

CULLEN/FROST BANKERS, INC.

Form 10-Q

April 23, 2014

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United States

Securities and Exchange Commission

Washington, D.C. 20549

Form 10-Q

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

For the quarterly period ended: March 31, 2014

Or

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

For the transition period from _____ to _____

Commission file number: 001-13221

Cullen/Frost Bankers, Inc.

(Exact name of registrant as specified in its charter)

Texas

74-1751768

(State or other jurisdiction of
incorporation or organization)

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

100 W. Houston Street, San Antonio, Texas

78205

(Address of principal executive offices)

(Zip code)

(210) 220-4011

(Registrant's telephone number, including area code)

N/A

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

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes ý No ¨

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

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

Large accelerated filer ý

Accelerated filer ¨

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

Smaller reporting company ¨

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

As of April 17, 2014, there were 60,911,318 shares of the registrant's Common Stock, \$.01 par value, outstanding.

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Part I. Financial Information

Item 1. Financial Statements (Unaudited)

Cullen/Frost Bankers, Inc.

Consolidated Balance Sheets

(Dollars in thousands, except per share amounts)

	March 31, 2014	December 31, 2013
Assets:		
Cash and due from banks	\$692,272	\$885,121
Interest-bearing deposits	4,480,586	3,646,756
Federal funds sold and resell agreements	5,273	24,248
Total cash and cash equivalents	5,178,131	4,556,125
Securities held to maturity, at amortized cost	3,082,082	3,139,748
Securities available for sale, at estimated fair value	5,482,465	5,895,436
Trading account securities	15,524	16,398
Loans, net of unearned discounts	9,750,645	9,515,700
Less: Allowance for loan losses	(95,156)	(92,438)
Net loans	9,655,489	9,423,262
Premises and equipment, net	320,701	313,331
Goodwill	536,649	536,649
Other intangible assets, net	5,656	6,345
Cash surrender value of life insurance policies	141,790	141,108
Accrued interest receivable and other assets	266,598	284,537
Total assets	\$24,685,085	\$24,312,939
Liabilities:		
Deposits:		
Non-interest-bearing demand deposits	\$8,617,316	\$8,311,149
Interest-bearing deposits	12,448,317	12,377,637
Total deposits	21,065,633	20,688,786
Federal funds purchased and repurchase agreements	515,235	668,253
Junior subordinated deferrable interest debentures	123,712	123,712
Other long-term borrowings	100,000	100,000
Accrued interest payable and other liabilities	314,586	218,027
Total liabilities	22,119,166	21,798,778
Shareholders' Equity:		
Preferred stock, par value \$0.01 per share; 10,000,000 shares authorized;		
6,000,000 Series A shares (\$25 liquidation preference) issued at March 31, 2014 and	144,486	144,486
at December 31, 2013		
Common stock, par value \$0.01 per share; 210,000,000 shares authorized; 61,632,464	617	617
shares issued at March 31, 2014 and December 31, 2013		
Additional paid-in capital	727,677	724,197
Retained earnings	1,599,337	1,575,282
Accumulated other comprehensive income, net of tax	142,748	140,434
Treasury stock, at cost; 736,196 shares at March 31, 2014 and 1,066,021 shares at	(48,946)	(70,855)
December 31, 2013		
Total shareholders' equity	2,565,919	2,514,161
Total liabilities and shareholders' equity	\$24,685,085	\$24,312,939

See Notes to Consolidated Financial Statements.

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Cullen/Frost Bankers, Inc.

