CULLEN/FROST BANKERS, INC.
Form 10-Q
April 29, 2015
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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, 2015
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 22, 2015 there were 63,177,648 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, 2015	December 31, 2014
Assets:		
Cash and due from banks	$639,575	$702,485
Interest-bearing deposits	3,175,572	3,630,846
Federal funds sold and resell agreements	29,617	30,792
Total cash and cash equivalents	3,844,764	4,364,123
Securities held to maturity, at amortized cost	2,817,511	2,926,486
Securities available for sale, at estimated fair value	8,672,497	8,461,254
Trading account securities	15,662	15,426
Loans, net of unearned discounts	11,214,813	10,987,535
Less: Allowance for loan losses	(105,708)	(99,542)
Net loans	11,109,105	10,887,993
Premises and equipment, net	487,490	442,170
Goodwill	654,668	654,668
Other intangible assets, net	11,231	12,125
Cash surrender value of life insurance policies	172,936	172,050
Accrued interest receivable and other assets	373,118	341,480
Total assets	$28,158,982	$28,277,775
Liabilities:		
Deposits:		
Non-interest-bearing demand deposits	$10,031,950	$10,149,061
Interest-bearing deposits	14,117,672	13,986,869
Total deposits	24,149,622	24,135,930
Federal funds purchased and repurchase agreements	604,207	803,119
Junior subordinated deferrable interest debentures	137,115	137,115
Other long-term borrowings	100,000	100,000
Accrued interest payable and other liabilities	257,107	250,208
Total liabilities	25,248,051	25,426,372
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, 2015 and December 31, 2014	144,486	144,486
Common stock, par value $0.01 per share; 210,000,000 shares authorized; 63,632,464 shares issued at March 31, 2015 and December 31, 2014	637	637
Additional paid-in capital	889,112	886,476
Retained earnings	1,747,958	1,710,324
Accumulated other comprehensive income, net of tax	160,119	141,814
Treasury stock, at cost; 468,691 shares at March 31, 2015 and 483,041 shares at December 31, 2014	(31,381)	(32,334)
Total shareholders' equity	2,910,931	2,851,403
Total liabilities and shareholders' equity	$28,158,982	$28,277,775

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,	
	2015	2014
Interest income:		
Loans, including fees	$105,666	$104,315
Securities:		
Taxable	30,172	21,403
Tax-exempt	46,546	35,564
Interest-bearing deposits	1,970	2,404
Federal funds sold and resell agreements	20	20
Total interest income	184,374	163,706
Interest expense:		
Deposits	2,756	2,561
Federal funds purchased and repurchase agreements	36	27
Junior subordinated deferrable interest debentures	655	561
Other long-term borrowings	224	222
Total interest expense	3,671	3,371
Net interest income	180,703	160,335
Provision for loan losses	8,162	6,600
Net interest income after provision for loan losses	172,541	153,735
Non-interest income:		
Trust and investment management fees	27,161	25,411
Service charges on deposit accounts	19,777	19,974
Insurance commissions and fees	14,635	13,126
Interchange and debit card transaction fees	4,643	4,243
Other charges, commissions and fees	8,441	8,207
Net gain (loss) on securities transactions	228	—
Other	8,330	6,529
Total non-interest income	83,215	77,490
Non-interest expense:		
Salaries and wages	76,072	70,217
Employee benefits	20,227	17,388
Net occupancy	15,081	12,953
Furniture and equipment	15,534	14,953
Deposit insurance	3,613	3,117
Intangible amortization	894	689
Other	40,090	38,624
Total non-interest expense	171,511	157,941
Income before income taxes	84,245	73,284
Income taxes	12,082	12,096
Net income	72,163	61,188
Preferred stock dividends	2,016	2,016
Net income available to common shareholders	$70,147	$59,172
Earnings per common share:		
Basic	$1.11	$0.97

Diluted	1.10	0.96

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,	
	2015	2014
Net income	$72,163	$61,188
Other comprehensive income (loss), before tax:		
Securities available for sale and transferred securities:		
Change in net unrealized gain/loss during the period	34,527	21,431
Change in net unrealized gain on securities transferred to held to maturity	(7,887)	(9,198)
Reclassification adjustment for net (gains) losses included in net income	(228)	—
Total securities available for sale and transferred securities	26,412	12,233
Defined-benefit post-retirement benefit plans:		
Change in the net actuarial gain/loss	1,749	672
Derivatives:		
Reclassification adjustment for gains on interest rate swaps on variable-rate loans included in net income	—	(9,345)
Other comprehensive income (loss), before tax	28,161	3,560
Deferred tax expense (benefit) related to other comprehensive income	9,856	1,246
Other comprehensive income (loss), net of tax	18,305	2,314
Comprehensive income	$90,468	$63,502

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,	
	2015	2014
Total shareholders’ equity at beginning of period	$2,851,403	$2,514,161
Net income	72,163	61,188
Other comprehensive income (loss)	18,305	2,314
Stock option exercises (14,350 shares in 2015 and 329,825 shares in 2014)	728	17,279
Stock compensation expense recognized in earnings	2,562	2,136
Tax benefits related to stock compensation	74	1,344
Cash dividends – preferred stock (approximately $0.34 per share in both 2015 and in 2014)	(2,016)	(2,016)
Cash dividends – common stock ($0.51 per share in 2015 and $0.50 per share in 2014)	(32,288)	(30,487)
Total shareholders’ equity at end of period	$2,910,931	$2,565,919

