

CULLEN/FROST BANKERS, INC.

Form 10-K

February 08, 2013

Table of Contents

UNITED STATES SECURITIES AND EXCHANGE COMMISSION Washington, D.C. 20549

FORM 10-K

Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the fiscal year ended: **December 31, 2012**
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
(State or other jurisdiction of
incorporation or organization)

74-1751768
(I.R.S. Employer
Identification No.)

100 W. Houston Street, San Antonio, Texas
(Address of principal executive offices)

78205
(Zip code)

(210) 220-4011

(Registrant's telephone number, including area code)

Securities registered pursuant to Section 12(b) of the Act:

Common Stock, \$.01 Par Value,
(Title of each class)

The New York Stock Exchange, Inc.
(Name of each exchange on which registered)

Securities registered pursuant to Section 12(g) of the Act: None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes No

Edgar Filing: CULLEN/FROST BANKERS, INC. - Form 10-K

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 No

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act.

Large accelerated filer

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

As of June 30, 2012, the last business day of the registrant's most recently completed second fiscal quarter, the aggregate market value of the shares of common stock held by non-affiliates, based upon the closing price per share of the registrant's common stock as reported on The New York Stock Exchange, Inc., was approximately \$3.4 billion.

As of January 31, 2013, there were 61,514,814 shares of the registrant's common stock, \$.01 par value, outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Proxy Statement for the 2013 Annual Meeting of Shareholders of Cullen/Frost Bankers, Inc. to be held on April 25, 2013 are incorporated by reference in this Form 10-K in response to Part III, Items 10, 11, 12, 13 and 14.

Table of Contents

CULLEN/FROST BANKERS, INC.
ANNUAL REPORT ON FORM 10-K
TABLE OF CONTENTS

	Page
PART I	
Item 1. <u>Business</u>	3
Item 1A. <u>Risk Factors</u>	21
Item 1B. <u>Unresolved Staff Comments</u>	32
Item 2. <u>Properties</u>	32
Item 3. <u>Legal Proceedings</u>	32
Item 4. <u>Mine Safety Disclosures</u>	32
PART II	
Item 5. <u>Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities</u>	33
Item 6. <u>Selected Financial Data</u>	36
Item 7. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	39
Item 7A. <u>Quantitative and Qualitative Disclosures About Market Risk</u>	78
Item 8. <u>Financial Statements and Supplementary Data</u>	80
Item 9. <u>Changes in and Disagreements With Accountants on Accounting and Financial Disclosure</u>	146
Item 9A. <u>Controls and Procedures</u>	146
Item 9B. <u>Other Information</u>	147
PART III	
Item 10. <u>Directors, Executive Officers and Corporate Governance</u>	148
Item 11. <u>Executive Compensation</u>	148
Item 12. <u>Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters</u>	148
Item 13. <u>Certain Relationships and Related Transactions, and Director Independence</u>	148
Item 14. <u>Principal Accounting Fees and Services</u>	148
PART IV	
Item 15. <u>Exhibits, Financial Statement Schedules</u>	149
<u>SIGNATURES</u>	151

Table of Contents

PART I

ITEM 1. BUSINESS

The disclosures set forth in this item are qualified by Item 1A. Risk Factors and the section captioned Forward-Looking Statements and Factors that Could Affect Future Results in Item 7. 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.

The Corporation

Cullen/Frost Bankers, Inc. (Cullen/Frost), a Texas business corporation incorporated in 1977, is a financial holding company and a bank holding company headquartered in San Antonio, Texas that provides, through its subsidiaries (collectively referred to as the Corporation), a broad array of products and services throughout numerous Texas markets. The Corporation offers commercial and consumer banking services, as well as trust and investment management, mutual funds, investment banking, insurance, brokerage, leasing, asset-based lending, treasury management and item processing services. At December 31, 2012, Cullen/Frost had consolidated total assets of \$23.1 billion and was one of the largest independent bank holding companies headquartered in the State of Texas.

The Corporation's philosophy is to grow and prosper, building long-term relationships based on top quality service, high ethical standards, and safe, sound assets. The Corporation operates as a locally oriented, community-based financial services organization, augmented by experienced, centralized support in select critical areas. The Corporation's local market orientation is reflected in its regional management and regional advisory boards, which are comprised of local business persons, professionals and other community representatives that assist the Corporation's regional management in responding to local banking needs. Despite this local market, community-based focus, the Corporation offers many of the products available at much larger money-center financial institutions.

The Corporation serves a wide variety of industries including, among others, energy, manufacturing, services, construction, retail, telecommunications, healthcare, military and transportation. The Corporation's customer base is similarly diverse. The Corporation is not dependent upon any single industry or customer.

The Corporation's operating objectives include expansion, diversification within its markets, growth of its fee-based income, and growth internally and through acquisitions of financial institutions, branches and financial services businesses. The Corporation generally seeks merger or acquisition partners that are culturally similar and have experienced management and possess either significant market presence or have potential for improved profitability through financial management, economies of scale and expanded services. The Corporation regularly evaluates merger and acquisition opportunities and conducts due diligence activities related to possible transactions with other financial institutions and financial services companies. As a result, merger or acquisition discussions and, in some cases, negotiations may take place and future mergers or acquisitions involving cash, debt or equity securities may occur. Acquisitions typically involve the payment of a premium over book and market values, and, therefore, some dilution of the Corporation's tangible book value and net income per common share may occur in connection with any future transaction. During 2012, the Corporation acquired Stone Partners, Inc., a Houston-based human resources consulting firm that specializes in compensation, benefits and outsourcing services. During 2011, the Corporation acquired an insurance agency in the San Antonio market area, while no acquisitions were made during 2010. Neither of these acquisitions had a significant impact on the Corporation's financial statements during their respective reporting periods.

The Corporation's ability to engage in certain merger or acquisition transactions, whether or not any regulatory approval is required, will be dependent upon the Corporation's bank regulators' views at the time as to the capital levels, quality of management and overall condition of the Corporation and their assessment of a variety of other

Table of Contents

factors. Certain merger or acquisition transactions, including those involving the acquisition of a depository institution or the assumption of the deposits of any depository institution, require formal approval from various bank regulatory authorities, which will be subject to a variety of factors and considerations. See the section captioned "Supervision and Regulation" included elsewhere in this item for further discussion of these matters.

Although Cullen/Frost is a corporate entity, legally separate and distinct from its affiliates, bank holding companies such as Cullen/Frost are required to act as a source of financial strength for their subsidiary banks. The principal source of Cullen/Frost's income is dividends from its subsidiaries. There are certain regulatory restrictions on the extent to which these subsidiaries can pay dividends or otherwise supply funds to Cullen/Frost. See the section captioned "Supervision and Regulation" included elsewhere in this item for further discussion of these matters.

Cullen/Frost's executive offices are located at 100 W. Houston Street, San Antonio, Texas 78205, and its telephone number is (210) 220-4011.

Subsidiaries of Cullen/Frost

The New Galveston Company

Incorporated under the laws of Delaware, The New Galveston Company is a wholly owned second-tier financial holding company and bank holding company, which directly owns all of Cullen/Frost's banking and non-banking subsidiaries with the exception of Cullen/Frost Capital Trust II.

Cullen/Frost Capital Trust II

Cullen/Frost Capital Trust II ("Trust II") is a Delaware statutory business trust formed in 2004 for the purpose of issuing \$120.0 million in trust preferred securities and lending the proceeds to Cullen/Frost. Cullen/Frost guarantees, on a limited basis, payments of distributions on the trust preferred securities and payments on redemption of the trust preferred securities.

Trust II is a variable interest entity for which the Corporation is not the primary beneficiary. As such, the accounts of Trust II are not included in the Corporation's consolidated financial statements. See the Corporation's accounting policy related to consolidation in Note 1 - Summary of Significant Accounting Policies in the notes to consolidated financial statements included in Item 8. Financial Statements and Supplementary Data, which is located elsewhere in this report.

Although the accounts of Trust II are not included in the Corporation's consolidated financial statements, the \$120.0 million in trust preferred securities issued by Trust II are included in the Tier 1 capital of Cullen/Frost for regulatory capital purposes. The aggregate amount of restricted core capital elements (which includes trust preferred securities, among other things) that may be included in the Tier 1 capital of most bank holding companies, including Cullen/Frost's, is limited to 25% of all core capital elements, including restricted core capital elements, net of goodwill less any associated deferred tax liability. Amounts of restricted core capital elements in excess of these limits generally may be included in Tier 2 capital. The quantitative limits do not currently preclude the Corporation from including the \$120.0 million in trust preferred securities in Tier 1 capital. As further discussed below, in June 2012, the Federal Reserve proposed new rules that would substantially revise the risk-based capital requirements applicable to bank holding companies and depository institutions, including Cullen/Frost and Frost Bank. Among other things, the proposed rules require the phase-out of certain hybrid securities, such as trust preferred securities, as Tier 1 capital in equal installments in each of the years from 2013 through 2016. Final rules have not yet been adopted, however, and the Basel III framework is therefore not yet applicable to Cullen/Frost or Frost Bank.

Table of Contents

Frost Bank

Frost Bank, the principal operating subsidiary and sole banking subsidiary of Cullen/Frost, is primarily engaged in the business of commercial and consumer banking through more than 110 financial centers across Texas in the Austin, Corpus Christi, Dallas, Fort Worth, Houston, Rio Grande Valley and San Antonio regions. Frost Bank also operates approximately 1,100 automated-teller machines (ATMs) throughout the State of Texas, including over 600 ATMs operated in connection with a branding arrangement to be the exclusive cash-machine provider for Valero Corner Stores in Texas. Frost Bank was chartered as a national banking association in 1899, but its origin can be traced to a mercantile partnership organized in 1868. At December 31, 2012, Frost Bank had consolidated total assets of \$23.1 billion and total deposits of \$19.5 billion and was one of the largest commercial banks headquartered in the State of Texas.

Significant services offered by Frost Bank include:

- “ *Commercial Banking.* Frost Bank provides commercial banking services to corporations and other business clients. Loans are made for a wide variety of general corporate purposes, including financing for industrial and commercial properties and to a lesser extent, financing for interim construction related to industrial and commercial properties, financing for equipment, inventories and accounts receivable, and acquisition financing, as well as commercial leasing and treasury management services.

- “ *Consumer Services.* Frost Bank provides a full range of consumer banking services, including checking accounts, savings programs, automated teller machines, overdraft facilities, installment and real estate loans, home equity loans and lines of credit, drive-in and night deposit services, safe deposit facilities, and brokerage services.

- “ *International Banking.* Frost Bank provides international banking services to customers residing in or dealing with businesses located in Mexico. These services consist of accepting deposits (generally only in U.S. dollars), making loans (in U.S. dollars only), issuing letters of credit, handling foreign collections, transmitting funds, and to a limited extent, dealing in foreign exchange.

- “ *Correspondent Banking.* Frost Bank acts as correspondent for approximately 332 financial institutions, which are primarily banks in Texas. These banks maintain deposits with Frost Bank, which offers them a full range of services including check clearing, transfer of funds, fixed income security services, and securities custody and clearance services.

- “ *Trust Services.* Frost Bank provides a wide range of trust, investment, agency and custodial services for individual and corporate clients. These services include the administration of estates and personal trusts, as well as the management of investment accounts for individuals, employee benefit plans and charitable foundations. At December 31, 2012, the estimated fair value of trust assets was \$26.2 billion, including managed assets of \$10.9 billion and custody assets of \$15.3 billion.

- “ *Capital Markets - Fixed-Income Services.* Frost Bank’s Capital Markets Division was formed to meet the transaction needs of fixed-income institutional investors. Services include sales and trading, new issue underwriting, money market trading, and securities safekeeping and clearance.

Frost Insurance Agency, Inc.

Frost Insurance Agency, Inc. is a wholly owned subsidiary of Frost Bank that provides insurance brokerage services to individuals and businesses covering corporate and personal property and casualty insurance products, as well as group health and life insurance products.

Table of Contents

Frost Brokerage Services, Inc.

Frost Brokerage Services, Inc. (FBS) is a wholly owned subsidiary of Frost Bank that provides brokerage services and performs other transactions or operations related to the sale and purchase of securities of all types. FBS is registered as a fully disclosed introducing broker-dealer under the Securities Exchange Act of 1934 and, as such, does not hold any customer accounts.

Frost Investment Advisors, LLC

Frost Investment Advisors is a registered investment advisor entity and a wholly owned subsidiary of Frost Bank that provides investors access to various Frost-managed mutual funds.

Tri Frost Corporation

Tri-Frost Corporation is a wholly-owned subsidiary of Frost Bank that primarily holds securities for investment purposes and the receipt of cash flows related to principal and interest on the securities until such time that the securities mature.

Frost Securities, Inc.

Frost Securities, Inc. is a wholly owned subsidiary of The New Galveston Company that provides advisory and private equity services to middle market companies in Texas.

Main Plaza Corporation

Main Plaza Corporation is a wholly owned subsidiary of The New Galveston Company that occasionally makes loans to qualified borrowers. Loans are funded with current cash or borrowings against internal credit lines.

Other Subsidiaries

Cullen/Frost has various other subsidiaries that are not significant to the consolidated entity.

Operating Segments

Cullen/Frost's operations are managed along two reportable operating segments consisting of Banking and Frost Wealth Advisors. See the sections captioned Results of Segment Operations in Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations and Note 17 - Operating Segments in the notes to consolidated financial statements included in Item 8. Financial Statements and Supplementary Data, which are located elsewhere in this report.

Competition

There is significant competition among commercial banks in the Corporation's market areas. In addition, the Corporation also competes with other providers of financial services, such as savings and loan associations, credit unions, consumer finance companies, securities firms, insurance companies, insurance agencies, commercial finance and leasing companies, full service brokerage firms and discount brokerage firms. Some of the Corporation's competitors have greater resources and, as such, may have higher lending limits and may offer other services that are not provided by the Corporation. The Corporation generally competes on the basis of customer service and responsiveness to customer needs, available loan and deposit products, the rates of interest charged on loans, the rates of interest paid for funds, and the availability and pricing of trust, brokerage and insurance services.

Table of Contents

Supervision and Regulation

Cullen/Frost, Frost Bank and many of its non-banking subsidiaries are subject to extensive regulation under federal and state laws. The regulatory framework is intended primarily for the protection of depositors, federal deposit insurance funds and the banking system as a whole and not for the protection of shareholders and creditors.

Significant elements of the laws and regulations applicable to Cullen/Frost and its subsidiaries are described below. The description is qualified in its entirety by reference to the full text of the statutes, regulations and policies that are described. Also, such statutes, regulations and policies are continually under review by Congress and state legislatures and federal and state regulatory agencies. A change in statutes, regulations or regulatory policies applicable to Cullen/Frost and its subsidiaries could have a material effect on the business, financial condition and results of operations of the Corporation.

Regulatory Reforms

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act or Dodd-Frank), which was enacted in July 2010, significantly restructures the financial regulatory regime in the United States. Although the Dodd-Frank Act's provisions that have received the most public attention generally have been those applying to or more likely to affect larger institutions such as bank holding companies with total consolidated assets of \$50 billion or more, it contains numerous other provisions that affect all bank holding companies and banks, including the Corporation and Frost Bank, some of which are described in more detail below.

Many of the Dodd-Frank Act's provisions are subject to final rulemaking by the U.S. financial regulatory agencies, and the implications of the Dodd-Frank Act for the Corporation's businesses will depend to a large extent on how such rules are adopted and implemented by the primary U.S. financial regulatory agencies. The Corporation continues to analyze the impact of rules adopted under Dodd-Frank, on the Corporation's businesses. However, the full impact will not be known until the rules, and other regulatory initiatives that overlap with the rules, are finalized and their combined impacts can be understood.

Regulatory Agencies

Cullen/Frost is a legal entity separate and distinct from Frost Bank and its other subsidiaries. As a financial holding company and a bank holding company, Cullen/Frost is regulated under the Bank Holding Company Act of 1956, as amended (BHC Act), and its subsidiaries are subject to inspection, examination and supervision by the Federal Reserve Board. The BHC Act provides generally for umbrella regulation of financial holding companies such as Cullen/Frost by the Federal Reserve Board, and for functional regulation of banking activities by bank regulators, securities activities by securities regulators, and insurance activities by insurance regulators. Cullen/Frost is also under the jurisdiction of the Securities and Exchange Commission (SEC) and is subject to the disclosure and regulatory requirements of the Securities Act of 1933, as amended, and the Securities Exchange Act of 1934, as amended, as administered by the SEC. Cullen/Frost's common stock is listed on the New York Stock Exchange (NYSE) under the trading symbol CFR, and is subject to the rules of the NYSE for listed companies.

Prior to June 22, 2012, Frost Bank was organized as a national banking association under the National Bank Act and was subject to regulation and examination by the Office of the Comptroller of the Currency (OCC). On June 22, 2012, Frost Bank became a Texas state chartered bank and a member of the Federal Reserve System. Accordingly, the Texas Department of Banking and the Federal Reserve are now the primary regulators of Frost Bank, and Frost Bank will no longer be regulated by the OCC. Deposits at Frost Bank continue to be insured by the Federal Deposit Insurance Corporation (FDIC) up to applicable limits.

Many of the Corporation's non-bank subsidiaries also are subject to regulation by the Federal Reserve Board and other federal and state agencies. Frost Securities, Inc. and Frost Brokerage Services, Inc. are regulated by the

Table of Contents

SEC, the Financial Industry Regulatory Authority (FINRA) and state securities regulators. Frost Investment Advisors, LLC is subject to the disclosure and regulatory requirements of the Investment Advisors Act of 1940, as administered by the SEC. The Corporation s insurance subsidiaries are subject to regulation by applicable state insurance regulatory agencies. Other non-bank subsidiaries are subject to both federal and state laws and regulations.

Bank Holding Company Activities

In general, the BHC Act limits the business of bank holding companies to banking, managing or controlling banks and other activities that the Federal Reserve Board has determined to be so closely related to banking as to be a proper incident thereto. In addition, bank holding companies that qualify and elect to be financial holding companies may engage in any activity, or acquire and retain the shares of a company engaged in any activity, that is either (i) financial in nature or incidental to such financial activity (as determined by the Federal Reserve Board in consultation with the Secretary of the Treasury) or (ii) complementary to a financial activity and does not pose a substantial risk to the safety and soundness of depository institutions or the financial system generally (as solely determined by the Federal Reserve Board), without prior approval of the Federal Reserve Board. Activities that are financial in nature include securities underwriting and dealing, insurance underwriting and making merchant banking investments.

To maintain financial holding company status, a financial holding company and all of its depository institution subsidiaries must be well capitalized and well managed. A depository institution subsidiary is considered to be well capitalized if it satisfies the requirements for this status discussed in the section captioned Capital Adequacy and Prompt Corrective Action, included elsewhere in this item. A depository institution subsidiary is considered well managed if it received a composite rating and management rating of at least satisfactory in its most recent examination. A financial holding company s status will also depend upon it maintaining its status as well capitalized and well managed under applicable Federal Reserve Board regulations. If a financial holding company ceases to meet these capital and management requirements, the Federal Reserve Board s regulations provide that the financial holding company must enter into an agreement with the Federal Reserve Board to comply with all applicable capital and management requirements. Until the financial holding company returns to compliance, the Federal Reserve Board may impose limitations or conditions on the conduct of its activities, and the company may not commence any of the broader financial activities permissible for financial holding companies or acquire a company engaged in such financial activities without prior approval of the Federal Reserve Board. If the company does not return to compliance within 180 days, the Federal Reserve Board may require divestiture of the holding company s depository institutions. Bank holding companies and banks must also be both well capitalized and well managed in order to acquire banks located outside their home state.

In order for a financial holding company to commence any new activity permitted by the BHC Act or to acquire a company engaged in any new activity permitted by the BHC Act, each insured depository institution subsidiary of the financial holding company must have received a rating of at least satisfactory in its most recent examination under the Community Reinvestment Act. See the section captioned Community Reinvestment Act included elsewhere in this item.

The Federal Reserve Board has the power to order any bank holding company or its subsidiaries to terminate any activity or to terminate its ownership or control of any subsidiary when the Federal Reserve Board has reasonable grounds to believe that continuation of such activity or such ownership or control constitutes a serious risk to the financial soundness, safety or stability of any bank subsidiary of the bank holding company.

The Dodd-Frank Act amends the BHC Act to require the federal financial regulatory agencies to adopt rules that prohibit banks and their affiliates from engaging in proprietary trading and investing in and sponsoring certain unregistered investment companies (defined as hedge funds and private equity funds). The statutory provision is commonly called the Volcker Rule . In October 2011, federal regulators proposed rules to implement the Volcker Rule that included an extensive request for comments on the proposal. Although the

Table of Contents

comment period has been closed for some time, a final rule has not been adopted. The proposed rules are highly complex, and many aspects of their application remain uncertain. Based on the proposed rules, the Corporation does not currently anticipate that the Volcker Rule will have a material effect on the operations of Cullen/Frost and its subsidiaries, as the Corporation does not engage in the businesses prohibited by the Volcker Rule. The Corporation may incur costs if it is required to adopt additional policies and systems to ensure compliance with the Volcker Rule, but any such costs are not expected to be material. Until a final rule is adopted, the precise financial impact of the rule on the Corporation, its customers or the financial industry more generally, cannot be determined.

The BHC Act, the Bank Merger Act, the Texas Banking Code and other federal and state statutes regulate acquisitions of commercial banks. The BHC Act requires the prior approval of the Federal Reserve Board for the direct or indirect acquisition by a bank holding company of more than 5.0% of the voting shares of a commercial bank or its parent holding company. Under the Bank Merger Act, the prior approval of the Federal Reserve Board or other appropriate bank regulatory authority is required for a member bank to merge with another bank or purchase the assets or assume the deposits of another bank. In reviewing applications seeking approval of merger and acquisition transactions, the bank regulatory authorities will consider, among other things, the competitive effect and public benefits of the transactions, the capital position of the combined organization, the risks to the stability of the U.S. banking or financial system, the applicant's performance record under the Community Reinvestment Act (see the section captioned "Community Reinvestment Act" included elsewhere in this item) and fair housing laws and the effectiveness of the subject organizations in combating money laundering activities.

Dividends

The principal source of Cullen/Frost's liquidity is dividends from Frost Bank. The prior approval of the Federal Reserve is required if the total of all dividends declared by a state-chartered member bank in any calendar year would exceed the sum of the bank's net profits for that year and its retained net profits for the preceding two calendar years, less any required transfers to surplus or to fund the retirement of preferred stock. Federal law also prohibits a state-chartered, member bank from paying dividends that would be greater than the bank's undivided profits. Frost Bank is also subject to limitations under Texas state law regarding the level of dividends that may be paid. Under the foregoing dividend restrictions, and while maintaining its well capitalized status, Frost Bank could pay aggregate dividends of approximately \$306.5 million to Cullen/Frost, without obtaining affirmative governmental approvals, at December 31, 2012. This amount is not necessarily indicative of amounts that may be paid or available to be paid in future periods.

In addition, Cullen/Frost and Frost Bank are subject to other regulatory policies and requirements relating to the payment of dividends, including requirements to maintain adequate capital above regulatory minimums. The appropriate federal regulatory authority is authorized to determine under certain circumstances relating to the financial condition of a bank holding company or a bank that the payment of dividends would be an unsafe or unsound practice and to prohibit payment thereof. The appropriate federal regulatory authorities have stated that paying dividends that deplete a bank's capital base to an inadequate level would be an unsafe and unsound banking practice and that banking organizations should generally pay dividends only out of current operating earnings. In addition, in the current financial and economic environment, the Federal Reserve Board has indicated that bank holding companies should carefully review their dividend policy and has discouraged payment ratios that are at maximum allowable levels unless both asset quality and capital are very strong.

In October 2012, as required by Dodd-Frank, the Federal Reserve Board announced publication of their final rules regarding company-run stress testing. The rules will require institutions, such as Cullen/Frost and Frost Bank, with average total consolidated assets greater than \$10 billion to conduct an annual company-run stress test of capital, consolidated earnings and losses under one base and at least two stress scenarios provided by the agencies. The rules delay implementation for covered institutions with total consolidated assets between \$10 billion and \$50 billion. Institutions with total consolidated assets between \$10 billion and \$50 billion will use data as of September 30, 2013 to conduct the stress test, using scenarios that are released by the agencies in

Table of Contents

November 2013. Stress test results must be reported to the agencies in March 2014. Public disclosure of summary stress test results under the severely adverse scenario will begin in June 2015 for stress tests commencing in 2014. It is anticipated that the Corporation's capital ratios reflected in the stress test calculations will be an important factor considered by the Federal Reserve Board in evaluating whether proposed payments of dividends or stock repurchases may be an unsafe or unsound practice.

Transactions with Affiliates

Transactions between Frost Bank, on the one hand, and Cullen/Frost and its other subsidiaries, on the other hand, are regulated by the Federal Reserve Board. These regulations limit the types and amounts of covered transactions engaged in by Frost Bank and generally require those transactions to be on an arm's-length basis. Covered transactions are defined by statute to include a loan or extension of credit, as well as a purchase of securities issued by an affiliate, a purchase of assets (unless otherwise exempted by the Federal Reserve Board) from the affiliate, certain derivative transactions that create a credit exposure to an affiliate, the acceptance of securities issued by the affiliate as collateral for a loan, and the issuance of a guarantee, acceptance or letter of credit on behalf of an affiliate. In general, these regulations require that any such transaction by Frost Bank (or its subsidiaries) with an affiliate must be secured by designated amounts of specified collateral and must be limited to certain thresholds on an individual and aggregate basis.

Source of Strength Doctrine

Federal Reserve Board policy and federal law require bank holding companies to act as a source of financial and managerial strength to their subsidiary banks. Under this requirement, Cullen/Frost is expected to commit resources to support Frost Bank, including at times when Cullen/Frost may not be in a financial position to provide such resources. Any capital loans by a bank holding company to any of its subsidiary banks are subordinate in right of payment to depositors and to certain other indebtedness of such subsidiary banks. In the event of a bank holding company's bankruptcy, any commitment by the bank holding company to a federal bank regulatory agency to maintain the capital of a subsidiary bank will be assumed by the bankruptcy trustee and entitled to priority of payment.

Capital Requirements

Cullen/Frost and Frost Bank are subject to the regulatory capital requirements administered by the Federal Reserve Board, and, for Frost Bank, the FDIC. The federal regulatory authorities' risk-based capital guidelines are based upon the 1988 capital accord (Basel I) of the Basel Committee on Banking Supervision (the Basel Committee). The Basel Committee is a committee of central banks and bank supervisors/regulators from the major industrialized countries that develops broad policy guidelines for use by each country's supervisors in determining the supervisory policies they apply. The requirements are intended to ensure that banking organizations have adequate capital given the risk levels of assets and off-balance sheet financial instruments. Under the requirements, banking organizations are required to maintain minimum ratios for Tier 1 capital and total capital to risk-weighted assets (including certain off-balance sheet items, such as letters of credit). For purposes of calculating the ratios, a banking organization's assets and some of its specified off-balance sheet commitments and obligations are assigned to various risk categories. A depository institution's or holding company's capital, in turn, is classified in one of two tiers, depending on type:

- *Core Capital (Tier 1).* Tier 1 capital includes common equity, retained earnings, qualifying non-cumulative perpetual preferred stock, minority interests in equity accounts of consolidated subsidiaries (and, under existing standards, a limited amount of qualifying trust preferred securities and qualifying cumulative perpetual preferred stock at the holding company level), less goodwill, most intangible assets and certain other assets.
- *Supplementary Capital (Tier 2).* Tier 2 capital includes, among other things, perpetual preferred stock and trust preferred securities not meeting the Tier 1 definition, qualifying mandatory convertible debt securities, qualifying subordinated debt, and allowances for loan and lease losses, subject to limitations.

Table of Contents

Cullen/Frost, like other bank holding companies, currently is required to maintain Tier 1 capital and total capital (the sum of Tier 1 and Tier 2 capital) equal to at least 4.0% and 8.0%, respectively, of its total risk-weighted assets (including various off-balance-sheet items, such as letters of credit). Frost Bank, like other depository institutions, is required to maintain similar capital levels under capital adequacy guidelines. In addition, for a depository institution to be considered well capitalized under the regulatory framework for prompt corrective action, its Tier 1 and total capital ratios must be at least 6.0% and 10.0% on a risk-adjusted basis, respectively.

Bank holding companies and banks are also required to comply with minimum leverage ratio requirements. The leverage ratio is the ratio of a banking organization's Tier 1 capital to its total adjusted quarterly average assets (as defined for regulatory purposes). The requirements necessitate a minimum leverage ratio of 3.0% for bank holding companies and member banks that either have the highest supervisory rating or have implemented the appropriate federal regulatory authority's risk-adjusted measure for market risk. All other bank holding companies and member banks are required to maintain a minimum leverage ratio of 4.0%, unless a different minimum is specified by an appropriate regulatory authority. In addition, for a depository institution to be considered well capitalized under the regulatory framework for prompt corrective action, its leverage ratio must be at least 5.0%. The Federal Reserve Board has not advised Cullen/Frost or Frost Bank, of any specific minimum leverage ratio applicable to either entity.

In June 2012, the Corporation's primary federal regulator, the Federal Reserve, published two notices of proposed rulemaking (the 2012 Capital Proposals) that would 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, which are based on the aforementioned Basel I capital accords of the Basel Committee. One of the 2012 Capital Proposals (the Basel III Proposal) addresses the components of capital and other issues affecting the numerator in banking institutions' regulatory capital ratios and would implement the Basel Committee's December 2010 framework known as Basel III for strengthening international capital standards. The other proposal (the Standardized Approach Proposal) addresses risk weights and other issues affecting the denominator in banking institutions' regulatory capital ratios and would replace the existing Basel I-derived risk-weighting approach with a more risk-sensitive approach based, in part, on the standardized approach in the Basel Committee's 2004 Basel II capital accords. The 2012 Capital Proposals would also implement the requirements of Section 939A of the Dodd-Frank Act to remove references to credit ratings from the federal banking agencies' rules. As proposed, the Basel III Proposal and the Standardized Approach Proposal would come into effect on January 1, 2013 (subject to a phase-in period) and January 1, 2015 (with an option for early adoption), respectively; however, final rules have not yet been adopted, and the Basel III framework is therefore not yet applicable to Cullen/Frost or Frost Bank.

The Basel III Proposal, among other things, (i) introduces a new capital measure called Common Equity Tier 1 (CET1), (ii) specifies that Tier 1 capital consist of CET1 and Additional Tier 1 capital instruments meeting specified requirements, (iii) defines 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) expands the scope of the deductions/adjustments as compared to existing regulations.

When fully phased in on January 1, 2019, the Basel III Proposal 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.

Table of Contents

The Basel III Proposal 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 Proposal, the initial minimum capital ratios were to be the following:

- “ 3.5% CET1 to risk-weighted assets.

- “ 4.5% Tier 1 capital to risk-weighted assets.

- “ 8.0% Total capital to risk-weighted assets.

The Basel III Proposal provides 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 Proposal, the effects of certain accumulated other comprehensive items are not excluded, which could result in 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 Proposal also requires the phase-out of certain hybrid securities, such as trust preferred securities, as Tier 1 capital of bank holding companies in equal installments between 2013 and 2016. Trust preferred securities no longer included in Tier 1 capital may nonetheless be included as a component of Tier 2 capital.

Implementation of the deductions and other adjustments to CET1 will begin on January 1, 2014 and will be phased-in over a five-year period (20% per year). 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 Proposal would 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, 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 proposal does not change the total risk-based capital requirement for any category.

The federal banking agencies in 2008 proposed, as an option for banking institutions that are not subject to the advanced risk-weighting approaches of Basel II, an approach based upon the Basel II standardized risk-weighting approach, but the agencies never proceeded with it. The Standardized Approach Proposal expands upon the initial U.S. Basel II approach from 2008 but would be mandatory and, because of Dodd-Frank's prohibition on the use of credit ratings, would substitute non ratings-based alternatives for Basel II's heavy reliance on credit ratings.

Table of Contents

The Standardized Approach Proposal would 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, including many residential mortgages and certain commercial real estate. Specifics 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.
- “ For residential mortgage exposures, the current approach of a 50% risk weight for high-quality seasoned mortgages and a 100% risk-weight for all other mortgages is replaced with a risk weight of between 35% and 200% depending upon the mortgage’s loan-to-value ratio and whether the mortgage is a category 1 or category 2 residential mortgage exposure (based on eight criteria that include the term, use of negative amortization, balloon payments and certain rate increases).
- “ 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 Standardized Approach Proposal also provides more advantageous risk weights for derivatives and repurchase-style transactions cleared through a qualifying central counterparty and increases the scope of eligible guarantors and eligible collateral for purposes of credit risk mitigation.

Management believes that, as of December 31, 2012, Cullen/Frost and Frost Bank would meet all capital adequacy requirements under the Basel III and Standardized Approach Proposals on a fully phased-in basis if such requirements were currently effective. There can be no guarantee that the Basel III and the Standardized Approach Proposals will be adopted in their current form, what changes may be made before adoption, or when ultimate adoption will occur. Requirements to maintain higher levels of capital or to maintain higher levels of liquid assets could adversely impact the Corporation’s net income and return on equity.

Liquidity Requirements

Historically, the regulation and monitoring of bank and bank holding company liquidity has been addressed as a supervisory matter, without required formulaic measures. The Basel III liquidity framework requires banks and bank holding companies to measure their liquidity against specific liquidity tests that, although similar in some respects to liquidity measures historically applied by banks and regulators for management and supervisory purposes, going forward would be required by regulation. One test, referred to as the liquidity coverage ratio (LCR), is designed to ensure that the banking entity maintains an adequate level of unencumbered high-quality liquid assets equal to the entity’s expected net cash outflow for a 30-day time horizon (or, if greater, 25% of its expected total cash outflow) under an acute liquidity stress scenario. The other test, referred to as the net stable funding ratio (NSFR), is designed to promote more medium- and long-term funding of the assets and activities of banking entities over a one-year time horizon. These requirements will incent banking entities to increase their holdings of U.S. Treasury securities and other sovereign debt as a component of assets and increase the use of long-term debt as a funding source. The Basel III liquidity framework contemplates that the LCR will be subject to an observation period continuing through mid-2013 and, subject to any revisions

resulting from the analyses

Table of Contents

conducted and data collected during the observation period, implemented as a minimum standard on January 1, 2015, with a phase-in period ending January 1, 2019. Similarly, it contemplates that the NSFR will be subject to an observation period through mid-2016 and, subject to any revisions resulting from the analyses conducted and data collected during the observation period, implemented as a minimum standard by January 1, 2018. These new standards are subject to further rulemaking and their terms may well change before implementation. The federal banking agencies have not proposed rules implementing the Basel III liquidity framework and have not determined to what extent they will apply to U.S. banks that are not large, internationally active banks.

Prompt Corrective Action

The Federal Deposit Insurance Act, as amended (FDIA), requires among other things, the federal banking agencies to take prompt corrective action in respect of depository institutions that do not meet minimum capital requirements. The FDIA includes the following five capital tiers: well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized and critically undercapitalized. A depository institution's capital tier will depend upon how its capital levels compare with various relevant capital measures and certain other factors, as established by regulation. The relevant capital measures are the total capital ratio, the Tier 1 capital ratio and the leverage ratio.

A bank will be (i) well capitalized if the institution has a total risk-based capital ratio of 10.0% or greater, a Tier 1 risk-based capital ratio of 6.0% or greater, and a leverage ratio of 5.0% or greater, and is not subject to any order or written directive by any such regulatory authority to meet and maintain a specific capital level for any capital measure; (ii) adequately capitalized if the institution has a total risk-based capital ratio of 8.0% or greater, a Tier 1 risk-based capital ratio of 4.0% or greater, and a leverage ratio of 4.0% or greater and is not well capitalized ; (iii) undercapitalized if the institution has a total risk-based capital ratio that is less than 8.0%, a Tier 1 risk-based capital ratio of less than 4.0% or a leverage ratio of less than 4.0%; (iv) significantly undercapitalized if the institution has a total risk-based capital ratio of less than 6.0%, a Tier 1 risk-based capital ratio of less than 3.0% or a leverage ratio of less than 3.0%; and (v) critically undercapitalized if the institution's tangible equity is equal to or less than 2.0% of average quarterly tangible assets. An institution may be downgraded to, or deemed to be in, a capital category that is lower than indicated by its capital ratios if it is determined to be in an unsafe or unsound condition or if it receives an unsatisfactory examination rating with respect to certain matters. A bank's capital category is determined solely for the purpose of applying prompt corrective action regulations, and the capital category may not constitute an accurate representation of the bank's overall financial condition or prospects for other purposes.

The FDIA generally prohibits a depository institution from making any capital distributions (including payment of a dividend) or paying any management fee to its parent holding company if the depository institution would thereafter be undercapitalized. Undercapitalized institutions are subject to growth limitations and are required to submit a capital restoration plan. The agencies may not accept such a plan without determining, among other things, that the plan is based on realistic assumptions and is likely to succeed in restoring the depository institution's capital. In addition, for a capital restoration plan to be acceptable, the depository institution's parent holding company must guarantee that the institution will comply with such capital restoration plan. The bank holding company must also provide appropriate assurances of performance. The aggregate liability of the parent holding company is limited to the lesser of (i) an amount equal to 5.0% of the depository institution's total assets at the time it became undercapitalized and (ii) the amount which is necessary (or would have been necessary) to bring the institution into compliance with all capital standards applicable with respect to such institution as of the time it fails to comply with the plan. If a depository institution fails to submit an acceptable plan, it is treated as if it is significantly undercapitalized.

Significantly undercapitalized depository institutions may be subject to a number of requirements and restrictions, including orders to sell sufficient voting stock to become adequately capitalized, requirements to reduce total assets, and cessation of receipt of deposits from correspondent banks. Critically undercapitalized institutions are subject to the appointment of a receiver or conservator.

