumption, for modeling purposes, that the Corporation will begin to pay interest on demand deposits in the third quarter of 2013, as further discussed below. As of June 30, 2012, the model simulations projected that 100 and 200 basis point increases in interest rates would result in negative variances in net interest income of 1.0% and 1.4%, respectively, relative to the base case over the next 12 months, while a decrease in interest rates of 25 basis points would result in a negative variance in net interest income of 1.7% relative to the base case over the next 12 months. The June 30, 2012 model simulations were impacted by the assumption, for modeling purposes, that the Corporation will begin to pay interest on demand deposits in the third quarter of 2012. The likelihood of a decrease in interest rates beyond 25 basis points as of June 30, 2013 and 2012 was considered to be remote given prevailing interest rate levels.

Financial regulatory reform legislation entitled the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act) repealed the federal prohibition on the payment of interest on demand deposits, thereby permitting depository institutions to pay interest on business transaction and other accounts beginning July 21, 2011. Although the ultimate impact of this legislation on the Corporation has not yet been determined, the Corporation may begin to incur interest costs associated with demand deposits in the future as market conditions warrant. If this were to occur, the Corporation s balance sheet would likely become more liability sensitive. Because the interest rate that will ultimately be paid on these demand deposits depends upon a variety of factors, some of which are beyond the Corporation s control, the Corporation assumed an aggressive pricing structure for the purposes of the model simulations discussed above with interest payments beginning in the third quarter of 2013. Should the actual interest rate paid on demand deposits be less than the rate assumed in the model simulations, or should the interest rate paid for demand deposits become an administered rate with less direct correlation to movements in general market interest rates, the Corporation s balance sheet could be more asset sensitive than the model simulations currently indicate.

The Corporation experienced significant growth in deposits during 2011 and 2012 which funded a significant increase in fixed-rate securities. During the first six months of 2012, higher-levels of fixed-rate securities coupled with the assumption, for modeling purposes, that the Corporation would begin paying interest on demand deposits that were previously non-interest-bearing as a result of the aforementioned legislation, resulted in the model simulations as of June 30, 2012 indicating that the Corporation s balance sheet would become more liability sensitive. The model simulations as of June 30, 2013 indicate that the Corporation s balance has become more asset sensitive in comparison to June 30, 2012 primarily due to a decrease in the relative proportion earning assets invested in fixed-rate securities and increases in the relative proportion of interest earning assets invested in variable rate interest-bearing deposits and loans.

As of June 30, 2013, the effects of a 200 basis point increase and a 25 basis point decrease in interest rates on the Corporation s derivative holdings would not result in a significant variance in the Corporation s net interest income.

The effects of hypothetical fluctuations in interest rates on the Corporation s securities classified as trading under ASC Topic 320, Investments Debt and Equity Securities, are not significant, and, as such, separate quantitative disclosure is not presented.

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Item 4. Controls and Procedures

As of the end of the period covered by this Quarterly Report on Form 10-Q, an evaluation was carried out by the Corporation s management, with the participation of its Chief Executive Officer and Chief Financial Officer, of the effectiveness of the Corporation s disclosure controls and procedures (as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934). Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the disclosure controls and procedures were effective as of the end of the period covered by this report. No change in the Corporation s internal control over financial reporting (as defined in Rule 13a-15(f) under the Securities Exchange Act of 1934) occurred during the last fiscal quarter that materially affected, or is reasonably likely to materially affect, the Corporation s internal control over financial reporting.

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Part II. Other Information

Item 1. Legal Proceedings

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

Item 1A. Risk Factors

There has been no material change in the risk factors previously disclosed under Item 1A. of the Corporation s 2012 Form 10-K.

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

The following table provides information with respect to purchases made by or on behalf of the Corporation or any affiliated purchaser (as defined in Rule 10b-18(a)(3) under the Securities Exchange Act of 1934), of the Corporation s common stock during the three months ended June 30, 2013. Dollar amounts in thousands.

Period	Total Number of Shares Purchased	Average Price Paid Per Share	Total Number of Shares Purchased as Part of Publicly Announced Plan	Maximum Number of Shares (or Approximate Dollar Value) That May Yet Be Purchased Under the Plan at the End of the Period
April 1, 2013 to April 30, 2013		$		$ 34,800
May 1, 2013 to May 31, 2013				34,800
June 1, 2013 to June 30, 2013				34,800
Total		$		

Item 3. Defaults Upon Senior Securities

None.

Item 4. Mine Safety Disclosures

None.

Item 5. Other Information

None.

Item 6. Exhibits

(a) Exhibits

Exhibit Number	**Description**
31.1	Rule 13a-14(a) Certification of the Corporation s Chief Executive Officer
31.2	Rule 13a-14(a) Certification of the Corporation s Chief Financial Officer
32.1+	Section 1350 Certification of the Corporation s Chief Executive Officer
32.2+	Section 1350 Certification of the Corporation s Chief Financial Officer
101	Interactive Data File

\+ This exhibit shall not be deemed filed for purposes of Section 18 of the Securities Exchange Act of 1934, or otherwise subject to the liability of that section, and shall not be deemed to be incorporated by reference into any filing under the Securities Act of 1933 or the Securities Exchange Act of 1934.

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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.

Cullen/Frost Bankers, Inc.
(Registrant)

Date: July 24, 2013

By: /s/ Phillip D. Green
Phillip D. Green
Group Executive Vice President
and Chief Financial Officer
(Duly Authorized Officer, Principal Financial Officer and Principal Accounting Officer)