Consolidated Statements of Income

(Dollars in thousands, except per share amounts)

	Three Months Ended March 31,	
	2014	2013
Interest income:		
Loans, including fees	\$104,315	\$102,056
Securities:		
Taxable	21,403	27,377
Tax-exempt	35,564	27,954
Interest-bearing deposits	2,404	1,353
Federal funds sold and resell agreements	20	22
Total interest income	163,706	158,762
Interest expense:		
Deposits	2,561	4,008
Federal funds purchased and repurchase agreements	27	30
Junior subordinated deferrable interest debentures	561	1,673
Other long-term borrowings	222	238
Total interest expense	3,371	5,949
Net interest income	160,335	152,813
Provision for loan losses	6,600	6,000
Net interest income after provision for loan losses	153,735	146,813
Non-interest income:		
Trust and investment management fees	25,411	21,885
Service charges on deposit accounts	19,974	20,044
Insurance commissions and fees	13,126	13,070
Interchange and debit card transaction fees	4,243	4,011
Other charges, commissions and fees	8,207	7,755
Net gain (loss) on securities transactions	—	5
Other	6,529	11,010
Total non-interest income	77,490	77,780
Non-interest expense:		
Salaries and wages	70,217	66,465
Employee benefits	17,388	17,991
Net occupancy	12,953	11,979
Furniture and equipment	14,953	14,185
Deposit insurance	3,117	2,889
Intangible amortization	689	820
Other	38,624	41,485
Total non-interest expense	157,941	155,814
Income before income taxes	73,284	68,779
Income taxes	12,096	13,591
Net income	61,188	55,188
Preferred stock dividends	2,016	—
Net income available to common shareholders	\$59,172	\$55,188
Earnings per common share:		
Basic	\$0.97	\$0.91

Diluted	0.96	0.91
See Notes to Consolidated Financial Statements.		

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Cullen/Frost Bankers, Inc.

Consolidated Statements of Comprehensive Income

(Dollars in thousands)

	Three Months Ended March 31,	
	2014	2013
Net income	\$61,188	\$55,188
Other comprehensive income (loss), before tax:		
Securities available for sale and transferred securities:		
Change in net unrealized gain/loss during the period	21,431	(21,344)
Change in net unrealized gain on securities transferred to held to maturity	(9,198)	(8,459)
Reclassification adjustment for net (gains) losses included in net income	—	(5)
Total securities available for sale and transferred securities	12,233	(29,808)
Defined-benefit post-retirement benefit plans:		
Change in the net actuarial gain/loss	672	1,640
Derivatives:		
Change in the accumulated gain/loss on effective cash flow hedge derivatives	—	—
Reclassification adjustments for (gains) losses included in net income:		
Interest rate swaps on variable-rate loans	(9,345)	(9,345)
Interest rate swap on junior subordinated deferrable interest debentures	—	1,085
Total derivatives	(9,345)	(8,260)
Other comprehensive income (loss), before tax	3,560	(36,428)
Deferred tax expense (benefit) related to other comprehensive income	1,246	(12,750)
Other comprehensive income (loss), net of tax	2,314	(23,678)
Comprehensive income	\$63,502	\$31,510
See Notes to Consolidated Financial Statements.		

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Cullen/Frost Bankers, Inc.

Consolidated Statements of Changes in Shareholders' Equity

(Dollars in thousands, except per share amounts)

	Three Months Ended March 31,	
	2014	2013
Total shareholders' equity at beginning of period	\$2,514,161	\$2,417,482
Net income	61,188	55,188
Other comprehensive income (loss)	2,314	(23,678)
Stock option exercises (329,825 shares in 2014 and 395,425 shares in 2013)	17,279	20,446
Stock compensation expense recognized in earnings	2,136	2,342
Tax benefits (deficiencies) related to stock compensation	1,344	(209)
Issuance of preferred stock (6,000,000 shares in 2013)	—	144,539
Purchase of treasury stock (1,905,077 shares in 2013)	—	(115,200)
Accelerated share repurchase forward contract	—	(28,800)
Cash dividends – preferred stock (approximately \$0.34 per share in 2014)	(2,016)	—
Cash dividends – common stock (\$0.50 per share in 2014 and \$0.48 per share in 2013)	(30,487)	(28,779)
Total shareholders' equity at end of period	\$2,565,919	\$2,443,331
See Notes to Consolidated Financial Statements.		