Table of Contents

The appropriate federal banking agency may, under certain circumstances, reclassify a well capitalized insured depository institution as adequately capitalized. The FDIA provides that an institution may be reclassified if the appropriate federal banking agency determines (after notice and opportunity for hearing) that the institution is in an unsafe or unsound condition or deems the institution to be engaging in an unsafe or unsound practice.

The appropriate agency is also permitted to require an adequately capitalized or undercapitalized institution to comply with the supervisory provisions as if the institution were in the next lower category (but not treat a significantly undercapitalized institution as critically undercapitalized) based on supervisory information other than the capital levels of the institution.

Cullen/Frost believes that, as of December 31, 2012, its bank subsidiary, Frost Bank, was well capitalized based on the aforementioned ratios. For further information regarding the capital ratios and leverage ratio of Cullen/Frost and Frost Bank see the discussion under the section captioned Capital and Liquidity included in Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations and Note 10 - Regulatory Matters in the notes to consolidated financial statements included in Item 8. Financial Statements and Supplementary Data, elsewhere in this report.

As stated above, the Basel III Proposal would revise the prompt corrective action categories. See Capital Requirements above.

Deposit Insurance

Substantially all of the deposits of Frost Bank are insured up to applicable limits by the Deposit Insurance Fund (DIF) of the FDIC and are subject to deposit insurance assessments to maintain the DIF. Deposit insurance assessments are based on average total assets minus average tangible equity. For larger institutions, such as Frost Bank, the FDIC uses a performance score and a loss-severity score that are used to calculate an initial assessment rate. In calculating these scores, the FDIC uses a bank's capital level and supervisory ratings (its CAMELS ratings) and certain financial measures to assess an institution's ability to withstand asset-related stress and funding-related stress. The FDIC has the ability to make discretionary adjustments to the total score based upon significant risk factors that are not adequately captured in the calculations.

The initial base assessment rate ranges from 5 to 35 basis points on an annualized basis. After the effect of potential base-rate adjustments, the total base assessment rate could range from 2.5 to 45 basis points on an annualized basis. As the DIF reserve ratio grows, the rate schedule will be adjusted downward. Additionally, an institution must pay an additional premium equal to 50 basis points on every dollar (above 3% of an institution's Tier 1 capital) of long-term, unsecured debt held that was issued by another insured depository institution (excluding debt guaranteed under the Temporary Liquidity Guarantee Program).

In November 2009, the FDIC issued a rule that required all insured depository institutions, with limited exceptions, to prepay their estimated quarterly risk-based assessments for the fourth quarter of 2009 and for all of 2010, 2011 and 2012. As of December 31, 2012, \$22.3 million in pre-paid deposit insurance is included in accrued interest receivable and other assets in the accompanying consolidated balance sheet.

In October 2010, the FDIC adopted a new DIF restoration plan to ensure that the fund reserve ratio reaches 1.35% by September 30, 2020, as required by the Dodd-Frank Act. At least semi-annually, the FDIC will update its loss and income projections for the fund and, if needed, will increase or decrease assessment rates, following notice-and-comment rulemaking if required.

The separate deposit insurance coverage for non-interest-bearing transaction accounts that became effective on December 31, 2010 terminated on December 31, 2012.

FDIC deposit insurance expense totaled \$11.1 million, \$12.7 million and \$20.5 million in 2012, 2011 and 2010, respectively. FDIC deposit insurance expense includes deposit insurance assessments and Financing

Table of Contents

Corporation (FICO) assessments related to outstanding FICO bonds. The FICO is a mixed-ownership government corporation established by the Competitive Equality Banking Act of 1987 whose sole purpose was to function as a financing vehicle for the now defunct Federal Savings & Loan Insurance Corporation.

Under the FDIA, the FDIC may terminate deposit insurance upon a finding that the institution has engaged in unsafe and unsound practices, is in an unsafe or unsound condition to continue operations, or has violated any applicable law, regulation, rule, order or condition imposed by the FDIC.

Safety and Soundness Standards

The FDIA requires the federal bank regulatory agencies to prescribe standards, by regulations or guidelines, relating to internal controls, information systems and internal audit systems, loan documentation, credit underwriting, interest rate risk exposure, asset growth, asset quality, earnings, stock valuation and compensation, fees and benefits, and such other operational and managerial standards as the agencies deem appropriate. Guidelines adopted by the federal bank regulatory agencies establish general standards relating to internal controls and information systems, internal audit systems, loan documentation, credit underwriting, interest rate exposure, asset growth and compensation, fees and benefits. In general, the guidelines require, among other things, appropriate systems and practices to identify and manage the risk and exposures specified in the guidelines. The guidelines prohibit excessive compensation as an unsafe and unsound practice and describe compensation as excessive when the amounts paid are unreasonable or disproportionate to the services performed by an executive officer, employee, director or principal stockholder. In addition, the agencies adopted regulations that authorize, but do not require, an agency to order an institution that has been given notice by an agency that it is not satisfying any of such safety and soundness standards to submit a compliance plan. If, after being so notified, an institution fails to submit an acceptable compliance plan or fails in any material respect to implement an acceptable compliance plan, the agency must issue an order directing action to correct the deficiency and may issue an order directing other actions of the types to which an undercapitalized institution is subject under the prompt corrective action provisions of the FDIA. See Prompt Corrective Action above. If an institution fails to comply with such an order, the agency may seek to enforce such order in judicial proceedings and to impose civil money penalties.

Consumer Financial Protection Bureau Supervision

Dodd-Frank centralized responsibility for consumer financial protection by creating a new agency, the Consumer Financial Protection Bureau (CFPB), and giving it responsibility for implementing, examining and enforcing compliance with federal consumer protection laws. In July 2011, Frost Bank was notified that it will be supervised by the CFPB for certain consumer protection purposes. The CFPB will focus on:

- “ Risks to consumers and compliance with the federal consumer financial laws, when it evaluates the policies and practices of a financial institution.
- “ The markets in which firms operate and risks to consumers posed by activities in those markets.
- “ Depository institutions that offer a wide variety of consumer financial products and services; depository institutions with a more specialized focus.
- “ Non-depository companies that offer one or more consumer financial products or services.

Banking regulators take into account compliance with consumer protection laws when considering approval of a proposed transaction.

Table of Contents

Depositor Preference

The FDIA provides that, in the event of the liquidation or other resolution of an insured depository institution, the claims of depositors of the institution, including the claims of the FDIC as subrogee of insured depositors, and certain claims for administrative expenses of the FDIC as a receiver, will have priority over other general unsecured claims against the institution. If an insured depository institution fails, insured and uninsured depositors, along with the FDIC, will have priority in payment ahead of unsecured, non-deposit creditors, including depositors whose deposits are payable only outside of the United States and the parent bank holding company, with respect to any extensions of credit they have made to such insured depository institution.

Community Reinvestment Act

The Community Reinvestment Act of 1977 (CRA) requires depository institutions to assist in meeting the credit needs of their market areas consistent with safe and sound banking practice. Under the CRA, each depository institution is required to help meet the credit needs of its market areas by, among other things, providing credit to low- and moderate-income individuals and communities. Depository institutions are periodically examined for compliance with the CRA and are assigned ratings. In order for a financial holding company to commence any new activity permitted by the BHC Act, or to acquire any company engaged in any new activity permitted by the BHC Act, each insured depository institution subsidiary of the financial holding company must have received a rating of at least satisfactory in its most recent examination under the CRA. Furthermore, banking regulators take into account CRA ratings when considering approval of a proposed transaction. Frost Bank received a rating of satisfactory in its most recent CRA examination.

Financial Privacy

The federal banking regulators adopted rules that limit the ability of banks and other financial institutions to disclose non-public information about consumers to nonaffiliated third parties. These limitations require disclosure of privacy policies to consumers and, in some circumstances, allow consumers to prevent disclosure of certain personal information to a nonaffiliated third party. These regulations affect how consumer information is transmitted through diversified financial companies and conveyed to outside vendors.

Anti-Money Laundering and the USA Patriot Act

A major focus of governmental policy on financial institutions in recent years has been aimed at combating money laundering and terrorist financing. The USA PATRIOT Act of 2001 (the USA Patriot Act) substantially broadened the scope of United States anti-money laundering laws and regulations by imposing significant new compliance and due diligence obligations, creating new crimes and penalties and expanding the extra-territorial jurisdiction of the United States. Failure of a financial institution to maintain and implement adequate programs to combat money laundering and terrorist financing, or to comply with all of the relevant laws or regulations, could have serious legal and reputational consequences for the institution, including causing applicable bank regulatory authorities not to approve merger or acquisition transactions when regulatory approval is required or to prohibit such transactions even if approval is not required.

Office of Foreign Assets Control Regulation

The United States has imposed economic sanctions that affect transactions with designated foreign countries, nationals and others which are administered by the U.S. Treasury Department Office of Foreign Assets Control. Failure to comply with these sanctions could have serious legal and reputational consequences, including causing applicable bank regulatory authorities not to approve merger or acquisition transactions when regulatory approval is required or to prohibit such transactions even if approval is not required.

Table of Contents

Incentive Compensation

The Dodd-Frank Act requires the federal bank regulatory agencies and the SEC to establish joint regulations or guidelines prohibiting incentive-based payment arrangements at specified regulated entities, such as the Corporation and Frost Bank, having at least \$1 billion in total assets that encourage inappropriate risks by providing an executive officer, employee, director or principal shareholder with excessive compensation, fees, or benefits or that could lead to material financial loss to the entity. In addition, these regulators must establish regulations or guidelines requiring enhanced disclosure to regulators of incentive-based compensation arrangements. The agencies proposed such regulations in April 2011, but the regulations have not been finalized. If the regulations are adopted in the form initially proposed, they will impose limitations on the manner in which the Corporation may structure compensation for its executives.

In June 2010, the Federal Reserve Board, OCC and FDIC issued a comprehensive final guidance on incentive compensation policies intended to ensure that the incentive compensation policies of banking organizations do not undermine the safety and soundness of such organizations by encouraging excessive risk-taking. The guidance, which covers all employees that have the ability to materially affect the risk profile of an organization, either individually or as part of a group, is based upon the key principles that a banking organization's incentive compensation arrangements should (i) provide incentives that do not encourage risk-taking beyond the organization's ability to effectively identify and manage risks, (ii) be compatible with effective internal controls and risk management, and (iii) be supported by strong corporate governance, including active and effective oversight by the organization's board of directors. These three principles are incorporated into the proposed joint compensation regulations under the Dodd-Frank Act, discussed above.

The Federal Reserve Board will review, as part of the regular, risk-focused examination process, the incentive compensation arrangements of banking organizations, such as the Corporation, that are not large, complex banking organizations. These reviews will be tailored to each organization based on the scope and complexity of the organization's activities and the prevalence of incentive compensation arrangements. The findings of the supervisory initiatives will be included in reports of examination. Deficiencies will be incorporated into the organization's supervisory ratings, which can affect the organization's ability to make acquisitions and take other actions. Enforcement actions may be taken against a banking organization if its incentive compensation arrangements, or related risk-management control or governance processes, pose a risk to the organization's safety and soundness and the organization is not taking prompt and effective measures to correct the deficiencies.

Legislative and Regulatory Initiatives

From time to time, various legislative and regulatory initiatives are introduced in Congress and state legislatures, as well as by regulatory agencies. Such initiatives may include proposals to expand or contract the powers of bank holding companies and depository institutions or proposals to substantially change the financial institution regulatory system. Such legislation could change banking statutes and the operating environment of the Corporation in substantial and unpredictable ways. If enacted, such legislation could increase or decrease the cost of doing business, limit or expand permissible activities or affect the competitive balance among banks, savings associations, credit unions, and other financial institutions. The Corporation cannot predict whether any such legislation will be enacted, and, if enacted, the effect that it, or any implementing regulations, would have on the financial condition or results of operations of the Corporation. A change in statutes, regulations or regulatory policies applicable to Cullen/Frost or any of its subsidiaries could have a material effect on the Corporation's business, financial condition and results of operations.

Table of Contents**Employees**

At December 31, 2012, the Corporation employed 3,878 full-time equivalent employees. None of the Corporation's employees are represented by collective bargaining agreements. The Corporation believes its employee relations to be good.

Executive Officers of the Registrant

The names, ages as of December 31, 2012, recent business experience and positions or offices held by each of the executive officers of Cullen/Frost are as follows:

Name and Position Held	Age	Recent Business Experience
Richard W. Evans, Jr. Chairman of the Board, Chief Executive Officer and Director	66	Officer of Frost Bank since 1973. Chairman of the Board and Chief Executive Officer of Cullen/Frost from October 1997 to present.
Patrick B. Frost President of Frost Bank and Director	52	Officer of Frost Bank since 1985. President of Frost Bank from August 1993 to present. Director of Cullen/Frost from May 1997 to present.
Phillip D. Green Group Executive Vice President, Chief Financial Officer	58	Officer of Frost Bank since July 1980. Group Executive Vice President, Chief Financial Officer of Cullen/Frost from October 1995 to present.
David W. Beck President, Chief Business Banking Officer of Frost Bank	62	Officer of Frost Bank since July 1973. President, Chief Business Banking Officer of Frost Bank from February 2001 to present.
Robert A. Berman Group Executive Vice President, E-Commerce Operations Research and Strategy of Frost Bank	50	Officer of Frost Bank since January 1989. Group Executive Vice President, E-Commerce Operations Research and Strategy of Frost Bank from May 2001 to present.
Paul H. Bracher President, State Regions of Frost Bank	56	Officer of Frost Bank since January 1982. President, State Regions of Frost Bank from February 2001 to present.
Richard Kardys Group Executive Vice President, Frost Wealth Advisors of Frost Bank	66	Officer of Frost Bank since January 1977. Group Executive Vice President, Frost Wealth Advisors of Frost Bank from May 2001 to present.
Paul J. Olivier Group Executive Vice President, Chief Consumer Banking Officer of Frost Bank	60	Officer of Frost Bank since August 1976. Group Executive Vice President, Chief Consumer Banking Officer of Frost Bank from May 2001 to present.
William L. Perotti Group Executive Vice President, Chief Credit Officer and Chief Risk Officer of Frost Bank	55	Officer of Frost Bank since December 1982. Group Executive Vice President, Chief Credit Officer of Frost Bank from May 2001 to present. Chief Risk Officer of Frost Bank from April 2005 to present.
Emily A. Skillman Group Executive Vice President, Human Resources of Frost Bank	68	Officer of Frost Bank since January 1998. Group Executive Vice President, Human Resources of Frost Bank from October 2003 to present.

There are no arrangements or understandings between any executive officer of Cullen/Frost and any other person pursuant to which such executive officer was or is to be selected as an officer.

Table of Contents

Available Information

Under the Securities Exchange Act of 1934, Cullen/Frost is required to file annual, quarterly and current reports, proxy statements and other information with the Securities and Exchange Commission (SEC). You may read and copy any document Cullen/Frost files with the SEC at the SEC's Public Reference Room at 100 F Street, N.E., Washington, D.C. 20549. Please call the SEC at 1-800-SEC-0330 for further information about the public reference room. The SEC maintains a website at <http://www.sec.gov> that contains reports, proxy and information statements, and other information regarding issuers that file electronically with the SEC. Cullen/Frost files electronically with the SEC.

Cullen/Frost makes available, free of charge through its website, its reports on Forms 10-K, 10-Q and 8-K, and amendments to those reports, as soon as reasonably practicable after such reports are filed with or furnished to the SEC. Additionally, the Corporation has adopted and posted on its website a code of ethics that applies to its principal executive officer, principal financial officer and principal accounting officer. The Corporation's website also includes its corporate governance guidelines and the charters for its audit committee, its compensation and benefits committee, and its corporate governance and nominating committee. The address for the Corporation's website is <http://www.frostbank.com>. The Corporation will provide a printed copy of any of the aforementioned documents to any requesting shareholder.

Table of Contents

ITEM 1A. RISK FACTORS

An investment in the Corporation's common stock is subject to risks inherent to the Corporation's business. The material risks and uncertainties that management believes affect the Corporation are described below. Before making an investment decision, you should carefully consider the risks and uncertainties described below together with all of the other information included or incorporated by reference in this report. The risks and uncertainties described below are not the only ones facing the Corporation. Additional risks and uncertainties that management is not aware of or focused on or that management currently deems immaterial may also impair the Corporation's business operations. This report is qualified in its entirety by these risk factors.

If any of the following risks actually occur, the Corporation's business, financial condition and results of operations could be materially and adversely affected. If this were to happen, the market price of the Corporation's common stock could decline significantly, and you could lose all or part of your investment.

Risks Related To The Corporation's Business

The Corporation's Business May Be Adversely Affected By Conditions In The Financial Markets and Economic Conditions Generally

From December 2007 through June 2009, the U.S. economy was in recession. Business activity across a wide range of industries and regions in the U. S. was greatly reduced. Although economic conditions have improved, certain sectors, such as real estate and manufacturing, remain weak and unemployment remains high. Local governments and many businesses are still in serious difficulty due to lower consumer spending and decreased liquidity in the credit markets.

Market conditions also led to the failure or merger of several prominent financial institutions and numerous regional and community-based financial institutions. These failures, as well as projected future failures, have had a significant negative impact on the capitalization level of the deposit insurance fund of the FDIC, which, in turn, has led to a significant increase in deposit insurance premiums paid by financial institutions.

The Corporation's financial performance generally, and in particular the ability of borrowers to pay interest on and repay principal of outstanding loans and the value of collateral securing those loans, as well as demand for loans and other products and services the Corporation offers, is highly dependent upon on the business environment in the markets where the Corporation operates, in the State of Texas and in the United States as a whole. A favorable business environment is generally characterized by, among other factors, economic growth, efficient capital markets, low inflation, low unemployment, high business and investor confidence, and strong business earnings. Unfavorable or uncertain economic and market conditions can be caused by declines in economic growth, business activity or investor or business confidence; limitations on the availability or increases in the cost of credit and capital; increases in inflation or interest rates; high unemployment, natural disasters; or a combination of these or other factors.

Overall, during 2012, the business environment has been adverse for many households and businesses in the United States and worldwide. While economic conditions in the State of Texas, the United States and worldwide have improved since the recession, there can be no assurance that this improvement will continue. Such conditions could adversely affect the credit quality of the Corporation's loans and the Corporation business, financial condition and results of operations.

The Corporation Is Subject To Lending Risk

There are inherent risks associated with the Corporation's lending activities. These risks include, among other things, the impact of changes in interest rates and changes in the economic conditions in the markets where the Corporation operates as well as those across the State of Texas and the United States. Increases in interest rates and/or weakening economic conditions could adversely impact the ability of borrowers to repay outstanding

Table of Contents

loans or the value of the collateral securing these loans. The Corporation is also subject to various laws and regulations that affect its lending activities. Failure to comply with applicable laws and regulations could subject the Corporation to regulatory enforcement action that could result in the assessment of significant civil money penalties against the Corporation.

As of December 31, 2012, approximately 89% of the Corporation's loan portfolio consisted of commercial and industrial, construction and commercial real estate mortgage loans. These types of loans are generally viewed as having more risk of default than residential real estate loans or consumer loans. These types of loans are also typically larger than residential real estate loans and consumer loans. Because the Corporation's loan portfolio contains a significant number of commercial and industrial, construction and commercial real estate loans with relatively large balances, the deterioration of one or a few of these loans could cause a significant increase in non-performing loans. An increase in non-performing loans could result in a net loss of earnings from these loans, an increase in the provision for loan losses and an increase in loan charge-offs, all of which could have a material adverse effect on the Corporation's business, financial condition and results of operations.

See the section captioned "Loans" in Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations located elsewhere in this report for further discussion related to commercial and industrial, construction and commercial real estate loans.

The Corporation Is Subject To Interest Rate Risk

The Corporation's earnings and cash flows are largely dependent upon its net interest income. Net interest income is the difference between interest income earned on interest-earning assets such as loans and securities and interest expense paid on interest-bearing liabilities such as deposits and borrowed funds. Interest rates are highly sensitive to many factors that are beyond the Corporation's control, including general economic conditions and policies of various governmental and regulatory agencies and, in particular, the Federal Open Market Committee. Changes in monetary policy, including changes in interest rates, could influence not only the interest the Corporation receives on loans and securities and the amount of interest it pays on deposits and borrowings, but such changes could also affect (i) the Corporation's ability to originate loans and obtain deposits, (ii) the fair value of the Corporation's financial assets and liabilities, and (iii) the average duration of the Corporation's mortgage-backed securities portfolio. If the interest rates paid on deposits and other borrowings increase at a faster rate than the interest rates received on loans and other investments, the Corporation's net interest income, and therefore earnings, could be adversely affected. Earnings could also be adversely affected if the interest rates received on loans and other investments fall more quickly than the interest rates paid on deposits and other borrowings. Any substantial, unexpected, prolonged change in market interest rates could have a material adverse effect on the Corporation's business, financial condition and results of operations.

See the section captioned "Net Interest Income" in Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations located elsewhere in this report for further discussion related to the Corporation's management of interest rate risk.

The Corporation's Allowance For Loan Losses May Be Insufficient

The Corporation maintains an allowance for loan losses, which 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 level of the allowance reflects management's continuing evaluation of industry concentrations; specific credit risks; loan loss experience; current loan portfolio quality; present economic, political and regulatory conditions and unidentified losses inherent in the current loan portfolio. The determination of the appropriate level of the allowance for loan losses inherently involves a high degree of subjectivity and requires the Corporation to make significant estimates of current credit risks and future trends, all of which may undergo material changes. Continuing deterioration in economic conditions affecting borrowers, new information regarding existing loans, identification of additional

Table of Contents

problem loans and other factors, both within and outside of the Corporation's control, may require an increase in the allowance for loan losses. In addition, bank regulatory agencies periodically review the Corporation's allowance for loan losses and may require an increase in the provision for loan losses or the recognition of further loan charge-offs, based on judgments different than those of management. Furthermore, if charge-offs in future periods exceed the allowance for loan losses, the Corporation will need additional provisions to increase the allowance for loan losses. Any increases in the allowance for loan losses will result in a decrease in net income and, possibly, capital, and may have a material adverse effect on the Corporation's business, financial condition and results of operations.

See the section captioned "Allowance for Loan Losses" in Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations located elsewhere in this report for further discussion related to the Corporation's process for determining the appropriate level of the allowance for loan losses.

The Corporation's Profitability Depends Significantly On Economic Conditions In The State Of Texas

The Corporation's success depends primarily on the general economic conditions of the State of Texas and the specific local markets in which the Corporation operates. Unlike larger national or other regional banks that are more geographically diversified, the Corporation provides banking and financial services to customers across Texas through financial centers in the Austin, Corpus Christi, Dallas, Fort Worth, Houston, Rio Grande Valley and San Antonio regions. The local economic conditions in these areas have a significant impact on the demand for the Corporation's products and services as well as the ability of the Corporation's customers to repay loans, the value of the collateral securing loans and the stability of the Corporation's deposit funding sources. Moreover, approximately 98.8% of securities in the Corporation's municipal bond portfolio were issued by political subdivisions or agencies within the State of Texas. A significant decline in general economic conditions in Texas, whether caused by recession, inflation, unemployment, changes in securities markets, acts of terrorism, outbreak of hostilities or other international or domestic occurrences or other factors could impact these local economic conditions and, in turn, have a material adverse effect on the Corporation's business, financial condition and results of operations.

The Corporation May Be Adversely Affected By The Soundness Of Other Financial Institutions

Financial services institutions are interrelated as a result of trading, clearing, counterparty, or other relationships. The Corporation has exposure to many different industries and counterparties, and routinely executes transactions with counterparties in the financial services industry, including commercial banks, brokers and dealers, investment banks, and other institutional clients. Many of these transactions expose the Corporation to credit risk in the event of a default by a counterparty or client. In addition, the Corporation's credit risk may be exacerbated when the collateral held by the Corporation cannot be realized upon or is liquidated at prices not sufficient to recover the full amount of the credit or derivative exposure due to the Corporation. Any such losses could have a material adverse effect on the Corporation's business, financial condition and results of operations.

The Corporation Operates In A Highly Competitive Industry and Market Area

The Corporation faces substantial competition in all areas of its operations from a variety of different competitors, many of which are larger and may have more financial resources. Such competitors primarily include national, regional, and community banks within the various markets where the Corporation operates. The Corporation also faces competition from many other types of financial institutions, including, without limitation, savings and loans, credit unions, finance companies, brokerage firms, insurance companies, factoring companies and other financial intermediaries. The financial services industry could become even more competitive as a result of legislative, regulatory and technological changes and continued consolidation. Also, technology and other changes have lowered barriers to entry and made it possible for non-banks to offer products and services traditionally provided by banks. For example, consumers can maintain funds that would have historically been held as bank deposits in brokerage accounts or mutual funds. Consumers can also complete transactions such as paying bills and/or transferring funds directly without the assistance of banks. The process of eliminating banks

Table of Contents

as intermediaries, known as disintermediation, could result in the loss of fee income, as well as the loss of customer deposits and the related income generated from those deposits. Further, many of the Corporation's competitors have fewer regulatory constraints and may have lower cost structures. Additionally, due to their size, many competitors may be able to achieve economies of scale and, as a result, may offer a broader range of products and services as well as better pricing for those products and services than the Corporation can.

The Corporation's ability to compete successfully depends on a number of factors, including, among other things:

- The ability to develop, maintain and build long-term customer relationships based on top quality service, high ethical standards and safe, sound assets.
- The ability to expand the Corporation's market position.
- The scope, relevance and pricing of products and services offered to meet customer needs and demands.
- The rate at which the Corporation introduces new products and services relative to its competitors.
- Customer satisfaction with the Corporation's level of service.
- Industry and general economic trends.

Failure to perform in any of these areas could significantly weaken the Corporation's competitive position, which could adversely affect the Corporation's growth and profitability, which, in turn, could have a material adverse effect on the Corporation's business, financial condition and results of operations.

The Corporation Is Subject To Extensive Government Regulation and Supervision and Possible Enforcement and Other Legal Actions

The Corporation, primarily through Cullen/Frost, Frost Bank and certain non-bank subsidiaries, is subject to extensive federal and state regulation and supervision, which vests a significant amount of discretion in the various regulatory authorities. Banking regulations are primarily intended to protect depositors' funds, federal deposit insurance funds and the banking system as a whole, not security holders. These regulations and supervisory guidance affect the Corporation's lending practices, capital structure, investment practices, dividend policy and growth, among other things. Congress and federal regulatory agencies continually review banking laws, regulations and policies for possible changes. The Dodd-Frank Act, enacted in July 2010, instituted major changes to the banking and financial institutions regulatory regimes in light of the recent performance of and government intervention in the financial services sector. Other changes to statutes, regulations or regulatory policies or supervisory guidance, including changes in interpretation or implementation of statutes, regulations, policies or supervisory guidance, could affect the Corporation in substantial and unpredictable ways. Such changes could subject the Corporation to additional costs, limit the types of financial services and products the Corporation may offer and/or increase the ability of non-banks to offer competing financial services and products, among other things. Failure to comply with laws, regulations, policies or supervisory guidance could result in enforcement and other legal actions by Federal or state authorities, including criminal and civil penalties, the loss of FDIC insurance, the revocation of a banking charter, other sanctions by regulatory agencies, civil money penalties and/or reputation damage. In this regard, government authorities, including the bank regulatory agencies, are pursuing aggressive enforcement actions with respect to compliance and other legal matters involving financial activities, which heightens the risks associated with actual and perceived compliance failures. Any of the foregoing could have a material adverse effect on the Corporation's business, financial condition and results of operations.

See the sections captioned "Supervision and Regulation" included in Item 1. Business and Note 10 - Regulatory Matters in the notes to consolidated financial statements included in Item 8. Financial Statements and Supplementary Data, which are located elsewhere in this report.

Table of Contents

The Corporation's Accounting Estimates and Risk Management Processes Rely On Analytical and Forecasting Models

The processes the Corporation uses to estimate its probable loan losses and to measure the fair value of financial instruments, as well as the processes used to estimate the effects of changing interest rates and other market measures on the Corporation's financial condition and results of operations, depends upon the use of analytical and forecasting models. These models reflect assumptions that may not be accurate, particularly in times of market stress or other unforeseen circumstances. Even if these assumptions are adequate, the models may prove to be inadequate or inaccurate because of other flaws in their design or their implementation. If the models the Corporation uses for interest rate risk and asset-liability management are inadequate, the Corporation may incur increased or unexpected losses upon changes in market interest rates or other market measures. If the models the Corporation uses for determining its probable loan losses are inadequate, the allowance for loan losses may not be sufficient to support future charge-offs. If the models the Corporation uses to measure the fair value financial instruments is inadequate, the fair value of such financial instruments may fluctuate unexpectedly or may not accurately reflect what the Corporation could realize upon sale or settlement of such financial instruments. Any such failure in the Corporation's analytical or forecasting models could have a material adverse effect on the Corporation's business, financial condition and results of operations.

The Repeal Of Federal Prohibitions On Payment Of Interest On Demand Deposits Could Increase The Corporation's Interest Expense

All federal prohibitions on the ability of financial institutions to pay interest on demand deposit accounts were repealed as part of the Dodd-Frank Act beginning on July 21, 2011. As a result, some financial institutions have commenced offering interest on demand deposits to compete for customers. The Corporation does not yet know what interest rates other institutions may offer as market interest rates begin to increase. The Corporation's interest expense will increase and its net interest margin will decrease if it begins offering interest on demand deposits to attract additional customers or maintain current customers, which could have a material adverse effect on the Corporation's business, financial condition and results of operations.

The Corporation May Need To Raise Additional Capital In The Future, and Such Capital May Not Be Available When Needed Or At All

The Corporation may need to raise additional capital in the future to provide it with sufficient capital resources and liquidity to meet its commitments and business needs, particularly if its asset quality or earnings were to deteriorate significantly. The Corporation's ability to raise additional capital, if needed, will depend on, among other things, conditions in the capital markets at that time, which are outside of its control, and its financial condition. Economic conditions and the loss of confidence in financial institutions may increase the Corporation's cost of funding and limit access to certain customary sources of capital, including inter-bank borrowings, repurchase agreements and borrowings from the discount window of the Federal Reserve Board.

The Corporation cannot assure that such capital will be available on acceptable terms or at all. Any occurrence that may limit the Corporation's access to the capital markets, such as a decline in the confidence of debt purchasers, depositors of Frost Bank or counterparties participating in the capital markets, or a downgrade of Cullen/Frost's or Frost Bank's debt ratings, may adversely affect the Corporation's capital costs and its ability to raise capital and, in turn, its liquidity. Moreover, if the Corporation needs to raise capital in the future, it may have to do so when many other financial institutions are also seeking to raise capital and would have to compete with those institutions for investors. An inability to raise additional capital on acceptable terms when needed could have a materially adverse effect on the Corporation's business, financial condition and results of operations.

Table of Contents

The Value Of The Corporation's Goodwill and Other Intangible Assets May Decline In The Future

As of December 31, 2012, the Corporation had \$543.7 million of goodwill and other intangible assets. A significant decline in the Corporation's expected future cash flows, a significant adverse change in the business climate, slower growth rates or a significant and sustained decline in the price of Cullen/Frost's common stock may necessitate taking charges in the future related to the impairment of the Corporation's goodwill and other intangible assets. If the Corporation were to conclude that a future write-down of goodwill and other intangible assets is necessary, the Corporation would record the appropriate charge, which could have a material adverse effect on the Corporation's business, financial condition and results of operations.

The Corporation's Controls and Procedures May Fail or Be Circumvented

The Corporation's internal controls, disclosure controls and procedures, and corporate governance policies and procedures are based in part on certain assumptions and can provide only reasonable, not absolute, assurances that the objectives of the system are met. Any failure or circumvention of the Corporation's controls and procedures or failure to comply with regulations related to controls and procedures could have a material adverse effect on the Corporation's business, financial condition and results of operations.

New Lines Of Business Or New Products and Services May Subject The Corporation To Additional Risks

From time to time, the Corporation may implement new lines of business or offer new products and services within existing lines of business. There are substantial risks and uncertainties associated with these efforts, particularly in instances where the markets are not fully developed. In developing and marketing new lines of business and/or new products and services the Corporation may invest significant time and resources. Initial timetables for the introduction and development of new lines of business and/or new products or services may not be achieved and price and profitability targets may not prove feasible. External factors, such as compliance with regulations, competitive alternatives, and shifting market preferences, may also impact the successful implementation of a new line of business or a new product or service. Furthermore, any new line of business and/or new product or service could have a significant impact on the effectiveness of the Corporation's system of internal controls. Failure to successfully manage these risks in the development and implementation of new lines of business or new products or services could have a material adverse effect on the Corporation's business, financial condition and results of operations.

Cullen/Frost Relies On Dividends From Its Subsidiaries For Most Of Its Revenue

Cullen/Frost is a separate and distinct legal entity from its subsidiaries. It receives substantially all of its revenue from dividends from its subsidiaries. These dividends are the principal source of funds to pay dividends on Cullen/Frost's common stock and interest and principal on Cullen/Frost's debt. Various federal and state laws and regulations limit the amount of dividends that Frost Bank and certain non-bank subsidiaries may pay to Cullen/Frost. Also, Cullen/Frost's right to participate in a distribution of assets upon a subsidiary's liquidation or reorganization is subject to the prior claims of the subsidiary's creditors. In the event Frost Bank is unable to pay dividends to Cullen/Frost, Cullen/Frost may not be able to service debt, pay obligations or pay dividends on the Corporation's common stock. The inability to receive dividends from Frost Bank could have a material adverse effect on the Corporation's business, financial condition and results of operations.

See the section captioned "Supervision and Regulation" in Item 1. Business and Note 10 - Regulatory Matters in the notes to consolidated financial statements included in Item 8. Financial Statements and Supplementary Data, which are located elsewhere in this report.

Table of Contents

Potential Acquisitions May Disrupt The Corporation's Business and Dilute Stockholder Value

The Corporation generally seeks merger or acquisition partners that are culturally similar and have experienced management and possess either significant market presence or have potential for improved profitability through financial management, economies of scale or expanded services. Acquiring other banks, businesses, or branches involves various risks commonly associated with acquisitions, including, among other things:

- .. Potential exposure to unknown or contingent liabilities of the target company.
- .. Exposure to potential asset quality issues of the target company.
- .. Potential disruption to the Corporation's business.
- .. Potential diversion of the Corporation's management's time and attention.
- .. The possible loss of key employees and customers of the target company.
- .. Difficulty in estimating the value of the target company.
- .. Potential changes in banking or tax laws or regulations that may affect the target company.

Acquisitions typically involve the payment of a premium over book and market values, and, therefore, some dilution of the Corporation's tangible book value and net income per common share may occur in connection with any future transaction. Furthermore, failure to realize the expected revenue increases, cost savings, increases in geographic or product presence, and/or other projected benefits from an acquisition could have a material adverse effect on the Corporation's business, financial condition and results of operations.

The Corporation Is Subject To Liquidity Risk

The Corporation requires liquidity to meet its deposit and debt obligations as they come due. The Corporation's access to funding sources in amounts adequate to finance its activities or on terms that are acceptable to it could be impaired by factors that affect it specifically or the financial services industry or economy generally. Factors that could reduce its access to liquidity sources include a downturn in the Texas market, difficult credit markets or adverse regulatory actions against the Corporation. The Corporation's access to deposits may also be affected by the liquidity needs of its depositors. In particular, a substantial majority of the Corporation's liabilities are demand, savings, interest checking and money market deposits, which are payable on demand or upon several days' notice, while by comparison, a substantial portion of its assets are loans, which cannot be called or sold in the same time frame. The Corporation may not be able to replace maturing deposits and advances as necessary in the future, especially if a large number of its depositors sought to withdraw their accounts, regardless of the reason. A failure to maintain adequate liquidity could have a material adverse effect on the Corporation's business, financial condition and results of operations.

The Corporation May Not Be Able To Attract and Retain Skilled People

The Corporation's success depends, in large part, on its ability to attract and retain key people. Competition for the best people in most activities engaged in by the Corporation can be intense and the Corporation may not be able to hire people or to retain them. The Corporation does not currently have employment agreements or non-competition agreements with any of its senior officers. The unexpected loss of services of key personnel of the Corporation could have a material adverse impact on the Corporation's business, financial condition and results of operations because of their skills, knowledge of the Corporation's market, years of industry experience and the difficulty of promptly finding qualified replacement personnel.

The Corporation's Information Systems May Experience An Interruption Or Breach In Security

The Corporation relies heavily on communications and information systems to conduct its business. Any failure, interruption or breach in security of these systems could result in failures or disruptions in the Corporation's customer relationship management, general ledger, deposit, loan and other systems. Moreover, if any such failures, interruptions or security breaches do occur, they may not be adequately addressed. The

Table of Contents

occurrence of any failures, interruptions or security breaches of the Corporation's information systems could damage the Corporation's reputation, result in a loss of customer business, subject the Corporation to additional regulatory scrutiny, or expose the Corporation to civil litigation and possible financial liability, any of which could have a material adverse effect on the Corporation's business, financial condition and results of operations.

The Corporation Continually Encounters Technological Change

The financial services industry is continually undergoing rapid technological change with frequent introductions of new technology-driven products and services. The effective use of technology increases efficiency and enables financial institutions to better serve customers and to reduce costs. The Corporation's future success depends, in part, upon its ability to address the needs of its customers by using technology to provide products and services that will satisfy customer demands, as well as to create additional efficiencies in the Corporation's operations. Many of the Corporation's competitors have substantially greater resources to invest in technological improvements. The Corporation may not be able to effectively implement new technology-driven products and services or be successful in marketing these products and services to its customers. Failure to successfully keep pace with technological change affecting the financial services industry could have a material adverse impact on the Corporation's business, financial condition and results of operations.

The Corporation Is Subject To Claims and Litigation Pertaining To Fiduciary Responsibility

From time to time, customers make claims and take legal action pertaining to the Corporation's performance of its fiduciary responsibilities. Whether customer claims and legal action related to the Corporation's performance of its fiduciary responsibilities are founded or unfounded, if such claims and legal actions are not resolved in a manner favorable to the Corporation they may result in significant financial liability and/or adversely affect the market perception of the Corporation and its products and services as well as impact customer demand for those products and services. Any financial liability or reputation damage could have a material adverse effect on the Corporation's business, financial condition and results of operations.