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,	
	2015	2014
Operating Activities:		
Net income	$72,163	$61,188
Adjustments to reconcile net income to net cash from operating activities:		
Provision for loan losses	8,162	6,600
Deferred tax expense (benefit)	(3,748)	(1,933)
Accretion of loan discounts	(3,571)	(3,503)
Securities premium amortization (discount accretion), net	17,308	13,810
Net (gain) loss on securities transactions	(228)	—
Depreciation and amortization	9,989	9,702
Net (gain) loss on sale/write-down of assets/foreclosed assets	(779)	147
Stock-based compensation	2,562	2,136
Net tax benefit (deficiency) from stock-based compensation	(1)	9
Excess tax benefits from stock-based compensation	(75)	(1,335)
Earnings on life insurance policies	(886)	(682)
Net change in:		
Trading account securities	(236)	909
Accrued interest receivable and other assets	(36,459)	14,633
Accrued interest payable and other liabilities	(9,423)	(29,098)
Net cash from operating activities	54,778	72,583
Investing Activities:		
Securities held to maturity:		
Purchases	—	—
Maturities, calls and principal repayments	95,453	42,113
Securities available for sale:		
Purchases	(772,500)	(617,914)
Sales	223,987	—
Maturities, calls and principal repayments	372,316	1,163,981
Net change in loans	(225,770)	(237,216)
Net cash (paid) received in acquisitions	—	—
Proceeds from sales of premises and equipment	—	15
Purchases of premises and equipment	(51,803)	(13,215)
Proceeds from sales of repossessed properties	2,901	1,719
Net cash from investing activities	(355,416)	339,483
Financing Activities:		
Net change in deposits	13,692	376,847
Net change in short-term borrowings	(198,912)	(153,018)
Proceeds from stock option exercises	728	17,279
Excess tax benefits from stock-based compensation	75	1,335
Cash dividends paid on preferred stock	(2,016)	(2,016)
Cash dividends paid on common stock	(32,288)	(30,487)
Net cash from financing activities	(218,721)	209,940

Net change in cash and cash equivalents	(519,359)	622,006
Cash and equivalents at beginning of period	4,364,123	4,556,125
Cash and equivalents at end of period	$3,844,764	$5,178,131

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 our 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, 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. All significant intercompany balances and transactions have been eliminated in consolidation. The accounting and financial reporting policies we follow 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 our 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 our consolidated financial statements, and notes thereto, for the year ended December 31, 2014, included in our Annual Report on Form 10-K filed with the SEC on February 5, 2015 (the "2014 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 and 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,	
	2015	2014
Cash paid for interest	$3,639	$3,495
Cash paid for income taxes	—	—
Significant non-cash transactions:		
Securities purchased not yet settled	12,192	119,155
Loans foreclosed and transferred to other real estate owned and foreclosed assets	67	1,994
Loans to facilitate the sale of other real estate owned	—	102

Reclassifications and Restatements. Certain items in prior financial statements have been reclassified to conform to the current presentation. Additionally, certain items in prior financial statements have been restated to reflect adjustments to initially reported provisional amounts recognized in business combinations so that the prior financial statements are reported as if the adjusted amounts had been known as of the measurement date of the business combination. In that regard, during 2015, we made acquisition valuation adjustments impacting certain assets acquired in connection with the acquisition of WNB Bancshares, Inc. (See Note 2 - Mergers and Acquisitions). As a result of these adjustments, our consolidated balance sheet as of December 31, 2014 reflects a $718 thousand increase in goodwill and a $718 thousand decrease in premises and equipment when compared to previously reported amounts.

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Note 2 - Mergers and Acquisitions

On May 30, 2014, we acquired WNB Bancshares, Inc. ("WNB"), including its subsidiary Western National Bank ("Western"), a privately-held bank holding company and bank located in the Permian Basin region of Texas. We purchased all of the outstanding shares of WNB for approximately $198.8 million. The total purchase price included $149.7 million of our common stock (2 million shares) and $49.1 million in cash. Western was integrated into Frost Bank as of the close of business on June 20, 2014.

The acquisition of WNB was accounted for using the acquisition method with all cash consideration funded through internal sources. The operating results of WNB are included with our results of operations since the date of acquisition. The total purchase price paid for the acquisition of WNB was allocated based on the estimated fair values of the assets acquired and liabilities assumed as set forth below. The purchase price allocation is preliminary and is subject to final determination and valuation of the fair value of assets acquired and liabilities assumed.

Cash and cash equivalents	$879,740
Securities available for sale	154,227
Loans	670,619
Premises and equipment	22,135
Core deposit intangible asset	9,300
Goodwill	118,019
Other assets	33,644
Deposits	(1,624,043)
Other borrowings	(63,592)
Other liabilities	(1,251)
	$198,798

The loans acquired in this transaction were recorded at fair value with no carryover of any existing allowance for loan losses. Loans that were not deemed to be credit impaired at acquisition were subsequently considered as a part of our determination of the adequacy of the allowance for loan losses. Purchased credit-impaired loans, meaning those loans with evidence of credit quality deterioration at acquisition, were not significant. The core deposit intangible asset acquired in this transaction will be amortized using an accelerated method over a period of 10 years. Pro forma condensed consolidated results of operations assuming WNB had been acquired at the beginning of the reported periods are not presented because the effect of this acquisition was not considered significant based on the SEC significance tests.

Expenditures related to the acquisition of WNB totaled $1.1 million during the three months ended March 31, 2014 and are reported as a component of other non-interest expense in the accompanying consolidated income statements.

As part of the approval process in connection with the acquisition of WNB, we agreed with the Federal Reserve that before bringing it any further expansionary proposals, we would enhance certain compliance programs, including those related to fair lending. We are currently working on these enhancements.