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

	Three Months Ended March 31,	
	2014	2013
Operating Activities:		
Net income	\$61,188	\$55,188
Adjustments to reconcile net income to net cash from operating activities:		
Provision for loan losses	6,600	6,000
Deferred tax expense (benefit)	(1,933	) (2,118
Accretion of loan discounts	(3,503	) (2,900
Securities premium amortization (discount accretion), net	13,810	8,710
Net (gain) loss on securities transactions	—	(5
Depreciation and amortization	9,702	9,464
Net (gain) loss on sale/write-down of assets/foreclosed assets	147	3,342
Stock-based compensation	2,136	2,342
Net tax benefit (deficiency) from stock-based compensation	9	(331
Excess tax benefits from stock-based compensation	(1,335	) (122
Earnings on life insurance policies	(682	) (893
Net change in:		
Trading account securities	909	7,410
Accrued interest receivable and other assets	14,633	9,460
Accrued interest payable and other liabilities	(29,098	) (140,719
Net cash from operating activities	72,583	(45,172
Investing Activities:		
Securities held to maturity:		
Purchases	—	(133,832
Maturities, calls and principal repayments	42,113	8,133
Securities available for sale:		
Purchases	(617,914	) (4,498,091
Sales	—	4,498,102
Maturities, calls and principal repayments	1,163,981	321,322
Net change in loans	(237,216	) 47,259
Net cash paid in acquisitions	—	—
Proceeds from sales of premises and equipment	15	12,550
Purchases of premises and equipment	(13,215	) (6,834
Proceeds from sales of repossessed properties	1,719	2,142
Net cash from investing activities	339,483	250,751
Financing Activities:		
Net change in deposits	376,847	(453,462
Net change in short-term borrowings	(153,018	) (50,959
Principal payments on long-term borrowings	—	(5
Proceeds from stock option exercises	17,279	20,446
Excess tax benefits from stock-based compensation	1,335	122
Proceeds from issuance of preferred stock	—	144,539
Purchase of treasury stock	—	(115,200

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Accelerated share repurchase forward contract	—	(28,800)
Cash dividends paid on preferred stock	(2,016) —	
Cash dividends paid on common stock	(30,487	) (28,779)
Net cash from financing activities	209,940	(512,098)
Net change in cash and cash equivalents	622,006	(306,519)
Cash and equivalents at beginning of period	4,556,125	3,524,979	
Cash and equivalents at end of period	\$5,178,131	\$3,218,460	

See Notes to Consolidated Financial Statements.

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Notes to Consolidated Financial Statements

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

Note 1 - Significant Accounting Policies

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

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

The consolidated financial statements in this Quarterly Report on Form 10-Q have not been audited by an independent registered public accounting firm, but in the opinion of management, reflect all adjustments necessary for a fair presentation of the Corporation's financial position and results of operations. All such adjustments were of a normal and recurring nature. The consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and with the instructions to Form 10-Q adopted by the Securities and Exchange Commission (SEC). Accordingly, the financial statements do not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements and should be read in conjunction with the Corporation's consolidated financial statements, and notes thereto, for the year ended December 31, 2013, included in the Corporation's Annual Report on Form 10-K filed with the SEC on February 6, 2014 (the "2013 Form 10-K"). Operating results for the interim periods disclosed herein are not necessarily indicative of the results that may be expected for a full year or any future period.