The Corporation's Operations Rely On Certain External Vendors

The Corporation relies on certain external vendors to provide products and services necessary to maintain day-to-day operations of the Corporation. Accordingly, the Corporation's operations are exposed to risk that these vendors will not perform in accordance with the contracted arrangements under service level agreements. The failure of an external vendor to perform in accordance with the contracted arrangements under service level agreements, because of changes in the vendor's organizational structure, financial condition, support for existing products and services or strategic focus or for any other reason, could be disruptive to the Corporation's operations, which could have a material adverse impact on the Corporation's business and, in turn, the Corporation's financial condition and results of operations.

The Corporation Is Subject to Claims and Litigation Pertaining to Intellectual Property

Banking and other financial services companies, such as the Corporation, rely on technology companies to provide information technology products and services necessary to support the Corporation's day-to-day operations. Technology companies frequently enter into litigation based on allegations of patent infringement or other violations of intellectual property rights. In addition, patent holding companies seek to monetize patents they have purchased or otherwise obtained. Competitors of the Corporation's vendors, or other individuals or companies, have from time to time claimed to hold intellectual property sold to the Corporation by its vendors. Such claims may increase in the future as the financial services sector becomes more reliant on information technology vendors. The plaintiffs in these actions frequently seek injunctions and substantial damages.

Regardless of the scope or validity of such patents or other intellectual property rights, or the merits of any claims by potential or actual litigants, the Corporation may have to engage in protracted litigation. Such litigation is often expensive, time-consuming, disruptive to the Corporation's operations, and distracting to management. If

Table of Contents

the Corporation is found to infringe one or more patents or other intellectual property rights, it may be required to pay substantial damages or royalties to a third-party. In certain cases, the Corporation may consider entering into licensing agreements for disputed intellectual property, although no assurance can be given that such licenses can be obtained on acceptable terms or that litigation will not occur. These licenses may also significantly increase the Corporation's operating expenses. If legal matters related to intellectual property claims were resolved against the Corporation or settled, the Corporation could be required to make payments in amounts that could have a material adverse effect on its business, financial condition and results of operations.

The Corporation Is Subject To Environmental Liability Risk Associated With Lending Activities

A significant portion of the Corporation's loan portfolio is secured by real property. During the ordinary course of business, the Corporation may foreclose on and take title to properties securing certain loans. In doing so, there is a risk that hazardous or toxic substances could be found on these properties. If hazardous or toxic substances are found, the Corporation may be liable for remediation costs, as well as for personal injury and property damage. Environmental laws may require the Corporation to incur substantial expenses and may materially reduce the affected property's value or limit the Corporation's ability to use or sell the affected property. In addition, future laws or more stringent interpretations or enforcement policies with respect to existing laws may increase the Corporation's exposure to environmental liability. Environmental reviews of real property before initiating foreclosure actions may not be sufficient to detect all potential environmental hazards. The remediation costs and any other financial liabilities associated with an environmental hazard could have a material adverse effect on the Corporation's business, financial condition and results of operations.

Severe Weather, Natural Disasters, Acts Of War Or Terrorism and Other External Events Could Significantly Impact The Corporation's Business

Severe weather, natural disasters, acts of war or terrorism and other adverse external events could have a significant impact on the Corporation's ability to conduct business. In addition, such events could affect the stability of the Corporation's deposit base, impair the ability of borrowers to repay outstanding loans, impair the value of collateral securing loans, cause significant property damage, result in loss of revenue and/or cause the Corporation to incur additional expenses. The occurrence of any such event in the future could have a material adverse effect on the Corporation's business, which, in turn, could have a material adverse effect on the Corporation's business, financial condition and results of operations.

Financial Services Companies Depend On The Accuracy and Completeness Of Information About Customers and Counterparties

In deciding whether to extend credit or enter into other transactions, the Corporation may rely on information furnished by or on behalf of customers and counterparties, including financial statements, credit reports and other financial information. The Corporation may also rely on representations of those customers, counterparties or other third parties, such as independent auditors, as to the accuracy and completeness of that information. Reliance on inaccurate or misleading financial statements, credit reports or other financial information could have a material adverse impact on the Corporation's business, financial condition and results of operations.

Table of Contents

Risks Associated With The Corporation's Common Stock

The Corporation's Stock Price Can Be Volatile

Stock price volatility may make it more difficult for you to resell your common stock when you want and at prices you find attractive. The Corporation's stock price can fluctuate significantly in response to a variety of factors including, among other things:

- .. Actual or anticipated variations in quarterly results of operations.
- .. Recommendations by securities analysts.
- .. Operating and stock price performance of other companies that investors deem comparable to the Corporation.
- .. News reports relating to trends, concerns and other issues in the financial services industry.
- .. Perceptions in the marketplace regarding the Corporation and/or its competitors.
- .. New technology used, or services offered, by competitors.
- .. Significant acquisitions or business combinations, strategic partnerships, joint ventures or capital commitments by or involving the Corporation or its competitors.
- .. Failure to integrate acquisitions or realize anticipated benefits from acquisitions.
- .. Changes in government regulations.
- .. Geopolitical conditions such as acts or threats of terrorism or military conflicts.

General market fluctuations, industry factors and general economic and political conditions and events, such as economic slowdowns or recessions, interest rate changes or credit loss trends, could also cause the Corporation's stock price to decrease regardless of operating results.

The Trading Volume In The Corporation's Common Stock Is Less Than That Of Other Larger Financial Services Companies

Although the Corporation's common stock is listed for trading on the New York Stock Exchange (NYSE), the trading volume in its common stock is less than that of other, larger financial services companies. A public trading market having the desired characteristics of depth, liquidity and orderliness depends on the presence in the marketplace of willing buyers and sellers of the Corporation's common stock at any given time. This presence depends on the individual decisions of investors and general economic and market conditions over which the Corporation has no control. Given the lower trading volume of the Corporation's common stock, significant sales of the Corporation's common stock, or the expectation of these sales, could cause the Corporation's stock price to fall.

Cullen/Frost May Not Continue To Pay Dividends On Its Common Stock In The Future

Holders of Cullen/Frost common stock are only entitled to receive such dividends as its board of directors may declare out of funds legally available for such payments. Although Cullen/Frost has historically declared cash dividends on its common stock, it is not required to do so and may reduce or eliminate its common stock dividend in the future. This could adversely affect the market price of Cullen/Frost's common stock. Also, Cullen/Frost is a bank holding company, and its ability to declare and pay dividends is dependent on certain federal regulatory considerations, including the guidelines of the Federal Reserve Board regarding capital adequacy and dividends.

An Investment In The Corporation's Common Stock Is Not An Insured Deposit

The Corporation's common stock is not a bank deposit and, therefore, is not insured against loss by the Federal Deposit Insurance Corporation (FDIC), any other deposit insurance fund or by any other public or private entity. Investment in the Corporation's common stock is inherently risky for the reasons described in this Risk Factors

Table of Contents

section and elsewhere in this report and is subject to the same market forces that affect the price of common stock in any company. As a result, if you acquire the Corporation's common stock, you could lose some or all of your investment.

Certain Banking Laws May Have An Anti-Takeover Effect

Provisions of federal banking laws, including regulatory approval requirements, could make it more difficult for a third party to acquire the Corporation, even if doing so would be perceived to be beneficial to the Corporation's shareholders. These provisions effectively inhibit a non-negotiated merger or other business combination, which, in turn, could adversely affect the market price of the Corporation's common stock.

Table of Contents

ITEM 1B. UNRESOLVED STAFF COMMENTS

None

ITEM 2. PROPERTIES

The Corporation's headquarters are located in downtown San Antonio, Texas. These facilities, which are owned by the Corporation, house the Corporation's executive and primary administrative offices, as well as the principal banking headquarters of Frost Bank. The Corporation also owns or leases other facilities within its primary market areas in the regions of Austin, Corpus Christi, Dallas, Fort Worth, Houston, Rio Grande Valley and San Antonio. The Corporation considers its properties to be suitable and adequate for its present needs.

ITEM 3. LEGAL PROCEEDINGS

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.

ITEM 4. MINE SAFETY DISCLOSURES

None

Table of Contents**PART II****ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES***Common Stock Market Prices and Dividends*

The Corporation's common stock is traded on the New York Stock Exchange, Inc. (NYSE) under the symbol CFR . The tables below set forth for each quarter of 2012 and 2011 the high and low intra-day sales prices per share of Cullen/Frost's common stock and the cash dividends declared per share.

Sales Price Per Share	2012		2011	
	High	Low	High	Low
First quarter	\$ 61.11	\$ 53.54	\$ 62.59	\$ 56.75
Second quarter	59.65	54.22	60.58	54.46
Third quarter	60.21	53.88	57.67	44.04
Fourth quarter	58.42	53.37	53.51	43.57
Cash Dividends Per Share				
			2012	2011
First quarter			\$ 0.46	\$ 0.45
Second quarter			0.48	0.46
Third quarter			0.48	0.46
Fourth quarter			0.48	0.46
Total			\$ 1.90	\$ 1.83

As of December 31, 2012, there were 61,479,189 shares of the Corporation's common stock outstanding held by 1,424 holders of record. The closing price per share of common stock on December 31, 2012, the last trading day of the Corporation's fiscal year, was \$54.27.

The Corporation's management is currently committed to continuing to pay regular cash dividends; however, there can be no assurance as to future dividends because they are dependent on the Corporation's future earnings, capital requirements and financial condition. See the section captioned *Supervision and Regulation* included in Item 1. Business, the section captioned *Capital and Liquidity* included in Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations and Note 10 - Regulatory Matters in the notes to consolidated financial statements included in Item 8. Financial Statements and Supplementary Data, all of which are included elsewhere in this report.

Stock-Based Compensation Plans

Information regarding stock-based compensation awards outstanding and available for future grants as of December 31, 2012, segregated between stock-based compensation plans approved by shareholders and stock-based compensation plans not approved by shareholders, is presented in the table below. Additional information regarding stock-based compensation plans is presented in Note 11 - Employee Benefit Plans in the notes to consolidated financial statements included in Item 8. Financial Statements and Supplementary Data located elsewhere in this report.

Plan Category	Number of Shares	Weighted-Average Exercise	Number of Shares Available for
---------------	------------------	---------------------------	--------------------------------

Edgar Filing: CULLEN/FROST BANKERS, INC. - Form 10-K

	to be Issued Upon Exercise of Outstanding Awards	Price of Outstanding Awards	Future Grants
Plans approved by shareholders	5,513,516	\$ 51.94	1,157,413
Plans not approved by shareholders	-	-	-
Total	5,513,516	\$ 51.94	1,157,413

Table of Contents*Stock Repurchase Plans*

From time to time, the Corporation has maintained several stock repurchase plans authorized by the Corporation's board of directors. In general, stock repurchase plans allow the Corporation to proactively manage its capital position and return excess capital to shareholders. Shares purchased under such plans also provide the Corporation with shares of common stock necessary to satisfy obligations related to stock compensation awards.

The 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 fourth quarter of 2012.

Period	Total Number of Shares Purchased	Average Price Paid Per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans	Maximum
				Number of Shares That May Yet Be Purchased Under the Plans at the End of the Period
October 1, 2012 to October 31, 2012	7,960 ⁽¹⁾	\$ 54.80	-	-
November 1, 2012 to November 30, 2012	-	-	-	-
December 1, 2012 to December 31, 2012	-	-	-	-
Total	7,960	\$ 54.80	-	-

(1) Represents repurchases made in connection with the vesting of certain share awards.

Table of Contents**Performance Graph**

The performance graph below compares the cumulative total shareholder return on Cullen/Frost Common Stock with the cumulative total return on the equity securities of companies included in the Standard & Poor's 500 Stock Index and the Standard and Poor's 500 Bank Index, measured at the last trading day of each year shown. The graph assumes an investment of \$100 on December 31, 2007 and reinvestment of dividends on the date of payment without commissions. The performance graph represents past performance and should not be considered to be an indication of future performance.

Cumulative Total Returns**on \$100 Investment Made on December 31, 2007**

	2007	2008	2009	2010	2011	2012
Cullen/Frost	\$ 100.00	\$ 103.20	\$ 105.45	\$ 133.10	\$ 119.24	\$ 126.45
S&P 500	100.00	63.06	79.69	91.68	93.62	108.55
S&P 500 Banks	100.00	80.25	75.92	91.01	81.12	100.80

Table of Contents**ITEM 6. SELECTED FINANCIAL DATA**

The following consolidated selected financial data is derived from the Corporation's audited financial statements as of and for the five years ended December 31, 2012. The following consolidated financial data should be read in conjunction with Management's Discussion and Analysis of Financial Condition and Results of Operations and the Consolidated Financial Statements and related notes included elsewhere in this report. All of the Corporation's acquisitions during the five years ended December 31, 2012 were accounted for using the purchase method. Accordingly, the operating results of the acquired companies are included with the Corporation's results of operations since their respective dates of acquisition. Dollar amounts, except per share data, and common shares outstanding are in thousands.

	Year Ended December 31,				
	2012	2011	2010	2009	2008
Consolidated Statements of Income					
Interest income:					
Loans, including fees	\$ 401,364	\$ 397,855	\$ 409,651	\$ 432,222	\$ 504,680
Securities	225,844	218,744	202,713	188,446	167,044
Interest-bearing deposits	4,300	6,357	4,901	2,161	429
Federal funds sold and resell agreements	104	61	74	207	3,498
Total interest income	631,612	623,017	617,339	623,036	675,651
Interest expense:					
Deposits	18,099	22,179	29,973	56,015	104,871
Federal funds purchased and repurchase agreements	140	312	437	1,052	12,954
Junior subordinated deferrable interest debentures	6,806	6,783	6,982	7,231	6,972
Subordinated notes payable and other borrowings	1,706	11,967	16,488	22,059	16,829
Total interest expense	26,751	41,241	53,880	86,357	141,626
Net interest income	604,861	581,776	563,459	536,679	534,025
Provision for loan losses	10,080	27,445	43,611	65,392	37,823
Net interest income after provision for loan losses	594,781	554,331	519,848	471,287	496,202
Non-interest income:					
Trust and investment management fees	83,317	78,297	72,321	69,933	76,424
Service charges on deposit accounts	83,392	86,125	91,025	96,525	82,526
Insurance commissions and fees	39,948	35,421	34,015	33,096	32,904
Interchange and debit card transaction fees	16,933	29,625	30,542	26,248	23,959
Other charges, commissions and fees	30,180	27,750	25,380	23,826	32,726
Net gain (loss) on securities transactions	4,314	6,414	6	(1,260)	(159)
Other	30,703	26,370	28,744	45,338	38,942
Total non-interest income	288,787	290,002	282,033	293,706	287,322
Non-interest expense:					
Salaries and wages	258,752	252,028	239,589	230,643	225,943
Employee benefits	57,635	52,939	52,352	55,224	47,219
Net occupancy	48,975	46,968	46,166	44,188	40,464
Furniture and equipment	55,279	51,469	47,651	44,223	37,799
Deposit insurance	11,087	12,714	20,451	25,812	4,597
Intangible amortization	3,896	4,387	5,125	6,537	7,906
Other	139,469	137,593	124,207	125,611	122,717
Total non-interest expense	575,093	558,098	535,541	532,238	486,645

Edgar Filing: CULLEN/FROST BANKERS, INC. - Form 10-K

Income before income taxes	308,475	286,325	266,340	232,755	296,879
Income taxes	70,523	68,700	57,576	53,721	89,624
Net income	\$ 237,952	\$ 217,535	\$ 208,764	\$ 179,034	\$ 207,255

Table of Contents**Selected Financial Data** (continued)

As of or for the Year Ended December 31,

	2012	2011	2010	2009	2008
Per Common Share Data					
Net income - basic	\$ 3.87	\$ 3.55	\$ 3.44	\$ 3.00	\$ 3.51
Net income - diluted	3.86	3.54	3.44	3.00	3.50
Cash dividends declared and paid	1.90	1.83	1.78	1.71	1.66
Book value	39.32	37.27	33.74	31.55	29.68
Common Shares Outstanding					
Period-end	61,479	61,264	61,108	60,038	59,416
Weighted-average shares - basic	61,298	61,101	60,411	59,456	58,846
Dilutive effect of stock compensation	345	177	175	58	324
Weighted - average shares - diluted	61,643	61,278	60,586	59,514	59,170
Performance Ratios					
Return on average assets	1.14%	1.17%	1.21%	1.14%	1.51%
Return on average equity	10.03	10.01	10.30	9.78	13.11
Net interest income to average earning assets	3.59	3.88	4.08	4.23	4.67
Dividend pay-out ratio	49.11	51.58	51.75	57.05	47.36
Balance Sheet Data					
Period-end:					
Loans	\$ 9,223,848	\$ 7,995,129	\$ 8,117,020	\$ 8,367,780	\$ 8,844,082
Earning assets	21,148,475	18,497,987	15,806,350	14,437,267	13,001,103
Total assets	23,124,069	20,317,245	17,617,092	16,288,038	15,034,142
Non-interest-bearing demand deposits	8,096,937	6,672,555	5,360,436	4,645,802	4,152,348
Interest-bearing deposits	11,400,429	10,084,193	9,118,906	8,667,508	7,356,589
Total deposits	19,497,366	16,756,748	14,479,342	13,313,310	11,508,937
Long-term debt and other borrowings	223,719	223,738	373,757	392,646	392,661
Shareholders equity	2,417,482	2,283,537	2,061,680	1,894,424	1,763,527
Average:					
Loans	\$ 8,456,818	\$ 8,042,968	\$ 8,125,150	\$ 8,652,563	\$ 8,314,265
Earning assets	19,015,707	16,769,028	15,333,348	13,803,919	11,868,262
Total assets	20,826,885	18,568,967	17,186,572	15,701,960	13,684,531
Non-interest-bearing demand deposits	7,021,927	5,738,982	5,023,780	4,258,484	3,614,747
Interest-bearing deposits	10,270,173	9,483,633	9,023,839	8,161,143	6,916,372
Total deposits	17,292,100	15,222,615	14,047,619	12,419,627	10,531,119
Long-term debt and other borrowings	223,728	310,870	382,651	576,161	394,763
Shareholders equity	2,372,745	2,172,096	2,027,699	1,831,133	1,580,311
Asset Quality					
Allowance for loan losses	\$ 104,453	\$ 110,147	\$ 126,316	\$ 125,309	\$ 110,244
Allowance for losses to period-end loans	1.13%	1.38%	1.56%	1.50%	1.25%
Net loan charge-offs	\$ 15,774	\$ 43,614	\$ 42,604	\$ 50,327	\$ 19,918
Net loan charge-offs to average loans	0.19%	0.54%	0.52%	0.58%	0.24%

Edgar Filing: CULLEN/FROST BANKERS, INC. - Form 10-K

Non-performing assets	\$	105,246	\$	120,946	\$	164,950	\$	180,179	\$	78,040
Non-performing assets to:										
Total loans plus foreclosed assets		1.14%		1.51%		2.03%		2.14%		0.88%
Total assets		0.46		0.60		0.94		1.11		0.52
Consolidated Capital Ratios										
Tier 1 risk-based capital ratio		13.71%		14.38%		13.82%		11.91%		10.30%
Total risk-based capital ratio		15.15		16.24		15.91		14.19		12.58
Leverage ratio		8.35		8.66		8.68		8.50		8.80
Average shareholders equity to average total assets		11.39		11.70		11.80		11.66		11.55

Table of Contents

The following tables set forth unaudited consolidated selected quarterly statement of operations data for the years ended December 31, 2012 and 2011. Dollar amounts are in thousands, except per share data.

	Year Ended December 31, 2012			
	4th Quarter	3rd Quarter	2nd Quarter	1st Quarter
Interest income	\$ 160,792	\$ 158,159	\$ 155,796	\$ 156,865
Interest expense	6,387	6,627	6,579	7,158
Net interest income	154,405	151,532	149,217	149,707
Provision for loan losses	4,125	2,500	2,355	1,100
Non-interest income ⁽¹⁾	75,887	71,158	69,763	71,979
Non-interest expense	146,067	144,450	142,536	142,040
Income before income taxes	80,100	75,740	74,089	78,546
Income taxes	19,912	17,071	16,027	17,513
Net income	\$ 60,188	\$ 58,669	\$ 58,062	\$ 61,033
Net income per common share:				
Basic	\$ 0.98	\$ 0.95	\$ 0.94	\$ 0.99
Diluted	0.97	0.95	0.94	0.99

	Year Ended December 31, 2011			
	4th Quarter	3rd Quarter	2nd Quarter	1st Quarter
Interest income	\$ 158,512	\$ 154,779	\$ 156,133	\$ 153,593
Interest expense	8,189	9,418	11,800	11,834
Net interest income	150,323	145,361	144,333	141,759
Provision for loan losses	-	9,010	8,985	9,450
Non-interest income ⁽²⁾	67,660	79,217	70,792	72,333
Non-interest expense	143,833	137,407	136,797	140,061
Income before income taxes	74,150	78,161	69,343	64,581
Income taxes	18,736	23,654	13,657	12,653
Net income	\$ 55,414	\$ 54,507	\$ 55,686	\$ 51,928
Net income per common share:				
Basic	\$ 0.90	\$ 0.89	\$ 0.91	\$ 0.85
Diluted	0.90	0.89	0.91	0.85

Edgar Filing: CULLEN/FROST BANKERS, INC. - Form 10-K

- (1) Includes net gains on securities transactions of \$4.4 million during the fourth quarter of 2012 and \$370 thousand during the second quarter of 2012 and net losses on securities transactions of \$491 thousand during the first quarter of 2012.
- (2) Includes net gains on securities transactions of \$6.4 million during the third quarter of 2011 and \$5 thousand during the first quarter of 2011.

Table of Contents**ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**
Forward-Looking Statements and Factors that Could Affect Future Results

Certain statements contained in this Annual Report on Form 10-K 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 similar expressions are 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.

Table of Contents

- .. 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. 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 Accounting Standards Codification (ASC) Topic 310, *Receivables* and allowance allocations calculated in accordance with ASC Topic 450, *Contingencies*. The level of the allowance reflects management's continuing evaluation of industry concentrations, specific credit risks, loan loss experience, current loan portfolio quality, present economic, political and regulatory conditions and unidentified losses inherent in the current loan portfolio, as well as trends in the foregoing. 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 adequacy of the allowance is dependent upon a variety of factors beyond the Corporation's control, including the performance of the Corporation's loan portfolio, the economy, changes in interest rates and the view of the regulatory authorities toward loan classifications. See the section captioned *Allowance for Loan Losses* elsewhere in this discussion and Note 3 - Loans in the notes to consolidated financial statements included in Item 8. Financial Statements and Supplementary Data elsewhere in this report for further details of the risk factors considered by management in estimating the necessary level of the allowance for loan losses.

Table of Contents

Overview

The following discussion and analysis presents the more significant factors affecting the Corporation's financial condition as of December 31, 2012 and 2011 and results of operations for each of the years in the three-year period ended December 31, 2012. This discussion and analysis should be read in conjunction with the Corporation's consolidated financial statements, notes thereto and other financial information appearing elsewhere in this report. The Corporation acquired a human resources consulting firm in the Houston market area, with offices in Dallas and Austin, in 2012 and an insurance agency in the San Antonio market area in 2011. All of the Corporation's acquisitions during the reported periods were accounted for as purchase transactions, and as such, their related results of operations are included from the date of acquisition, though none of these acquisitions had a significant impact on the Corporation's financial statements during their respective reporting periods.

Taxable-equivalent adjustments are the result of increasing income from tax-free loans and investments by an amount equal to the taxes that would be paid if the income were fully taxable based on a 35% federal tax rate, thus making tax-exempt yields comparable to taxable asset yields.

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

Results of Operations

Net income totaled \$238.0 million, or \$3.86 diluted per common share, in 2012 compared to \$217.5 million, or \$3.54 diluted per common share, in 2011 and \$208.8 million, or \$3.44 diluted per common share, in 2010.

Selected income statement data, returns on average assets and average equity and dividends per share for the comparable periods were as follows:

	2012	2011	2010
Taxable-equivalent net interest income	\$ 668,176	\$ 642,066	\$ 616,319
Taxable-equivalent adjustment	63,315	60,290	52,860
Net interest income	604,861	581,776	563,459
Provision for loan losses	10,080	27,445	43,611
Non-interest income	288,787	290,002	282,033
Non-interest expense	575,093	558,098	535,541
Income before income taxes	308,475	286,235	266,340
Income taxes	70,523	68,700	57,576
Net income	\$ 237,952	\$ 217,535	\$ 208,764
Earnings per common share:			
Basic	\$ 3.87	\$ 3.55	\$ 3.44
Diluted	3.86	3.54	3.44
Return on average assets	1.14%	1.17%	1.21%
Return on average equity	10.03	10.01	10.30

Net income for 2012 increased \$20.4 million, or 9.4%. The increase was primarily the result of a \$23.1 million increase in net interest income and a \$17.4 million decrease in the provision for loan losses partly offset by \$17.0 million increase in non-interest expense, a \$1.8 million increase in income tax expense and a \$1.2 million decrease in non-interest income. Net income for 2011 increased \$8.8 million, or 4.2%. The increase was primarily the result of an \$18.3 million increase in net interest income, a \$16.2 million decrease in the provision for loan losses and an \$8.0 million increase in non-interest income partly offset by a \$22.6 million increase in non-interest expense and an \$11.1 million increase in income tax expense.

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

Table of Contents

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 67.7% of total revenue during 2012. 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 Board 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% during 2012, 2011 and 2010. The Corporation's loan portfolio is also impacted, to a lesser extent, by changes in the London Interbank Offered Rate (LIBOR). At December 31, 2012, the one-month and three-month U.S. dollar LIBOR rates were 0.21% and 0.31%, respectively, while at December 31, 2011, the one-month and three-month U.S. dollar LIBOR rates were 0.30% and 0.58%, respectively. The intended federal funds rate, which is the cost of immediately available overnight funds, remained at zero to 0.25% during 2012, 2011 and 2010.

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 gain applicable to the settled interest rate contracts included in accumulated other comprehensive income totaled \$68.0 million (\$44.2 million on an after-tax basis) at December 31, 2012. The deferred gain will be recognized ratably in earnings through October 2014. See Note 15 - 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 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. See Item 7A. 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.

Table of Contents

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 Corporation's consolidated average balance sheets along with an analysis of taxable-equivalent net interest income are presented on pages 144 and 145 of this report.

	2012 vs. 2011			2011 vs. 2010		
	Increase (Decrease) Due to Change in			Increase (Decrease) Due to Change in		
	Rate	Volume	Total	Rate	Volume	Total
Interest-bearing deposits	\$ 449	\$ (2,506)	\$ (2,057)	\$ -	\$ 1,456	\$ 1,456
Federal funds sold and resell agreements	(1)	44	43	11	(24)	(13)
Securities:						
Taxable	(55,750)	61,110	5,360	(19,601)	25,271	5,670
Tax-exempt	(6,268)	10,737	4,469	(1,296)	18,607	17,311
Loans, net of unearned discounts	(16,472)	20,277	3,805	(7,188)	(4,128)	(11,316)
Total earning assets	(78,042)	89,662	11,620	(28,074)	41,182	13,108
Savings and interest checking	(840)	343	(497)	(1,258)	307	(951)
Money market deposit accounts	(3,360)	1,114	(2,246)	(4,517)	1,056	(3,461)
Time accounts	(783)	(449)	(1,232)	(2,428)	(741)	(3,169)
Public funds	(79)	(26)	(105)	(168)	(45)	(213)
Federal funds purchased and repurchase agreements	(176)	4	(172)	(219)	94	(125)
Junior subordinated deferrable interest debentures	23	-	23	142	(341)	(199)
Subordinated notes payable and other notes	(6,272)	(3,988)	(10,260)	(342)	(4,011)	(4,353)
Federal Home Loan Bank advances	-	(1)	(1)	(13)	(155)	(168)
Total interest-bearing liabilities	(11,487)	(3,003)	(14,490)	(8,803)	(3,836)	(12,639)
Net change	\$ (66,555)	\$ 92,665	\$ 26,110	\$ (19,271)	\$ 45,018	\$ 25,747

Taxable-equivalent net interest income for 2012 increased \$26.1 million, or 4.1%, compared to 2011. The increase 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 2012 increased \$2.2 billion or 13.4% compared to 2011. The net interest margin decreased 29 basis points from 3.88% during 2011 to 3.59% during 2012. The decrease in the net interest margin was partly due to an increase in the relative proportion of average interest-earning assets invested in lower-yielding, taxable securities during 2012 compared to 2011 while the relative proportion of average interest-earning assets invested in higher-yielding loans decreased. The impact of this shift was partly mitigated by a decrease in the relative proportion of average interest-earning assets invested in lower-yielding interest-bearing deposits. The net interest margin was also negatively impacted by a decrease in the average yield on securities, as further discussed below. The average yield on interest-earning assets decreased 40 basis points to 3.73% during 2012 from 4.13% during 2011 while the average cost of funds decreased 16 basis points from 0.40% during 2011 to 0.24% during 2012. 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.

Table of Contents

Taxable-equivalent net interest income for 2011 increased \$25.7 million, or 4.2%, compared to 2010. 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. The average volume of interest-earning assets for 2011 increased \$1.4 billion, or 9.4%, compared to 2010. The net interest margin decreased 20 basis points from 4.08% during 2010 to 3.88% during 2011. The decrease in the net interest margin was partly due to a 31 basis point decrease in the average yield on interest earning assets from 4.44% during 2010 to 4.13% during 2011 while the average cost of funds only decreased 15 basis points from 0.55% during 2010 to 0.40% during 2011. The negative effect of the decrease in the average yield on interest-earning assets on taxable-equivalent net interest income exceeded the positive effect of the decrease in the average cost of funds. The decrease in the average yield on interest-earning assets was partly due to an increase in the relative proportion of average interest-earning assets invested in lower-yielding interest-bearing deposits during 2011 compared to 2010 while the relative proportion of average interest-earning assets invested in higher-yielding loans decreased. The average yield on interest-earning assets was also negatively impacted by a decrease in the average yield on securities.

The average volume of loans increased \$413.9 million, or 5.1%, in 2012 compared to 2011 and decreased \$82.2 million, or 1.0%, in 2011 compared to 2010. Loans made up approximately 44.5% of average interest-earning assets during 2012 compared to 48.0% during 2011 and 53.0% in 2010. The average yield on loans was 4.82% during 2012 compared to 5.02% during 2011 and 5.11% during 2010. 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 \$2.7 billion in 2012 compared to 2011 and increased \$998.6 million in 2011 compared to 2010. Securities made up approximately 47.0% of average interest-earning assets in 2012 compared to 37.0% in 2011 and 34.0% in 2010. The average yield on securities was 3.31% in 2012 compared to 4.57% in 2011 and 5.02% in 2010. The decrease in the average yield on securities was partly due to a decrease in the yield on taxable securities as proceeds from principal repayments were reinvested at lower market rates. Furthermore, a large portion of the growth in taxable securities was in lower-yielding U.S. Treasury securities. The decrease in the average yield on securities was also partly related to a decrease in the relative proportion of higher-yielding, tax-exempt municipal securities in 2012 compared to 2011. The relative proportion of higher-yielding, tax-exempt municipal securities to total average securities totaled 27.4% in 2012 compared to 35.2% in 2011 and 37.0% in 2010. The average yield on taxable securities was 2.10% in 2012 compared to 3.27% in 2011 and 3.84% in 2010, while the average taxable-equivalent yield on tax-exempt securities was 6.68% in 2012 compared to 6.97% in 2011 and 7.04% in 2010.

Average federal funds sold, resell agreements and interest-bearing deposits during 2012 decreased \$899.1 million, or 35.8%, compared to 2011 and increased \$519.2 million, or 26.0%, in 2011 compared to 2010. Federal funds sold, resell agreements and interest-bearing deposits made up approximately 8.5% of average interest-earning assets in 2012 compared to approximately 15.0% in 2011 and 13.0% in 2010. The combined average yield on federal funds sold, resell agreements and interest-bearing deposits was 0.27% in 2012 compared to 0.26% in 2011 and 0.25% in 2010. The decrease in federal funds sold, resell agreements and interest-bearing deposits during 2012 compared to 2011 was due to the reinvestment of funds into higher-yielding securities and loans. The increase in federal funds sold, resell agreements and interest-bearing deposits during 2011 compared to 2010 was primarily due to significant deposit growth, as further discussed below.

Average deposits increased \$2.1 billion, or 13.6%, in 2012 compared to 2011 and \$1.2 billion, or 8.4%, in 2011 compared to 2010. Average interest-bearing deposits increased \$786.5 million in 2012 compared to 2011 and \$459.8 million in 2011 compared to 2010, while average non-interest-bearing deposits increased \$1.3 billion in 2012 compared to 2011 and \$715.2 million in 2011 compared to 2010. The ratio of average interest-bearing deposits to total average deposits was 59.4% in 2012 compared to 62.3% in 2011 and 64.2% in 2010. The average cost of interest-bearing deposits and total deposits was 0.18% and 0.10% in 2012 compared to 0.23% and 0.15% in 2011 and 0.33% and 0.21% in 2010. 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

Table of Contents

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 to 10.0% in 2012 from 11.9% in 2011 and 13.9% in 2010.

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 3.49% in 2012 compared to 3.73% in 2011 and 3.89% in 2010. 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 7A. Quantitative and Qualitative Disclosures About Market Risk included elsewhere in this report.

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 15 - 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 7A. 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 \$10.1 million in 2012 compared to \$27.4 million in 2011 and \$43.6 million in 2010. 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:

	2012	2011	2010
Trust and investment management fees	\$ 83,317	\$ 78,297	\$ 72,321
Service charges on deposit accounts	83,392	86,125	91,025
Insurance commissions and fees	39,948	35,421	34,015
Interchange and debit card transaction fees	16,933	29,625	30,542
Other charges, commissions and fees	30,180	27,750	25,380
Net gain (loss) on securities transactions	4,314	6,414	6
Other	30,703	26,370	28,744
Total	\$ 288,787	\$ 290,002	\$ 282,033

Total non-interest income for 2012 decreased \$1.2 million, or 0.4%, compared to 2011 while total non-interest income for 2011 increased \$8.0 million, or 2.8%, compared to 2010. Changes in the various components of non-interest income are discussed in more detail below.

Trust and Investment Management Fees. Trust and investment management fee income for 2012 increased \$5.0 million, or 6.4%, compared to 2011 while trust and investment management fee income for 2011 increased \$6.0 million, or 8.3%, compared to 2010. Trust investment fees are the most significant component of trust and investment management fees, making up approximately 66%, 68% and 69% of total trust and investment

Table of Contents

management fees in 2012, 2011 and 2010, respectively. 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 2012 compared to 2011 was primarily the result of an increase in trust investment fees (up \$1.8 million), oil and gas trust management fees (up \$846 thousand), custody fees (up \$777 thousand), securities lending income (up \$623 thousand), estate fees (up \$524 thousand) and mutual fund and investment management fees (up \$294 thousand). The increases in trust investment fees and custody fees were partly related to the general appreciation in the market values of assets in trust accounts on which these fees are generally based. The increase in trust investment fees was also partly related to increases in the number of trust accounts. The increase in oil and gas trust management fees was partly related to new lease bonus fees. The increase in securities lending income was partly related to new business and increased loan spreads. Estate fees are transactional in nature and can vary from period to period.

The increase in trust and investment management fee income during 2011 compared to 2010 was primarily the result of increases in trust investment fees (up \$3.5 million), mutual fund and investment management fees (up \$1.2 million), securities lending income (up \$445 thousand), custody fees (up \$289 thousand), real estate fees (up \$165 thousand) and estate fees (up \$156 thousand). The increase in trust investment fees was primarily due to the general appreciation in the market values of assets in trust accounts on which these fees are generally based. Equity valuations during 2011 were higher on average compared to 2010.

At December 31, 2012, trust assets, including both managed assets and custody assets, were primarily composed of fixed income securities (42.1% of trust assets), equity securities (42.1% of trust assets) and cash equivalents (10.2% of trust assets). The estimated fair value of trust assets was \$26.2 billion (including managed assets of \$10.9 billion and custody assets of \$15.3 billion) at December 31, 2012 compared to \$25.2 billion (including managed assets of \$10.3 billion and custody assets of \$14.9 billion) at December 31, 2011 and \$24.9 billion (including managed assets of \$9.9 billion and custody assets of \$15.0 billion) at December 31, 2010.

Service Charges on Deposit Accounts. Service charges on deposit accounts for 2012 decreased \$2.7 million, or 3.2%, compared to 2011. The decrease was primarily due to a decrease in service charges on commercial accounts (down \$2.1 million) and decreases in overdraft/insufficient funds charges on both consumer and commercial accounts (down \$787 thousand). The decrease in service charges on commercial accounts during 2012 was partly related to decreases in service volumes for billable services.

Service charges on deposit accounts for 2011 decreased \$4.9 million, or 5.4%, compared to 2010. The decrease during 2011 was primarily due to decreases in overdraft/insufficient funds charges on both consumer and commercial accounts (down \$4.1 million), service charges on commercial accounts (down \$487 thousand) and service charges on consumer accounts (down \$224 thousand). The decrease in overdraft/insufficient funds charges on consumer accounts during 2011 was partly related to a new rule issued by the Federal Reserve that became effective in the third quarter of 2010, as further discussed below. The decrease in service charges on commercial accounts during 2011 was partly related to decreases in service volumes for billable services.