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Note 3 - Securities

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

	March 31, 2015				December 31, 2014			
	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	$249,115	$14,030	$—	$263,145	$249,009	$14,604	$—	$263,613
Residential mortgage-backed securities	7,499	113	—	7,612	8,012	92	—	8,104
States and political subdivisions	2,559,547	43,007	7,957	2,594,597	2,668,115	34,243	9,035	2,693,323
Other	1,350	—	—	1,350	1,350	—	—	1,350
Total	$2,817,511	$57,150	$7,957	$2,866,704	$2,926,486	$48,939	$9,035	$2,966,390
Available for Sale								
U.S. Treasury	$3,711,872	$64,203	$1,998	$3,774,077	$3,783,899	$30,594	$3,241	$3,811,252
Residential mortgage-backed securities	1,256,377	67,713	377	1,323,713	1,331,114	68,027	417	1,398,724
States and political subdivisions	3,428,238	107,136	3,071	3,532,303	3,104,563	104,500	156	3,208,907
Other	42,404	—	—	42,404	42,371	—	—	42,371
Total	$8,438,891	$239,052	$5,446	$8,672,497	$8,261,947	$203,121	$3,814	$8,461,254

All mortgage-backed securities included in the above table were issued by U.S. government agencies and corporations. At March 31, 2015, approximately 97.5% of the securities in our municipal bond portfolio were issued by political subdivisions or agencies within the State of Texas, of which approximately 64.1% 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 $3.1 billion at March 31, 2015 and $3.0 billion and December 31, 2014.

During the fourth quarter of 2012, we 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, 2015 totaled $86.0 million ($55.9 million, net of tax). This amount will be amortized out of accumulated other comprehensive income over the remaining life of the underlying securities as an adjustment of the yield on those securities.

As of March 31, 2015, 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						
States and political subdivisions	$227,355	$1,163	$296,614	$6,794	$523,969	$7,957
Total	$227,355	$1,163	$296,614	$6,794	$523,969	$7,957
Available for Sale						
U.S. Treasury	$526,222	$1,998	$—	$—	$526,222	$1,998

Residential mortgage-backed securities	8,360	95	12,398	282	20,758	377
States and political subdivisions	286,513	3,071	—	—	286,513	3,071
Total	$821,095	$5,164	$12,398	$282	$833,493	$5,446

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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 to retain our 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 we will receive full value for the securities. Furthermore, as of March 31, 2015, 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 we 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, 2015, management believes the impairments detailed in the table above are temporary and no impairment loss has been realized in our consolidated income statement.

The amortized cost and estimated fair value of securities, excluding trading securities, at March 31, 2015 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	$186,337	$191,861	$14,228	$14,542
Due after one year through five years	491,938	523,304	3,110,546	3,146,176
Due after five years through ten years	220,730	222,875	1,718,927	1,778,335
Due after ten years	1,911,007	1,921,052	2,296,409	2,367,327
Residential mortgage-backed securities	7,499	7,612	1,256,377	1,323,713
Equity securities	—	—	42,404	42,404
Total	$2,817,511	$2,866,704	$8,438,891	$8,672,497

Sales of securities available for sale were as follows:

	Three Months Ended March 31,	
	2015	2014
Proceeds from sales	$223,987	$—
Gross realized gains	228	—
Gross realized losses	—	—
Tax (expense) benefit of securities gains/losses	(80)	—

Premium amortization and discount accretion included in interest income on securities was as follows:

	Three Months Ended March 31,	
	2015	2014
Premium amortization	$(20,006)	$(15,396)
Discount accretion	2,698	1,586
Net (premium amortization) discount accretion	$(17,308)	$(13,810)

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

	March 31, 2015	December 31, 2014
U.S. Treasury	$12,833	$15,339
States and political subdivisions	2,829	87
Total	$15,662	$15,426

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

	Three Months Ended March 31,	
	2015	2014
Net gain on sales transactions	$280	$240
Net mark-to-market gains (losses)	(14)	(3)
Net gain (loss) on trading account securities	$266	$237

Note 4 - Loans

Loans were as follows:

	March 31, 2015	Percentage of Total	December 31, 2014	Percentage of Total
Commercial and industrial:				
Commercial	$5,582,282	49.8 %	$5,429,206	49.4 %
Leases	326,253	2.9	338,537	3.1
Total commercial and industrial	5,908,535	52.7	5,767,743	52.5
Commercial real estate:				
Commercial mortgages	3,095,830	27.6	3,080,202	28.0
Construction	685,629	6.1	629,988	5.7
Land	292,966	2.6	291,907	2.7
Total commercial real estate	4,074,425	36.3	4,002,097	36.4
Consumer real estate:				
Home equity loans	338,732	3.0	342,725	3.1
Home equity lines of credit	222,967	2.0	220,128	2.0
Other	290,704	2.6	286,198	2.6
Total consumer real estate	852,403	7.6	849,051	7.7
Total real estate	4,926,828	43.9	4,851,148	44.1
Consumer and other:				
Consumer installment	395,879	3.5	385,479	3.5
Other	7,239	0.1	8,122	0.1
Total consumer and other	403,118	3.6	393,601	3.6
Unearned discounts	(23,668)	(0.2)	(24,957)	(0.2)
Total loans	$11,214,813	100.0 %	$10,987,535	100.0 %

Loan Origination/Risk Management. We have 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, our management examines current and projected cash flows to determine the ability of the borrower to repay their obligations as agreed. Commercial and industrial loans are primarily made based on the

identified cash flows of the borrower and secondarily on the underlying collateral provided by the borrower. The cash flows of borrowers, however, may not be as expected and the collateral securing these loans may fluctuate in value. Most commercial and industrial loans are secured by the assets being financed or other business assets such as accounts receivable or inventory and may incorporate a personal guarantee; however, some short-term loans may

be made on an unsecured basis. In the case of loans secured by accounts receivable, the availability of funds for the repayment of these loans may be substantially dependent on the ability of the borrower to collect amounts due from its customers.