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

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

	Three Months Ended March 31,	
	2014	2013
Cash paid for interest	\$3,495	\$6,056
Cash paid for income tax	—	—
Significant non-cash transactions:		
Loans foreclosed and transferred to other real estate owned and foreclosed assets	1,994	274
Loans to facilitate the sale of other real estate owned	102	—
Deferred gain on sale of building and parking garage	—	1,318

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Note 2 - Securities

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

	March 31, 2014				December 31, 2013			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Held to Maturity								
U.S. Treasury	\$248,693	\$18,475	\$—	\$267,168	\$248,592	\$20,139	\$—	\$268,731
Residential mortgage-backed securities	9,512	92	58	9,546	9,674	89	143	9,620
States and political subdivisions	2,822,877	11,989	67,121	2,767,745	2,880,482	7,691	137,861	2,750,312
Other	1,000	—	—	1,000	1,000	—	—	1,000
Total	\$3,082,082	\$30,556	\$67,179	\$3,045,459	\$3,139,748	\$27,919	\$138,004	\$3,029,663
Available for Sale								
U.S. Treasury	\$1,825,033	\$15,178	\$1,453	\$1,838,758	\$2,522,159	\$18,395	\$—	\$2,540,554
U.S. Government agencies/corporations	—	—	—	—	54,024	—	44	53,980
Residential mortgage-backed securities	1,610,400	68,553	1,036	1,677,917	1,710,664	66,791	1,439	1,776,016
States and political subdivisions	1,893,310	38,680	2,190	1,929,800	1,476,316	20,090	7,492	1,488,914
Other	35,990	—	—	35,990	35,972	—	—	35,972
Total	\$5,364,733	\$122,411	\$4,679	\$5,482,465	\$5,799,135	\$105,276	\$8,975	\$5,895,436

All mortgage-backed securities included in the above table were issued by U.S. government agencies and corporations. At March 31, 2014, approximately 96.7% 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 68.8% are either guaranteed by the Texas Permanent School Fund, which has a "triple A" insurer financial strength rating, or secured by U.S. Treasury securities via defeasance of the debt by the issuers. Securities with limited marketability, such as stock in the Federal Reserve Bank and the Federal Home Loan Bank, are carried at cost and are reported as other available for sale securities in the above table. The carrying value of securities pledged to secure public funds, trust deposits, repurchase agreements and for other purposes, as required or permitted by law was \$2.6 billion at March 31, 2014 and \$3.0 billion and December 31, 2013.

During the fourth quarter of 2012, the Corporation reclassified certain securities from available for sale to held to maturity. The securities had an aggregate fair value of \$2.3 billion with an aggregate net unrealized gain of \$165.7 million (\$107.7 million, net of tax) on the date of the transfer. The net unamortized, unrealized gain on the transferred securities included in accumulated other comprehensive income in the accompanying balance sheet as of March 31, 2014 totaled \$120.2 million (\$78.1 million, net of tax). This amount will be amortized out of accumulated other comprehensive income over the remaining life of the underlying securities as an adjustment of the yield on those securities.

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As of March 31, 2014, securities, with unrealized losses segregated by length of impairment, were as follows:

	Less than 12 Months		More than 12 Months		Total	
	Estimated Fair Value	Unrealized Losses	Estimated Fair Value	Unrealized Losses	Estimated Fair Value	Unrealized Losses
Held to Maturity						
Residential mortgage-backed securities	\$6,967	\$58	\$—	\$—	\$6,967	\$58
States and political subdivisions	909,160	20,135	1,338,645	46,986	2,247,805	67,121
Total	\$916,127	\$20,193	\$1,338,645	\$46,986	\$2,254,772	\$67,179
Available for Sale						
U.S. Treasury	\$300,984	\$1,453	\$—	\$—	\$300,984	\$1,453
Residential mortgage-backed securities	14,598	804	2,745	232	17,343	1,036
States and political subdivisions	332,824	2,190	—	—	332,824	2,190
Total	\$648,406	\$4,447	\$2,745	\$232	\$651,151	\$4,679

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 March 31, 2014, management does not have the intent to sell any of the securities classified as available for sale in the table above and believes that it is more likely than not that the Corporation will not have to sell any such securities before a recovery of cost. Any unrealized losses are largely due to increases in market interest rates over the yields available at the time the underlying securities were purchased. The fair value is expected to recover as the bonds approach their maturity date or repricing date or if market yields for such investments decline. Management does not believe any of the securities are impaired due to reasons of credit quality. Accordingly, as of March 31, 2014, management believes the impairments detailed in the table above are temporary and no impairment loss has been realized in the Corporation's consolidated income statement.