Overdraft/insufficient funds charges totaled \$34.1 million during 2012 compared to \$34.9 million during 2011 and \$39.0 million in 2010. Overdraft/insufficient funds charges included \$27.0 million, \$27.7 million and \$30.4 million related to consumer accounts during 2012, 2011 and 2010, respectively, and \$7.1 million, \$7.2 million and \$8.6 million related to commercial accounts during 2012, 2011 and 2010, respectively. Overdraft/insufficient funds charges were partly impacted by changes in policies and a new rule issued by the Federal Reserve that became effective in the third quarter of 2010. The new rule prohibits financial institutions from charging consumers fees for paying overdrafts on automated teller machine and one-time debit card transactions, unless a consumer consents, or opts in, to the overdraft service for those types of transactions. Consumers must be provided a notice that explains the financial institution's overdraft services, including the fees associated with the service, and the consumer's choices.

Table of Contents

Insurance Commissions and Fees. Insurance commissions and fees for 2012 increased \$4.5 million, or 12.8%, compared to 2011. The increase was primarily related to an increase in commission income (up \$4.6 million), in part due to an increase in employee benefit commissions and fees. The increase in employee benefit commissions and fees was partly related to the acquisitions of Clark Benefit Group during the second quarter of 2011 and Stone Partners, Inc. during the first quarter of 2012. The increase in commission income was also partly related to an increase in property and casualty commissions resulting from normal variation in the market demand for insurance products and rate increases. Insurance commissions and fees for 2011 increased \$1.4 million, or 4.1%, compared to 2010. The increase was related to an increase in commission income (up \$1.4 million). The increase in commission income was partly related to the aforementioned acquisition of Clark Benefit Group in the second quarter of 2011 as well as normal variation in the timing of renewals and market demand for insurance products.

Insurance commissions and fees include contingent commissions which totaled \$3.8 million in each year for 2012, 2011 and 2010. 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 mostly received during the first quarter of each year. These commissions totaled \$2.1 million in 2012, \$2.2 million in 2011 and \$2.5 million in 2010. 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 commissions totaled \$1.7 million in 2012, \$1.6 million in 2011 and \$1.2 million in 2010.

Interchange and Debit Card Transaction Fees. Interchange and debit card transaction fees consist of income from signature and PIN-based debit card transactions and ATM service fees. Interchange and debit card transaction fees for the year ended December 31, 2012 decreased \$12.7 million, or 42.8%, compared to 2011. Income from debit card transactions totaled \$14.1 million in 2012 compared to \$26.6 million in 2011 and \$27.4 million in 2010. Income from ATM service fees totaled \$2.8 million in 2012 compared to \$3.0 million in 2011 and \$3.2 million in 2010. The decrease in income from debit card transactions during the comparable years was primarily related to new rules, effective as of October 1, 2011, that significantly reduced the interchange fees that may be charged, as further discussed below. The impact of these rules was partly mitigated in 2011 as a result of an increase in the volume of transactions as well as a higher interchange pricing structure during the first nine months of 2011.

The Dodd-Frank Act amended the Electronic Fund Transfer Act (EFTA) which, among other things, gave the Federal Reserve the authority to establish rules regarding interchange fees charged for electronic debit transactions by payment card issuers, such as Frost Bank. The Federal Reserve issued new standards that took effect on October 1, 2011 and apply to issuers, such as the Corporation, that, together with their affiliates, have assets of \$10 billion or more. Under the rule, 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. The Federal Reserve rules also allow for an upward adjustment of no more than 1 cent to an issuer's debit card interchange fee if the 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 2012 increased \$2.4 million, or 8.8%, compared to 2011. The increase in other charges, commissions and fees during 2012 included increases in human resources consulting revenues, primarily related to the acquisition of Stone Partners, Inc. (up \$1.7 million); referral fees from the Corporation's merchant services payment processor (up \$791 thousand); an increase in unused balance fees on loan commitments (up \$561 thousand), service charges on funds transfers (up \$560 thousand) and income from the sale of mutual funds (up \$518 thousand), among other things. These increases were partly offset by decreases in income related to investment banking fees related to corporate advisory services (down \$1.4 million) and the sale of annuities (down \$605 thousand). Investment banking fees related to corporate advisory services are transactional in nature and can vary significantly from year to year.

Other charges, commissions and fees for 2011 increased \$2.4 million, or 9.3%, compared to 2010. The increase was primarily related to increases in loan processing fees (up \$1.2 million), investment banking fees

Table of Contents

related to corporate advisory services (up \$965 thousand), unused balance fees on loan commitments (up \$700 thousand), lease processing fees (up \$318 thousand) and income related to sale of annuities and mutual funds (up \$167 thousand and \$161 thousand, respectively).

Net Gain/Loss on Securities Transactions. During 2012, the Corporation realized a net gain of \$4.3 million on the sale of available-for-sale securities. During 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 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 fourth quarter of 2012, the Corporation sold U.S. Treasury securities with an amortized cost totaling \$595.6 million and realized a \$4.4 million gain on the sale. The Corporation purchased the securities during the fourth quarter of 2012. Shortly thereafter, U.S. Treasury prices rallied and the Corporation sold the securities to capitalize on the gain as management believed the increase in U.S. Treasury prices would be temporary. During 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 tax planning strategy 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 2011, the Corporation sold available-for-sale securities with an amortized cost totaling \$5.6 billion and realized a net gain of \$6.4 million on those sales. With the exception of the sales during the third quarter of 2011 discussed below, these securities were primarily purchased during 2011 and subsequently sold in connection with the Corporation's aforementioned tax planning strategy related to the Texas franchise tax. During the third quarter of 2011, the Corporation sold available-for-sale securities with an amortized cost totaling \$32.6 million and realized a net gain of \$6.4 million on those sales. Many of these were longer-duration municipal securities. During 2010, the Corporation sold available-for-sale securities with an amortized cost totaling \$10.0 billion and realized a net gain of \$6 thousand on those sales. These securities were purchased during 2010 and subsequently sold in connection with the aforementioned tax planning strategy related to the Texas franchise tax.

Other Non-Interest Income. Other non-interest income for 2012 increased \$4.3 million, or 16.4% compared to 2011. The increase during 2012 was primarily related to an increase in sundry income from various miscellaneous items (up \$2.0 million), mineral interest income (up \$1.6 million) and income from securities trading and customer derivative activities (up \$1.1 million) partly offset by a decrease in gains on the sale of assets/foreclosed assets (down \$982 thousand). The increase in sundry income from various miscellaneous items were partly related to proceeds realized in a settlement totaling \$1.4 million and the reversal of a prior contingency accrual totaling \$765 thousand. Mineral interest income is 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. The increase in income from securities trading and customer derivative activities was primarily related to customer interest rate swap transactions.

Other non-interest income for 2011 decreased \$2.4 million, or 8.3%, compared to 2010. Components of other non-interest income with significant decreases included sundry income from various miscellaneous items (down \$1.7 million), lease rental income (down \$908 thousand), income from municipal bond underwriting discounts/fees (down \$729 thousand) and earnings on the cash surrender value of life insurance policies (down \$472 thousand). Components of other non-interest income with significant increases included gains on the sale of assets/foreclosed assets (up \$1.7 million) and mineral interest income (up \$232 thousand).

Table of Contents**Non-Interest Expense**

The components of non-interest expense were as follows:

	2012	2011	2010
Salaries and wages	\$ 258,752	\$ 252,028	\$ 239,589
Employee benefits	57,635	52,939	52,352
Net occupancy	48,975	46,968	46,166
Furniture and equipment	55,279	51,469	47,651
Deposit insurance	11,087	12,714	20,451
Intangible amortization	3,896	4,387	5,125
Other	139,469	137,593	124,207
Total	\$ 575,093	\$ 558,098	\$ 535,541

Total non-interest expense for 2012 increased \$17.0 million, or 3.0%, compared to 2011 while total non-interest expense for 2011 increased \$22.6 million, or 4.2%, compared to 2010. Changes in the various components of non-interest expense are discussed below.

Salaries and Wages. Salaries and wages for 2012 increased \$6.7 million, or 2.7%, compared to 2011. The increase was primarily related to normal annual merit and market increases, increased commissions related to higher insurance revenues and increased incentive compensation expense partly offset by a decrease in stock-based compensation expense and an increase in cost deferrals related to lending activity.

Salaries and wages for 2011 increased \$12.4 million, or 5.2%, compared to 2010. The increase was primarily related to normal annual merit and market increases as well as increases in incentive compensation expense and stock-based compensation expense.

Employee Benefits. Employee benefits expense for 2012 increased \$4.7 million, or 8.9%, compared to 2011. The increase during 2012 was primarily related to increases in expenses related to the Corporation's defined benefit retirement plans (up \$3.5 million), medical expense (up \$2.1 million) and expenses related to the Corporation's 401(k) plan (up \$652 thousand) partly offset by a decrease in expenses related to the Corporation's profit sharing plans (down \$2.6 million). The decrease in expenses related to the Corporation's profit sharing plans was related to the termination of the transition contributions that were only applicable to plan years before 2012.

Employee benefits expense for 2011 increased \$587 thousand, or 1.1%, compared to 2010. The increase was primarily related to increases in expenses related to payroll taxes (up \$595 thousand), medical insurance expense (up \$501 thousand) and the Corporation's 401(k) (up \$378 thousand).

The Corporation's defined benefit retirement and restoration plans were frozen effective as of December 31, 2001 and were replaced by the profit sharing plan. Management believes these actions help 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. The Corporation recognized net expense related to the defined benefit retirement and restoration plans totaling \$3.1 million in 2012 compared to net benefits of \$412 thousand in 2011 and \$369 thousand in 2010. Future expense/benefits related to these plans is dependent upon a variety of factors, including the actual return on plan assets. The increase in expense related to the Corporation's defined benefit retirement plan during 2012 compared to 2011 and 2010 was partly related to a decrease in the return on plan assets.

For additional information related to the Corporation's employee benefit plans, see Note 11 - Employee Benefit Plans in the accompanying notes to consolidated financial statements included elsewhere in this report.

Table of Contents

Net Occupancy. Net occupancy expense for 2012 increased \$2.0 million, or 4.3%, compared to 2011. The increase was primarily related to increases in lease expense (up \$1.1 million), building maintenance and repair expense (up \$460 thousand) and depreciation expense related to leasehold improvements (up \$371 thousand), among other things. These increases were partly offset by a decrease in utilities expense (down \$303 thousand).

Net occupancy expense for 2011 increased \$802 thousand, or 1.7%, compared to 2010. The increase was primarily related to increases in service contracts expense (up \$480 thousand), repairs expense (up \$394 thousand), a decrease in parking garage income (down \$161 thousand) and a decrease in rental income (down \$153 thousand). Offsetting these items were decreases in property tax expense (down \$247 thousand) and utilities expense (down \$138 thousand).

Furniture and Equipment. Furniture and equipment expense for 2012 increased \$3.8 million, or 7.4%, compared to 2011. The increase was primarily related to increases in software maintenance (up \$2.1 million), service contracts expense (up \$1.2 million) and software amortization (up \$589 thousand).

Furniture and equipment expense for 2011 increased \$3.8 million, or 8.0%, compared to 2010. The increase was primarily related to increases in software maintenance (up \$2.6 million) and software amortization (up \$1.2 million) partly offset by a decrease in depreciation on furniture and fixtures (down \$404 thousand).

Deposit Insurance. Deposit insurance expense totaled \$11.1 million in 2012 compared to \$12.7 million in 2011 and \$20.5 million in 2010. The decrease in deposit insurance expense during the comparable years was primarily related to a change in the deposit insurance assessment base and a change in the method by which the assessment rate is determined for large financial institutions, which became effective on April 1, 2011. The decrease in 2011 compared to 2010 was also partly related to the Corporation opting out of the Transaction Account Guarantee (TAG) component of the Temporary Liquidity Guarantee Program (TLGP) effective July 1, 2010. See the discussion regarding deposit insurance included in the section captioned Supervision and Regulation included in Item 1. Business elsewhere in this report for further discussion of these matters.

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 totaled \$3.9 million in 2012 compared to \$4.4 million in 2011 and \$5.1 million in 2010. The decrease in amortization expense during the comparable years was primarily the result of the completion of amortization of certain intangible assets, as well as 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. The decreases in amortization were partly offset by the additional amortization related to intangible assets recorded in connection with the acquisitions of Stone Partners Inc. on January 1, 2012 and Clark Benefit Group on May 1, 2011. See Note 5 - Goodwill and Other Intangible Assets in the accompanying notes to consolidated financial statements included elsewhere in this report.

Other Non-Interest Expense. Other non-interest expense for 2012 increased \$1.9 million, or 1.4%, compared to 2011. Components of other non-interest expense with significant increases during 2012 included professional services expense (up \$2.5 million), travel/meals and entertainment (up \$1.6 million), advertising/promotions expense (up \$1.2 million), amortization of net deferred costs related to loan commitments (up \$925 thousand) and Visa check card expense (up \$726 thousand). The increase in advertising/promotions expense is partly related to the Corporation's branding arrangement to be the exclusive cash-machine provider for Valero Corner Stores in Texas. The increase in the amortization of net deferred costs related to loan commitments is primarily related to an increase in commitments outstanding. The increases in the aforementioned items were partly offset by decreases in donation expense (down \$2.5 million), sundry losses from various miscellaneous items (down \$2.0 million), losses on the sale/write-down of assets/foreclosed assets (down \$994 thousand) examination fees (down \$642 thousand), property taxes on foreclosed assets (down \$623 thousand) and sub-advisor investment management fees related to Frost Investment Advisors, LLC, (down \$459 thousand).

Table of Contents

Other non-interest expense for 2011 increased \$13.4 million, or 10.8%, compared to 2010. Components of other non-interest expense with significant increases during 2011 included advertising/promotions expense (up \$7.5 million), donation expense (up \$2.2 million), web-site maintenance and enhancement expense (up \$2.1 million), Visa check card expense (up \$1.2 million), travel expense (up \$896 thousand), sub-advisor investment management fees related to Frost Investment Advisors, LLC, (up \$808 thousand) and losses on the sale/write-down of assets (up \$747 thousand). The increase in advertising/promotions expense is primarily related to a new, expanded marketing campaign that began during the first quarter of 2011. The increases in the aforementioned items were partly offset by decreases in losses on the sale/write-down of foreclosed assets (down \$1.2 million), amortization of net deferred costs related to loan commitments (down \$1.2 million), property taxes on foreclosed assets (down \$955 thousand), professional service expense (down \$990 thousand) and Federal Reserve service charges (down \$536 thousand).

Results of Segment Operations

The Corporation's operations are managed along two operating segments: Banking and Frost Wealth Advisors (formerly the Financial Management Group or FMG). A description of each business and the methodologies used to measure financial performance is described in Note 17 - Operating Segments in the accompanying notes to consolidated financial statements included elsewhere in this report. Net income (loss) by operating segment is presented below:

	2012	2011	2010
Banking	\$ 229,312	\$ 216,419	\$ 210,351
Frost Wealth Advisors	14,198	9,050	7,624
Non-Banks	(5,558)	(7,934)	(9,211)
Consolidated net income	\$ 237,952	\$ 217,535	\$ 208,764

Banking

Net income for 2012 increased \$12.9 million, or 6.0%, compared to 2011. The increase was primarily the result of a \$17.4 million decrease in the provision for loan losses, a \$17.2 million increase in net interest income and a \$2.2 million decrease in income tax expense partly offset by a \$16.2 million increase in non-interest expense and a \$7.8 million decrease in non-interest income. Net income for 2011 increased \$6.1 million, or 2.9%, compared to 2010. The increase was primarily the result of an \$18.1 million increase in net interest income, a \$16.2 million decrease in the provision for loan losses and a \$2.1 million increase in non-interest income partly offset by a \$19.7 million increase in non-interest expense and a \$10.6 million increase in income tax expense.

Net interest income for 2012 increased \$17.2 million, or 2.9%, compared to 2011 while net interest income for 2011 increased \$18.1 million, or 3.2%, compared to 2010. The increases primarily resulted from increases in the average volume of interest-earning assets partly offset by decreases in the net interest margin. 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 2012 totaled \$10.1 million compared to \$27.5 million in 2011 and \$43.6 million in 2010. 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 2012 decreased \$7.8 million, or 4.0%, and compared to 2011. The decreases were primarily due to decreases in interchange and debit card transaction fees, service charges on deposit accounts and the net gain on securities transactions partly offset by increases in insurance commissions and fees, other charges, commissions and fees and other non-interest income. The decrease in interchange and debit card transaction fees

Table of Contents

was primarily related to new rules, effective on October 1, 2011, that significantly reduced the interchange fees that may be charged. The decrease in service charges on deposit accounts was related to decreases in service charges on commercial accounts and in overdraft/insufficient funds charges on both consumer and commercial accounts. The increase in insurance commissions was partly due to an increase in employee benefit commissions and fees and an increase in property and casualty commissions. The increase in other charges, commissions and fees was related to increases in human resources consulting revenues, referral fees from the Corporation's merchant services payment processor, unused balance fees on loan commitments and service charges on funds transfers, among other things. The increase in other non-interest income was primarily related to increases in sundry income from various miscellaneous items and income from securities trading and customer derivative activities. See the analysis of these categories of non-interest income included in the section captioned "Non-Interest Income" included elsewhere in this discussion.

Non-interest income for 2011 increased \$2.1 million, or 1.1%, compared to 2010. The increase was primarily due to increases in the net gain on securities transactions, other charges, commissions and fees and insurance commissions and fees partly offset by decreases in service charges on deposit accounts, other non-interest income and interchange and debit card transaction fees. The increase in the net gain on securities transactions was primarily related to the sale of \$32.6 million of certain longer-duration securities during the third quarter of 2011 on which the Banking segment realized a \$6.4 million gain. The increase in other charges commissions and fees was primarily related to increases in loan and lease processing fees, investment banking fees related to corporate advisory services and unused balance fees on loan commitments. The decrease in service charges on deposit accounts was primarily related to decreases in overdraft/insufficient funds charges and service charges on both consumer and commercial accounts. The decrease in other non-interest income was primarily related to decreases in sundry income from various miscellaneous items, lease rental income, income from municipal bond underwriting discounts/fees and earnings on cash surrender value of life insurance policies. The decrease in interchange and debit card transaction fees was primarily related to new rules, effective on October 1, 2011, that significantly reduced the interchange fees that may be charged. See the analysis of these categories of non-interest income included in the section captioned "Non-Interest Income" included elsewhere in this discussion.

Non-interest expense for 2012 increased \$16.2 million, or 3.4%, compared to the 2011. The increase during 2012 was primarily related to increases in salaries and wages, employee benefits, furniture and equipment expense, occupancy expense and other non-interest expense partly offset by a decrease in deposit insurance expense and intangible amortization. The increase in salaries and wages was primarily related to normal annual merit and market increases, increased commissions related to higher insurance revenues and increased incentive compensation partly offset by a decrease in stock-based compensation expense and an increase in cost deferrals related to lending activity. The increase in employee benefits expense was primarily related to increases in expenses related to the Corporation's defined benefit retirement and 401(k) plans and medical expense partly offset by a decrease in expense related to the Corporation's profit sharing plans. The increase in furniture and equipment expense was due to increases in software maintenance, service contract expenses and software amortization. The increase in net occupancy expense was due to increases in lease expense, building maintenance and repair expense and depreciation expense related to leasehold improvements. The increase in other non-interest expense was related to increases in professional services expense, travel/meals and entertainment, advertising/promotions expense and amortization of net deferred costs related to loan commitments, among other things, as well as increases in overhead cost allocations. The decrease in deposit insurance expense was primarily related to a change in the deposit insurance assessment base and a change in the method by which the assessment rate is determined for large financial institutions which became effective on April 1, 2011. See the analysis of these items included in the section captioned "Non-Interest Expense" included elsewhere in this discussion.

Non-interest expense for 2011 increased \$19.7 million, or 4.4%, compared to 2010. The increase was primarily due to an increase in other non-interest expense, salaries and wages and furniture and equipment expense partly offset by decreases in deposit insurance expense and intangible amortization. The increase in other non-interest expense was partly related to an increase in advertising/promotions expense, among other things. The increases in salaries and wages were primarily related to normal annual merit and market increases as

Table of Contents

well as increases in incentive compensation expense and stock-based compensation expense. The increase in furniture and equipment expense was due to increases in software maintenance and software amortization. The decrease in deposit insurance was primarily related to a change in the deposit insurance assessment base and a change in the method by which the assessment rate is determined for large financial institutions. The decrease was also partly related to the Corporation opting out of the Transaction Account Guarantee component of the Temporary Liquidity Guarantee Program effective July 1, 2010. See the analysis of these items included in the section captioned *Non-Interest Expense* included elsewhere in this discussion.

Income tax expense for 2012 decreased \$2.2 million, or 3.1%, compared to 2011. The decrease was primarily due to the correction, during the third quarter of 2011, of an under-accrual of taxes that resulted from incorrectly deducting premium amortization on municipal securities for federal income tax purposes since 2008. See the section captioned *Income Taxes* included elsewhere in this discussion.

Frost Insurance Agency, which is included in the Banking operating segment, had gross commission revenues of \$40.6 million during 2012 compared to \$36.0 million in 2011 and \$34.6 million in 2010. Insurance commission revenues increased \$4.6 million, or 12.7%, during 2012 compared to 2011 and increased \$1.4 million, or 4.1%, during 2011 compared to 2010. See the analysis of insurance commissions and fees included in the section captioned *Non-Interest Income* included elsewhere in this discussion.

Frost Wealth Advisors

Net income for 2012 increased \$5.1 million, or 56.9%, compared to 2011. The increase was primarily due to a \$4.9 million increase in non-interest income, a \$1.7 million increase in net interest income and a \$1.4 million decrease in non-interest expense partly offset by a \$2.8 million increase in income tax expense. Net income for 2011 increased \$1.4 million, or 18.7%, compared to 2010. The increase was primarily due to a \$5.9 million increase in non-interest income partly offset by a \$3.8 million increase in non-interest expense and a \$772 thousand increase in income tax expense.

Net interest income 2012 increased \$1.7 million, or 26.7%, compared to 2011. The increase in net interest income was due to an increase in the average volume of funds provided due to an increase in the average volume of Frost Wealth Advisors' repurchase agreements combined with an increase in the funds transfer price received for providing those funds. Net interest income for 2011 increased \$52 thousand, or 0.8%, compared to 2010. The increase was due to an increase in the average volume of funds provided due to an increase in the average volume of Frost Wealth Advisors' repurchase agreements partly offset by a decrease in the funds transfer price received for funds provided to the Corporation.

Non-interest income for 2012 increased \$4.9 million, or 5.3%, compared to 2011. The increase was primarily due to increases in trust and investment management fees (up \$5.2 million) partly offset by decreases in other charges, commissions and fees (down \$228 thousand). Non-interest income for 2011 increased \$5.9 million, or 6.9%, compared to 2010. The increase was primarily due to increases in trust and investment management fees (up \$6.2 million) and other charges, commissions and fees (up \$123 thousand) partly offset by a decrease in other non-interest income (down \$402 thousand).

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 66%, 68% and 69% of total trust and investment management fees in 2012, 2011 and 2010, respectively. 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 2012 compared to 2011 was primarily the result of an increase in trust investment fees, oil and gas trust management fees, custody fees, securities lending income, estate fees and mutual fund and investment management fees. The increase in trust and investment fee income during 2011 compared to 2010 was primarily the result of increases in trust

Table of Contents

investment fees, mutual fund and investment management fees, securities lending income, custody fees, real estate fees and 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 decrease in other charges, commissions and fees during 2012 compared to 2011 was primarily due to a decrease in income related to the sale of annuities partly offset by an increase in income from the sale of mutual funds. The increase in other charges, commissions and fees during 2011 compared to 2010 was primarily due to increases in income related to the sale of annuities and mutual funds and brokerage commissions partly offset by a decrease in commission income related to the sale of money market accounts.

Non-interest expense for 2012 decreased \$1.4 million, or 1.6%, compared to 2011. The decrease was primarily due to a decrease in other non-interest expense (down \$2.4 million) partly offset by increases in salaries and wages and employee benefits (up \$909 thousand on a combined basis). The decrease in other non-interest expense was related to decreases in various overhead cost allocations as well as decreases in sundry losses from various miscellaneous items and sub-advisor investment management fees related to Frost Investment Advisors, LLC, among other things. The increases in salaries and wages and employee benefits were primarily related to normal annual merit and market increases as well as increases in medical insurance and retirement plan expense.

Non-interest expense for 2011 increased \$3.8 million, or 4.7%, compared to 2010. The increase was primarily due to increases in salaries and wages (up \$1.7 million) and other non-interest expense (up \$2.3 million). The increases in salaries and wages was primarily related to normal annual merit and market increases and an increase in stock-based compensation expense. The increase in other non-interest expense was partly related to increases in sub-advisor investment management fees related to Frost Investment Advisors, LLC, and increases in various overhead cost allocations, among other things, partly offset by decreases in sundry losses from various miscellaneous items.

Non-Banks

The net loss for the Non-Banks operating segment for 2012 decreased \$2.4 million, or 29.9%, compared to 2011. The decrease in the net loss was primarily due to a \$4.2 million decrease in net interest expense and a \$1.7 million increase in non-interest income partly offset by a \$2.2 million increase in non-interest expense and a \$1.3 million decrease in the net income tax benefit. 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 increase in non-interest income was primarily related to increased 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. The increase in non-interest expense was partly related to non-recurring write-downs of certain equipment assets totaling \$903 thousand in 2012 as well as increases in professional services expense, travel expense and directors fees.

The net loss for the Non-Banks operating segment for 2011 decreased \$1.3 million compared to 2010. The decrease was primarily due to a \$933 thousand decrease in non-interest expense, a \$204 thousand increase in income tax benefit and a \$192 thousand decrease in net interest expense partly offset by a \$52 thousand decrease in non-interest income. The decrease in non-interest expense was primarily related to decreases in professional services expense and property taxes partly offset by an increase in directors fees.

Income Taxes

The Corporation recognized income tax expense of \$70.5 million, for an effective tax rate of 22.9%, in 2012 compared to \$68.7 million, for an effective tax rate of 24.0%, in 2011 and \$57.6 million, for an effective rate of 21.6%, in 2010. 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 higher effective tax rate for 2011 was primarily due to the correction, during the third quarter of 2011, of an under-accrual of taxes that resulted from incorrectly deducting premium amortization on municipal

Table of Contents

securities for federal income tax purposes since 2008. As a result, the Corporation recognized additional income tax expense totaling \$4.1 million, which included interest, related to the 2010, 2009 and 2008 tax years. Excluding the effect of the correction related to prior year amounts, the Corporation's effective tax rate would have been 22.6% for 2011.

Sources and Uses of Funds

The following table illustrates, during the years presented, the mix of the Corporation's funding sources and the assets in which those funds are invested as a percentage of the Corporation's average total assets for the period indicated. Average assets totaled \$20.8 billion in 2012 compared to \$18.6 billion in 2011 and \$17.2 billion in 2010.

	2012	2011	2010
Sources of Funds:			
Deposits:			
Non-interest-bearing	33.7%	30.9%	29.2%
Interest-bearing	49.3	51.1	52.5
Federal funds purchased and repurchase agreements	2.9	3.2	2.8
Long-term debt and other borrowings	1.1	1.7	2.2
Other non-interest-bearing liabilities	1.6	1.4	1.5
Equity capital	11.4	11.7	11.8
Total	100.0%	100.0%	100.0%
Uses of Funds:			
Loans	40.6%	43.3%	47.3%
Securities	42.9	33.5	30.3
Federal funds sold, resell agreements and interest-bearing deposits	7.8	13.5	11.6
Other non-interest-earning assets	8.7	9.7	10.8
Total	100.0%	100.0%	100.0%

Deposits continue to be the Corporation's primary source of funding. Average deposits increased \$2.1 billion, or 13.6% in 2012 compared to 2011 and \$1.2 billion, or 8.4% in 2011 compared to 2010. Non-interest-bearing deposits remain a significant source of funding, which has been a key factor in maintaining the Corporation's relatively low cost of funds. Average non-interest-bearing deposits totaled 40.6% of total average deposits in 2012 compared to 37.7% in 2011, and 35.8% in 2010. 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, in which case, the relative proportion of non-interest-bearing deposits to total deposits would be expected to decrease.

The Corporation primarily invests funds in loans and securities. Loans continue to be a large component of the Corporation's mix of invested assets despite decreasing balances in previous years. Average loans increased \$413.9 million, or 5.1% in 2012 compared to 2011 and decreased \$82.2 million, or 1.0% in 2011 compared to 2010. Average securities increased \$2.7 billion, or 44.0% in 2012 compared to 2011 and increased \$998.6 million, or 19.2% in 2011 compared to 2010. The increase in average securities during the comparable years was primarily funded by deposit growth and, in 2012, excess liquidity. Average federal funds sold, resell agreements and interest-bearing deposits decreased \$899.1 million in 2012 compared to 2011 and increased \$519.2 million in 2011 compared to 2010.

Table of Contents**Loans**

Year-end loans were as follows:

	2012	Percentage of Total	2011	2010	2009	2008
Commercial and industrial:						
Commercial	\$ 4,357,100	47.2%	\$ 3,553,989	\$ 3,479,349	\$ 3,577,758	\$ 3,950,648
Leases	278,535	3.0	193,412	186,443	197,605	205,290
Asset-based	192,977	2.1	169,466	122,866	117,213	85,865
Total commercial and industrial	4,828,612	52.3	3,916,867	3,788,658	3,892,576	4,241,803
Commercial real estate:						
Commercial mortgages	2,495,481	27.1	2,383,479	2,374,542	2,327,471	2,250,442
Construction	608,306	6.6	434,870	593,273	659,459	755,704
Land	216,008	2.3	202,478	234,952	259,200	346,591
Total commercial real estate	3,319,795	36.0	3,020,827	3,202,767	3,246,130	3,352,737
Consumer real estate:						
Home equity loans	310,675	3.4	282,244	275,806	289,535	320,220
Home equity lines of credit	186,522	2.0	191,960	186,465	166,441	122,608
1-4 family residential mortgages	38,323	0.4	45,943	57,877	66,351	79,446
Construction	17,621	0.2	17,544	23,565	30,325	55,947
Other	224,206	2.4	225,118	254,551	275,780	266,862
Total consumer real estate	777,347	8.4	762,809	798,264	828,432	845,083
Total real estate	4,097,142	44.4	3,783,636	4,001,031	4,074,562	4,197,820
Consumer and other:						
Consumer installment	311,310	3.4	301,518	319,384	346,255	349,641
Student loans held for sale	-	-	-	-	24,201	28,889
Other	8,435	0.1	11,018	28,234	52,406	53,662
Total consumer and other	319,745	3.5	312,536	347,618	422,862	432,192
Unearned discounts	(21,651)	(0.2)	(17,910)	(20,287)	(22,220)	(27,733)
Total	\$ 9,223,848	100.0%	\$ 7,995,129	\$ 8,117,020	\$ 8,367,780	\$ 8,844,082

Overview. Year-end total loans increased \$1.2 billion, or 15.4% during 2012 compared to 2011. The Corporation generally stopped originating 1-4 family residential mortgage loans in 2000, and as such, this portfolio is excluded when analyzing the growth of the loan portfolio. Student loans are similarly excluded because the Corporation primarily originated these loans for resale. Accordingly, student loans were classified as held for sale. During 2008, the Corporation elected to discontinue the origination of student loans for resale, aside from previously outstanding commitments. All remaining student loans were sold during the second quarter of 2010. Excluding 1-4 family residential mortgages and student loans, year-end loans increased \$1.2 billion, or 15.6% during 2012 compared to 2011, decreased \$110.0 million, or 1.4% during 2011 compared to 2010, decreased \$218.1 million, or 2.6%, during 2010 compared to 2009, and decreased \$458.5 million, or 5.3%, during 2009 compared to 2008.

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 52.3% and 49.0% of total loans at December 31, 2012 and 2011 while real estate loans made up 44.4% and 47.3% of total loans at December 31, 2012 and 2011. Real estate loans include both commercial and consumer balances.

Table of Contents

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. See Note 3 - Loans in the accompanying notes to consolidated financial statements included elsewhere in this report for further details of the Corporation's policies and procedures related to loan origination and risk management.

Commercial and Industrial Loans. Commercial and industrial loans increased \$911.7 million, or 23.3%, from \$3.9 billion at December 31, 2011 to \$4.8 billion at December 31, 2012. At December 31, 2012, commercial and industrial loans included \$95.3 million related to an overdraft by a correspondent bank customer. The overdraft cleared subsequent to year-end. Excluding the effect of this overdraft, commercial and industrial loans increased \$816.5 million, or 20.8%, in 2012 compared to 2011. 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 (SNCs), which are discussed in more detail below.

Industry Concentrations. As of December 31, 2012 and 2011, other than energy loans, there were no concentrations of loans within any single industry in excess of 10% of total loans, as segregated by Standard Industrial Classification code (SIC code). The SIC code is a federally designed standard industrial numbering system used by the Corporation to categorize loans by the borrower's type of business. The following table summarizes the industry concentrations of the Corporation's loan portfolio, as segregated by SIC code. Industry concentrations are stated as a percentage of year-end total loans as of December 31, 2012 and 2011:

	2012	2011
Industry concentrations:		
Energy	11.7%	10.9%
Public finance	6.3	5.5
Medical services	5.7	6.8
Manufacturing, other	3.1	2.8
General and specific trade contractors	3.0	3.0
Services	2.9	3.0
Religion	2.8	2.8
Insurance	2.1	2.4
Transportation	2.1	1.7
Automobile dealers	2.0	1.3
Legal services	1.8	2.2
All other (35 categories in 2012 and 2011)	56.5	57.6
Total loans	100.0%	100.0%

Table of Contents

The Corporation's largest concentration in any single industry is in energy. Year-end energy loans were as follows:

	<u>2012</u>	<u>2011</u>
Energy loans:		
Production	\$ 765,424	\$ 683,795
Service	242,448	126,496
Manufacturing	50,721	40,265
Traders	20,126	16,768
Refining	4,467	3,262
Total energy loans	\$ 1,083,186	\$ 870,586

Large Credit Relationships. The market areas served by the Corporation include three of the top ten most populated cities in the United States. These market areas are also home to a significant number of Fortune 500 companies. As a result, the Corporation originates and maintains large credit relationships with numerous commercial customers in the ordinary course of business. The Corporation considers large credit relationships to be those with commitments equal to or in excess of \$10.0 million, excluding treasury management lines exposure, prior to any portion being sold. Large relationships also include loan participations purchased if the credit relationship with the agent is equal to or in excess of \$10.0 million. In addition to the Corporation's normal policies and procedures related to the origination of large credits, the Corporation's Central Credit Committee (CCC) must approve all new and renewed credit facilities which are part of large credit relationships. The CCC meets regularly and reviews large credit relationship activity and discusses the current pipeline, among other things. The following table provides additional information on the Corporation's large credit relationships outstanding at year-end.

	<u>2012</u>		<u>2011</u>	
	<u>Number of Relationships Committed</u>	<u>Period-End Balances Outstanding</u>	<u>Number of Relationships Committed</u>	<u>Period-End Balances Outstanding</u>
Large credit relationships:				
\$20.0 million and greater	149	\$ 5,539,527	137	\$ 4,625,356
\$10.0 million to \$19.9 million	170	2,343,440	140	1,960,852

The average commitment per large credit relationship in excess of \$20.0 million totaled \$37.2 million at December 31, 2012 and \$33.8 million at December 31, 2011. The average outstanding balance per large credit relationship with a commitment in excess of \$20.0 million totaled \$20.0 million at December 31, 2012 and \$15.6 million at December 31, 2011. The average commitment per large credit relationship between \$10.0 million and \$19.9 million totaled \$13.8 million at December 31, 2012 and \$14.0 million at December 31, 2011. The average outstanding balance per large credit relationship with a commitment between \$10 million and \$19.9 million totaled \$7.6 million at December 31, 2012 and \$8.1 million at December 31, 2011.

Purchased Shared National Credits. Purchased SNCs 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 \$628.0 million at December 31, 2012 increasing \$90.6 million, or 16.9%, from \$537.4 million at December 31, 2011. At December 31, 2012, 66.6% 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,

Table of Contents

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. The following table provides additional information about certain credits within the Corporation's purchased SNCs portfolio as of year-end.

	2012		2011	
	Number of Relationships Committed	Period-End Balances Outstanding	Number of Relationships Committed	Period-End Balances Outstanding
Purchased shared national credits:				
\$20.0 million and greater	37	\$ 1,194,902	36	\$ 1,024,373
\$10.0 million to \$19.9 million	17	233,262	16	224,141

Real Estate Loans. Real estate loans totaled \$4.1 billion at December 31, 2012 increasing \$313.5 million, or 8.3%, compared to \$3.8 billion at December 31, 2011. Commercial real estate loans totaled \$3.3 billion, or 81.0% of total real estate loans, at December 31, 2012 and \$3.0 billion, or 79.8% of total real estate loans, at December 31, 2011. The majority of this portfolio consists of commercial real estate mortgages, which includes both permanent and intermediate term loans. The Corporation's primary focus for the 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 following tables summarize the Corporation's commercial real estate loan portfolio, as segregated by (i) the type of property securing the credit and (ii) the geographic region in which the loans were originated. Property type concentrations are stated as a percentage of year-end total commercial real estate loans as of December 31, 2012 and 2011:

	2012	2011
Property type:		
Office building	16.7%	17.4%
Office/warehouse	15.5	15.8
Medical offices and services	9.8	9.7
Religious	7.5	7.3
Retail	7.1	4.9
Non-farm/non-residential	7.1	7.8
1-4 family	4.3	3.8
Multifamily	4.2	4.0
All other	27.8	29.3
Total commercial real estate loans	100.0%	100.0%
Geographic region:		
San Antonio	24.9%	23.9%
Fort Worth	24.7	25.8
Houston	19.6	19.9
Dallas	10.2	8.3
Austin	9.9	10.9
Rio Grande Valley	6.1	6.5
Corpus Christi	4.6	4.7

Total commercial real estate loans	100.0%	100.0%
------------------------------------	--------	--------

Table of Contents

Consumer Loans. The consumer loan portfolio, including all consumer real estate, increased \$24.3 million, or 2.3%, from December 31, 2011. As the following table illustrates, the consumer loan portfolio has two distinct segments, including consumer real estate and consumer installment.