Commercial real estate loans are subject to underwriting standards and processes similar to commercial and industrial loans, in addition to those of real estate loans. These loans are viewed primarily as cash flow loans and secondarily as loans secured by real estate. Commercial real estate lending typically involves higher loan principal amounts and the repayment of these loans is generally largely dependent on the successful operation of the property securing the loan or the business conducted on the property securing the loan. Commercial real estate loans may be more adversely affected by conditions in the real estate markets or in the general economy. The properties securing our commercial real estate portfolio are diverse in terms of type and geographic location. This diversity helps reduce our 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, we avoid financing single-purpose projects unless other underwriting factors are present to help mitigate risk. We also utilize third-party experts to provide insight and guidance about economic conditions and trends affecting market areas we serve. In addition, management tracks the level of owner-occupied commercial real estate loans versus non-owner occupied loans. At March 31, 2015, approximately 54.0% of the outstanding principal balance of our 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 we may originate from time to time, we generally require the borrower to have had an existing relationship with us 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 us 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.

We originate 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.

We maintain 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 our policies and procedures.

Concentrations of Credit. Most of our 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 our loan portfolio consists of commercial and industrial and commercial real estate loans. As of March 31, 2015, there were no concentrations of loans related to any single industry in excess of 10% of total loans other than energy loans, which totaled 16.2% of total loans.

Foreign Loans. We have 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, 2015 or December 31, 2014.

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, we consider the borrower's debt service capacity through the analysis of current financial information, if available, and/or current information with regards to our 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

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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, 2015	December 31, 2014
Commercial and industrial:		
Energy	$636	$636
Other commercial	32,965	34,108
Commercial real estate:		
Buildings, land and other	17,145	19,639
Construction	2,740	2,792
Consumer real estate	2,347	2,212
Consumer and other	481	538
Total	$56,314	$59,925

As of March 31, 2015, non-accrual loans reported in the table above included $613 thousand related to loans that were restructured as “troubled debt restructurings” during 2015. See the section captioned “Troubled Debt Restructurings” elsewhere in this note. Had non-accrual loans performed in accordance with their original contract terms, we would have recognized additional interest income, net of tax, of approximately $397 thousand for the three months ended March 31, 2015, compared to $358 thousand for three months ended March 31, 2014.
An age analysis of past due loans (including both accruing and non-accruing loans), segregated by class of loans, as of March 31, 2015 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	$1,000	$4,538	$5,538	$1,813,511	$1,819,049	$3,902
Other commercial	23,685	25,431	49,116	4,040,370	4,089,486	6,078
Commercial real estate:						
Buildings, land and other	13,405	7,005	20,410	3,368,386	3,388,796	1,278
Construction	1,371	50	1,421	684,208	685,629	50
Consumer real estate	5,670	1,961	7,631	844,772	852,403	1,662
Consumer and other	4,096	721	4,817	398,301	403,118	669
Unearned discounts	—	—	—	(23,668)	(23,668)	—
Total	$49,227	$39,706	$88,933	$11,125,880	$11,214,813	$13,639

Impaired Loans. Loans are considered impaired when, based on current information and events, it is probable we 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 us to reevaluate the fair value of collateral supporting impaired collateral dependent loans on at least an annual basis. While our policy is to comply with the regulatory guidelines, our 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 we do not need to make any adjustments to the appraised values. The fair value of collateral supporting impaired collateral dependent loans is evaluated by our internal appraisal

services using a methodology that is consistent with the Uniform Standards of Professional Appraisal Practice. The fair value of collateral supporting impaired collateral dependent construction loans is based on an “as is” valuation.

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

	Unpaid Contractual Principal Balance	Recorded Investment With No Allowance	Recorded Investment With Allowance	Total Recorded Investment	Related Allowance
March 31, 2015					
Commercial and industrial:					
Energy	$705	$636	$—	$636	$—
Other commercial	42,262	28,275	2,720	30,995	1,404
Commercial real estate:					
Buildings, land and other	20,257	14,723	197	14,920	71
Construction	3,004	2,740	—	2,740	—
Consumer real estate	789	568	—	568	—
Consumer and other	—	—	—	—	—
Total	$67,017	$46,942	$2,917	$49,859	$1,475
December 31, 2014					
Commercial and industrial:					
Energy	$706	$636	$—	$636	$—
Other commercial	42,212	29,007	2,853	31,860	1,613
Commercial real estate:					
Buildings, land and other	22,919	17,441	265	17,706	67
Construction	3,007	2,793	—	2,793	—
Consumer real estate	812	596	—	596	—
Consumer and other	—	—	—	—	—
Total	$69,656	$50,473	$3,118	$53,591	$1,680

The average recorded investment in impaired loans was as follows:

	Three Months Ended March 31,	
	2015	2014
Commercial and industrial:		
Energy	$636	$529
Other commercial	31,428	20,866
Commercial real estate:		
Buildings, land and other	16,313	22,798
Construction	2,767	156
Consumer real estate	582	732
Consumer and other	—	271
Total	$51,726	$45,352

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, 2015 and March 31, 2014 are set forth in the following table.

	Three Months Ended March 31, 2015		Three Months Ended March 31, 2014	
	Balance at Restructure	Balance at Period-End	Balance at Restructure	Balance at Period-End

Commercial and industrial:				
Energy	$—	$—	$—	$—
Other commercial	709	613	819	793
	$709	$613	$819	$793

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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 our determination of the allowance for loan losses. As of March 31, 2015, there were no loans restructured during the last year that were in excess of 90 days past due. During the three months ended March 31, 2015, we charged-off $88 thousand in connection with the restructuring of a commercial and industrial loan. Approximately $314 thousand of commercial and industrial loans restructured during the three months ended March 31, 2015 was related to a loan relationship previously restructured during 2014. During the three months ended March 31, 2014, we foreclosed upon certain commercial real estate loans that were restructured during 2013. We recognized $500 thousand of other real estate owned and no charge-offs in connection with these foreclosures. The aforementioned charge-offs and foreclosures did not significantly impact our determination of the allowance for loan losses.

Credit Quality Indicators. As part of the on-going monitoring of the credit quality of our 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.