The amortized cost and estimated fair value of securities, excluding trading securities, at March 31, 2014 are presented below by contractual maturity. Expected maturities may differ from contractual maturities because issuers may have the right to call or prepay obligations. Residential mortgage-backed securities and equity securities are shown separately since they are not due at a single maturity date.

	Held to Maturity		Available for Sale	
	Amortized Cost	Estimated Fair Value	Amortized Cost	Estimated Fair Value
Due in one year or less	\$136,041	\$140,005	\$798,320	\$806,678
Due after one year through five years	451,340	478,859	880,127	889,983
Due after five years through ten years	167,188	163,840	1,298,721	1,305,841
Due after ten years	2,318,001	2,253,209	741,175	766,056
Residential mortgage-backed securities	9,512	9,546	1,610,400	1,677,917
Equity securities	—	—	35,990	35,990
Total	\$3,082,082	\$3,045,459	\$5,364,733	\$5,482,465

Sales of securities available for sale were as follows:

Three Months Ended
March 31,

	2014	2013
Proceeds from sales	\$—	\$4,498,102
Gross realized gains	—	5
Gross realized losses	—	—
Tax (expense) benefit of securities gains/losses	—	(2)

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

	March 31, 2014	December 31, 2013
U.S. Treasury	\$15,489	\$15,389
States and political subdivisions	35	1,009
Total	\$15,524	\$16,398

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

	Three Months Ended March 31,	
	2014	2013
Net gain on sales transactions	\$240	\$294
Net mark-to-market gains (losses)	(3	) (3
Net gain on trading account securities	\$237	\$291

Note 3 - Loans

Loans were as follows:

	March 31, 2014	Percentage of Total		December 31, 2013	Percentage of Total	
Commercial and industrial:						
Commercial	\$4,686,817	48.1	%	\$4,460,543	46.9	%
Leases	307,269	3.1		319,577	3.4	
Asset-based	112,640	1.2		126,956	1.3	
Total commercial and industrial	5,106,726	52.4		4,907,076	51.6	
Commercial real estate:						
Commercial mortgages	2,800,091	28.7		2,800,760	29.4	
Construction	445,491	4.6		426,639	4.5	
Land	250,557	2.6		239,937	2.5	
Total commercial real estate	3,496,139	35.9		3,467,336	36.4	
Consumer real estate:						
Home equity loans	334,802	3.4		329,853	3.5	
Home equity lines of credit	199,734	2.0		195,132	2.1	
1-4 family residential mortgages	29,749	0.3		32,447	0.3	
Construction	15,509	0.2		13,123	0.1	
Other	239,203	2.5		237,649	2.5	
Total consumer real estate	818,997	8.4		808,204	8.5	
Total real estate	4,315,136	44.3		4,275,540	44.9	
Consumer and other:						
Consumer installment	346,798	3.5		350,827	3.7	
Other	5,522	0.1		7,289	0.1	
Total consumer and other	352,320	3.6		358,116	3.8	
Unearned discounts	(23,537	) (0.3	)	(25,032	) (0.3)
Total loans	\$9,750,645	100.0	%	\$9,515,700	100.0	%

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

Commercial and industrial loans are underwritten after evaluating and understanding the borrower's ability to operate profitably and prudently expand its business. Underwriting standards are designed to promote relationship banking

rather than transactional banking. Once it is determined that the borrower's management possesses sound ethics and solid business acumen, the Corporation's management examines current and projected cash flows to determine the ability of the borrower to repay their obligations as agreed. Commercial and industrial loans are primarily made based on the identified cash flows of the borrower and secondarily

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on the underlying collateral provided by the borrower. The cash flows of borrowers, however, may not be as expected and the collateral securing these loans may fluctuate in value. Most commercial and industrial loans are secured by the assets being financed or other business assets such as accounts receivable or inventory and may incorporate a personal guarantee; however, some short-term loans may be made on an unsecured basis. In the case of loans secured by accounts receivable, the availability of funds for the repayment of these loans may be substantially dependent on the ability of the borrower to collect amounts due from its customers.