	2012	2011
Consumer real estate:		
Home equity loans	\$ 310,675	\$ 282,244
Home equity lines of credit	186,522	191,960
1-4 family residential mortgages	38,323	45,943
Construction	17,621	17,544
Other	224,206	225,118
Total consumer real estate	777,347	762,809
Consumer installment	311,310	301,518
Total consumer loans	\$ 1,088,657	\$ 1,064,327

Consumer real estate loans, increased \$14.5 million, or 1.9%, from December 31, 2011. Combined, home equity loans and lines of credit made up 64.0% and 62.2% of the consumer real estate loan total at December 31, 2012 and 2011, 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.

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.

As previously stated, the Corporation discontinued the origination of student loans for resale, aside from previously outstanding commitments, during 2008 and sold all remaining student loans during 2010. Student loans were primarily originated for resale on the secondary market and classified as held for sale though included in total loans in the consolidated balance sheet. Student loans were generally sold on a non-recourse basis after the deferment period ended; however, from time to time, the Corporation sold such loans prior to the end of the deferment period. The Corporation sold approximately \$23.5 million of student loans during 2010.

Foreign Loans. The Corporation makes 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 December 31, 2012 or 2011.

Maturities and Sensitivities of Loans to Changes in Interest Rates. The following table presents the maturity distribution of the Corporation's loans, excluding 1-4 family residential real estate loans and unearned discounts, at December 31, 2012. The table also presents the portion of loans that have fixed interest rates or variable interest rates that fluctuate over the life of the loans in accordance with changes in an interest rate index such as the prime rate or LIBOR.

	Due in			Total
	One Year or Less	After One, but Within Five Years	After Five Years	
Commercial and industrial	\$ 2,358,846	\$ 2,009,546	\$ 460,220	\$ 4,828,612
Real estate construction	213,636	293,233	119,058	625,927
Commercial real estate and land	355,899	1,290,661	1,064,929	2,711,489

Edgar Filing: CULLEN/FROST BANKERS, INC. - Form 10-K

Consumer and other	178,250	187,144	675,754	1,041,148
Total	\$ 3,106,631	\$ 3,780,584	\$ 2,319,961	\$ 9,207,176
Loans with fixed interest rates	\$ 1,054,369	\$ 1,230,180	\$ 1,273,737	\$ 3,558,286
Loans with floating interest rates	2,052,262	2,550,404	1,046,224	5,648,890
Total	\$ 3,106,631	\$ 3,780,584	\$ 2,319,961	\$ 9,207,176

Table of Contents

The Corporation generally structures commercial loans with shorter-term maturities in order to match the Corporation's funding sources and to enable the Corporation to effectively manage the loan portfolio by providing the flexibility to respond to liquidity needs, changes in interest rates and changes in underwriting standards and loan structures, among other things. Due to the shorter-term nature of such loans, from time to time and in the ordinary course of business, the Corporation will renew/extend maturing lines of credit or refinance existing loans at their maturity dates. These renewals, extensions and refinancings are made in the ordinary course of business for customers that meet the Corporation's normal level of credit standards. Such borrowers typically request renewals to support their on-going working capital needs to finance their operations. Such borrowers are not experiencing financial difficulties and generally could obtain similar financing from another financial institution. In connection with each renewal, extension or refinancing, the Corporation may require a principal reduction, adjust the rate of interest and/or modify the structure and other terms to reflect the current market pricing/structuring for such loans or to maintain competitiveness with other financial institutions. In such cases, the Corporation does not generally grant concessions, and, except for those reported in Note 3 - Loans, any such renewals, extensions or refinancings that occurred during the reported periods were not deemed to be troubled debt restructurings pursuant to applicable accounting guidance. During 2012, renewals, extensions and refinancings of commercial and industrial loans totaled approximately \$1.4 billion while renewals, extensions and refinancings of commercial real estate and construction loans totaled approximately \$432.3 million. Due to the shorter-term structuring of the Corporation's loan portfolio, some loans may renew multiple times in a given year as a result of general customer practice and need. Loans exceeding \$1.0 million undergo a complete underwriting process at each renewal.

Non-Performing Assets and Potential Problem Loans

Non-Performing Assets. Year-end non-performing assets and accruing past due loans were as follows:

	2012	2011	2010	2009	2008
Non-accrual loans:					
Commercial and industrial	\$ 46,308	\$ 43,874	\$ 60,408	\$ 82,219	\$ 27,123
Real estate	42,504	49,736	76,270	63,926	36,764
Consumer and other	932	728	462	722	1,287
Total non-accrual loans	89,744	94,338	137,140	146,867	65,174
Restructured loans	-	-	-	-	-
Foreclosed assets:					
Real estate	15,152	26,608	27,339	33,305	12,312
Other	350	-	471	7	554
Total foreclosed assets	15,502	26,608	27,810	33,312	12,866
Total non-performing assets	\$ 105,246	\$ 120,946	\$ 164,950	\$ 180,179	\$ 78,040
Ratio of non-performing assets to:					
Total loans and foreclosed assets	1.14%	1.51%	2.03%	2.14%	0.88%
Total assets	0.46	0.60	0.94	1.11	0.52
Accruing past due loans:					
30 to 89 days past due	\$ 35,969	\$ 42,463	\$ 55,045	\$ 90,173	\$ 102,053
90 or more days past due	6,994	17,417	26,922	23,911	19,751
Total accruing past due loans	\$ 42,963	\$ 59,880	\$ 81,967	\$ 114,084	\$ 121,804
Ratio of accruing past due loans to total loans:					
30 to 89 days past due	0.39%	0.53%	0.68%	1.08%	1.16%
90 or more days past due	0.08	0.22	0.33	0.28	0.22
Total accruing past due loans	0.47%	0.75%	1.01%	1.36%	1.38%

Table of Contents

Non-performing assets include non-accrual loans and foreclosed assets. Non-performing assets at December 31, 2012 decreased \$15.7 million from December 31, 2011. While down significantly in 2012, in general, the level of non-performing assets in recent years is reflective of the weaker economic conditions which began in the latter part of 2008. Non-accrual commercial and industrial loans included three credit relationships in excess of \$5 million totaling \$27.8 million at December 31, 2012 and two credit relationships in excess of \$5 million totaling \$17.3 million at December 31, 2011. 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 relationship in excess of \$5 million totaling \$18.2 million at December 31, 2012 and one credit relationship in excess of \$5 million totaling \$5.8 million at December 31, 2011. Approximately \$15.0 million of the non-accrual commercial and industrial loans and \$12.6 million of the non-accrual commercial real estate loans at December 31, 2012 pertained to the same customer.

Non-performing assets at December 31, 2011 decreased \$44.0 million from December 31, 2010. Non-accrual commercial loans included two credit relationships in excess of \$5 million totaling \$17.3 million at December 31, 2011 and three credit relationships in excess of \$5 million totaling \$25.8 million at December 31, 2010. Non-performing assets at December 31, 2010 decreased \$15.2 million from December 31, 2009. Non-accrual commercial and industrial loans included three credit relationships in excess of \$5 million totaling \$37.6 million at December 31, 2009. Non-accrual commercial and industrial and real estate loans also included \$6.5 million and \$16.3 million in loans to certain Mexican borrowers at December 31, 2010 and December 31, 2009, respectively, primarily related to deterioration in the U.S. dollar exchange rate of the Mexican peso. Non-performing assets at December 31, 2009 increased \$102.1 million from December 31, 2008. The increase in non-accrual commercial and industrial loans was partly related to the addition of two credit relationships with an aggregate total of \$31.4 million. Non-accrual commercial and industrial and real estate loans at December 31, 2009 also included the aforementioned \$16.3 million in loans to certain Mexican borrowers. The increase in non-accrual real estate loans was primarily related to land development and 1-4 family residential construction credit relationships. The increase in non-performing assets was primarily related to land development and 1-4 family residential construction credit relationships. The increase was reflective of the deterioration of economic conditions during 2008, as well as overall growth in the loan portfolio.

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. Write-downs occurring at foreclosure are charged against the allowance for loan losses. 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. During 2012 and 2011, foreclosed assets, particularly among certain classes of property (primarily land), experienced significant deterioration in fair values as a result of the prevailing weaker economic conditions. Write-downs of foreclosed assets totaled \$2.1 million and \$2.8 million, during 2012 and 2011, respectively. During 2012, the Corporation recognized write-downs on 33 different properties/relationships with the average write-down totaling \$63 thousand and the largest individual write-down totaling \$575 thousand. The weighted-average percentage write-down was 17.3%. During 2011, the Corporation recognized write-downs on 29 different properties/relationships with the average write-down totaling \$96 thousand and the largest individual write-down totaling \$689 thousand. The weighted-average percentage write-down was 30.3%. There were no significant concentrations of any properties, to which the aforementioned write-downs relate, in any single geographic region.

Table of Contents

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 December 31, 2012 and 2011, the Corporation had \$10.7 million and \$42.6 million in loans of this type which are not included in either of the non-accrual or 90 days past due loan categories. At December 31, 2012, potential problem loans consisted of six credit relationships. Of the total outstanding balance at December 31, 2012, 27.0% related to a customer in the broadcasting industry, 25.6% related to two customers with commercial real estate properties and 19.4% related to a customer in manufacturing. 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 an allocation of the year-end 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. Prior to 2012, certain general valuation allowances were not allocated to specific loan portfolio segments and were included in unallocated allowances. See Note 3 - Loans for details of amounts allocated to specific portfolio segments.

	2012		2011		2010		2009		2008	
	Allowance for Loan Losses	Percentage of Loans in each Category to Total Loans	Allowance for Loan Losses	Percentage of Loans in each Category to Total Loans	Allowance for Loan Losses	Percentage of Loans in each Category to Total Loans	Allowance for Loan Losses	Percentage of Loans in each Category to Total Loans	Allowance for Loan Losses	Percentage of Loans in each Category to Total Loans
Commercial and industrial	\$ 54,164	52.3%	\$ 42,774	49.0%	\$ 57,789	46.7%	\$ 57,394	46.5%	\$ 51,534	48.0%
Commercial real estate	29,346	36.0	20,912	37.8	28,534	39.5	28,514	38.8	25,928	37.9
Consumer real estate	5,252	8.4	3,540	9.5	3,223	9.8	2,560	9.9	3,217	9.6
Consumer and other	3,507	3.3	12,635	3.7	11,974	4.0	16,929	4.8	18,846	4.5
Unallocated	12,184	-	30,286	-	24,796	-	19,912	-	10,719	-
Total	\$ 104,453	100.0%	\$ 110,147	100.0%	\$ 126,316	100.0%	\$ 125,309	100.0%	\$ 110,244	100.0%

As of December 31, 2012, the reserve allocated to commercial and industrial loans increased \$11.4 million compared to December 31, 2011. As of December 31, 2012, the reserve allocated to commercial and industrial loans included \$6.0 million related to certain general valuation

allowances that were previously reported as components of the unallocated portion of the allowance for loan losses (see Note 3 - Loans for details). Excluding the impact of this reclassification of certain general

Table of Contents

valuation allowances, the reserve allocated to commercial and industrial loans at December 31, 2012 increased \$5.4 million from December 31, 2011. The increase was primarily related to increases in historical valuation allowances due to an increase in the volume of non-classified commercial and industrial loans, an increase in allocations for specific loans, an increase in the allocation for distressed industries and an increase in the environmental risk adjustment partly offset by a decrease in classified loans. Classified commercial and industrial loans (loans having a risk grade of 11, 12 or 13) totaled \$100.1 million at December 31, 2012 compared to \$139.2 million at December 31, 2011. Specific allocations of the allowance for loan losses related to commercial and industrial loans totaled \$5.1 million at December 31, 2012 compared to \$2.7 million at December 31, 2011. The environmental adjustment factor resulted in additional general valuation allowances for commercial and industrial loans totaling \$6.6 million at December 31, 2012, compared to \$5.7 million at December 31, 2011. Although the environmental risk adjustment factor at December 31, 2012 decreased compared to December 31, 2011, the dollar amount of the environmental risk adjustment increased compared to December 31, 2011 as a result of an increase in the volume of non-classified commercial and industrial loans. The distressed industries allocation related to commercial and industrial loans totaled \$5.9 million at December 31, 2012 and \$4.1 million at December 31, 2011. As more fully discussed in Note 3 - Loans in the accompanying notes to consolidated financial statements, the distressed industries allocation was added to the Corporation's methodology for the determination of reserves allocated to specific loan portfolio segments in the fourth quarter of 2011.

As of December 31, 2012, the reserve allocated to commercial real estate loans increased \$8.4 million compared to December 31, 2011. The reserve allocated to commercial real estate loans included \$5.7 million related to certain general valuation allowances that were previously reported as components of the unallocated portion of the allowance for loan losses (see Note 3 - Loans for details). Excluding the impact of this reclassification of certain general valuation allowances, the reserve allocated to commercial real estate loans at December 31, 2012 increased \$2.8 million compared to December 31, 2011. The increase was primarily related to an increase in allocations for specific loans, an increase in historical valuation allowances due to an increase in the volume of non-classified commercial real estate loans and an increase in the allocation for distressed industries partly offset by the effect of a decrease in classified loans. The allowance allocated to commercial real estate loans at December 31, 2012 was also impacted by a decrease in the historical loss allocation factors applied to certain categories of non-classified and classified commercial real estate loans compared to the historical loss allocation factors used in 2011. Classified commercial real estate loans totaled \$118.1 million at December 31, 2012 compared to \$180.0 million at December 31, 2011. Specific allocations of the allowance for loan losses related to commercial real estate loans totaled \$3.1 million at December 31, 2012 and \$1.1 million at December 31, 2011. The environmental adjustment factor resulted in additional general valuation allowances for commercial real estate loans totaling \$3.7 million at both December 31, 2012 and 2011. Although the environmental risk adjustment factor at December 31, 2012 decreased compared to December 31, 2011, the dollar amount of the environmental risk adjustment was flat compared to December 31, 2011 as a result of an increase in the volume of non-classified commercial real estate loans. The distressed industries allocation related to commercial real estate loans totaled \$1.2 million at December 31, 2012 and \$922 thousand at December 31, 2011.

The reserve allocated to consumer real estate loans at December 31, 2012 increased \$1.7 million compared to December 31, 2011. The reserve allocated to consumer real estate loans included \$1.6 million related to certain general valuation allowances that were previously reported as components of the unallocated portion of the allowance for loan losses (see Note 3 - Loans for details). Excluding the impact of this reclassification of certain general valuation allowances, the reserve allocated to consumer real estate loans at December 31, 2012 did not significantly fluctuate compared to December 31, 2011. An increase in the level of allowance required for consumer real estate loans resulted from the impact of increases in historical valuation allowances due to an increase in the volume of non-classified consumer real estate loans and the effect of an increase in the historical loss allocation factor applied to pass-grade loans at December 31, 2012 compared to the historical loss allocation factors used in 2011. A decrease in the level of allowance required for consumer real estate loans resulted from the effect of decreases in certain categories of classified loans and watch/special mention grade loans, the effect

Table of Contents

of decreases in the historical loss allocation factors applied to certain categories of classified loans and watch/special mention grade loans at December 31, 2012 compared to the historical loss allocation factors used in 2011, a decrease in allocations for specific loans compared to December 31, 2011 and a decrease in the environmental risk adjustment compared to December 31, 2011. As the impact of factors requiring an increase in the level of allowance required for consumer real estate loans were for the most part offset by the impact of factors requiring a decrease in the level of allowance required for consumer real estate loans, the reserve allocated to consumer real estate loans did not significantly fluctuate.

The reserve allocated to consumer and other loans at December 31, 2012 decreased \$9.1 million compared to December 31, 2011. As of December 31, 2012, the reserve allocated to consumer and other loans included a reduction of \$5.7 million related to certain general valuation allowances that were previously reported as components of the unallocated portion of the allowance for loan losses (see Note 3 - Loans for details). Excluding the impact of this reclassification of certain general valuation allowances, the reserve allocated to consumer and other loans at December 31, 2012 decreased \$3.5 million compared to December 31, 2011. The decrease was primarily related to a decrease in the historical loss allocation factor applied to consumer and other loans combined with a decrease in the environmental risk adjustment factor partly offset by the effect of an increase in the volume of consumer and other loans.

The unallocated portion of the allowance for loan losses represents certain 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 December 31, 2012 decreased \$18.1 million compared to December 31, 2011. Excluding certain general valuation allowances that were reclassified to specific loan portfolio segments, as discussed above, the unallocated portion of the allowance for loan losses at December 31, 2012 would have decreased \$9.4 million compared to December 31, 2011 primarily due to a decrease in the allocation for general macroeconomic risk, down \$9.8 million at December 31, 2012 compared to December 31, 2011. The decrease in the allocation for general macroeconomic risk is reflective of improving trends in certain components of the Texas Leading Index and an improved outlook on the credit quality of the Corporation's loan portfolio.

During 2011, the reserve allocated to commercial and industrial loans and commercial real estate loans decreased \$15.0 million and \$7.6 million, respectively, compared to 2010 primarily due to decreases in the level of classified loans and allocations for specific loans. Classified commercial and industrial loans and commercial real estate loans totaled \$139.2 million and \$180.0 million, respectively, at December 31, 2011 compared to \$198.3 million and \$213.6 million, respectively at December 31, 2010. Specific allocations of the allowance for loan losses related to commercial and industrial loans and commercial real estate loans totaled \$2.7 million and \$1.1 million, respectively, at December 31, 2011 compared to \$9.1 million and \$4.4 million, respectively, at December 31, 2010. The decreases in reserves allocated to commercial and industrial and commercial real estate loans were also partly due to decreases in the historical loss allocation factors applied to non-classified loans in these loan categories. The base historical loss allocation for each category of loans is the product of the volume of loans within each level of risk classification and the historical loss allocation factor for that particular level of risk classification, adjusted, as necessary to reflect the impact of current conditions. The base historical loss allocation is then adjusted upwards utilizing an environmental adjustment factor that is based upon a more qualitative analysis of risk. See Note 3 - Loans in the accompanying notes to consolidated financial statements for information regarding the various risks that may be considered in the determination of the environmental adjustment factor. Prior to the first quarter of 2011, the base historical loss allocation factors for non-classified loans determined based upon actual historical loss experience were adjusted upwards given the continued higher levels of charge-offs relative to historical average and the prevailing uncertain economic conditions. During the first quarter of 2011, the amounts of these upward adjustments were partly reduced in light of the decreasing trend in classified loans and an improvement in the outlook related to credit quality. The impact of these reductions was partly offset by the effect of a new allocation for distressed industries and an increase in the environmental adjustment factor. As more fully discussed in Note 3 - Loans in the accompanying notes to

Table of Contents

consolidated financial statements, the distressed industries allocation was added to the Corporation's methodology for the determination of reserves allocated to specific loan portfolio segments in 2011. The distressed industries allocation related to commercial and industrial loans and commercial real estate loans totaled \$4.1 million and \$922 thousand, respectively, at December 31, 2011. The environmental adjustment factor resulted in additional general valuation allowances for commercial and industrial loans and commercial real estate loans totaling \$5.6 million and \$3.7 million, respectively, at December 31, 2011 and \$4.4 million and \$3.0 million, respectively, at December 31, 2010.

During 2011, the reserve allocated to consumer real estate loans increased \$317 thousand compared 2010, while the reserve allocated to consumer and other loans increased \$661 thousand in 2011 compared to 2010. The increases in the reserves allocated to consumer real estate loans and consumer and other loans were primarily related to increases in the historical loss allocation factors applied to these loan segments and an increase in the environmental adjustment factor, partly offset by the effect of a decrease in the volume of loans in each of these segments. The unallocated portion of the allowance for loan losses increased \$5.5 million in 2011 compared to 2010. This fluctuation was primarily due to an increase in the allocation for excessive industry concentrations which totaled \$7.0 million at December 31, 2011 compared to \$1.7 million at December 31, 2010. The increase was primarily related to new industry concentrations that were not considered to be excessive industry concentrations in 2010. In addition, during 2011, the Corporation refined its methodology for the determination of general valuation allowances to (i) provide additional allocations for loans that did not undergo a separate, independent concurrence review during the underwriting process (generally those loans under \$1.0 million at origination), (ii) reduce the minimum balance/commitment threshold for which allocations are made for highly leveraged credit relationships that exceed specified risk grades, (iii) lower the maximum risk grade thresholds for highly leveraged credit relationships, and (iv) include 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 net effect of these changes to the Corporation's methodology for the determination of general valuation allowances did not significantly impact the level of the unallocated portion of the allowance for loan losses at December 31, 2011 compared to December 31, 2010.

During 2010, the reserve allocated to commercial and industrial loans and commercial and consumer real estate loans did not significantly fluctuate compared to 2009 as the effect of a slight decrease in the level of classified loans as well as decreases in the overall volume of commercial and industrial loans and real estate loans was offset by the effect of increases in the historical loss allocation factors applied to both classified and non-classified loans. The historical loss allocation factors for non-classified loans determined based upon actual historical experience were adjusted upwards given the continued higher levels of net charge-offs relative to historical average and the continued uncertain economic conditions. Specific valuation allowances related to commercial and industrial loans decreased approximately \$2.8 million in 2010 compared to 2009 while specific valuation allowances related to real estate loans increased \$2.8 million in 2010 compared to 2009. The decrease in the reserve allocated to consumer and other loans during 2010 compared to 2009 was primarily related to a decrease in the volume of such loans. Despite improving economic conditions relative to 2009, the increase in the unallocated portion of the allowance for loan losses during 2010 compared to 2009 was reflective of continued economic uncertainty resulting from weakness in certain business sectors (including contractors, builders, commercial real estate, manufacturing and healthcare), high unemployment and relatively low consumer spending activity. The Corporation primarily monitors communications and statistical data from the Federal Reserve and other agencies of the U.S. government in assessing the status of these factors. By the end of 2010, management believed that the improving trends seen in certain components of the Texas Leading Index, as well as in the national economy as a whole, were primarily driven by government stimulus programs, the extension of tax cuts and the monetary policy of the Federal Reserve with regards to quantitative easing. Such measures were expected to act as a catalyst for long-term growth; however, while short-term improvements were seen, management believes that these measures did not lead to private-sector employment growth and increased consumer spending levels as they were expected.

Table of Contents

During 2009, the reserve allocated to commercial and industrial loans and commercial real estate loans increased \$5.9 million and \$2.6 million, respectively, compared to 2008 primarily due to an increase in the historical loss allocation factors applied to non-classified loans. The historical loss allocation factors for non-classified loans determined based upon actual historical experience were adjusted upwards in 2009 given the significant increase in net charge-offs relative to historical average and the continued uncertain economic conditions. Specific valuation allowances related to commercial and industrial loans increased approximately \$4.8 million in 2009 compared to 2008 while specific valuation allowances related to real estate loans decreased \$461 thousand in 2009 compared to 2008. The \$9.2 million increase in the unallocated portion of the allowance for loan losses during 2009 compared to 2008 was reflective of continued recessionary economic conditions which began in 2008.

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

	2012	2011	2010	2009	2008
Balance of allowance for loan losses at beginning of year	\$ 110,147	\$ 126,316	\$ 125,309	\$ 110,244	\$ 92,339
Provision for loan losses	10,080	27,445	43,611	65,392	37,823
Charge-offs:					
Commercial and industrial	(18,493)	(33,678)	(31,324)	(35,432)	(13,910)
Real estate	(5,446)	(13,565)	(10,206)	(12,132)	(6,855)
Consumer and other	(9,101)	(9,442)	(11,893)	(12,047)	(8,422)
Total charge-offs	(33,040)	(56,685)	(53,423)	(59,611)	(29,187)
Recoveries:					
Commercial and industrial	4,870	4,526	2,794	2,525	3,285
Real estate	5,584	1,838	1,603	497	1,101
Consumer and other	6,812	6,707	6,422	6,262	4,883
Total recoveries	17,266	13,071	10,819	9,284	9,269
Net charge-offs	(15,774)	(43,614)	(42,604)	(50,327)	(19,918)
Balance at end of year	\$ 104,453	\$ 110,147	\$ 126,316	\$ 125,309	\$ 110,244
Net charge-offs as a percentage of average loans	0.19%	0.54%	0.52%	0.58%	0.24%
Allowance for loan losses as a percentage of year-end loans	1.13	1.38	1.56	1.50	1.25
Allowance for loan losses as a percentage of year-end non-accrual loans	116.39	116.76	92.11	85.32	169.15
Average loans outstanding during the year	\$ 8,456,818	\$ 8,042,968	\$ 8,125,150	\$ 8,652,563	\$ 8,314,265
Loans outstanding at year-end	9,223,848	7,995,129	8,117,020	8,367,780	8,844,082
Non-accrual loans outstanding at year-end	89,744	94,338	137,140	146,867	65,174

As stated above, the provision for loan losses reflects loan quality trends, including the level of net charge-offs or recoveries, among other factors. The provision for loan losses decreased \$17.4 million in 2012 to \$10.1 million compared to \$27.4 million in 2011 and decreased \$16.2 million in 2011 compared to \$43.6 million in 2010. The level of the provision for loan losses during 2012 is reflective of the decreasing trend in classified loans and a decrease in net charge-offs. The decrease in the level of the provision for loan losses during 2011 is reflective of the decreasing trend in classified loans. The decrease in the provision for loan losses during 2010 is reflective of a decrease in the level of net charge-offs compared to 2009 as well as decreases in the level of classified loans and overall loan volumes. The increase in the provision for loan losses during 2009 compared to

Table of Contents

2008 was partly due to higher levels of net charge-offs and an increase in classified loans related to the weaker economic conditions. The weak economic conditions particularly affected the performance of many of the Corporation's land development and 1-4 family residential construction credit relationships.

Net charge-offs for 2012 decreased \$27.8 million compared to 2011 while net charge-offs for 2011 increased \$1.0 million compared to 2010, net charge-offs for 2010 decreased \$7.7 million compared to 2009 and net charge-offs for 2009 increased \$30.4 million compared to 2008. The ratio of the allowance for loan losses to total loans decreased 25 basis points from 1.38% at December 31, 2011 to 1.13% at December 31, 2012. As a percentage of average loans, net charge-offs decreased 35 basis points in 2012 compared to 2011, increased 2 basis points in 2011 compared to 2010, decreased 6 basis points in 2010 compared to 2009 and increased 34 basis points in 2009 compared to 2008. The level of net charge-offs in 2011 was partly related to the charge-off of several large credit relationships during the third quarter of 2011. Aside from these charge-offs, the overall trend in net charge-offs since 2009 reflects the continued improvement in the level of classified loans. The increase in net charge-offs in 2009 is related to the deterioration of economic conditions which began in 2008. The Corporation currently expects the level of net charge-offs to remain stable for the foreseeable future.

The ratio of the allowance for loan losses to total loans decreased 25 basis points from 1.38% at December 31, 2011 to 1.13% at December 31, 2012, which is reflective of continued improvement in the level of classified loans. 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.

Securities

Year-end securities were as follows:

	2012		2011		2010	
	Amount	Percentage of Total	Amount	Percentage of Total	Amount	Percentage of Total
Held to maturity:						
U.S. Treasury	\$ 248,188	2.7%	\$ 247,797	3.0%	\$ 247,421	4.5%
Residential mortgage-backed securities	10,725	0.1	11,874	0.2	4,405	0.1
States and political subdivisions	2,696,468	29.4	105,325	1.3	30,803	0.6
Other	1,000	-	1,000	-	1,000	-
Total	2,956,381	32.2	365,996	4.5	283,629	5.2
Available for sale:						
U.S. Treasury	3,057,921	33.3	2,056,732	25.2	987,031	18.1
U.S. government agencies/corporations	-	-	250,884	3.1	-	-
Residential mortgage-backed securities	2,518,003	27.4	3,289,270	40.2	2,091,330	38.3
States and political subdivisions	591,483	6.4	2,154,813	26.4	2,040,300	37.4
Other	35,892	0.4	38,001	0.4	38,809	0.7
Total	6,203,299	67.5	7,789,700	95.3	5,157,470	94.5
Trading:						
U.S. Treasury	14,038	0.1	13,609	0.2	14,986	0.3
States and political subdivisions	16,036	0.2	-	-	115	-
Total	30,074	0.3	13,609	0.2	15,101	0.3
Total securities	\$ 9,189,754	100.0%	\$ 8,169,305	100.0%	\$ 5,456,200	100.0%

Table of Contents

The following tables summarize the maturity distribution schedule with corresponding weighted-average yields of securities held to maturity and securities available for sale as of December 31, 2012. Weighted-average yields have been computed on a fully taxable-equivalent basis using a tax rate of 35%. Mortgage-backed securities are included in maturity categories based on their stated maturity date. Expected maturities may differ from contractual maturities because issuers may have the right to call or prepay obligations. Other securities classified as available for sale include stock in the Federal Reserve Bank and the Federal Home Loan Bank, which have no maturity date. These securities have been included in the total column only.

	Within 1 Year		1-5 Years		5-10 Years		After 10 Years		Total	
	Amount	Weighted Average Yield	Amount	Weighted Average Yield	Amount	Weighted Average Yield	Amount	Weighted Average Yield	Amount	Weighted Average Yield
Held to maturity:										
U.S. Treasury	\$ -	-%	\$ 248,188	3.44%	\$ -	-%	\$ -	-%	\$ 248,188	3.44%
Residential mortgage-backed securities	-	-	510	3.75	2,654	1.70	7,561	3.06	10,725	2.76
States and political subdivisions	9,635	16.46	98,915	5.05	162,466	4.50	2,425,452	5.50	2,696,468	5.46
Other	-	-	1,000	1.20	-	-	-	-	1,000	1.20
Total	\$ 9,635	16.46	\$ 348,613	3.89	\$ 165,120	4.45	\$ 2,433,013	5.49	\$ 2,956,381	5.27
Available for sale:										
U.S. Treasury	\$ 502,324	0.96%	\$ 2,555,597	0.86%	\$ -	-%	\$ -	-%	\$ 3,057,921	0.88%
Residential mortgage-backed securities	-	-	37,436	4.89	989,846	2.23	1,490,721	3.93	2,518,003	3.26
States and political subdivisions	129,532	1.04	58,268	6.00	80,067	6.19	323,616	6.53	591,483	5.15
Other	-	-	-	-	-	-	-	-	35,892	-
Total	\$ 631,856	0.98	\$ 2,651,301	1.02	\$ 1,069,913	2.51	\$ 1,814,337	4.38	\$ 6,203,299	2.23

Securities are classified as held to maturity and carried at amortized cost when management has the positive intent and ability to hold them to maturity. Securities are classified as available for sale when they might be sold before maturity. Securities available for sale are carried at fair value, with unrealized holding gains and losses reported in other comprehensive income, net of tax. The remaining securities are classified as trading. Trading securities are held primarily for sale in the near term and are carried at their fair values, with unrealized gains and losses included immediately in other income. Management determines the appropriate classification of securities at the time of purchase. Securities with limited marketability, such as stock in the Federal Reserve Bank and the Federal Home Loan Bank, are carried at cost.

All mortgage-backed securities included in the above tables were issued by U.S. government agencies and corporations. At December 31, 2012, there were no holdings of any one issuer, other than the U.S. government and its agencies, in an amount greater than 10% of the Corporation's shareholders' equity. At December 31, 2012, approximately 98.8% 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 73.8% 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.

The average taxable-equivalent yield on the securities portfolio was 3.31% in 2012 compared to 4.57% in 2011 and 5.02% in 2010. The decreases during the comparable years were primarily related to a decrease in the yield on taxable securities as proceeds from principal repayments were reinvested at lower market rates. Tax-exempt municipal securities totaled 27.4% of average securities in 2012 compared to 35.2% in 2011 and 37.0% in 2010. The average yield on taxable securities was 2.10% in 2012 compared to 3.27% in 2011 and 3.84% in 2010, while the average taxable-equivalent yield on tax-exempt securities was 6.68% in 2012 compared to 6.97% in 2011 and 7.04% in 2010. See the section captioned "Net Interest Income" included elsewhere in this discussion. The overall growth in the securities portfolio over the comparable periods was primarily funded by deposit growth.

Table of Contents**Deposits**

The table below presents the daily average balances of deposits by type and weighted-average rates paid thereon during the years presented:

	2012		2011		2010	
	Average Balance	Average Rate Paid	Average Balance	Average Rate Paid	Average Balance	Average Rate Paid
Non-interest-bearing demand deposits:						
Commercial and individual	\$ 6,300,944		\$ 5,093,948		\$ 4,546,054	
Correspondent banks	332,136		324,954		310,599	
Public funds	388,847		320,080		167,127	
Total	7,021,927		5,738,982		5,023,780	
Interest-bearing deposits:						
Private accounts:						
Savings and interest checking	3,018,116	0.05%	2,541,677	0.08%	2,277,982	0.13%
Money market accounts	5,834,822	0.21	5,407,207	0.27	5,066,747	0.35
Time accounts of \$100,000 or more	533,944	0.41	583,219	0.48	634,185	0.67
Time accounts under \$100,000	491,078	0.33	544,512	0.41	616,903	0.63
Public funds	392,213	0.16	407,018	0.18	428,022	0.22
Total	10,270,173	0.18	9,483,633	0.23	9,023,839	0.33
Total deposits	\$ 17,292,100	0.10	\$ 15,222,615	0.15	\$ 14,047,619	0.21

Average deposits increased \$2.1 billion, or 13.6% in 2012 compared to 2011 and increased \$1.2 billion, or 8.4% in 2011 compared to 2010. The most significant volume growth during the comparable years was in non-interest-bearing commercial and individual accounts, savings and interest checking accounts and money market accounts. Deposit growth was driven by new customer relationships as well as increased balances from existing customers. This growth was related, in part, to an expanded marketing campaign that began during the first quarter of 2011. The ratio of average interest-bearing deposits to total average deposits was 59.4% in 2012 compared to 62.3% in 2011 and 64.2% in 2010. The average cost of interest-bearing deposits and total deposits was 0.18% and 0.10% during 2012 compared to 0.23% and 0.15% during 2011 and 0.33% and 0.21% during 2010. 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 time accounts to total average interest-bearing deposits decreased from 13.9% in 2010 to 11.9% in 2011 and 10.0% in 2012. 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.

Table of Contents

The following table presents the proportion of each component of average non-interest-bearing deposits to the total of such deposits during the years presented:

	2012	2011	2010
Commercial and individual	89.7%	88.8%	90.5%
Correspondent banks	4.7	5.6	6.2
Public funds	5.6	5.6	3.3
Total	100.0%	100.0%	100.0%

Average non-interest-bearing deposits increased \$1.3 billion, or 22.4% in 2012 compared to 2011 while average non-interest-bearing deposits increased \$715.2 million, or 14.2% in 2011 compared to 2010. The increase in 2012 compared to 2011 was primarily due to a \$1.2 billion, or 23.7%, increase in average commercial and individual deposits. The increase in 2011 compared to 2010 was primarily due to a \$547.9 million, or 12.1%, increase in average commercial and individual deposits.

The following table presents the proportion of each component of average interest-bearing deposits to the total of such deposits during the years presented:

	2012	2011	2010
Private accounts:			
Savings and interest checking	29.4%	26.8%	25.3%
Money market accounts	56.8	57.0	56.2
Time accounts of \$100,000 or more	5.2	6.2	7.0
Time accounts under \$100,000	4.8	5.7	6.8
Public funds	3.8	4.3	4.7
Total	100.0%	100.0%	100.0%

Total average interest-bearing deposits increased \$786.5 million, or 8.3%, in 2012 compared to 2011 and increased \$459.8 million, or 5.1%, in 2011 compared to 2010. The relative proportion of time accounts to total average interest-bearing deposits decreased from 13.8% in 2010 to 11.9% in 2011 and 10.0% in 2012, in favor of savings and interest checking accounts. The shift in relative proportions toward savings and interest checking accounts appears to be related to the lower interest rate environment experienced over the last four years as many customers appear to have become less inclined to invest their funds for extended periods.

Some of the Corporation's interest-bearing deposits were obtained through brokered transactions and the Corporation's participation in the Certificate of Deposit Account Registry Service (CDARS). Average brokered money market deposits totaled \$1.2 million in 2012 compared to \$27.4 million in 2011 and \$222.6 million in 2010. The decrease in average brokered money market deposits in 2011 was a result of a decrease in the contracted amount during the fourth quarter of 2010. Average CDARS deposits totaled \$19.4 million in 2012 compared to \$52.8 million in 2011 and \$81.7 million in 2010.

Table of Contents

Geographic Concentrations. The following table summarizes the Corporation's average total deposit portfolio, as segregated by the geographic region from which the deposit accounts were originated. Certain accounts, such as correspondent bank deposits, are recorded at the statewide level. Geographic concentrations are stated as a percentage of average total deposits during the years presented.

	2012	2011	2010
San Antonio	31.5%	31.3%	32.1%
Fort Worth	19.0	18.7	18.6
Houston	18.7	18.0	16.6
Austin	11.4	10.5	10.1
Dallas	7.0	6.9	5.8
Corpus Christi	6.2	6.3	6.3
Rio Grande Valley	3.2	3.4	3.6
Statewide	3.0	4.9	6.9
Total	100.0%	100.0%	100.0%

The Corporation experienced deposit growth in all regions, except for the Statewide region, during 2012 compared to 2011. The San Antonio region had the largest dollar volume increase during 2012, increasing \$682.1 million, or 14.3%. The Austin region had the largest percentage increase, increasing \$369.9 million, or 23.1%. Average deposits for the Houston region increased \$491.8 million, or 17.9%, while average deposits for the Fort Worth and Dallas regions increased \$434.7 million, or 15.3%, and \$150.2 million, or 14.2%, respectively. Average deposits for the Corpus Christi and Rio Grande Valley regions increased \$109.9 million, or 11.5%, and \$51.3 million, or 10.0%. The Statewide region decreased \$220.4 million, or 29.6%, primarily due to a decrease in correspondent banking balances as well as a decrease in brokered money market accounts within the Corporation's capital markets division.