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

- Grades 1, 2 and 3 – These grades include loans to very high credit quality borrowers of investment or near investment grade. These borrowers are generally publicly traded (grades 1 and 2), have significant capital strength, moderate leverage, stable earnings and growth, and readily available financing alternatives. Smaller entities, regardless of strength, would generally not fit in these grades.
- Grades 4 and 5 – These grades include loans to borrowers of solid credit quality with moderate risk. Borrowers in these grades are differentiated from higher grades on the basis of size (capital and/or revenue), leverage, asset quality and the stability of the industry or market area.
- Grades 6, 7 and 8 – These grades include "pass grade" loans to borrowers of acceptable credit quality and risk. Such borrowers are differentiated from Grades 4 and 5 in terms of size, secondary sources of repayment or they are of lesser stature in other key credit metrics in that they may be over-leveraged, under capitalized, inconsistent in performance or in an industry or an economic area that is known to have a higher level of risk, volatility, or susceptibility to weaknesses in the economy.
- Grade 9 – This grade includes loans on management's "watch list" and is intended to be utilized on a temporary basis for pass grade borrowers where a significant risk-modifying action is anticipated in the near term.
- Grade 10 – This grade is for "Other Assets Especially Mentioned" in accordance with regulatory guidelines. This grade is intended to be temporary and includes loans to borrowers whose credit quality has clearly deteriorated and are at risk of further decline unless active measures are taken to correct the situation.
- Grade 11 – This grade includes "Substandard" loans, in accordance with regulatory guidelines, for which the accrual of interest has not been stopped. By definition under regulatory guidelines, a "Substandard" loan has defined weaknesses which make payment default or principal exposure likely, but not yet certain. Such loans are apt to be dependent upon collateral liquidation, a secondary source of repayment or an event outside of the normal course of business.
- Grade 12 – This grade includes "Substandard" loans, in accordance with regulatory guidelines, for which the accrual of interest has been stopped. This grade includes loans where interest is more than 120 days past due and not fully secured and loans where a specific valuation allowance may be necessary, but generally does not exceed 30% of the principal balance.
- Grade 13 – This grade includes "Doubtful" loans in accordance with regulatory guidelines. Such loans are placed on non-accrual status and may be dependent upon collateral having a value that is difficult to determine or upon some near-term event which lacks certainty. Additionally, these loans generally have a specific valuation allowance in excess of 30% of the principal balance.
- Grade 14 – This grade includes "Loss" loans in accordance with regulatory guidelines. Such loans are to be charged-off or charged-down when payment is acknowledged to be uncertain or when the timing or value of payments cannot be

determined. “Loss” is not intended to imply that the loan or some portion of it will never be paid, nor does it in any way imply that there has been a forgiveness of debt.

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In monitoring credit quality trends in the context of assessing the appropriate level of the allowance for loan losses, we monitor 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, 2015		December 31, 2014	
	Weighted Average Risk Grade	Loans	Weighted Average Risk Grade	Loans
Commercial and industrial:				
Energy				
Risk grades 1-8	5.88	$1,734,701	5.37	$1,740,455
Risk grade 9	9.00	24,922	9.00	27,313
Risk grade 10	10.00	36,632	10.00	161
Risk grade 11	11.00	22,158	11.00	5,380
Risk grade 12	12.00	636	12.00	636
Risk grade 13	13.00	—	13.00	—
Total energy	6.07	$1,819,049	5.45	$1,773,945
Other commercial				
Risk grades 1-8	5.97	$3,848,801	5.93	$3,785,171
Risk grade 9	9.00	73,842	9.00	65,166
Risk grade 10	10.00	87,050	10.00	54,519
Risk grade 11	11.00	46,828	11.00	55,034
Risk grade 12	12.00	30,980	12.00	31,683
Risk grade 13	13.00	1,985	13.00	2,225
Total other commercial	6.22	$4,089,486	6.16	$3,993,798
Commercial real estate:				
Buildings, land and other				
Risk grades 1-8	6.57	$3,135,623	6.53	$3,148,339
Risk grade 9	9.00	104,344	9.00	72,906
Risk grade 10	10.00	90,872	10.00	87,889
Risk grade 11	11.00	40,812	11.00	43,336
Risk grade 12	12.00	17,074	12.00	19,501
Risk grade 13	13.00	71	13.00	138
Total commercial real estate	6.82	$3,388,796	6.76	$3,372,109
Construction				
Risk grades 1-8	6.98	$639,505	6.91	$617,805
Risk grade 9	9.00	41,422	9.00	8,003
Risk grade 10	10.00	1,900	10.00	1,323
Risk grade 11	11.00	62	11.00	64
Risk grade 12	12.00	2,740	12.00	2,793
Risk grade 13	13.00	—	13.00	—
Total construction	7.13	$685,629	6.97	$629,988

We have established maximum loan to value standards to be applied during the origination process of commercial and consumer real estate loans. We do 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, we reassess 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. We do not monitor loan-to-value ratios on a weighted-average basis for commercial real estate loans having a calculated risk grade of 10 or higher. Nonetheless, there were three commercial real estate loans having a calculated risk grade of 10 or higher in excess of $5 million

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as of March 31, 2015, which totaled $33.2 million and had a weighted-average loan-to-value ratio of approximately 64.2%. When an individual consumer real estate loan becomes past due by more than 10 days, the assigned relationship manager will begin collection efforts. We only reassess 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, we do 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 our 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 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 we become 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 any event the charge-off must be taken within specified delinquency time frames. Such delinquency time frames state that closed-end retail loans (loans with pre-defined maturity dates, such as real estate mortgages, home equity loans and consumer installment loans) that become past due 120 cumulative days and open-end retail loans (loans that roll-over at the end of each term, such as home equity lines of credit) that become past due 180 cumulative days should be classified as a loss and charged-off.