Commercial real estate loans are subject to underwriting standards and processes similar to commercial and industrial loans, in addition to those of real estate loans. These loans are viewed primarily as cash flow loans and secondarily as loans secured by real estate. Commercial real estate lending typically involves higher loan principal amounts and the repayment of these loans is generally largely dependent on the successful operation of the property securing the loan or the business conducted on the property securing the loan. Commercial real estate loans may be more adversely affected by conditions in the real estate markets or in the general economy. The properties securing the Corporation's commercial real estate portfolio are diverse in terms of type and geographic location. This diversity helps reduce the Corporation's exposure to adverse economic events that affect any single market or industry. Management monitors and evaluates commercial real estate loans based on collateral, geography and risk grade criteria. As a general rule, the Corporation avoids financing single-purpose projects unless other underwriting factors are present to help mitigate risk. The Corporation also utilizes third-party experts to provide insight and guidance about economic conditions and trends affecting market areas it serves. In addition, management tracks the level of owner-occupied commercial real estate loans versus non-owner occupied loans. At March 31, 2014, approximately 58% 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 March 31, 2014 there were no concentrations of loans related to any single industry in excess of 10% of total loans.

Foreign Loans. The Corporation has U.S. dollar denominated loans and commitments to borrowers in Mexico. The outstanding balance of these loans and the unfunded amounts available under these commitments were not significant at March 31, 2014 or December 31, 2013.

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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.

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

	March 31, 2014	December 31, 2013
Commercial and industrial:		
Energy	\$526	\$590
Other commercial	22,458	26,143
Commercial real estate:		
Buildings, land and other	23,319	27,035
Construction	312	—
Consumer real estate	2,178	2,207
Consumer and other	710	745
Total	\$49,503	\$56,720

As of March 31, 2014, non-accrual loans reported in the table above included \$793 thousand related to loans that were restructured as "troubled debt restructurings" during three months ended March 31, 2014. Had non-accrual loans performed in accordance with their original contract terms, the Corporation would have recognized additional interest income, net of tax, of approximately \$358 thousand for the three months ended March 31, 2014, compared to \$608 thousand for the same period in 2013.

An age analysis of past due loans (including both accruing and non-accruing loans), segregated by class of loans, as of March 31, 2014 was as follows:

	Loans 30-89 Days Past Due	Loans 90 or More Days Past Due	Total Past Due Loans	Current Loans	Total Loans	Accruing Loans 90 or More Days Past Due
Commercial and industrial:						
Energy	\$1	\$526	\$527	\$1,151,792	\$1,152,319	\$—
Other commercial	10,078	12,602	22,680	3,931,727	3,954,407	4,419
Commercial real estate:						
Buildings, land and other	9,814	15,287	25,101	3,025,547	3,050,648	1,622
Construction	411	—	411	445,080	445,491	—
Consumer real estate	5,876	2,332	8,208	810,789	818,997	2,105
Consumer and other	2,539	1,053	3,592	348,728	352,320	893
Unearned discounts	—	—	—	(23,537)	(23,537)	—
Total	\$28,719	\$31,800	\$60,519	\$9,690,126	\$9,750,645	\$9,039

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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.