The Corporation experienced deposit growth in all regions, except for the Statewide region, during 2011 compared to 2010. The Houston region had the largest dollar volume increase during 2011, increasing \$408.7 million, or 17.5%. The Dallas region had the largest percentage increase, increasing \$244.6 million, or 30.1%. Average deposits for the San Antonio region increased \$246.1 million, or 5.5%, while average deposits for the Fort Worth and Austin regions increased \$240.6 million, or 9.2%, and \$181.9 million, or 12.8%, respectively. Average deposits for the Corpus Christi and Rio Grande Valley regions increased \$71.4 million, or 8.1%, and \$11.5 million, or 2.3%. The Statewide region decreased \$229.8 million, or 23.6%, primarily due to a decrease in brokered money market accounts within the Corporation's capital markets division.

Foreign Deposits. Mexico has historically been considered a part of the natural trade territory of the Corporation's banking offices. Accordingly, U.S. dollar-denominated foreign deposits from sources within Mexico have traditionally been a significant source of funding. Average deposits from foreign sources, primarily Mexico, totaled \$789.5 million in 2012, \$745.4 million in 2011 and \$782.7 million in 2010.

Table of Contents**Short-Term Borrowings**

The Corporation's primary source of short-term borrowings is federal funds purchased from correspondent banks and repurchase agreements in the natural trade territory of the Corporation, as well as from upstream banks. Federal funds purchased and repurchase agreements totaled \$561.1 million, \$722.2 million and \$475.7 million at December 31, 2012, 2011 and 2010. The maximum amount of these borrowings outstanding at any month-end was \$659.8 million in 2012, \$722.2 million in 2011 and \$532.8 million in 2010. The weighted-average interest rate on federal funds purchased and repurchase agreements was 0.01% at December 31, 2012, 2011 and 2010.

The following table presents the Corporation's average net funding position during the years indicated:

	2012		2011		2010	
	Average Balance	Average Rate	Average Balance	Average Rate	Average Balance	Average Rate
Federal funds sold and resell agreements	\$ 25,364	0.41%	\$ 14,509	0.42%	\$ 20,646	0.36%
Federal funds purchased and repurchase agreements	(603,934)	0.02	(596,159)	0.05	(472,492)	0.09
Net funds position	\$ (578,570)		\$ (581,650)		\$ (451,846)	

The net funds purchased position did not significantly fluctuate in 2012 compared to 2011. The net funds purchased position increased in 2011 compared to 2010 primarily due to a \$137.2 million increase in average repurchase agreements. Average interest-bearing deposits totaled \$1.6 billion in 2012 compared to \$2.5 billion in 2011 and \$2.0 billion in 2010. During the reported periods, the Corporation has maintained excess liquid funds in interest-bearing deposits with the Federal Reserve rather than federal funds sold in order to capitalize on higher available yields.

Off Balance Sheet Arrangements, Commitments, Guarantees, and Contractual Obligations

The following table summarizes the Corporation's contractual obligations and other commitments to make future payments as of December 31, 2012. Payments for borrowings do not include interest. Payments related to leases are based on actual payments specified in the underlying contracts. Loan commitments and standby letters of credit are presented at contractual amounts; however, since many of these commitments are expected to expire unused or only partially used, the total amounts of these commitments do not necessarily reflect future cash requirements.

	Payments Due by Period				
	1 Year or Less	More than 1 Year but Less than 3 Years	3 Years or More but Less than 5 Years	5 Years or More	Total
Contractual obligations:					
Subordinated notes payable	\$ -	\$ -	\$ 100,000	\$ -	\$ 100,000
Junior subordinated deferrable interest debentures	-	-	-	123,712	123,712
Federal Home Loan Bank advances	7	-	-	-	7
Operating leases	18,298	31,581	25,706	59,873	135,458
Deposits with stated maturity dates	957,190	165,280	-	-	1,122,470
	975,495	196,861	125,706	183,585	1,481,647
Other commitments:					
Commitments to extend credit	74,246	3,764,315	1,257,812	614,075	5,710,448

Edgar Filing: CULLEN/FROST BANKERS, INC. - Form 10-K

Standby letters of credit	5,799	167,724	12,038	488	186,049
	80,045	3,932,039	1,269,850	614,563	5,896,497
Total contractual obligations and other commitments	\$ 1,055,540	\$ 4,128,900	\$ 1,395,556	\$ 798,148	\$ 7,378,144

Table of Contents

Financial Instruments with Off-Balance-Sheet Risk. In the normal course of business, the Corporation enters into various transactions, which, in accordance with accounting principles generally accepted in the United States, 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 also holds certain assets which are not included in its consolidated balance sheets including assets held in fiduciary or custodial capacity on behalf of its trust customers and certain collateral funds resulting from acting as an agent in its securities lending program.

Commitments to Extend Credit. 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. Commitments to extend credit outstanding at December 31, 2012 are included in the table above.

Standby Letters of Credit. 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 is 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. Standby letters of credit outstanding at December 31, 2012 are included in the table above.

Trust Accounts. The Corporation also holds certain assets in fiduciary or custodial capacity on behalf of its trust customers. The estimated fair value of trust assets was approximately \$26.2 billion (including managed assets of \$10.9 billion and custody assets of \$15.3 billion) at December 31, 2012. These assets were primarily composed of fixed income securities (42.1% of trust assets), equity securities (42.1% of trust assets) and cash equivalents (10.2% of trust assets).

Securities Lending. The Corporation lends certain customer securities to creditworthy brokers on behalf of those customers. If the borrower fails to return these securities, the Corporation indemnifies its customers based on the then current net realizable fair value of the securities. The Corporation holds collateral received in securities lending transactions as an agent. Accordingly, such collateral assets are not assets of the Corporation. The Corporation requires borrowers to provide collateral equal to or in excess of 100% of the fair value of the securities borrowed. The collateral is valued daily and additional collateral is requested as necessary. The maximum future payments guaranteed by the Corporation under these contractual agreements (representing the fair value of securities lent to brokers) totaled \$1.8 billion at December 31, 2012. At December 31, 2012, the Corporation held in trust liquid assets with a fair value of \$1.8 billion as collateral for these agreements.

Capital and Liquidity

Capital. At December 31, 2012, shareholders' equity totaled \$2.4 billion compared to \$2.3 billion at December 31, 2011. In addition to net income of \$238.0 million, other significant changes in shareholders' equity during 2012 included \$116.9 million of dividends paid, \$12.8 million related to stock-based compensation, \$10.5 million in proceeds from stock option exercises and the related tax deficiency of \$384 thousand and other comprehensive loss, net of tax, of \$9.7 million.

The accumulated other comprehensive income/loss component of shareholders' equity totaled a net, after-tax, unrealized gain of \$238.0 million at December 31, 2012 compared to a net, after-tax, unrealized gain of

Table of Contents

\$247.7 million at December 31, 2011. The decrease was primarily due to a \$22.1 million net after-tax decrease in the accumulated net gain on effective cash flow hedges and a \$6.1 million net after-tax increase in the net actuarial loss of the Corporation's defined benefit post-retirement benefit plans partly offset by a \$18.5 million net after-tax increase in the net unrealized gain on securities available for sale. Under current regulatory requirements, amounts reported as accumulated other comprehensive income/loss related to securities available for sale, 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 10 - Regulatory Matters in the accompanying notes to consolidated financial statements included elsewhere in this report.

The Corporation paid quarterly dividends of \$0.46, \$0.48, \$0.48 and \$0.48 per common share during the first, second, third and fourth quarters of 2012, respectively, and quarterly dividends of \$0.45, \$0.46, \$0.46 and \$0.46 per common share during the first, second, third and fourth quarters of 2011. This equates to a dividend payout ratio of 49.1% in 2012 and 51.6% in 2011.

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. No shares were repurchased under stock repurchase plans during 2012, 2011 or 2010. See Part II, Item 5 - Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities, included elsewhere in this report.

In June 2012, the Corporation's primary federal regulator, the Federal Reserve, published two notices of proposed rulemaking (the 2012 Capital Proposals) that would 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, which are based on the aforementioned Basel I capital accords of the Basel Committee. See the section captioned "Supervision and Regulation" included in Item 1. Business, elsewhere in this report for additional information about the 2012 Capital Proposals.

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.

Table of Contents

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 December 31, 2012, 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 - Regulatory Matters in the accompanying notes to consolidated financial statements included elsewhere in this report regarding such dividends. At December 31, 2012, Cullen/Frost had liquid assets, including cash and resell agreements, totaling \$231.1 million, which included \$3.4 million in cash collateral on deposit with other financial institution counterparties to interest rate swap transactions.

Impact of Inflation and Changing Prices

The Corporation's financial statements included herein have been prepared in accordance with accounting principles generally accepted in the United States (GAAP). GAAP presently requires the Corporation to measure financial position and operating results primarily in terms of historic dollars. Changes in the relative value of money due to inflation or recession are generally not considered. The primary effect of inflation on the operations of the Corporation is reflected in increased operating costs. In management's opinion, changes in interest rates affect the financial condition of a financial institution to a far greater degree than changes in the inflation rate. While interest rates are greatly influenced by changes in the inflation rate, they do not necessarily change at the same rate or in the same magnitude as the inflation rate. Interest rates are highly sensitive to many factors that are beyond the control of the Corporation, including changes in the expected rate of inflation, the influence of general and local economic conditions and the monetary and fiscal policies of the United States government, its agencies and various other governmental regulatory authorities, among other things, as further discussed in the next section.

Regulatory and Economic Policies

The Corporation's business and earnings are affected by general and local economic conditions and by the monetary and fiscal policies of the United States government, its agencies and various other governmental regulatory authorities, among other things. The Federal Reserve Board regulates the supply of money in order to influence general economic conditions. Among the instruments of monetary policy historically available to the Federal Reserve Board are (i) conducting open market operations in United States government obligations, (ii) changing the discount rate on financial institution borrowings, (iii) imposing or changing reserve requirements against financial institution deposits, and (iv) restricting certain borrowings and imposing or changing reserve requirements against certain borrowings by financial institutions and their affiliates. In addition, the Federal Reserve Board has taken a variety of extraordinary actions during the current economic climate that have had a material expansionary effect on the money supply. These methods are used in varying degrees and combinations to affect directly the availability of bank loans and deposits, as well as the interest rates charged on loans and paid on deposits. For that reason alone, the policies of the Federal Reserve Board have a material effect on the earnings of the Corporation.

Table of Contents

Governmental policies have had a significant effect on the operating results of commercial banks in the past and are expected to continue to do so in the future; however, the Corporation cannot accurately predict the nature, timing or extent of any effect such policies may have on its future business and earnings.

Accounting Standards Updates

See Note 19 - 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.

Table of Contents**ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

The disclosures set forth in this item are qualified by Item 1A. Risk Factors and the section captioned Forward-Looking Statements and Factors that Could Affect Future Results included in Item 7. 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.

Market risk refers to the risk of loss arising from adverse changes in interest rates, foreign currency exchange rates, commodity prices, and other relevant market rates and prices, such as equity prices. The risk of loss can be assessed from the perspective of adverse changes in fair values, cash flows, and future earnings. Due to the nature of its operations, the Corporation is primarily exposed to interest rate risk and, to a lesser extent, liquidity risk.

Interest rate risk on the Corporation's balance sheets consists of repricing, option, and basis risks. Repricing risk results from differences in the maturity, or repricing, of asset and liability portfolios. Option risk arises from embedded options present in many financial instruments such as loan prepayment options, deposit early withdrawal options and interest rate options. These options allow customers opportunities to benefit when market interest rates change, which typically results in higher costs or lower revenue for the Corporation. Basis risk refers to the potential for changes in the underlying relationship between market rates and indices, which subsequently result in a narrowing of the profit spread on an earning asset or liability. Basis risk is also present in administered rate liabilities, such as savings accounts, negotiable order of withdrawal accounts, and money market accounts where historical pricing relationships to market rates may change due to the level or directional change in market interest rates.

The Corporation seeks to avoid fluctuations in its net interest margin and to maximize net interest income within acceptable levels of risk through periods of changing interest rates. Accordingly, the Corporation's interest rate sensitivity and liquidity are monitored on an ongoing basis by its Asset and Liability Committee (ALCO), which oversees market risk management and establishes risk measures, limits and policy guidelines for managing the amount of interest rate risk and its effect on net interest income and capital. A variety of measures are used to provide for a comprehensive view of the magnitude of interest rate risk, the distribution of risk, the level of risk over time and the exposure to changes in certain interest rate relationships.

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.

ALCO continuously monitors and manages the balance between interest rate-sensitive assets and liabilities. The objective is to manage the impact of fluctuating market rates on net interest income within acceptable levels. In order to meet this objective, management may lengthen or shorten the duration of assets or liabilities or enter into derivative contracts to mitigate potential market risk.

For modeling purposes, as of December 31, 2012, the model simulations projected that a 100 basis point increase in interest rates would result in a negative variance in net interest income of 0.3% and a 200 basis point increase in interest rates would result in a positive variance in net interest income of 0.2%, 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 1.6% relative to the base case over the next 12 months. The December 31, 2012 model simulations were impacted by the assumption, for modeling purposes, that the Corporation will begin to

Table of Contents

pay interest on demand deposits in the first quarter of 2013, as further discussed below. As of December 31, 2011, the model simulations projected that 100 and 200 basis point increases in interest rates would result in negative variances in net interest income of 1.7% and 2.2%, 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 1.6% relative to the base case over the next 12 months. The December 31, 2011 model simulations were impacted by the assumption, for modeling purposes, that the Corporation would begin to pay interest on demand deposits in the first quarter of 2012, as further discussed below. The likelihood of a decrease in interest rates beyond 25 basis points as of December 31, 2012 and 2011 was considered to be remote given prevailing interest rate levels.

The Corporation has experienced significant growth in deposits in 2012 compared to 2011 which funded a significant increase in fixed-rate securities. In 2011, this increase in 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 recent legislation, as further discussed below, resulted in the 2011 model simulations indicating that the Corporation's balance sheet would become more liability sensitive. In 2012, the Corporation restructured its securities portfolio which resulted in the model simulations indicating that the Corporation's balance sheet will become less sensitive to increases in interest rates relative to the base over the next 12 months.

As mentioned above, 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 first 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 less liability sensitive than the model simulations currently indicate.

As of December 31, 2012, 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.

Table of Contents

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

Report of Ernst & Young LLP

Independent Registered Public Accounting Firm

The Board of Directors and Shareholders

of Cullen/Frost Bankers, Inc.

We have audited the accompanying consolidated balance sheets of Cullen/Frost Bankers, Inc. (the Corporation) as of December 31, 2012 and 2011, and the related consolidated statements of income and comprehensive income, changes in shareholders' equity, and cash flows for each of the three years in the period ended December 31, 2012. These financial statements are the responsibility of the Corporation's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Cullen/Frost Bankers, Inc. at December 31, 2012 and 2011, and the consolidated results of their operations and their cash flows for each of the three years in the period ended December 31, 2012, in conformity with U.S. generally accepted accounting principles.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), Cullen/Frost Bankers, Inc.'s internal control over financial reporting as of December 31, 2012, based on criteria established in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission, and our report dated February 8, 2013 expressed an unqualified opinion thereon.

San Antonio, Texas

February 8, 2013

Table of Contents**Cullen/Frost Bankers, Inc.****Consolidated Balance Sheets**

(Dollars in thousands, except per share amounts)

	December 31,	
	2012	2011
Assets:		
Cash and due from banks	\$ 790,106	\$ 574,039
Interest-bearing deposits	2,650,425	2,314,251
Federal funds sold and resell agreements	84,448	19,302
Total cash and cash equivalents	3,524,979	2,907,592
Securities held to maturity, at amortized cost	2,956,381	365,996
Securities available for sale, at estimated fair value	6,203,299	7,789,700
Trading account securities	30,074	13,609
Loans, net of unearned discounts	9,223,848	7,995,129
Less: Allowance for loan losses	(104,453)	(110,147)
Net loans	9,119,395	7,884,982
Premises and equipment, net	315,934	319,042
Goodwill	535,509	528,072
Other intangible assets, net	8,147	10,604
Cash surrender value of life insurance policies	138,005	133,967
Accrued interest receivable and other assets	292,346	363,681
Total assets	\$ 23,124,069	\$ 20,317,245
Liabilities:		
Deposits:		
Non-interest-bearing demand deposits	\$ 8,096,937	\$ 6,672,555
Interest-bearing deposits	11,400,429	10,084,193
Total deposits	19,497,366	16,756,748
Federal funds purchased and repurchase agreements	561,061	722,202
Junior subordinated deferrable interest debentures	123,712	123,712
Other long-term borrowings	100,007	100,026
Accrued interest payable and other liabilities	424,441	331,020
Total liabilities	20,706,587	18,033,708
Shareholders Equity:		
Preferred stock, par value \$0.01 per share; 10,000,000 shares authorized; none issued	-	-
Common stock, par value \$0.01 per share; 210,000,000 shares authorized; 61,479,189 shares issued in 2012 and 61,271,603 shares issued in 2011	615	613
Additional paid-in capital	702,968	680,803
Retained earnings	1,475,851	1,354,759
Accumulated other comprehensive income, net of tax	238,048	247,734
Treasury stock, 7,640 shares in 2011, at cost	-	(372)

Edgar Filing: CULLEN/FROST BANKERS, INC. - Form 10-K

Total shareholders' equity	2,417,482	2,283,537
Total liabilities and shareholders' equity	\$ 23,124,069	\$ 20,317,245

See accompanying Notes to Consolidated Financial Statements.

Table of Contents**Cullen/Frost Bankers, Inc.****Consolidated Statements of Income**

(Dollars in thousands, except per share amounts)

	Year Ended December 31,		
	2012	2011	2010
Interest income:			
Loans, including fees	\$ 401,364	\$ 397,855	\$ 409,651
Securities:			
Taxable	132,432	127,072	121,402
Tax-exempt	93,412	91,672	81,311
Interest-bearing deposits	4,300	6,357	4,901
Federal funds sold and resell agreements	104	61	74
Total interest income	631,612	623,017	617,339
Interest expense:			
Deposits	18,099	22,179	29,973
Federal funds purchased and repurchase agreements	140	312	437
Junior subordinated deferrable interest debentures	6,806	6,783	6,982
Other long-term borrowings	1,706	11,967	16,488
Total interest expense	26,751	41,241	53,880
Net interest income	604,861	581,776	563,459
Provision for loan losses	10,080	27,445	43,611
Net interest income after provision for loan losses	594,781	554,331	519,848
Non-interest income:			
Trust and investment management fees	83,317	78,297	72,321
Service charges on deposit accounts	83,392	86,125	91,025
Insurance commissions and fees	39,948	35,421	34,015
Interchange and debit card transaction fees	16,933	29,625	30,542
Other charges, commissions and fees	30,180	27,750	25,380
Net gain (loss) on securities transactions	4,314	6,414	6
Other	30,703	26,370	28,744
Total non-interest income	288,787	290,002	282,033
Non-interest expense:			
Salaries and wages	258,752	252,028	239,589
Employee benefits	57,635	52,939	52,352
Net occupancy	48,975	46,968	46,166
Furniture and equipment	55,279	51,469	47,651
Deposit insurance	11,087	12,714	20,451
Intangible amortization	3,896	4,387	5,125
Other	139,469	137,593	124,207
Total non-interest expense	575,093	558,098	535,541

Income before income taxes	308,475	286,235	266,340
Income taxes	70,523	68,700	57,576
Net income	\$ 237,952	\$ 217,535	\$ 208,764
Earnings per common share:			
Basic	\$ 3.87	\$ 3.55	\$ 3.44
Diluted	3.86	3.54	3.44

See accompanying Notes to Consolidated Financial Statements.

Table of Contents**Cullen/Frost Bankers, Inc.****Consolidated Statements of Comprehensive Income**

(Dollars in thousands)

	Year Ended December 31,		
	2012	2011	2010
Net income	\$ 237,952	\$ 217,535	\$ 208,764
Other comprehensive income (loss), before tax:			
Securities available for sale:			
Change in net unrealized gain/loss during the period	32,755	208,015	(21,568)
Reclassification adjustment for net (gains) losses included in net income	(4,314)	(6,414)	(6)
Total securities available for sale	28,441	201,601	(21,574)
Defined-benefit post-retirement benefit plans:			
Change in the net actuarial gain/loss	(9,405)	(22,463)	(887)
Derivatives:			
Change in the accumulated gain/loss on effective cash flow hedge derivatives	(783)	(2,321)	61,553
Reclassification adjustments for (gains) losses included in net income:			
Interest rate swaps on variable-rate loans	(37,380)	(37,380)	(43,389)
Interest rate swap on junior subordinated deferrable interest debentures	4,224	4,386	4,367
Total derivatives	(33,939)	(35,315)	22,531
Other comprehensive income (loss), before tax	(14,903)	143,823	70
Deferred tax expense (benefit) related to other comprehensive income	(5,217)	50,339	25
Other comprehensive income (loss), net of tax	(9,686)	93,484	45
Comprehensive income	\$ 228,266	\$ 311,019	\$ 208,809

See Notes to Consolidated Financial Statements.

Table of Contents**Cullen/Frost Bankers, Inc.****Consolidated Statement of Changes in Shareholders' Equity**

(Dollars in thousands, except per share amounts)

	Common Stock	Additional Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss), Net of Tax	Treasury Stock	Total
Balance at January 1, 2010	\$ 602	\$ 600,355	\$ 1,150,103	\$ 154,205	\$ (10,841)	\$ 1,894,424
Net income	-	-	208,764	-	-	208,764
Other comprehensive income, net of tax	-	-	-	45	-	45
Stock option exercises/deferred stock unit conversions (820,853 shares)	7	31,191	(1,225)	-	8,834	38,807
Tax benefits from stock-based compensation	-	419	-	-	-	419
Stock-based compensation expense recognized in earnings	-	14,925	-	-	-	14,925
Non-vested stock awards (22,360 shares)	-	(793)	-	-	793	-
Purchase of treasury stock (18,424 shares)	-	-	-	-	(986)	(986)
Treasury stock issued/sold to the 401(k) stock purchase plan (40,019 shares)	-	-	(131)	-	2,200	2,069
Common stock issued/sold to the 401(k) stock purchase plan (205,100 shares)	2	11,238	-	-	-	11,240
Cash dividends (\$1.78 per share)	-	-	(108,027)	-	-	(108,027)
Balance at December 31, 2010	611	657,335	1,249,484	154,250	-	2,061,680
Net income	-	-	217,535	-	-	217,535
Other comprehensive income, net of tax	-	-	-	93,484	-	93,484
Stock option exercises/deferred stock unit conversions (148,203 shares)	1	7,065	(50)	-	422	7,438
Tax benefits from stock-based compensation	-	316	-	-	-	316
Stock-based compensation expense recognized in earnings	-	15,963	-	-	-	15,963
Non-vested stock awards (22,360 shares)	-	(1,235)	-	-	1,235	-
Purchase of treasury stock (37,464 shares)	-	-	-	-	(2,029)	(2,029)
Common stock issued/sold to the 401(k) stock purchase plan (22,680 shares)	1	1,359	-	-	-	1,360
Cash dividends (\$1.83 per share)	-	-	(112,210)	-	-	(112,210)
Balance at December 31, 2011	613	680,803	1,354,759	247,734	(372)	2,283,537
Net income	-	-	237,952	-	-	237,952
Other comprehensive loss, net of tax	-	-	-	(9,686)	-	(9,686)
Stock option exercises/deferred stock unit conversions (206,336 shares)	2	10,100	(6)	-	420	10,516
Tax benefits from stock-based compensation	-	(384)	-	-	-	(384)
Stock-based compensation expense recognized in earnings	-	12,836	-	-	-	12,836

Edgar Filing: CULLEN/FROST BANKERS, INC. - Form 10-K

Non-vested stock awards (16,850 shares)	-	(387)	(1)	-	388	-
Purchase of treasury stock (7,960 shares)	-	-	-	-	(436)	(436)
Cash dividends (\$1.90 per share)	-	-	(116,853)	-	-	(116,853)
Balance at December 31, 2012	\$ 615	\$ 702,968	\$ 1,475,851	\$ 238,048	\$ -	\$ 2,417,482

See accompanying Notes to Consolidated Financial Statements

Table of Contents**Cullen/Frost Bankers, Inc.****Consolidated Statements of Cash Flows**

(Dollars in thousands)

	Year Ended December 31,		
	2012	2011	2010
Operating Activities:			
Net income	\$ 237,952	\$ 217,535	\$ 208,764
Adjustments to reconcile net income to net cash from operating activities:			
Provision for loan losses	10,080	27,445	43,611
Deferred tax expense (benefit)	(6,405)	8,167	4,644
Accretion of loan discounts	(10,888)	(12,974)	(11,336)
Securities premium amortization (discount accretion), net	21,701	11,441	8,065
Net (gain) loss on securities transactions	(4,314)	(6,414)	(6)
Depreciation and amortization	37,776	37,628	37,588
Net (gain) loss on sale of loans held for sale and other assets	4,603	4,677	5,929
Stock-based compensation	12,836	15,963	14,925
Net tax benefit (deficiency) from stock-based compensation	(555)	(106)	(264)
Excess tax benefits from stock-based compensation	(171)	(422)	(683)
Earnings on life insurance policies	(4,038)	(4,045)	(4,517)
Net change in:			
Trading account securities	(16,465)	1,492	1,025
Student loans held for sale	-	-	24,029
Accrued interest receivable and other assets	48,176	(15,502)	69,830
Accrued interest payable and other liabilities	(30,289)	(10,516)	22,929
Net cash from operating activities	299,999	274,369	424,533
Investing Activities:			
Securities held to maturity:			
Purchases	(237,503)	(83,184)	(277,998)
Maturities, calls and principal repayments	2,100	665	708
Securities available for sale:			
Purchases	(18,328,058)	(8,752,573)	(11,194,766)
Sales	16,587,482	5,587,391	9,997,994
Maturities, calls and principal repayments	1,073,122	729,678	893,702
Net change in loans	(1,241,422)	70,200	176,599
Net cash paid in acquisitions	(7,199)	(650)	-
Proceeds from sales of premises and equipment	5,085	1,339	1,063
Purchases of premises and equipment	(24,891)	(26,719)	(16,826)
Proceeds from sales of repossessed properties	15,816	18,562	19,705
Net cash from investing activities	(2,155,468)	(2,455,291)	(399,819)
Financing Activities:			
Net change in deposits	2,740,618	2,277,406	1,166,032
Net change in short-term borrowings	(161,141)	246,529	(6,375)
Principal payments on long-term borrowings	(19)	(150,019)	(18,889)
Proceeds from stock option exercises	10,516	7,438	38,807
Excess tax benefits from stock-based compensation	171	422	683

Edgar Filing: CULLEN/FROST BANKERS, INC. - Form 10-K

Purchase of treasury stock	(436)	(2,029)	(986)
Common stock/treasury stock sold to the 401(k) stock purchase plan	-	-	3,539
Cash dividends paid	(116,853)	(112,210)	(108,027)
Net cash from financing activities	2,472,856	2,267,537	1,074,784
Net change in cash and cash equivalents	617,387	86,615	1,099,498
Cash and cash equivalents at beginning of year	2,907,592	2,820,977	1,721,479
Cash and cash equivalents at end of year	\$ 3,524,979	\$ 2,907,592	\$ 2,820,977

See accompanying Notes to Consolidated Financial Statements

Table of Contents

Cullen/Frost Bankers, Inc.

Notes To Consolidated Financial Statements

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

Note 1 - Summary of 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 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 Corporation determines whether it has a controlling financial interest in an entity by first evaluating whether the entity is a voting interest entity or a variable interest entity (VIE) under accounting principles generally accepted in the United States. Voting interest entities are entities in which the total equity investment at risk is sufficient to enable the entity to finance itself independently and provides the equity holders with the obligation to absorb losses, the right to receive residual returns and the right to make decisions about the entity's activities. The Corporation consolidates voting interest entities in which it has all, or at least a majority of, the voting interest. As defined in applicable accounting standards, VIEs are entities that lack one or more of the characteristics of a voting interest entity. A controlling financial interest in a VIE is present when an enterprise has both the power to direct the activities of the VIE that most significantly impact the VIE's economic performance and an obligation to absorb losses or the right to receive benefits that could potentially be significant to the VIE. The enterprise with a controlling financial interest, known as the primary beneficiary, consolidates the VIE. The Corporation's wholly owned subsidiary Cullen/Frost Capital Trust II is a VIE for which the Corporation is not the primary beneficiary. Accordingly, its accounts are not included in the Corporation's consolidated financial statements.

The Corporation has evaluated subsequent events for potential recognition and/or disclosure through the date these consolidated financial statements were issued. All acquisitions during the reported periods were accounted for using the purchase method. Accordingly, the operating results of the acquired companies are included with the Corporation's results of operations since their respective dates of acquisition.

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.

Table of Contents

Cash Flow Reporting. Cash and cash equivalents include cash, deposits with other financial institutions that have an initial maturity of less than 90 days when acquired by the Corporation, federal funds sold and resell agreements. Net cash flows are reported for loans, deposit transactions and short-term borrowings. Additional cash flow information was as follows:

	Year Ended December 31,		
	2012	2011	2010
Cash paid for interest	\$ 29,378	\$ 46,801	\$ 56,924
Cash paid for income tax	58,950	54,437	62,830
Significant non-cash transactions:			
Transfer of securities from available for sale to held to maturity	2,266,195	-	-
Unsettled purchases of securities	90,073	-	-
Loans foreclosed and transferred to other real estate owned and foreclosed assets	7,817	21,126	19,518
Loans to facilitate the sale of other real estate owned	-	75	480
Common stock/treasury stock issued to the Corporation's 401(k) stock purchase plan	-	1,360	9,770

Concentrations and Restrictions on Cash and Cash Equivalents. The Corporation maintains deposits with other financial institutions in amounts that exceed federal deposit insurance coverage. Furthermore, federal funds sold are essentially uncollateralized loans to other financial institutions. Management regularly evaluates the credit risk associated with the counterparties to these transactions and believes that the Corporation is not exposed to any significant credit risks on cash and cash equivalents.

The Corporation was required to have \$108.9 million and \$112.0 million of cash on hand or on deposit with the Federal Reserve Bank to meet regulatory reserve and clearing requirements at December 31, 2012 and 2011. These deposits with the Federal Reserve Bank do not earn interest. Additionally, as of December 31, 2012 and 2011, the Corporation had \$3.4 million and \$6.9 million in cash collateral on deposit with other financial institution counterparties to interest rate swap transactions.

Repurchase/Resell Agreements. The Corporation purchases certain securities under agreements to resell. The amounts advanced under these agreements represent short-term loans and are reflected as assets in the accompanying consolidated balance sheets. The securities underlying these agreements are book-entry securities. The Corporation also sells certain securities under agreements to repurchase. The agreements are treated as collateralized financing transactions and the obligations to repurchase securities sold are reflected as a liability in the accompanying consolidated balance sheets. The dollar amount of the securities underlying the agreements remain in the asset accounts.

Securities. Securities are classified as held to maturity and carried at amortized cost when management has the positive intent and ability to hold them until maturity. Securities to be held for indefinite periods of time are classified as available for sale and carried at fair value, with the unrealized holding gains and losses reported as a component of other comprehensive income, net of tax. Securities held for resale in anticipation of short-term market movements are classified as trading and are carried at fair value, with changes in unrealized holding gains and losses included in income. Management determines the appropriate classification of securities at the time of purchase. Securities with limited marketability, such as stock in the Federal Reserve Bank and the Federal Home Loan Bank, are carried at cost.

Interest income includes amortization of purchase premiums and discounts. Realized gains and losses are derived from the amortized cost of the security sold. 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. In estimating other-than-temporary impairment losses, management considers, among other

Table of Contents

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 fair value.

Loans. Loans are reported at the principal balance outstanding net of unearned discounts. Interest income on loans is reported on the level-yield method and includes amortization of deferred loan fees and costs over the loan term. Net loan commitment fees or costs for commitment periods greater than one year are deferred and amortized into fee income or other expense on a straight-line basis over the commitment period. Income on direct financing leases is recognized on a basis that achieves a constant periodic rate of return on the outstanding investment. Further information regarding the Corporation's accounting policies related to past due loans, non-accrual loans, impaired loans and troubled-debt restructurings is presented in Note 3 - Loans.

Loans Acquired Through Transfer. Loans acquired through the completion of a transfer, including loans acquired in a business combination, that have evidence of deterioration of credit quality since origination and for which it is probable, at acquisition, that the Corporation will be unable to collect all contractually required payments receivable are initially recorded at fair value (as determined by the present value of expected future cash flows) with no valuation allowance. The difference between the undiscounted cash flows expected at acquisition and the investment in the loan, or the accretible yield, is recognized as interest income on a level-yield method over the life of the loan. Contractually required payments for interest and principal that exceed the undiscounted cash flows expected at acquisition, or the nonaccretible difference, are not recognized as a yield adjustment or as a loss accrual or a valuation allowance. Increases in expected cash flows subsequent to the initial investment are recognized prospectively through adjustment of the yield on the loan over its remaining life. Decreases in expected cash flows are recognized as impairment. Valuation allowances on these impaired loans reflect only losses incurred after the acquisition (meaning the present value of all cash flows expected at acquisition that ultimately are not to be received).

Loans Held for Sale. Prior to the second quarter of 2008, the Corporation originated student loans primarily for sale in the secondary market. These loans were generally sold on a non-recourse basis and were carried at the lower of cost or market on an aggregate basis. Gains or losses recognized upon the sale of loans were determined on a specific identification basis. During the second quarter of 2008, the Corporation elected to discontinue the origination of student loans for resale, aside from previously outstanding commitments. All remaining student loans were sold during the second quarter of 2010.

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 inherent in the loan portfolio. The allowance for loan losses includes allowance allocations calculated in accordance with Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) Topic 310, Receivables and allowance allocations calculated in accordance with ASC Topic 450, Contingencies. Further information regarding the Corporation's policies and methodology used to estimate the allowance for loan losses is presented in Note 3 - Loans.

Premises and Equipment. Land is carried at cost. Building and improvements, and furniture and equipment are carried at cost, less accumulated depreciation, computed principally by the straight-line method based on the estimated useful lives of the related property. Leasehold improvements are generally depreciated over the lesser of the term of the respective leases or the estimated useful lives of the improvements.

Foreclosed Assets. Assets acquired through or instead of loan foreclosure are held for sale and are initially recorded at fair value less estimated selling costs when acquired, establishing a new cost basis. Costs after acquisition are generally expensed. If the fair value of the asset declines, a write-down is recorded through expense. The valuation of foreclosed assets is subjective in nature and may be adjusted in the future because of changes in economic conditions. Foreclosed assets are included in other assets in the accompanying consolidated balance sheets and totaled \$15.5 million and \$26.6 million at December 31, 2012 and 2011.

Table of Contents

Goodwill. Goodwill represents the excess of the cost of businesses acquired over the fair value of the net assets acquired. Goodwill is assigned to reporting units and tested for impairment at least annually, or on an interim basis if an event occurs or circumstances change that would more likely than not reduce the fair value of the reporting unit below its carrying value. See Note 5 - Goodwill and Other Intangible Assets.

Intangibles and Other Long-Lived Assets. Intangible assets are acquired assets that lack physical substance but can be distinguished from goodwill because of contractual or other legal rights or because the asset is capable of being sold or exchanged either on its own or in combination with a related contract, asset, or liability. The Corporation's intangible assets relate to core deposits, non-compete agreements and customer relationships. Intangible assets with definite useful lives are amortized on an accelerated basis over their estimated life. Intangible assets with indefinite useful lives are not amortized until their lives are determined to be definite. Intangible assets, premises and equipment and other long-lived assets are tested for impairment whenever events or changes in circumstances indicate the carrying amount of the assets may not be recoverable from future undiscounted cash flows. If impaired, the assets are recorded at fair value. See Note 5 - Goodwill and Other Intangible Assets.

Insurance Commissions and Fees. Commission revenue is recognized as of the effective date of the insurance policy. The Corporation also receives contingent commissions from insurance companies as additional incentive for achieving specified premium volume goals and/or the loss experience of the insurance placed by the Corporation. Contingent commissions from insurance companies are recognized when determinable, which is generally when such commissions are received or when the Corporation receives data from the insurance companies that allows the reasonable estimation of these amounts. The Corporation maintains a reserve for commission adjustments based on estimated policy cancellations. This reserve was not significant at December 31, 2012 or 2011.

Stock-Based Compensation. Compensation expense for stock options, non-vested stock awards/stock units and deferred stock units is based on the fair value of the award on the measurement date, which, for the Corporation, is the date of the grant and is recognized ratably over the service period of the award. The fair value of stock options is estimated using a binomial lattice-based valuation model. The fair value of stock options granted prior to the fourth quarter of 2006 was estimated using the Black-Scholes option-pricing model. The fair value of non-vested stock awards/stock units and deferred stock units is generally the market price of the Corporation's stock on the date of grant.

Advertising Costs. Advertising costs are expensed as incurred.

Income Taxes. Income tax expense is the total of the current year income tax due or refundable and the change in deferred tax assets and liabilities (excluding deferred tax assets and liabilities related to business combinations or components of other comprehensive income). Deferred tax assets and liabilities are the expected future tax amounts for the temporary differences between carrying amounts and tax bases of assets and liabilities, computed using enacted tax rates. A valuation allowance, if needed, reduces deferred tax assets to the expected amount most likely to be realized. Realization of deferred tax assets is dependent upon the generation of a sufficient level of future taxable income and recoverable taxes paid in prior years. Although realization is not assured, management believes it is more likely than not that all of the deferred tax assets will be realized. Interest and/or penalties related to income taxes are reported as a component of income tax expense.

The Corporation files a consolidated income tax return with its subsidiaries. Federal income tax expense or benefit has been allocated to subsidiaries on a separate return basis.