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

	Three Months Ended March 31,	
	2015	2014
Commercial and industrial:		
Energy	$2	$(13)
Other commercial	(852)	(1,683)
Commercial real estate:		
Buildings, land and other	(307)	(1,618)
Construction	1	40
Consumer real estate	(28)	23
Consumer and other	(812)	(631)
Total	$(1,996)	$(3,882)

In assessing the general economic conditions in the State of Texas, management monitors and tracks the Texas Leading Index ("TLI"), which is produced by the Federal Reserve Bank of Dallas. The TLI is a single summary statistic that is designed to signal the likelihood of the Texas economy's transition from expansion to recession and vice versa. Management believes this index provides a reliable indication of the direction of overall credit quality. The TLI is a composite of the following eight leading indicators: (i) Texas Value of the Dollar, (ii) U.S. Leading Index, (iii) real oil prices (iv) well permits, (v) initial claims for unemployment insurance, (vi) Texas Stock Index, (vii) Help-Wanted Index and (viii) average weekly hours worked in manufacturing. The TLI totaled 126.9 at February 28, 2015 (most recent date available) and 129.4 at December 31, 2014. 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. Our allowance for loan loss methodology follows the accounting guidance set forth in U.S. generally accepted accounting principles and the Interagency Policy Statement on the Allowance for Loan and Lease Losses, which was jointly issued by U.S. bank regulatory agencies. In that regard, our

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. Our 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 our control, including, among other things, the performance of our loan portfolio, the economy, changes in interest rates and the view of the regulatory authorities toward loan classifications. We monitor 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 we experience over time.

Our 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 us.

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

Historical valuation allowances are calculated based on the historical gross loss experience of specific types of loans and the internal risk grade of such loans at the time they were charged-off. We calculate 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 (no less than annually) 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. Our 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 our loan policies, procedures and internal controls; (iii) changes in asset quality; (iv) the impact of legislative and governmental influences affecting industry sectors; (v) the effectiveness of the internal loan review function; (vi) the impact of competition on loan structuring and pricing; and (vii) the impact of rising interest rates on portfolio risk. In periods where the surveyed risks are perceived

to be higher, the risk-weighting matrix will generally result in a higher environmental adjustment factor, which, in turn will result in higher levels of general valuation allowance allocations. The opposite holds true in periods where the surveyed risks are perceived to be lower.
General valuation allowances also include amounts allocated for loans to borrowers in distressed industries. To determine the amount of the allocation for each loan portfolio segment, management calculates the weighted-average risk grade for all loans to borrowers in distressed industries by loan portfolio segment. A multiple is then applied to the amount by which the weighted-average risk grade for loans to borrowers in distressed industries exceeds the weighted-average risk grade for all pass-grade loans within the loan portfolio segment to derive an allocation factor for loans to borrowers in distressed industries. The amount of the allocation for each loan portfolio segment is the product of this allocation factor and the outstanding balance of pass-grade loans

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within the identified distressed industries that have a risk grade of 6 or higher. Management identifies potential distressed industries by analyzing industry trends related to delinquencies, classifications and charge-offs. At March 31, 2015 and December 31, 2014, certain segments of contractors were considered to be a distressed industry based on elevated levels of delinquencies, classifications and charge-offs relative to other industries within our loan portfolio. Furthermore, we determined, through a review of borrower financial information that, as a whole, contractors have experienced, among other things, decreased revenues, reduced backlog of work, compressed margins and little, if any, net income.

General valuation allowances also include allocations for groups of loans with similar risk characteristics that exceed certain concentration limits established by management and/or our board of directors. Concentration risk limits have been established, among other things, for certain industry concentrations, large balance and highly leveraged credit relationships that exceed specified risk grades, and loans originated with policy, credit and/or collateral exceptions that exceed specified risk grades. Additionally, general valuation allowances are provided for loans that did not undergo a separate, independent concurrence review during the underwriting process (generally those loans under $1.0 million at origination). Our 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. General valuation allowances are also allocated for general macroeconomic risk related to current economic trends and other quantitative and qualitative factors that could impact our loan portfolio segments.

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

	Commercial and Industrial	Commercial Real Estate	Consumer Real Estate	Consumer and Other	Unallocated	Total
March 31, 2015						
Historical valuation allowances	$35,339	$14,620	$2,046	$11,900	$—	$63,905
Specific valuation allowances	1,404	71	—	—	—	1,475
General valuation allowances:						
Environmental risk adjustment	7,263	3,546	478	3,060	—	14,347
Distressed industries	2,762	234	—	—	—	2,996
Excessive industry concentrations	5,903	530	—	—	—	6,433
Large relationship concentrations	2,690	1,855	—	—	—	4,545
Highly-leveraged credit relationships	5,395	1,707	—	—	—	7,102
Policy exceptions	2,116	886	—	—	—	3,002
Credit and collateral exceptions	2,168	908	—	—	—	3,076
Loans not reviewed by concurrence	2,043	2,261	2,364	1,178	—	7,846
Adjustment for recoveries	(5,199)	(698)	(211)	(7,576)	—	(13,684)
General macroeconomic risk	2,829	1,185	230	421	—	4,665
Total	$64,713	$27,105	$4,907	$8,983	$—	$105,708
December 31, 2014						
Historical valuation allowances	$32,421	$14,684	$2,017	$10,482	$—	$59,604
Specific valuation allowances	1,613	67	—	—	—	1,680
General valuation allowances:						
Environmental risk adjustment	6,773	3,547	474	2,683	—	13,477
Distressed industries	3,090	3	—	—	—	3,093
Excessive industry concentrations	2,114	378	—	—	—	2,492

Large relationship concentrations	2,248	1,559	—	—	—	3,807
Highly-leveraged credit relationships	3,958	1,347	—	—	—	5,305
Policy exceptions	1,907	875	—	—	—	2,782
Credit and collateral exceptions	1,483	681	—	—	—	2,164
Loans not reviewed by concurrence	2,110	2,284	2,336	1,176	—	7,906
Adjustment for recoveries	(6,234)	(1,800)	(364)	(7,439)	—	(15,837)
General macroeconomic risk	7,709	3,538	715	1,107	—	13,069
Total	$59,192	$27,163	$5,178	$8,009	$—	$99,542

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We monitor 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 we experience over time. In assessing the general macroeconomic trends/conditions, we analyze 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 us and our customers. With regard to assessing loan portfolio conditions, we analyze 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, we would expect to see the allowance for loan loss allocation model, as a whole, calculate higher levels of required allowances than in periods where general macroeconomic and loan portfolio conditions are in an improving trend or remain at an elevated level, based on historical trends.