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
March 31, 2014					
Commercial and industrial:					
Energy	\$545	\$526	\$—	\$526	\$—
Other commercial	28,100	15,663	3,728	19,391	2,731
Commercial real estate:					
Buildings, land and other	25,842	20,015	1,013	21,028	776
Construction	481	312	—	312	—
Consumer real estate	894	718	—	718	—
Consumer and other	310	264	—	264	—
Total	\$56,172	\$37,498	\$4,741	\$42,239	\$3,507
December 31, 2013					
Commercial and industrial:					
Energy	\$545	\$531	\$—	\$531	\$—
Other commercial	31,429	15,337	7,004	22,341	4,140
Commercial real estate:					
Buildings, land and other	27,792	15,697	8,870	24,567	2,786
Construction	—	—	—	—	—
Consumer real estate	907	745	—	745	—
Consumer and other	334	278	—	278	—
Total	\$61,007	\$32,588	\$15,874	\$48,462	\$6,926

The average recorded investment in impaired loans was as follows:

	Three Months Ended March 31,	
	2014	2013
Commercial and industrial:		
Energy	\$529	\$535

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Other commercial	20,866	42,452
Commercial real estate:		
Buildings, land and other	22,798	36,338
Construction	156	1,078
Consumer real estate	732	849
Consumer and other	271	392
Total	\$45,352	\$81,644

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

Troubled debt restructurings during the three months ended March 31, 2014 and March 31, 2013 are set forth in the following table.

	Three Months Ended March 31, 2014		Three Months Ended March 31, 2013	
	Balance at Restructure	Balance at Period-End	Balance at Restructure	Balance at Period-End
Commercial and industrial:				
Energy	\$—	\$—	\$—	\$—
Other commercial	819	793	275	275
Commercial real estate:				
Buildings, land and other	—	—	1,680	1,613
	\$819	\$793	\$1,955	\$1,888

The modifications during the reported periods primarily related to extending amortization periods, converting the loans to interest only for a limited period of time, consolidating notes and/or reducing collateral or interest rates. The modifications did not significantly impact the Corporation’s determination of the allowance for loan losses. As of March 31, 2014, \$5.2 million of loans restructured during 2013 were in excess of 90 days past due. During the three months ended March 31, 2014, the Corporation charged-off \$427 thousand of commercial and industrial loans that were restructured during 2013. During the three months ended March 31, 2014, the Corporation also foreclosed upon certain commercial real estate loans that were restructured during 2013. The Corporation recognized \$500 thousand of other real estate owned and no charge-offs in connection with these foreclosures. The aforementioned charge-offs, foreclosures and past due loans did not significantly impact the Corporation’s determination of the allowance for loan losses.

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

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

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

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

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

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

Grade 10 – This grade is for “Other Assets Especially Mentioned” in accordance with regulatory guidelines. This grade is intended to be temporary and includes loans to borrowers whose credit quality has clearly deteriorated and are at risk

of further decline unless active measures are taken to correct the situation.

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

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

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

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

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

	March 31, 2014		December 31, 2013	
	Weighted Average Risk Grade	Loans	Weighted Average Risk Grade	Loans
Commercial and industrial:				
Energy				
Risk grades 1-8	5.36	\$1,129,839	5.37	\$1,106,348
Risk grade 9	9.00	21,733	9.00	7,726
Risk grade 10	10.00	221	10.00	245
Risk grade 11	11.00	—	11.00	500
Risk grade 12	12.00	526	12.00	590
Risk grade 13	13.00	—	13.00	—
Total energy	5.43	\$1,152,319	5.40	\$1,115,409
Other commercial				
Risk grades 1-8	5.98	\$3,671,876	5.95	\$3,507,963
Risk grade 9	9.00	76,294	9.00	74,766
Risk grade 10	10.00	87,148	10.00	89,878
Risk grade 11	11.00	96,581	11.00	92,917
Risk grade 12	12.00	19,253	12.00	21,389
Risk grade 13	13.00	3,255	13.00	4,754
Total other commercial	6.28	\$3,954,407	6.27	\$3,791,667
Commercial real estate:				
Buildings, land and other				
Risk grades 1-8	6.59	\$2,840,771	6.59	\$2,844,665
Risk grade 9	9.00	88,408	9.00	