Basic and Diluted Earnings Per Common Share. Earnings per common share is computed using the two-class method prescribed under ASC Topic 260, Earnings Per Share. ASC Topic 260 provides that unvested share-based payment awards that contain nonforfeitable rights to dividends or dividend equivalents (whether paid or

Table of Contents

unpaid) are participating securities and shall be included in the computation of earnings per share pursuant to the two-class method. The Corporation has determined that its outstanding non-vested stock awards/stock units and deferred stock units are participating securities.

Under 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. 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. A reconciliation of the weighted-average shares used in calculating basic earnings per common share and the weighted average common shares used in calculating diluted earnings per common share for the reported periods is provided in Note 9 - Shareholders' Equity and Earnings Per Common Share.

Comprehensive Income. Comprehensive income includes all changes in shareholders' equity during a period, except those resulting from transactions with shareholders. Besides net income, other components of the Corporation's comprehensive income include the after tax effect of changes in the net unrealized gain/loss on securities available for sale, changes in the net actuarial gain/loss on defined benefit post-retirement benefit plans and changes in the accumulated gain/loss on effective cash flow hedging instruments. See Note 14 - Other Comprehensive Income (Loss).

Derivative Financial Instruments. The Corporation's hedging policies permit the use of various derivative financial instruments to manage interest rate risk or to hedge specified assets and liabilities. All derivatives are recorded at fair value on the Corporation's balance sheet. Derivatives executed with the same counterparty are generally subject to master netting arrangements, however, fair value amounts recognized for derivatives and fair value amounts recognized for the right/obligation to reclaim/return cash collateral are not offset for financial reporting purposes. The Corporation may be required to recognize certain contracts and commitments as derivatives when the characteristics of those contracts and commitments meet the definition of a derivative.

To qualify for hedge accounting, derivatives must be highly effective at reducing the risk associated with the exposure being hedged and must be designated as a hedge at the inception of the derivative contract. The Corporation considers a hedge to be highly effective if the change in fair value of the derivative hedging instrument is within 80% to 125% of the opposite change in the fair value of the hedged item attributable to the hedged risk. If derivative instruments are designated as hedges of fair values, and such hedges are highly effective, both the change in the fair value of the hedge and the hedged item are included in current earnings. Fair value adjustments related to cash flow hedges are recorded in other comprehensive income and are reclassified to earnings when the hedged transaction is reflected in earnings. Ineffective portions of hedges are reflected in earnings as they occur. Actual cash receipts and/or payments and related accruals on derivatives related to hedges are recorded as adjustments to the interest income or interest expense associated with the hedged item. During the life of the hedge, the Corporation formally assesses whether derivatives designated as hedging instruments continue to be highly effective in offsetting changes in the fair value or cash flows of hedged items. If it is determined that a hedge has ceased to be highly effective, the Corporation will discontinue hedge accounting prospectively. At such time, previous adjustments to the carrying value of the hedged item are reversed into current earnings and the derivative instrument is reclassified to a trading position recorded at fair value.

Fair Value Measurements. In general, fair values of financial instruments are 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.

Transfers of Financial Assets. Transfers of financial assets are accounted for as sales when control over the assets has been surrendered. Control over transferred assets is deemed to be surrendered when (i) the assets have

Table of Contents

been isolated from the Corporation, (ii) the transferee obtains the right (free of conditions that constrain it from taking advantage of that right) to pledge or exchange the transferred assets, and (iii) the Corporation does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity.

Loss Contingencies. Loss contingencies, including claims and legal actions arising in the ordinary course of business are recorded as liabilities when the likelihood of loss is probable and an amount or range of loss can be reasonably estimated.

Trust Assets. Assets of the Corporation's trust department, other than cash on deposit at Frost Bank, are not included in the accompanying financial statements because they are not assets of the Corporation.

Reclassifications. Certain items in prior financial statements have been reclassified to conform to the current presentation. Mutual fund and investment management fees previously reported as a component of other charges, commissions and fees are now included with trust fees and reported as trust and investment management fees in the consolidated statements of income. In addition, interchange and debit card transaction fees (including automated teller machine fees) previously reported as components of service charges on deposit accounts; other charges, commissions and fees; or other non-interest income are now reported as interchange and debit card transaction fees in the consolidated statements of income.

Note 2 - Securities

Year-end securities held to maturity and available for sale consisted of the following:

	2012				2011			
	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	\$ 248,188	\$ 29,859	\$ -	\$ 278,047	\$ 247,797	\$ 31,715	\$ -	\$ 279,512
Residential mortgage-backed securities	10,725	300	-	11,025	11,874	153	-	12,027
States and political subdivisions	2,696,468	15,397	4,993	2,706,872	105,325	6,597	-	111,922
Other	1,000	-	-	1,000	1,000	-	-	1,000
Total	\$ 2,956,381	\$ 45,556	\$ 4,993	\$ 2,996,944	\$ 365,996	\$ 38,465	\$ -	\$ 404,461
Available for Sale:								
U. S. Treasury	\$ 3,020,115	\$ 37,806	\$ -	\$ 3,057,921	\$ 2,020,621	\$ 36,111	\$ -	\$ 2,056,732
U.S. government agencies/corporations	-	-	-	-	250,000	884	-	250,884
Residential mortgage-backed securities	2,382,514	135,514	25	2,518,003	3,135,064	154,386	180	3,289,270
States and political subdivisions	552,056	39,427	-	591,483	1,996,703	158,133	23	2,154,813
Other	35,892	-	-	35,892	38,001	-	-	38,001

Edgar Filing: CULLEN/FROST BANKERS, INC. - Form 10-K

Total	\$ 5,990,577	\$ 212,747	\$ 25	\$ 6,203,299	\$ 7,440,389	\$ 349,514	\$ 203	\$ 7,789,700
-------	--------------	------------	-------	--------------	--------------	------------	--------	--------------

All mortgage-backed securities included in the above table were issued by U.S. government agencies and corporations. At December 31, 2012, approximately 98.8% 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 73.8% are either guaranteed by the Texas Permanent School Fund, which has a triple-A insurer financial

Table of Contents

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 table above. The carrying value of securities pledged to secure public funds, trust deposits, repurchase agreements and for other purposes, as required or permitted by law was \$2.7 billion and \$2.4 billion at December 31, 2012 and 2011.

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 December 31, 2012 totaled \$107.3 million. 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.

Year-end 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
2012						
Held to Maturity						
States and political subdivisions	\$ 353,626	\$ 4,993	\$ -	\$ -	\$ 353,626	\$ 4,993
Available for Sale						
Residential mortgage-backed securities	\$ 3,007	\$ 24	\$ 59	\$ 1	\$ 3,066	\$ 25
2011						
Available for Sale						
Residential mortgage-backed securities	\$ 103,258	\$ 180	\$ -	\$ -	\$ 103,258	\$ 180
States and political subdivisions	-	-	1,164	23	1,164	23
Total	\$ 103,258	\$ 180	\$ 1,164	\$ 23	\$ 104,422	\$ 203

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

Management has the ability and intent to hold the securities classified as held to maturity in the table above until they mature, at which time the Corporation will receive full value for the securities. Furthermore, as of December 31, 2012, 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 December 31, 2012, 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.

Table of Contents

The amortized cost and estimated fair value of securities, excluding trading securities, at December 31, 2012 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	\$ 9,635	\$ 9,701	\$ 629,451	\$ 631,856
Due after one year through five years	348,103	382,359	2,574,842	2,613,865
Due after five years through ten years	162,466	162,209	73,658	80,067
Due after ten years	2,425,452	2,431,650	294,220	323,616
Residential mortgage-backed securities	10,725	11,025	2,382,514	2,518,003
Equity securities	-	-	35,892	35,892
Total	\$ 2,956,381	\$ 2,996,944	\$ 5,990,577	\$ 6,203,299

Sales of securities available for sale were as follows:

	2012	2011	2010
Proceeds from sales	\$ 16,587,482	\$ 5,587,391	\$ 9,997,994
Gross realized gains	6,943	6,418	8
Gross realized losses	(2,629)	(4)	(2)
Tax (expense) benefit of securities gains/losses	(1,510)	(2,245)	(2)

Year-end trading account securities, at estimated fair value, were as follows:

	2012	2011
U.S. Treasury	\$ 14,038	\$ 13,609
States and political subdivisions	16,036	-
Total	\$ 30,074	\$ 13,609

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

	Year Ended December 31,		
	2012	2011	2010
Net gain on sales transactions	\$ 1,219	\$ 1,607	\$ 1,688
Net mark-to-market gains (losses)	(161)	(15)	145

Net gain on trading account securities	\$ 1,058	\$ 1,592	\$ 1,833
--	----------	----------	----------

Table of Contents**Note 3 - Loans**

Year-end loans consisted of the following:

	2012	2011
Commercial and industrial:		
Commercial	\$ 4,357,100	\$ 3,553,989
Leases	278,535	193,412
Asset-based	192,977	169,466
Total commercial and industrial	4,828,612	3,916,867
Commercial real estate:		
Commercial mortgages	2,495,481	2,383,479
Construction	608,306	434,870
Land	216,008	202,478
Total commercial real estate	3,319,795	3,020,827
Consumer real estate:		
Home equity loans	310,675	282,244
Home equity lines of credit	186,522	191,960
1-4 family residential mortgages	38,323	45,943
Construction	17,621	17,544
Other	224,206	225,118
Total consumer real estate	777,347	762,809
Total real estate	4,097,142	3,783,636
Consumer and other:		
Consumer installment	311,310	301,518
Other	8,435	11,018
Total consumer and other	319,745	312,536
Unearned discounts	(21,651)	(17,910)
Total loans	\$ 9,223,848	\$ 7,995,129

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.

Table of Contents

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 December 31, 2012, 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 December 31, 2012 and 2011, there were no concentrations of loans related to any single industry in excess of 10% of total loans.

Student Loans Held for Sale. Prior to the second quarter of 2008, the Corporation originated student loans primarily for sale in the secondary market. These loans were generally sold on a non-recourse basis and were

Table of Contents

carried at the lower of cost or market on an aggregate basis. During the second quarter of 2008, the Corporation elected to discontinue the origination of student loans for resale, aside from previously outstanding commitments. All remaining student loans were sold during the second quarter of 2010.

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 December 31, 2012 or 2011.

Overdrafts. Deposit account overdrafts reported as loans totaled \$102.4 million and \$5.2 million at December 31, 2012 and 2011. At December 31, 2012, commercial and industrial loans included \$95.3 million related to an overdraft by a correspondent bank customer. The overdraft cleared subsequent to year-end.

Related Party Loans. In the ordinary course of business, the Corporation has granted loans to certain directors, executive officers and their affiliates (collectively referred to as related parties). These loans were made on substantially the same terms, including interest rates and collateral, as those prevailing at the time for comparable transactions with other unaffiliated persons and do not involve more than normal risk of collectibility. Activity in related party loans during 2012 is presented in the following table. Other changes were primarily related to decreased letters of credit and changes in related party status.

Balance outstanding at December 31, 2011	\$ 61,357
Principal additions	107,935
Principal reductions	(99,273)
Other changes	(4,773)
	<hr/>
Balance outstanding at December 31, 2012	\$ 65,246
	<hr/>

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.

Year-end non-accrual loans, segregated by class of loans, were as follows:

	<u>2012</u>	<u>2011</u>
Commercial and industrial:		
Energy	\$ 1,150	\$ -
Other commercial	45,158	43,874
Commercial real estate:		
Buildings, land and other	38,631	43,820
Construction	1,100	1,329
Consumer real estate	2,773	4,587
Consumer and other	932	728
	<hr/>	<hr/>
Total	\$ 89,744	\$ 94,338

Table of Contents

As of December 31, 2012, non-accrual loans reported in the table above included \$2.2 million related to loans that were restructured as troubled debt restructurings during 2012. See the section captioned Troubled Debt Restructurings elsewhere in this note.

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 \$2.6 million in 2012, \$3.3 million in 2011, and \$3.9 million in 2010.

An age analysis of past due loans (including both accruing and non-accruing loans), segregated by class of loans, as of December 31, 2012 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	\$ 714	\$ 1,427	\$ 2,141	\$ 1,081,045	\$ 1,083,186	\$ 1,427
Other commercial	21,328	8,438	29,766	3,715,660	3,745,426	1,722
Commercial real estate:						
Buildings, land and other	14,413	4,528	18,941	2,692,548	2,711,489	438
Construction	1,028	-	1,028	607,278	608,306	-
Consumer real estate	5,601	3,874	9,475	767,872	777,347	2,786
Consumer and other	2,755	827	3,582	316,163	319,745	621
Unearned discounts	-	-	-	(21,651)	(21,651)	-
Total	\$ 45,839	\$ 19,094	\$ 64,933	\$ 9,158,915	\$ 9,223,848	\$ 6,994

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.

Table of Contents

Year-end 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	Average Recorded Investment
2012						
Commercial and industrial:						
Energy	\$ 1,255	\$ -	\$ 1,069	\$ 1,069	\$ 900	\$ 214
Other commercial	56,784	21,709	19,096	40,805	4,200	42,630
Commercial real estate:						
Buildings, land and other	44,652	19,010	17,149	36,159	3,137	40,258
Construction	1,497	1,100	-	1,100	-	1,392
Consumer real estate	961	864	-	864	-	1,617
Consumer and other	428	400	-	400	-	469
Total	\$ 105,577	\$ 43,083	\$ 37,314	\$ 80,397	\$ 8,237	\$ 86,580
2011						
Commercial and industrial:						
Energy	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
Other commercial	57,723	34,712	4,619	39,331	2,696	53,830
Commercial real estate:						
Buildings, land and other	51,163	38,686	2,243	40,929	1,113	48,635
Construction	1,568	1,281	-	1,281	-	4,339
Consumer real estate	2,499	1,719	751	2,470	95	1,845
Consumer and other	562	554	-	554	-	265
Total	\$ 113,515	\$ 76,952	\$ 7,613	\$ 84,565	\$ 3,904	\$ 108,914

The average recorded investment in impaired loans was \$130.8 million in 2010.

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 and other actions intended to minimize potential losses. Troubled debt restructurings during 2012 and 2011 are set forth in the following table. There were no troubled debt restructurings during 2010.

	2012		2011	
	Balance at Restructure	Balance at Year-end	Balance at Restructure	Balance at Year-end
Commercial and industrial:				
Other commercial	\$ 1,602	\$ 1,478	\$ 191	\$ 179
Commercial real estate:				
Buildings, land and other	714	710	7,519	6,183
Consumer real estate	-	-	969	932
Consumer	-	-	469	456

\$	2,316	\$	2,188	\$	9,148	\$	7,750
----	-------	----	-------	----	-------	----	-------

All of the loans identified as troubled debt restructurings by the Corporation were previously on non-accrual status and reported as impaired loans prior to restructuring. The modifications primarily related to extending the amortization periods of the loans or converting the loans to interest only for a limited period of time. The Corporation did not grant interest-rate concessions on any restructured loan. All loans restructured during 2011

Table of Contents

and 2012 that remain outstanding are on non-accrual status as of December 31, 2012. See the section captioned *Non-accrual Loans* elsewhere in this note. Because the loans were classified and on non-accrual status both before and after restructuring, the modifications did not impact the Corporation's determination of the allowance for loan losses. Payment defaults on loans restructured in troubled debt restructurings during the reported periods were not significant.

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.

Table of Contents

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.

	December 31, 2012		December 31, 2011	
	Weighted Average Risk Grade	Loans	Weighted Average Risk Grade	Loans
Commercial and industrial:				
Energy				
Risk grades 1-8	5.24	\$ 1,081,725	5.21	\$ 868,561
Risk grade 9	9.00	392	9.00	2,025
Risk grade 10	10.00	-	10.00	-
Risk grade 11	11.00	-	11.00	-
Risk grade 12	12.00	169	12.00	-
Risk grade 13	13.00	900	13.00	-
Total energy	5.25	\$ 1,083,186	5.22	\$ 870,586
Other commercial				
Risk grades 1-8	5.81	\$ 3,367,443	6.20	\$ 2,802,037
Risk grade 9	9.00	250,508	9.00	55,105
Risk grade 10	10.00	28,440	10.00	49,982
Risk grade 11	11.00	53,797	11.00	96,046
Risk grade 12	12.00	40,603	12.00	39,826
Risk grade 13	13.00	4,635	13.00	3,285
Total other commercial	6.21	\$ 3,745,426	6.55	\$ 3,046,281
Commercial real estate:				
Buildings, land and other				
Risk grades 1-8	6.63	\$ 2,460,448	6.69	\$ 2,266,576
Risk grade 9	9.00	92,041	9.00	103,894
Risk grade 10	10.00	42,603	10.00	45,278
Risk grade 11	11.00	77,658	11.00	126,594
Risk grade 12	12.00	35,602	12.00	41,747
Risk grade 13	13.00	3,137	13.00	1,868
Total commercial real estate	6.97	\$ 2,711,489	7.14	\$ 2,585,957
Construction				
Risk grades 1-8	6.82	\$ 579,108	6.95	\$ 378,530
Risk grade 9	9.00	23,046	9.00	30,376
Risk grade 10	10.00	4,435	10.00	16,186
Risk grade 11	11.00	617	11.00	8,449
Risk grade 12	12.00	1,100	12.00	1,329
Risk grade 13	13.00	-	13.00	-

Total construction	6.94	<u>\$ 608,306</u>	7.30	<u>\$ 434,870</u>
--------------------	------	-------------------	------	-------------------

Table of Contents

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 4 commercial real estate loans having a calculated risk grade of 10 or higher in excess of \$5 million as of December 31, 2012, which totaled \$38.5 million and had a weighted-average loan-to-value ratio of 65.9%. When an individual consumer real estate loan becomes past due by more than 10 days, the assigned relationship manager will begin collection efforts. The Corporation only reassesses the loan to value position in a consumer real estate loan if, during the course of the collections process, it is determined that the loan has become collateral dependent, and any collateral deficiency is recognized as a charge-off to the allowance for loan losses. Accordingly, the Corporation does not monitor loan-to-value ratios on a weighted-average basis for collateral dependent consumer real estate loans.

Generally, a commercial loan, or a portion thereof, is charged-off immediately when it is determined, through the analysis of any available current financial information with regards to the borrower, that the borrower is incapable of servicing unsecured debt, there is little or no prospect for near term improvement and no realistic strengthening action of significance is pending or, in the case of secured debt, when it is determined, through analysis of current information with regards to the Corporation's collateral position, that amounts due from the borrower are in excess of the calculated current fair value of the collateral. Notwithstanding the foregoing, generally, commercial loans that become past due 180 cumulative days are classified as a loss and charged-off. Generally, a consumer loan, or a portion thereof, is charged-off in accordance with regulatory guidelines which provide that such loans be charged-off when the Corporation becomes aware of the loss, such as from a triggering event that may include new information about a borrower's intent/ability to repay the loan, bankruptcy, fraud or death, among other things, but in no case should the charge-off exceed specified delinquency 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 loan, were as follows:

	2012	2011	2010
Commercial and industrial:			
Energy	\$ 4	\$ 6	\$ -
Other commercial	(13,627)	(29,158)	(28,530)
Commercial real estate:			
Buildings, land and other	698	(8,980)	(5,928)
Construction	78	(454)	(616)
Consumer real estate	(638)	(2,293)	(2,059)
Consumer and other	(2,289)	(2,735)	(5,471)
Total	\$ (15,774)	\$ (43,614)	\$ (42,604)

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

Table of Contents

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 123.0 at November 30, 2012 (most recent date available) and 120.3 at December 31, 2011. 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 the 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

Table of Contents

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.

During 2011, the Corporation refined its methodology for the determination of reserves allocated to specific loan portfolio segments to provide reserves for loans to borrowers in distressed industries. To determine the amount of the allocation, 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. This change in the Corporation's methodology for the determination of reserves allocated to specific loan portfolio segments did not significantly impact the provision for loan losses recorded during 2011. Management identifies potential distressed industries by analyzing industry trends related to delinquencies, classifications and charge-offs. At December 31, 2012 and 2011, 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 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.

Table of Contents

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. Prior to 2012, certain general valuation allowances were not allocated to specific loan portfolio segments.

	Commercial and Industrial	Commercial Real Estate	Consumer Real Estate	Consumer and Other	Unallocated	Total
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
December 31, 2011						
Historical valuation allowances	\$ 30,368	\$ 15,153	\$ 2,742	\$ 9,876	\$ -	\$ 58,139
Specific valuation allowances	2,696	1,113	95	-	-	3,904
General valuation allowances:						
Environmental risk adjustment	5,656	3,724	703	2,759	-	12,842
Distressed industries	4,054	922	-	-	-	4,976
Excessive industry concentrations	-	-	-	-	6,995	6,995
Large relationship concentrations	-	-	-	-	2,232	2,232
Highly-leveraged credit relationships	-	-	-	-	3,530	3,530
Policy exceptions	-	-	-	-	2,121	2,121
Credit and collateral exceptions	-	-	-	-	1,603	1,603
Loans not reviewed by concurrence	-	-	-	-	9,030	9,030
Adjustment for recoveries	-	-	-	-	(13,071)	(13,071)
General macroeconomic risk	-	-	-	-	17,846	17,846
Total	\$ 42,774	\$ 20,912	\$ 3,540	\$ 12,635	\$ 30,286	\$ 110,147

Table of Contents

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 2012, 2011 and 2010. 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
2012						
Beginning balance	\$ 42,774	\$ 20,912	\$ 3,540	\$ 12,635	\$ 30,286	\$ 110,147
Provision for loan losses	25,013	7,658	2,350	(6,839)	(18,102)	10,080
Charge-offs	(18,493)	(3,951)	(1,495)	(9,101)	-	(33,040)
Recoveries	4,870	4,727	857	6,812	-	17,266
Net charge-offs	(13,623)	776	(638)	(2,289)	-	(15,774)
Ending balance	\$ 54,164	\$ 29,346	\$ 5,252	\$ 3,507	\$ 12,184	\$ 104,453
Period-end amount allocated to:						
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
Ending balance	\$ 54,164	\$ 29,346	\$ 5,252	\$ 3,507	\$ 12,184	\$ 104,453
2011						
Beginning balance	\$ 57,789	\$ 28,534	\$ 3,223	\$ 11,974	\$ 24,796	\$ 126,316
Provision for loan losses	14,137	1,812	2,610	3,396	5,490	27,445
Charge-offs	(33,678)	(10,776)	(2,789)	(9,442)	-	(56,685)
Recoveries	4,526	1,342	496	6,707	-	13,071
Net charge-offs	(29,152)	(9,434)	(2,293)	(2,735)	-	(43,614)
Ending balance	\$ 42,774	\$ 20,912	\$ 3,540	\$ 12,635	\$ 30,286	\$ 110,147
Period-end amount allocated to:						
Loans individually evaluated for impairment	\$ 15,829	\$ 3,625	\$ 95	\$ -	\$ -	\$ 19,549
Loans collectively evaluated for impairment	26,945	17,287	3,445	12,635	30,286	90,598
Ending balance	\$ 42,774	\$ 20,912	\$ 3,540	\$ 12,635	\$ 30,286	\$ 110,147

Table of Contents

	Commercial and Industrial	Commercial Real Estate	Consumer Real Estate	Consumer and Other	Unallocated	Total
2010						
Beginning balance	\$ 57,394	\$ 28,514	\$ 2,560	\$ 16,929	\$ 19,912	\$ 125,309
Provision for loan losses	28,925	6,564	2,722	516	4,884	43,611
Charge-offs	(31,324)	(7,524)	(2,682)	(11,893)	-	(53,423)
Recoveries	2,794	980	623	6,422	-	10,819
Net charge-offs	(28,530)	(6,544)	(2,059)	(5,471)	-	(42,604)
Ending balance	\$ 57,789	\$ 28,534	\$ 3,223	\$ 11,974	\$ 24,796	\$ 126,316
Period-end amount allocated to:						
Loans individually evaluated for impairment	\$ 31,948	\$ 8,591	\$ -	\$ -	\$ -	\$ 40,539
Loans collectively evaluated for impairment	25,841	19,943	3,223	11,974	24,796	85,777
Ending balance	\$ 57,789	\$ 28,534	\$ 3,223	\$ 11,974	\$ 24,796	\$ 126,316

The Corporation's recorded investment in loans as of December 31, 2012 and 2011 related to each balance in the allowance for loan losses by portfolio segment and disaggregated on the basis of the Corporation's impairment methodology was as follows:

	Commercial and Industrial	Commercial Real Estate	Consumer Real Estate	Consumer and Other	Unearned Discounts	Total
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
2011						
Loans individually evaluated for impairment	\$ 189,139	\$ 241,451	\$ 2,470	\$ 554	\$ -	\$ 433,614
Loans collectively evaluated for impairment	3,727,728	2,779,376	760,339	311,982	(17,910)	7,561,515
Ending balance	\$ 3,916,867	\$ 3,020,827	\$ 762,809	\$ 312,536	\$ (17,910)	\$ 7,995,129

Note 4 - Premises and Equipment

Year-end premises and equipment were as follows:

	2012	2011
Land	\$ 105,004	\$ 103,359
Buildings	238,782	248,232

Edgar Filing: CULLEN/FROST BANKERS, INC. - Form 10-K

Furniture and equipment	201,843	196,681
Leasehold improvements	59,489	56,531
Construction in progress	3,503	4,269
	<u>608,621</u>	<u>609,072</u>
Less accumulated depreciation and amortization	(292,687)	(290,030)
Total premises and equipment, net	<u>\$ 315,934</u>	<u>\$ 319,042</u>

Depreciation and amortization of premises and equipment totaled \$21.8 million in both 2012 and 2011 and \$22.2 million in 2010.

Table of Contents**Note 5 - Goodwill and Other Intangible Assets**

Goodwill and other intangible assets are presented in the table below. The increases in goodwill and certain other intangible assets were primarily related to the acquisition of Stone Partners Inc. (Stone), a human resources consulting firm that specializes in compensation, benefits and outsourcing services, on January 1, 2012. Stone was based in Houston with additional offices in Dallas and Austin. Stone was fully integrated into Frost Insurance Agency subsequent to acquisition. The acquisition of Stone did not significantly impact the Corporation's financial statements.

Goodwill. Year-end goodwill was as follows:

	2012	2011
Goodwill	\$ 535,509	\$ 528,072

Other Intangible Assets. Year-end other intangible assets were as follows:

	Gross Intangible Assets	Accumulated Amortization	Net Intangible Assets
2012			
Core deposits	\$ 34,966	\$ (29,670)	\$ 5,296
Customer relationships	6,839	(4,577)	2,262
Non-compete agreements	986	(397)	589
	<u>\$ 42,791</u>	<u>\$ (34,644)</u>	<u>\$ 8,147</u>
2011			
Core deposits	\$ 34,966	\$ (26,732)	\$ 8,234
Customer relationships	5,975	(3,862)	2,113
Non-compete agreements	567	(310)	257
	<u>\$ 41,508</u>	<u>\$ (30,904)</u>	<u>\$ 10,604</u>

Other intangible assets are amortized on an accelerated basis over their estimated lives, which range from 5 to 10 years. Amortization expense related to intangible assets totaled \$3.9 million in 2012, \$4.4 million in 2011, and \$5.1 million in 2010. The estimated aggregate future amortization expense for intangible assets remaining as of December 31, 2012 is as follows:

2013	\$ 3,115
2014	2,271
2015	1,489
2016	777
2017	215
Thereafter	280
	<u>\$ 8,147</u>

Table of Contents**Note 6 - Deposits**

Year-end deposits were as follows:

	2012	2011
Non-interest-bearing demand deposits:		
Commercial and individual	\$ 7,186,105	\$ 5,848,840
Correspondent banks	436,381	370,275
Public funds	474,451	453,440
Total non-interest-bearing demand deposits	8,096,937	6,672,555
Interest-bearing deposits:		
Private accounts:		
Savings and interest checking	3,812,712	2,912,937
Money market accounts	6,127,256	5,664,780
Time accounts of \$100,000 or more	514,346	533,682
Time accounts under \$100,000	464,641	522,887
Total private accounts	10,918,955	9,634,286
Public funds:		
Savings and interest checking	287,391	265,747
Money market accounts	50,600	44,590
Time accounts of \$100,000 or more	140,191	136,422
Time accounts under \$100,000	3,292	3,148
Total public funds	481,474	449,907
Total interest-bearing deposits	11,400,429	10,084,193
Total deposits	\$ 19,497,366	\$ 16,756,748

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

	2012	2011
Money market deposits obtained through brokers	\$ -	\$ 24,500
Deposits from the Certificate of Deposit Account Registry Service (CDARS)	2,723	45,005
Deposits from foreign sources (primarily Mexico)	799,504	744,669
Deposits from certain directors, executive officers and their affiliates	158,971	115,837

Scheduled maturities of time deposits, including both private and public funds, at December 31, 2012 were as follows:

2013	\$ 957,190
2014	165,280

\$ 1,122,470

Scheduled maturities of time deposits in amounts of \$100,000 or more, including both private and public funds, at December 31, 2012, were as follows:

Due within 3 months or less	\$ 239,465
Due after 3 months and within 6 months	120,625
Due after 6 months and within 12 months	176,978
Due after 12 months	117,469
	<u>654,537</u>

Table of Contents**Note 7 - Borrowed Funds**

Federal Home Loan Bank Advances. Federal Home Loan Bank (FHLB) advances totaled \$7 thousand at December 31, 2012 and totaled \$26 thousand at December 31, 2011. The advances mature in 2013 and had a weighted-average rate of 6.0% at December 31, 2012 and 2011. The advances are collateralized by a blanket floating lien on all first mortgage loans, certain pledged securities, the FHLB capital stock owned by the Corporation and any funds on deposit with the FHLB.

Federal Funds Purchased and Securities Sold Under Agreements to Repurchase. Federal funds purchased are short-term borrowings that typically mature within one to ninety days. Federal funds purchased totaled \$1.6 million and \$875 thousand at December 31, 2012 and 2011. Securities sold under agreements to repurchase are secured short-term borrowings that typically mature within thirty to ninety days. Securities sold under agreements to repurchase are stated at the amount of cash received in connection with the transaction. The Corporation may be required to provide additional collateral based on the fair value of the underlying securities. Securities sold under agreements to repurchase totaled \$559.5 million and \$721.3 million at December 31, 2012 and 2011.

Subordinated Notes Payable. In February 2007, the Corporation issued \$100 million of 5.75% fixed-to-floating rate subordinated notes that mature on February 15, 2017. The notes, which qualify as Tier 2 capital for Cullen/Frost, had an interest rate of 5.75% per annum, payable semi-annually on each February 15 and August 15, commencing on August 15, 2007 until February 15, 2012. From February 15, 2012, to but excluding the maturity date or date of earlier redemption and commencing on May 15, 2012, the notes will bear interest at a rate per annum equal to three-month LIBOR for the related interest period plus 0.53% (0.84% at December 31, 2012), payable quarterly on each February 15, May 15, August 15 and November 15. The notes are subordinated in right of payment to all our senior indebtedness and effectively subordinated to all existing and future debt and all other liabilities of our subsidiaries. The notes cannot be accelerated except in the event of bankruptcy or the occurrence of certain other events of bankruptcy, insolvency or reorganization. The notes mature on February 15, 2017. The Corporation may elect to redeem the notes (subject to regulatory approval), in whole or in part, on any interest payment date on or after February 15, 2012 at a redemption price equal to 100% of the principal amount plus any accrued and unpaid interest. Unamortized debt issuance costs related to these notes, which are included in other assets, totaled \$490 thousand and \$610 thousand at December 31, 2012 and 2011. Proceeds from sale of the notes were used to fund a portion of the redemption of certain junior subordinated deferrable interest debentures.

In August 2011, Frost Bank redeemed \$150 million of subordinated notes that were originally issued in 2001 and had an interest rate of 6.875%, per annum, which was payable semi-annually. A portion of the notes qualified as Tier 2 capital for both Frost Bank and Cullen/Frost during the reported periods prior to the third quarter of 2010.

Junior Subordinated Deferrable Interest Debentures. At December 31, 2012 and 2011, the Corporation had \$123.7 million of junior subordinated deferrable interest debentures issued to Cullen/Frost Capital Trust II (Trust II), a wholly owned Delaware statutory business trust. Unamortized debt issuance costs related to Trust II, which are included in other assets, totaled \$1.2 million and \$1.3 million at December 31, 2012 and 2011. The trust is considered a variable interest entity for which the Corporation is not the primary beneficiary. Accordingly, the accounts of the trust are not included in the Corporation's consolidated financial statements. See Note 1 - Summary of Significant Accounting Policies for additional information about the Corporation's consolidation policy. Details of the Corporation's transactions with the capital trust are presented below.

Trust II was formed in 2004 for the purpose of issuing \$120 million of floating rate (three-month LIBOR plus a margin of 1.55%) trust preferred securities, which represent beneficial interests in the assets of the trust. The trust preferred securities will mature on March 1, 2034 and are redeemable with the approval of the Federal Reserve Board in whole or in part at the option of the Corporation at any time after March 1, 2009 and in whole at any time upon the occurrence of certain events affecting their tax or regulatory capital treatment. Distributions

Table of Contents

on the trust preferred securities are payable quarterly in arrears on March 1, June 1, September 1 and December 1 of each year. Trust II also issued \$3.7 million of common equity securities to Cullen/Frost. The proceeds of the offering of the trust preferred securities and common equity securities were used to purchase \$123.7 million of floating rate (three-month LIBOR plus a margin of 1.55%, which was equal to 1.86% and 2.08% at December 31, 2012 and 2011) junior subordinated deferrable interest debentures issued by the Corporation, which have terms substantially similar to the trust preferred securities. In October 2008, the Corporation entered into an interest rate swap contract on the junior subordinated deferrable interest debentures that effectively fixed the interest rate on the debentures for a period of five years. See Note 15 - Derivative Financial Instruments.

The Corporation has the right to defer payments of interest on the debentures at any time or from time to time for a period of up to twenty consecutive quarterly periods with respect to each deferral period. Under the terms of the debentures, in the event that under certain circumstances there is an event of default under the debentures or the Corporation has elected to defer interest on the debentures, the Corporation may not, with certain exceptions, declare or pay any dividends or distributions on its capital stock or purchase or acquire any of its capital stock.

Payments of distributions on the trust preferred securities and payments on redemption of the trust preferred securities are guaranteed by the Corporation on a limited basis. The Corporation also entered into an agreement with the Trust II as to expenses and liabilities pursuant to which the Corporation has agreed, on a subordinated basis, to pay any costs, expenses or liabilities of Trust II other than those arising under the trust preferred securities. The obligations of the Corporation under the junior subordinated debentures, the related indenture, the trust agreement establishing the trust, the guarantee and the agreement as to expenses and liabilities, in the aggregate, constitute a full and unconditional guarantee by the Corporation of Trust II's obligations under the trust preferred securities.

In July 2010, the Corporation redeemed the \$12.4 million of floating rate (three-month LIBOR plus a margin of 2.65%) junior subordinated deferrable interest debentures, due July 7, 2034, held of record by Summit Trust. Concurrently, the \$12.0 million of floating rate (three-month LIBOR plus a margin of 2.65%) trust preferred securities issued by Summit Trust were also redeemed.

Despite the fact that the accounts of the capital trusts are not included in the Corporation's consolidated financial statements, the trust preferred securities issued by these subsidiary trusts are included in the Tier 1 capital of Cullen/Frost for regulatory capital purposes. Federal Reserve Board rules limit the aggregate amount of restricted core capital elements (which includes trust preferred securities, among other things) that may be included in the Tier 1 capital of most bank holding companies to 25% of all core capital elements, including restricted core capital elements, net of goodwill less any associated deferred tax liability. Large, internationally active bank holding companies (as defined) are subject to a 15% limitation. Amounts of restricted core capital elements in excess of these limits generally may be included in Tier 2 capital. The current quantitative limits do not preclude the Corporation from including the \$120 million in trust preferred securities outstanding in Tier 1 capital as of December 31, 2012. In June 2012, the Federal Reserve published two notices of proposed rulemaking (the 2012 Capital Proposals) that would 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. Among other things, certain provisions of the 2012 Capital Proposals will require the Corporation to deduct, over four years beginning on January 1, 2013, all trust preferred securities from the Corporation's Tier 1 capital. Nonetheless, excluding trust preferred securities from Tier 1 capital at December 31, 2012 would not affect the Corporation's ability to meet all capital adequacy requirements to which it is subject.

Table of Contents**Note 8 - Off-Balance-Sheet Arrangements, Commitments, Guarantees 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.

Year-end financial instruments with off-balance-sheet risk were as follows:

	2012	2011
Commitments to extend credit	\$ 5,710,448	\$ 5,147,363
Standby letters of credit	186,049	235,903
Deferred standby letter of credit fees	1,412	1,488

Credit Card Guarantees. The Corporation guarantees the credit card debt of certain customers to the merchant bank that issues the cards. At December 31, 2012 and 2011, the guarantees totaled \$8.8 million and \$7.6 million, of which amounts, \$1.0 million and \$738 thousand were fully collateralized.

Securities Lending. The Corporation lends certain customer securities to creditworthy brokers on behalf of those customers. If the borrower fails to return these securities, the Corporation indemnifies its customers based on the then current net realizable fair value of the securities. The Corporation holds collateral received in securities lending transactions as an agent. Accordingly, such collateral assets are not assets of the Corporation. The Corporation requires borrowers to provide collateral equal to or in excess of 100% of the fair value of the securities borrowed. The collateral is valued daily and additional collateral is requested as necessary. The maximum future payments guaranteed by the Corporation under these contractual agreements (representing the fair value of securities lent to brokers) totaled \$1.8 billion at December 31, 2012. At December 31, 2012, the Corporation held in trust liquid assets with a fair value of \$1.8 billion as collateral for these agreements.

Table of Contents

Lease Commitments. The Corporation leases certain office facilities and office equipment under operating leases. Rent expense for all operating leases totaled \$22.7 million in 2012, and \$21.6 million in both 2011 and 2010. Future minimum lease payments due under non-cancelable operating leases at December 31, 2012 were as follows:

2013	\$ 18,298
2014	16,410
2015	15,171
2016	13,728
2017	11,978
Thereafter	59,873
	<u>135,458</u>
	<u>\$ 135,458</u>

It is expected that certain leases will be renewed, or equipment replaced with new leased equipment, as these leases expire. Aggregate future minimum rentals to be received under non-cancelable subleases greater than one year at December 31, 2012, were \$436 thousand.

The Corporation leases a branch facility from a partnership interest of a director. Payments related to this lease totaled \$902 thousand in 2012, \$898 thousand in 2011, and \$852 thousand in 2010. The terms of the lease are substantially the same as those offered for comparable transactions with non-related parties at the time the lease transaction was consummated.

Change in Control Agreements. The Corporation has change-in-control agreements with certain executive officers. Under these agreements, each covered person could receive, upon the effectiveness of a change-in-control, two to three times (depending on the person) his or her base compensation plus the target bonus established for the year, and any unpaid base salary and pro rata target bonus for the year in which the termination occurs, including vacation pay. Additionally, the executive's insurance benefits will continue for two to three full years after the termination and all long-term incentive awards will immediately vest.

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 9 - Shareholders' Equity and Earnings Per Common Share

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.

Table of Contents

The following table presents a reconciliation of the number of shares used in the calculation of basic and diluted earnings per common share.

	2012	2011	2010
Distributed earnings allocated to common stock	\$ 116,471	\$ 111,827	\$ 107,597
Undistributed earnings allocated to common stock	120,707	104,980	100,340
Net earnings allocated to common stock	\$ 237,178	\$ 216,807	\$ 207,937
Weighted-average shares outstanding for basic earnings per common share	61,298,041	61,101,072	60,410,680
Dilutive effect of stock compensation	345,341	176,697	174,972
Weighted-average shares outstanding for diluted earnings per common share	61,643,382	61,277,769	60,585,652

Stock Repurchase Plans. From time to time, the Corporation's board of directors has authorized stock repurchase plans. In general, stock repurchase plans allow the Corporation to proactively manage its capital position and return excess capital to shareholders. Shares purchased under such plans also provide the Corporation with shares of common stock necessary to satisfy obligations related to stock compensation awards.

Note 10 - Regulatory Matters

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

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

Cullen/Frost's and Frost Bank's Tier 1 capital consists of shareholders' equity excluding unrealized gains and losses on securities available for sale, the accumulated gain or loss on effective cash flow hedging derivatives, the net actuarial gain/loss on the Corporation's defined benefit post-retirement benefit plans, goodwill and other intangible assets. Tier 1 capital for Cullen/Frost also includes trust preferred securities issued by its unconsolidated subsidiary trust totaling \$120 million in 2012 and 2011 (see Note 7 Borrowed Funds). 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 \$80 million at December 31, 2012 and \$100 million at December 31, 2011, 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.

Table of Contents

Year-end 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
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
2011						
Total Capital to Risk-Weighted Assets						
Cullen/Frost	\$ 1,835,428	16.24%	\$ 903,970	8.00%	\$ 1,129,962	10.00%
Frost Bank	1,641,921	14.54	903,427	8.00	1,129,284	10.00
Tier 1 Capital to Risk-Weighted Assets						
Cullen/Frost	1,625,281	14.38	451,985	4.00	677,977	6.00
Frost Bank	1,531,774	13.56	451,713	4.00	677,570	6.00
Leverage Ratio						
Cullen/Frost	1,625,281	8.66	750,643	4.00	938,304	5.00
Frost Bank	1,531,774	8.17	750,249	4.00	937,811	5.00

Management believes that, as of December 31, 2012, 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 (see the section captioned "Charter Conversion" below) 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 December 31, 2012, that Cullen/Frost and Frost Bank meet all capital adequacy requirements to which they are subject.

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 December 31, 2012, Frost Bank could pay aggregate dividends of up to \$306.5 million to Cullen/Frost without prior regulatory approval.

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

Table of Contents

regulatory capital purposes pursuant to guidance from the Federal Reserve. As previously stated in Note 7 - Borrowed Funds, certain provisions of the 2012 Capital Proposals will require the Corporation to deduct, over four years beginning on January 1, 2013, all trust preferred securities from the Corporation's Tier 1 capital. Trust preferred securities no longer included in Tier 1 capital would nonetheless be included as a component of Tier 2 capital. Excluding trust preferred securities from Tier 1 capital at December 31, 2012 would not affect the Corporation's ability to meet all capital adequacy requirements to which it is subject.

Charter Conversion. On June 22, 2012, Frost Bank, the sole banking subsidiary of the Corporation, became a Texas state chartered bank and a member of the Federal Reserve System. Accordingly, the Texas Department of Banking and the Federal Reserve are now the primary regulators of Frost Bank, and Frost Bank will no longer be regulated by the Office of the Comptroller of the Currency (OCC). Deposits at Frost Bank continue to be insured by the FDIC up to applicable limits.

Note 11 - Employee Benefit Plans

Retirement Plans

Profit Sharing Plans. The profit-sharing plan is a defined contribution retirement plan that covers employees who have completed at least one year of service and are age 21 or older. All contributions to the plan are made at the discretion of the Corporation and may be made without regard to current or accumulated profits. Contributions are allocated to eligible participants pro rata, based upon compensation, age and other factors. Plan participants self-direct the investment of allocated contributions by choosing from a menu of investment options. Account assets are subject to withdrawal restrictions and participants vest in their accounts after three years of service. The Corporation also maintains a separate non-qualified profit sharing plan for certain employees whose participation in the qualified profit sharing plan is limited. The plan offers such employees an alternative means of receiving comparable benefits. Expense related to these plans totaled \$9.2 million in 2012, \$11.8 million in 2011 and \$12.0 million in 2010.

Retirement Plan and Restoration Plan. The Corporation maintains a non-contributory defined benefit plan (the Retirement Plan) that was frozen as of December 31, 2001. The plan provides pension and death benefits to substantially all employees who were at least 21 years of age and had completed at least one year of service prior to December 31, 2001. Defined benefits are provided based on an employee's final average compensation and years of service at the time the plan was frozen and age at retirement. The freezing of the plan provides that future salary increases will not be considered. The Corporation's funding policy is to contribute yearly, at least the amount necessary to satisfy the funding standards of the Employee Retirement Income Security Act (ERISA).

The Corporation's Restoration of Retirement Income Plan (the Restoration Plan) provides benefits for eligible employees that are in excess of the limits under Section 415 of the Internal Revenue Code of 1986, as amended, that apply to the Retirement Plan. The Restoration Plan is designed to comply with the requirements of ERISA. The entire cost of the plan, which was also frozen as of December 31, 2001, is supported by contributions from the Corporation.

Table of Contents

The Corporation uses a December 31 measurement date for its defined benefit plans. Combined activity in the Corporation's defined benefit pension plans was as follows:

	2012	2011	2010
Change in benefit obligation:			
Benefit obligation at beginning of year	\$ 157,855	\$ 145,246	\$ 132,456
Interest cost	7,801	7,892	7,724
Actuarial (gain) loss	18,436	10,383	10,189
Benefits paid	(5,934)	(5,666)	(5,123)
Benefit obligation at end of year	178,158	157,855	145,246
Change in plan assets:			
Fair value of plan assets at beginning of year	137,253	141,050	128,044
Actual return on plan assets	13,931	(3,776)	17,580
Employer contributions	651	5,645	549
Benefits paid	(5,934)	(5,666)	(5,123)
Fair value of plan assets at end of year	145,901	137,253	141,050
Funded status of the plan at end of year and accrued benefit liability recognized	\$ 32,257	\$ 20,602	\$ 4,196
Accumulated benefit obligation at end of year	\$ 178,158	\$ 157,855	\$ 145,246

Certain disaggregated information related to the Corporation's defined benefit pension plans as of year-end was as follows:

	Retirement Plan		Restoration Plan	
	2012	2011	2012	2011
Projected benefit obligation	\$ 160,738	\$ 141,277	\$ 17,420	\$ 16,578
Accumulated benefit obligation	160,738	141,277	17,420	16,578
Fair value of plan assets	145,901	137,253	-	-
Funded status of the plan at end of year and accrued benefit (asset) liability recognized	14,837	4,024	17,420	16,578

The components of the combined net periodic benefit cost (benefit) for the Corporation's defined benefit pension plans were as follows:

	2012	2011	2010
Expected return on plan assets, net of expenses	\$ (10,412)	\$ (11,434)	\$ (11,008)
Interest cost on projected benefit obligation	7,801	7,892	7,724
Net amortization and deferral	5,709	3,130	2,915
Net periodic cost (benefit)	\$ 3,098	\$ (412)	\$ (369)

Amounts related to the Corporation's defined benefit pension plans recognized as a component of other comprehensive income were as follows:

	2012	2011	2010
Net actuarial gain (loss)	\$ (9,405)	\$ (22,463)	\$ (702)
Deferred tax (expense) benefit	3,292	7,862	245
Other comprehensive income (loss), net of tax	\$ (6,113)	\$ (14,601)	\$ (457)

Table of Contents

Amounts recognized as a component of accumulated other comprehensive loss as of year-end that have not been recognized as a component of the combined net period benefit cost of the Corporation's defined benefit pension plans are presented in the following table. The Corporation expects to recognize approximately \$6.6 million of the net actuarial loss reported in the following table as of December 31, 2012 as a component of net periodic benefit cost during 2013.

	2012	2011
Net actuarial loss	\$ (75,494)	\$ (66,287)
Deferred tax benefit	26,423	23,200
Amounts included in accumulated other comprehensive loss, net of tax	\$ (49,071)	\$ (43,087)

The weighted-average assumptions used to determine the benefit obligations as of the end of the years indicated and the net periodic benefit cost for the years indicated are presented in the table below. Because the plans were frozen, increases in compensation are not considered after 2001.

	2012	2011	2010
Benefit obligations:			
Discount rate	4.20%	5.05%	5.55%
Net periodic benefit cost:			
Discount rate	5.05%	5.55%	5.95%
Expected return on plan assets	7.75	8.25	8.75

Management uses an asset allocation optimization model to analyze the potential risks and rewards associated with various asset allocation strategies on a quarterly basis. As of December 31, 2012, management's investment objective for the Corporation's defined benefit plans is to achieve long-term growth. This strategy provides for a target asset allocation of approximately 62% invested in equity securities, approximately 35% invested in fixed income debt securities with any remainder invested in cash or short-term cash equivalents. The modeling process calculates, with a 90% confidence ratio, the potential risk associated with a given asset allocation and helps achieve adequate diversification of investment assets. The plan assets are reviewed annually to determine if the obligations can be met with the current investment mix and funding strategy.

The major categories of assets in the Corporation's Retirement Plan as of year-end is presented in the following table. Assets are segregated by the level of the valuation inputs within the fair value hierarchy established by ASC Topic 820 Fair Value Measurements and Disclosures, utilized to measure fair value (see Note 16 - Fair Value Measurements). The Plan previously reported certain investments using Level 1 market inputs. Plan management has determined that certain of these investments should have been reported as Level 2. This change had no impact on the fair value of the investments in any of the periods presented. The Corporation's Restoration Plan is unfunded.

	2012	2011
Level 1:		
Mutual funds	\$ 141,115	\$ 127,022
Cash and cash equivalents	2,466	7,091
Level 2:		
Corporate bonds and notes	1,350	1,973
U.S. government agency securities	696	896
States and political subdivisions	274	271
Total fair value of plan assets	\$ 145,901	\$ 137,253

Mutual funds include various equity, fixed-income and blended funds with varying investment strategies. Approximately 64% of mutual fund investments consist of equity investments. The investment objective of

Table of Contents

equity funds is long-term capital appreciation with current income. The remaining mutual fund investments consist of U.S. fixed-income securities, including investment-grade U.S. Treasury securities, U.S. government agency securities and mortgage-backed securities, corporate bonds and notes and collateralized mortgage obligations. The investment objective of fixed-income funds is to maximize investment return while preserving investment principal. Corporate bonds and notes include investment-grade bonds and notes of U.S. companies from diversified industries. U.S. government agency securities include obligations of Ginnie Mae. States and political subdivisions include fixed income municipal securities. The Corporation's investment strategies prohibit selling assets short and the use of derivatives. Additionally, the Corporation's defined benefit plans do not directly invest in real estate, commodities, or private investments.

The asset allocation optimization model is used to estimate the expected long-term rate of return for a given asset allocation strategy. Expectations of returns for each asset class are based on comprehensive reviews of historical data and economic/financial market theory. During periods with volatile interest rates and equity security prices, the model may call for changes in the allocation of plan investments to achieve desired returns. Management assumed a long-term rate of return of 7.75% in the determination of the net periodic benefit cost for 2012. The expected long-term rate of return on assets was selected from within the reasonable range of rates determined by historical real returns, net of inflation, for the asset classes covered by the plan's investment policy and projections of inflation over the long-term period during which benefits are payable to plan participants.

As of December 31, 2012, expected future benefit payments related to the Corporation's defined benefit plans were as follows:

2013	\$ 7,282
2014	7,720
2015	8,263
2016	8,688
2017	9,178
2018 through 2022	52,841
	\$ 93,972

The Corporation expects to contribute \$1.0 million to the defined benefit plans during 2013.

Supplemental Executive Retirement Plan. The Corporation maintains a supplemental executive retirement plan (SERP) for one active key executive. The plan provides for target retirement benefits, as a percentage of pay, beginning at age 55. The target percentage is 45 percent of pay at age 55, increasing to 60 percent at age 60 and later. Benefits under the SERP are reduced, dollar-for-dollar, by benefits received under the profit sharing, non-qualified profit sharing, defined benefit retirement and restoration plans, described above, and any social security benefits.

Savings Plans

401(k) Plan and Thrift Incentive Plan. The Corporation maintains a 401(k) stock purchase plan that permits each participant to make before- or after-tax contributions in an amount not less than 2% and not exceeding 50% of eligible compensation and subject to dollar limits from Internal Revenue Service regulations. The Corporation matches 100% of the employee's contributions to the plan based on the amount of each participant's contributions up to a maximum of 6% of eligible compensation. Eligible employees must complete 90 days of service in order to enroll and vest in the Corporation's matching contributions immediately. Expense related to the plan totaled \$10.8 million in 2012, \$10.2 million in 2011, and \$9.8 million in 2010. The Corporation's matching contribution is initially invested in the Cullen/Frost common stock fund. However, employees may immediately reallocate the Corporation's matching portion, as well as invest their individual contribution, to any of a variety of investment alternatives offered under the 401(k) Plan.

Table of Contents

The Corporation maintains a thrift incentive stock purchase plan to offer certain employees whose participation in the 401(k) plan is limited an alternative means of receiving comparable benefits. Expense related to this plan was not significant during 2012, 2011 and 2010.

Stock Compensation Plans

The Corporation has one active executive stock plan (the 2005 Omnibus Incentive Plan) and one active outside director stock plan (the 2007 Outside Directors Incentive Plan). The executive stock plan was established to help the Corporation retain and motivate key employees, while the outside director stock plans were established as a means to compensate outside directors for their service to the Corporation. All of the plans have been approved by the Corporation's shareholders. The Compensation and Benefits Committee (Committee) of the Corporation's Board of Directors has sole authority to select the employees, establish the awards to be issued, and approve the terms and conditions of each award contract under the executive stock plans.

During 2005, the 2005 Omnibus Incentive Plan (2005 Plan) was established to replace all other previously approved executive stock plans and the remaining shares authorized for grant under the 2001 Stock Plan were cancelled. Under the 2005 Plan, the Corporation may grant, among other things, nonqualified stock options, incentive stock options, stock awards, stock award units, stock appreciation rights, or any combination thereof to certain employees.

During 2007, the 2007 Outside Directors Incentive Plan (the 2007 Directors Plan) was established to replace the 1997 Directors Plan. The 2007 Directors Plan allows the Corporation to grant nonqualified stock options, stock awards and stock award units to outside directors. Subject to the terms of the plan, stock options, stock awards and/or stock award units may be awarded in such number, and upon such terms, and at any time and from time to time as determined by the Committee.

Options awarded under the 2005 Plan during the periods presented have a ten-year life and generally vest in equal annual installments over a four-year period. Non-vested stock awards/stock units awarded under the 2005 Plan generally have a four-year-cliff vesting period. No options were awarded under the 2007 Directors Plan during the reported periods. Director deferred stock units awarded under the 2007 Directors Plan have immediate vesting. Upon retirement from the Corporation's board of directors, non-employee directors will receive one share of the Corporation's common stock for each deferred stock unit held. Outstanding non-vested stock units and director deferred stock units receive equivalent dividend payments as such dividends are declared on the Corporation's common stock.

Each award from all plans is evidenced by an award agreement that specifies the option price, the duration of the option, the number of shares to which the option pertains, and such other provisions as the Committee determines. The option price for each grant is at least equal to the fair market value of a share of Cullen/Frost's common stock on the date of grant. Options granted expire at such time as the Committee determines at the date of grant and in no event does the exercise period exceed a maximum of ten years. Upon a change-in-control of Cullen/Frost, as defined in the plans, all outstanding options and non-vested stock awards/units immediately vest.

Table of Contents

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		Stock Options Outstanding	
			Number of Shares	Weighted-Average Grant-Date Fair Value	Number of Shares	Weighted-Average Exercise Price
Balance, January 1, 2010	3,445,507	12,688	233,200	\$ 52.27	4,600,455	\$ 51.18
Granted	(814,910)	5,030	56,300	52.46	753,580	52.51
Stock options exercised	-	-	-	-	(819,650)	47.34
Stock awards vested	-	-	(61,950)	56.73	-	-
Deferred stock unit conversions	-	(1,203)	-	-	-	-
Forfeited	150,500	-	-	-	(150,500)	52.49
Cancelled/expired	(21,750)	-	-	-	-	-
Balance, December 31, 2010	2,759,347	16,515	227,550	51.10	4,383,885	52.08
Granted	(868,267)	5,577	56,300	48.00	806,390	48.02
Stock options exercised	-	-	-	-	(148,203)	50.18
Stock awards vested	-	-	(114,320)	50.19	-	-
Forfeited	73,250	-	-	-	(73,250)	51.43
Cancelled/expired	(875)	-	-	-	-	-
Balance, December 31, 2011	1,963,455	22,092	169,530	50.33	4,968,822	51.49
Granted	(825,542)	5,632	49,130	54.56	770,780	54.56
Stock options exercised	-	-	-	-	(206,336)	50.96
Stock awards vested	-	-	(30,100)	52.44	-	-
Forfeited	19,750	-	-	-	(19,750)	50.49
Cancelled/expired	(250)	-	-	-	-	-
Balance, December 31, 2012	1,157,413	27,724	188,560	\$ 51.67	5,513,516	\$ 51.94

Of the shares available for grant included in the above table as of December 31, 2012, a total of 63,043 shares may be granted as full value awards, meaning awards other than in the form of stock options or stock appreciation rights, and which are settled by the issuance of shares.

Other information regarding options outstanding and exercisable as of December 31, 2012 is as follows:

Range of Exercise Prices	Options Outstanding			Options Exercisable	
	Number of Shares	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Life in Years	Number of Shares	Weighted-Average Exercise Price
\$ 45.01 - \$ 50.00	1,401,394	\$ 48.37	7.07	807,474	\$ 49.27

Edgar Filing: CULLEN/FROST BANKERS, INC. - Form 10-K

50.01	-	55.00	3,420,072	52.23	6.89	2,110,954	51.48
55.01	-	60.00	692,050	57.73	3.85	689,550	57.73
		Total	5,513,516	51.94	6.55	3,607,978	52.18

The total intrinsic value of outstanding in-the-money stock options and outstanding in-the-money exercisable stock options was \$15.5 million and \$10.4 million at December 31, 2012.

Table of Contents

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:

	2012	2011	2010
New shares issued from available authorized shares	207,586	140,739	666,222
Issued from available treasury stock	15,600	29,824	176,991
Total	223,186	170,563	843,213

Proceeds from stock option exercises	\$ 10,516	\$ 7,438	\$ 38,807
Intrinsic value of stock options exercised	1,538	1,475	6,639
Fair value of stock awards/units vested	1,649	6,161	3,322

Stock-based Compensation Expense Stock-based compensation expense is recognized ratably over the requisite service period for all awards. Stock-based compensation expense and the related income tax benefit was as follows:

	2012	2011	2010
Stock options	\$ 9,663	\$ 10,834	\$ 9,839
Non-vested stock awards/stock units	2,843	4,799	4,786
Deferred stock-units	330	330	300
Total	\$ 12,836	\$ 15,963	\$ 14,925
Income tax benefit	\$ 4,493	\$ 5,587	\$ 5,224

Unrecognized stock-based compensation expense at December 31, 2012 was as follows:

Stock options	\$ 17,675
Non-vested stock awards/stock units	2,933
Total	\$ 20,608

The weighted-average period over which this unrecognized expense related to stock options was expected to be recognized was 2.8 years. The weighted-average period over which this unrecognized expense related to non-vested stock awards/stock units was expected to be recognized was 2.6 years.

Valuation of Stock-Based Compensation. The fair value of the Corporation's employee stock options granted is estimated on the measurement date, which, for the Corporation, is the date of grant. The fair value of stock options is estimated using a binomial lattice-based valuation model that takes into account employee exercise patterns based on changes in the Corporation's stock price and other variables, and allows for the use of dynamic assumptions about interest rates and expected volatility. The fair value of stock options granted prior to the fourth quarter of 2006 was estimated using the Black-Scholes option-pricing model.

The weighted-average fair value of stock options granted during 2012, 2011 and 2010 estimated using a binomial lattice-based valuation model, was \$11.07, \$9.78, and \$12.94. The assumptions used to determine the fair value of options granted are detailed in the table below.

	2012	2011	2010
Risk-free interest rate	0.10% to 3.58%	0.01% to 3.91%	0.14% to 4.98%
Weighted-average risk-free interest rate	1.85%	2.23%	2.79%
Dividend yield	3.28%	2.84%	2.79%
Expected market price volatility	24.97% to 31.15%	24.87% to 31.32%	31.11% to 41.40%
Weighted-average expected market price volatility	28.06%	29.43%	34.65%
Expected term	6.0 to 6.9 Years	6.0 to 7.0 Years	5.6 to 6.9 Years
Weighted-average expected term	6.5 Years	6.3 Years	6.0 Years

Table of Contents

Expected volatility is based on the short-term historical volatility (estimated over the most recent two years) and the long-term historical volatility (estimated over a period at least equal to the contractual term of the options) of the Corporation's stock, and other factors. A variance targeting methodology is utilized to estimate the convergence, or mean reversion, from short-term to long-term volatility within the model. In estimating the fair value of stock options under the binomial lattice-based valuation model, separate groups of employees that have similar historical exercise behavior are considered separately. The expected term of options granted is derived using a regression model and represents the period of time that options granted are expected to be outstanding. The range of expected term results from certain groups of employees exhibiting different behavior.

The fair value of non-vested stock awards/stock units and deferred stock units for the purposes of recognizing stock-based compensation expense is the market price of the stock on the measurement date, which, for the Corporation, is the date of the award.

Note 12 - Other Non-Interest Income and Expense

Other non-interest income and expense totals are presented in the following tables. Components of these totals exceeding 1% of the aggregate of total net interest income and total non-interest income for any of the years presented are stated separately.

	2012	2011	2010
Other non-interest income:			
Other	\$ 30,703	\$ 26,370	\$ 28,744
Total	\$ 30,703	\$ 26,370	\$ 28,744
Other non-interest expense:			
Advertising, promotions and public relations	\$ 23,773	\$ 22,584	\$ 15,087
Legal and other professional fees	22,341	19,802	20,792
Travel/meals and entertainment	13,049	11,493	10,350
Visa check card expense	8,940	8,214	7,048
Other	71,366	75,500	70,930
Total	\$ 139,469	\$ 137,593	\$ 124,207

Note 13 - Income Taxes

Income tax expense was as follows:

	2012	2011	2010
Current income tax expense	\$ 76,928	\$ 60,533	\$ 52,932
Deferred income tax expense (benefit)	(6,405)	8,167	4,644
Income tax expense, as reported	\$ 70,523	\$ 68,700	\$ 57,576

Reported income tax expense differed from the amounts computed by applying the U.S. federal statutory income tax rate of 35% to income before income taxes as follows:

2012	2011	2010
------	------	------

Edgar Filing: CULLEN/FROST BANKERS, INC. - Form 10-K

Income tax expense computed at the statutory rate	\$ 107,966	\$ 100,182	\$ 93,219
Effect of tax-exempt interest	(36,543)	(35,741)	(34,355)
Bank owned life insurance income	(1,413)	(1,416)	(1,581)
Accrual adjustment for premium amortization on municipal securities	-	4,146	-
Other	513	1,529	293
Income tax expense, as reported	\$ 70,523	\$ 68,700	\$ 57,576

Table of Contents

Income tax expense for 2011 included the correction of an under-accrual of taxes that resulted from incorrectly deducting premium amortization on municipal securities for federal income tax purposes since 2008. As a result, the Corporation recognized additional income tax expense totaling \$4.1 million, which included interest, related to the 2010, 2009 and 2008 tax years. 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.

Year-end deferred taxes were as follows:

	2012	2011
Deferred tax assets:		
Allowance for loan losses	\$ 36,514	\$ 38,552
Net actuarial loss on defined benefit post-retirement benefit plans	26,423	23,131
Stock-based compensation	19,270	16,411
Bonus accrual	5,006	4,352
Gain on sale of assets	2,329	2,424
Partnerships	1,808	1,115
Non-accrual loans	1,719	1,763
Other	4,014	4,269
Total gross deferred tax assets	97,083	92,017
Deferred tax liabilities:		
Net unrealized gain on securities available for sale and effective cash flow hedging derivatives	(154,603)	(156,528)
Premises and equipment	(22,451)	(23,948)
Defined benefit post-retirement benefit plans	(14,895)	(15,732)
Intangible assets	(6,924)	(7,383)
Leases	(4,717)	(5,563)
Bonus accrual 481(a) adjustment	(2,182)	(3,273)
Prepaid expenses	(1,516)	(1,509)
Reserve for medical insurance	(1,509)	(1,325)
Other	(355)	(447)
Total gross deferred tax liabilities	(209,152)	(215,708)
Net deferred tax asset (liability)	\$ (112,069)	\$ (123,691)

No valuation allowance for deferred tax assets was recorded at December 31, 2012 and 2011 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.

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.

Table of Contents**Note 14 - Other Comprehensive Income (Loss)**

The tax effects allocated to each component of other comprehensive income (loss) were as follows:

	Before Tax Amount	Tax Expense, (Benefit)	Net of Tax Amount
2012			
Securities available for sale:			
Change in net unrealized gain/loss during the period	\$ 32,755	\$ 11,464	\$ 21,291
Reclassification adjustment for net (gains) losses included in net income	(4,314)	(1,510)	(2,804)
Total securities available for sale	28,441	9,954	18,487
Defined-benefit post-retirement benefit plans:			
Change in the net actuarial gain/loss	(9,405)	(3,292)	(6,113)
Derivatives:			
Change in the accumulated gain/loss on effective cash flow hedge derivatives	(783)	(274)	(509)
Reclassification adjustments for (gains) losses included in net income:			
Interest rate swaps on variable-rate loans	(37,380)	(13,083)	(24,297)
Interest rate swap on junior subordinated deferrable interest debentures	4,224	1,478	2,746
Total derivatives	(33,939)	(11,879)	(22,060)
Total other comprehensive income (loss)	\$ (14,903)	\$ (5,217)	\$ (9,686)
2011			
Securities available for sale:			
Change in net unrealized gain/loss during the period	\$ 208,015	\$ 72,806	\$ 135,209
Reclassification adjustment for net (gains) losses included in net income	(6,414)	(2,245)	(4,169)
Total securities available for sale	201,601	70,561	131,040
Defined-benefit post-retirement benefit plans:			
Change in the net actuarial gain/loss	(22,463)	(7,862)	(14,601)
Derivatives:			
Change in the accumulated gain/loss on effective cash flow hedge derivatives	(2,321)	(812)	(1,509)
Reclassification adjustments for (gains) losses included in net income:			
Interest rate swaps on variable-rate loans	(37,380)	(13,083)	(24,297)
Interest rate swap on junior subordinated deferrable interest debentures	4,386	1,535	2,851
Total derivatives	(35,315)	(12,360)	(22,955)
Total other comprehensive income (loss)	\$ 143,823	\$ 50,339	\$ 93,484

Table of Contents

	Before Tax Amount	Tax Expense, (Benefit)	Net of Tax Amount
2010			
Securities available for sale:			
Change in net unrealized gain/loss during the period	\$ (21,568)	\$ (7,549)	\$ (14,019)
Reclassification adjustment for net (gains) losses included in net income	(6)	(2)	(4)
Total securities available for sale	(21,574)	(7,551)	(14,023)
Defined-benefit post-retirement benefit plans:			
Change in the net actuarial gain/loss	(887)	(310)	(577)
Derivatives:			
Change in the accumulated gain/loss on effective cash flow hedge derivatives	61,553	21,544	40,009
Reclassification adjustments for (gains) losses included in net income:			
Interest rate swaps on variable-rate loans	(43,389)	(15,186)	(28,203)
Interest rate swap on junior subordinated deferrable interest debentures	4,367	1,528	2,839
Total derivatives	22,531	7,886	14,645
Total other comprehensive income (loss)	\$ 70	\$ 25	\$ 45

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

	Securities Available For Sale	Defined Benefit Plans	Derivatives	Accumulated Other Comprehensive Income
Balance January 1, 2012	\$ 227,052	\$ (42,958)	\$ 63,640	\$ 247,734
Other comprehensive income (loss)	18,487	(6,113)	(22,060)	(9,686)
Balance December 31, 2012	\$ 245,539	\$ (49,071)	\$ 41,580	\$ 238,048
Balance January 1, 2011	\$ 96,012	\$ (28,357)	\$ 86,595	\$ 154,250
Other comprehensive income (loss)	131,040	(14,601)	(22,955)	93,484
Balance December 31, 2011	\$ 227,052	\$ (42,958)	\$ 63,640	\$ 247,734
Balance January 1, 2010	\$ 110,035	\$ (27,780)	\$ 71,950	\$ 154,205
Other comprehensive income (loss)	(14,023)	(577)	14,645	45
Balance December 31, 2010	\$ 96,012	\$ (28,357)	\$ 86,595	\$ 154,250

Table of Contents**Note 15 - Derivative Financial Instruments**

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

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

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

During 2007, the Corporation entered into three interest rate swap contracts on variable-rate loans with a total notional amount of \$1.2 billion. The interest rate swap contracts were designated as hedging instruments in cash flow hedges with the objective of 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 further discussed below, 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. Under the initial hedge relationship, the desired constant yield was 7.559% in the case of the first contract (underlying loan pool totaling \$650.0 million carrying an interest rate equal to Prime), 8.059% in the case of the second contract (underlying loan pool totaling \$230.0 million carrying an interest rate equal to Prime plus a margin of 50 basis points) and 8.559% in the case of the third contract (underlying loan pool totaling \$320.0 million carrying an interest rate equal to Prime plus a margin of 100 basis points). Under the swaps, the Corporation received a fixed interest rate of 7.559% and paid a variable interest rate equal to the daily Federal Reserve Statistical Release H-15 Prime Rate (Prime), with monthly settlements.

As stated above, during November 2009, the Corporation settled portions of two of the interest rate swap contracts having a total notional amount of \$400.0 million and concurrently terminated the hedges related to the interest cash flows on a rolling portfolio of \$400.0 million of variable rate loans. The terminated hedges had underlying loan pools totaling \$300.0 million carrying an interest rate equal to Prime and \$100.0 million carrying an interest rate equal to Prime plus a margin of 50 basis points. In November 2010, the Corporation settled the remaining interest rate swap contracts having a total notional amount of \$800.0 million and concurrently terminated the hedges related to the interest cash flows on a rolling portfolio of \$800.0 million of variable rate loans. The terminated hedges had underlying loan pools totaling \$350.0 million carrying an interest rate equal to Prime, \$130.0 million carrying an interest rate equal to Prime plus a margin of 50 basis points and \$320.0 million carrying an interest rate equal to Prime plus a margin of 100 basis points. The deferred accumulated after-tax gain applicable to the settled interest rate contracts included in accumulated other comprehensive income totaled \$68.0 million and \$105.4 million (\$44.2 million and \$68.5 million on an after-tax basis) at December 31, 2012 and 2011, respectively. The remaining deferred gain of \$68.0 million (\$44.2 million on an after-tax basis) at December 31, 2012 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

Table of Contents

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.

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 outstanding at December 31, 2012 and 2011 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.

	December 31, 2012		December 31, 2011	
	Notional Amount	Estimated Fair Value	Notional Amount	Estimated Fair Value
Interest rate derivatives designated as hedges of fair value:				
Commercial loan/lease interest rate swaps	\$ 99,325	\$ (7,162)	\$ 71,181	\$ (8,376)
Interest rate derivatives designated as hedges of cash flows:				
Interest rate swap on junior subordinated deferrable interest debentures	120,000	(4,365)	120,000	(7,807)
Non-hedging interest rate derivatives:				
Commercial loan/lease interest rate swaps	797,311	60,854	613,883	61,137
Commercial loan/lease interest rate swaps	797,311	(60,994)	613,883	(61,393)
Commercial loan/lease interest rate caps	30,000	12	20,000	50
Commercial loan/lease interest rate caps	30,000	(12)	20,000	(50)

The weighted-average rates paid and received for interest rate swaps outstanding at December 31, 2012 were as follows:

	Weighted-Average	
	Interest Rate Paid	Interest Rate Received
Interest rate swaps:		
Fair value hedge commercial loan/lease interest rate swaps	2.82%	0.21%
Cash flow hedge interest rate swaps on junior subordinated deferrable interest debentures	5.47	1.86
Non-hedging interest rate swaps	1.85	4.51
Non-hedging interest rate swaps	4.51	1.85

The weighted-average strike rate for outstanding interest rate caps was 2.73% at December 31, 2012.

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 to mitigate the exposure to fluctuations in commodity prices.

Table of Contents

The notional amounts and estimated fair values of commodity derivative positions outstanding are presented in the following table. The Corporation obtains dealer quotations and uses internally developed valuation models to value its commodity derivative positions.

		December 31, 2012		December 31, 2011	
		Notional Units	Notional Amount	Estimated Fair Value	Notional Amount
Non-hedging commodity swaps:					
Oil	Barrels	499	\$ 479	459	\$ 1,068
Oil	Barrels	499	(384)	459	(963)
Natural gas	MMBTUs	-	-	1,905	3,540
Natural gas	MMBTUs	-	-	1,905	(3,480)
Non-hedging commodity options:					
Oil	Barrels	366	1,380	2,920	18,206
Oil	Barrels	366	(1,380)	2,920	(18,206)
Natural gas	MMBTUs	240	44	480	490
Natural gas	MMBTUs	240	(44)	480	(490)

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 not significant at December 31, 2012 and 2011.

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.

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

	2012	2011	2010
Commercial loan/lease interest rate swaps:			
Amount of gain (loss) included in interest income on loans	\$ (2,587)	\$ (3,640)	\$ (5,082)
Amount of (gain) loss included in other non-interest expense	46	(3)	(110)

Table of Contents

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:

	2012	2011	2010
Interest rate swaps/caps/floors on variable-rate loans:			
Amount reclassified from accumulated other comprehensive income to interest income on loans	\$ 37,380	\$ 37,380	\$ 43,389
Amount of gain (loss) recognized in other comprehensive income	-	-	68,865
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	4,224	4,386	4,367
Amount of gain (loss) recognized in other comprehensive income	(783)	(2,321)	(7,312)

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 \$41.6 million at December 31, 2012 and \$63.6 million at December 31, 2011. The Corporation currently expects approximately \$21.7 million of the net after-tax gain related to effective cash flow hedges included in accumulated other comprehensive income at December 31, 2012 will be reclassified into earnings during 2013, with the remaining amount expected to be reclassified 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 and commodity derivative instruments are presented in the table below. Amounts included in the consolidated statements of income related to foreign currency derivatives during the reported periods were not significant.

	2012	2011	2010
Non-hedging interest rate derivatives:			
Other non-interest income	\$ 4,722	\$ 2,270	\$ 2,713
Other non-interest expense	(116)	(76)	154
Non-hedging commodity derivatives:			
Other non-interest income	124	627	221

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 is limited to the net favorable value of all swaps/options by each counterparty. Credit exposure may be reduced by the amount of collateral pledged by the counterparty. There are no credit-risk-related

Table of Contents

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 and commodity swaps/options with bank customers was approximately \$62.8 million at December 31, 2012. 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 and commodity swaps/options with upstream financial institution counterparties was approximately \$406 thousand at December 31, 2012. Collateral levels for upstream financial institution counterparties are monitored and adjusted as necessary.

The aggregate fair value of securities posted as collateral by the Corporation related to derivative contracts totaled \$66.2 million at December 31, 2012. At such date, the Corporation also had \$3.4 million in cash collateral on deposit with other financial institution counterparties.

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

Table of Contents

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:

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.

Table of Contents

The following table summarizes financial assets and financial liabilities measured at fair value on a recurring basis as of December 31, 2012 and 2011, segregated by the level of the valuation inputs within the fair value hierarchy utilized to measure fair value:

	Level 1	Level 2	Level 3	Total
	Inputs	Inputs	Inputs	Fair Value
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	-	60,511	355	60,866
Commodity and foreign exchange derivatives	3	1,903	-	1,906
Derivative liabilities:				
Interest rate swaps, caps and floors	-	72,533	-	72,533
Commodity and foreign exchange derivatives	-	1,808	-	1,808
2011				
Securities available for sale:				
U.S. Treasury	\$ 2,056,732	\$ -	\$ -	\$ 2,056,732
U.S. government agencies/corporations	-	250,884	-	250,884
Residential mortgage-backed securities	-	3,289,270	-	3,289,270
States and political subdivisions	-	2,154,813	-	2,154,813
Other	-	38,001	-	38,001
Trading account securities:				
U.S. Treasury	13,609	-	-	13,609
Derivative assets:				