The following table details activity in the allowance for loan losses by portfolio segment for the three months ended March 31, 2015 and 2014. Allocation of a portion of the allowance to one category of loans does not preclude its availability to absorb losses in other categories.

	Commercial and Industrial	Commercial Real Estate	Consumer Real Estate	Consumer and Other	Unallocated	Total
Three months ended:						
March 31, 2015						
Beginning balance	$59,192	$27,163	$5,178	$8,009	$—	$99,542
Provision for loan losses	6,371	248	(243)	1,786	—	8,162
Charge-offs	(2,132)	(478)	(80)	(2,805)	—	(5,495)
Recoveries	1,282	172	52	1,993	—	3,499
Net charge-offs	(850)	(306)	(28)	(812)	—	(1,996)
Ending balance	$64,713	$27,105	$4,907	$8,983	$—	$105,708
March 31, 2014						
Beginning balance	$52,790	$22,590	$5,230	$5,010	$6,818	$92,438
Provision for loan losses	5,960	8	(720)	1,312	40	6,600
Charge-offs	(2,367)	(1,791)	(21)	(2,487)	—	(6,666)
Recoveries	671	213	44	1,856	—	2,784
Net charge-offs	(1,696)	(1,578)	23	(631)	—	(3,882)
Ending balance	$57,054	$21,020	$4,533	$5,691	$6,858	$95,156

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The following table details the amount of the allowance for loan losses allocated to each portfolio segment as of March 31, 2015, December 31, 2014 and March 31, 2014, detailed on the basis of the impairment methodology we used:

	Commercial and Industrial	Commercial Real Estate	Consumer Real Estate	Consumer and Other	Unallocated	Total
March 31, 2015						
Loans individually evaluated for impairment	$1,404	$71	$—	$—	$—	$1,475
Loans collectively evaluated for impairment	63,309	27,034	4,907	8,983	—	104,233
Balance at March 31, 2015	$64,713	$27,105	$4,907	$8,983	$—	$105,708
December 31, 2014						
Loans individually evaluated for impairment	$1,613	$67	$—	$—	$—	$1,680
Loans collectively evaluated for impairment	57,579	27,096	5,178	8,009	—	97,862
Balance at December 31, 2014	$59,192	$27,163	$5,178	$8,009	$—	$99,542
March 31, 2014						
Loans individually evaluated for impairment	$2,731	$776	$—	$—	$—	$3,507
Loans collectively evaluated for impairment	54,323	20,244	4,533	5,691	6,858	91,649
Balance at March 31, 2014	$57,054	$21,020	$4,533	$5,691	$6,858	$95,156

Our recorded investment in loans as of March 31, 2015, December 31, 2014 and March 31, 2014 related to each balance in the allowance for loan losses by portfolio segment and detailed on the basis of the impairment methodology we used was as follows:

	Commercial and Industrial	Commercial Real Estate	Consumer Real Estate	Consumer and Other	Unearned Discounts	Total
March 31, 2015						
Loans individually evaluated for impairment	$31,631	$17,660	$568	$—	$—	$49,859
Loans collectively evaluated for impairment	5,876,904	4,056,765	851,835	403,118	(23,668)	11,164,954
Ending balance	$5,908,535	$4,074,425	$852,403	$403,118	$(23,668)	$11,214,813
December 31, 2014						
Loans individually evaluated for impairment	$32,496	$20,499	$596	$—	$—	$53,591
Loans collectively evaluated for impairment	5,735,247	3,981,598	848,455	393,601	(24,957)	10,933,944
Ending balance	$5,767,743	$4,002,097	$849,051	$393,601	$(24,957)	$10,987,535
March 31, 2014						
Loans individually evaluated for impairment	$19,917	$21,340	$718	$264	$—	$42,239
Loans collectively evaluated for impairment	5,086,809	3,474,799	818,279	352,056	(23,537)	9,708,406
Ending balance	$5,106,726	$3,496,139	$818,997	$352,320	$(23,537)	$9,750,645

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Note 5 - Goodwill and Other Intangible Assets

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

	March 31, 2015	December 31, 2014
Goodwill	$654,668	$654,668
Other intangible assets:		
Core deposits	$8,972	$9,675
Customer relationships	1,978	2,128
Non-compete agreements	281	322
	$11,231	$12,125

The estimated aggregate future amortization expense for intangible assets remaining as of March 31, 2015 is as follows:

Remainder of 2015	$2,431
2016	2,413
2017	1,619
2018	1,346
2019	1,102
Thereafter	2,320
	$11,231

Note 6 - Deposits

Deposits were as follows:

	March 31, 2015	Percentage of Total		December 31, 2014	Percentage of Total	
Non-interest-bearing demand deposits:						
Commercial and individual	$9,186,477	38.0	%	$9,256,045	38.3	%
Correspondent banks	367,977	1.5		429,000	1.8	
Public funds	477,496	2.0		464,016	1.9	
Total non-interest-bearing demand deposits	10,031,950	41.5		10,149,061	42.0	
Interest-bearing deposits:						
Private accounts:						
Savings and interest checking	4,917,918	20.3		4,743,963	19.7	
Money market accounts	7,889,909	32.7		7,860,403	32.6	
Time accounts of $100,000 or more	480,604	2.0		490,209	2.0	
Time accounts under $100,000	429,845	1.8		454,220	1.9	
Total private accounts	13,718,276	56.8		13,548,795	56.2	
Public funds:						
Savings and interest checking	297,449	1.3		326,090	1.4	
Money market accounts	53,003	0.2		57,145	0.2	
Time accounts of $100,000 or more	47,711	0.2		53,684	0.2	
Time accounts under $100,000	1,233	—		1,155	—	
Total public funds	399,396	1.7		438,074	1.8	
Total interest-bearing deposits	14,117,672	58.5		13,986,869	58.0	
Total deposits	$24,149,622	100.0	%	$24,135,930	100.0	%

The following table presents additional information about our deposits:

	March 31, 2015	December 31, 2014
Deposits from the Certificate of Deposit Account Registry Service (CDARS)	$13,123	$22,229
Deposits from the Promontory Interfinancial Network Insured Cash Sweep Service (acquired in the acquisition of WNB)	96,482	148,665

Deposits from foreign sources (primarily Mexico)	757,374	744,295

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Note 7 - Commitments and Contingencies

Financial Instruments with Off-Balance-Sheet Risk. In the normal course of business, we enter into various transactions, which, in accordance with generally accepted accounting principles are not included in our consolidated balance sheets. We enter into these transactions to meet the financing needs of our 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. We minimize our exposure to loss under these commitments by subjecting them to credit approval and monitoring procedures.

We enter into contractual commitments to extend credit, normally with fixed expiration dates or termination clauses, at specified rates and for specific purposes. Substantially all of our 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 we issued 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, we would be required to fund the commitment. The maximum potential amount of future payments we could be required to make is represented by the contractual amount of the commitment. If the commitment were funded, we would be entitled to seek recovery from the customer. Our policies generally require that standby letter of credit arrangements contain security and debt covenants similar to those contained in loan agreements.

We consider the fees collected in connection with the issuance of standby letters of credit to be representative of the fair value of our obligation undertaken in issuing the guarantee. In accordance with applicable accounting standards related to guarantees, we defer 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 our potential obligations under the standby letter of credit guarantees.

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

	March 31, 2015	December 31, 2014
Commitments to extend credit	$8,033,631	$7,955,779
Standby letters of credit	248,267	248,360
Deferred standby letter of credit fees	1,798	1,942

Lease Commitments. We lease certain office facilities and office equipment under operating leases. Rent expense for all operating leases totaled $7.7 million and $6.5 million during the three months ended March 31, 2015 and 2014. There has been no significant change in our expected future minimum lease payments since December 31, 2014. See the 2014 Form 10-K for information regarding these commitments.

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

Note 8 - Capital and Regulatory Matters

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.

The Basel III Capital Rules became effective for Cullen/Frost and Frost Bank on January 1, 2015 (subject to a phase-in period for certain provisions). Quantitative measures established by the Basel III Capital Rules to ensure capital adequacy require the maintenance of minimum amounts and ratios (set forth in the table below) of Common Equity Tier 1 capital, Tier 1 capital and Total 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 Common Equity Tier 1 capital consists of common stock and related paid-in capital, net of treasury stock, and retained earnings. In connection with the adoption of the Basel III Capital Rules, we elected to opt-out of the requirement to include most components of accumulated other comprehensive income in Common Equity Tier 1. Common Equity Tier 1 for both Cullen/Frost and Frost Bank is reduced by goodwill and other

intangible assets, net of associated deferred tax liabilities and subject to transition provisions.
Tier 1 capital includes Common Equity Tier 1 capital and additional Tier 1 capital. For Cullen/Frost, additional Tier 1 capital at March 31, 2015 includes $144.5 million of 5.375% non-cumulative perpetual preferred stock and the allowable portion of the

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$133.0 million of trust preferred securities issued by our unconsolidated subsidiary trusts. Under the Basel III Capital Rules, trust preferred securities do not qualify as Tier 1 capital instruments and must be phased-out of Tier 1 capital. At March 31, 2015, $33.3 million of trust preferred securities were included in Cullen/Frost's additional Tier 1 capital. Beginning January 1, 2016, trust preferred securities may not be included in Tier 1 capital. Trust preferred securities excluded from additional Tier 1 capital may be included in Tier 2 capital, without limitation. Frost Bank did not have any additional Tier 1 capital beyond Common Equity Tier 1 as of March 31, 2015.

Total capital includes Tier 1 capital and Tier 2 capital. Tier 2 capital for both Cullen/Frost and Frost Bank includes a permissible portion of the allowance for loan losses. Tier 2 capital for Cullen/Frost also includes trust preferred securities that were excluded from Tier 1 capital and qualified subordinated debt. At March 31, 2015, Cullen/Frost's Tier 2 capital included $99.7 million of trust preferred securities and the permissible portion of our aggregate $100.0 million of floating rate subordinated notes (which decreases 20% per year during the final five years of the term of the notes) totaling $20.0 million at March 31, 2015. Our aggregate $100.0 million of floating rate subordinated notes mature on February 15, 2017. No portion of these notes will be permissible as a component of Tier 2 capital subsequent to February 15, 2016.

Prior to January 1, 2015, Cullen/Frost’s and Frost Bank’s Tier 1 capital consisted of total shareholders’ equity excluding accumulated other comprehensive income, goodwill and other intangible assets. Tier 1 capital for Cullen/Frost also included $144.5 million of 5.375% non-cumulative perpetual preferred stock and $133.0 million of trust preferred securities issued by our unconsolidated subsidiary trusts. Cullen/Frost’s and Frost Bank’s Total capital was comprised of Tier 1 capital for each entity plus a permissible portion of the allowance for loan losses and the permissible portion of outstanding subordinated debt. The permissible portion of our aggregate $100.0 million of floating rate subordinated notes totaled $40.0 million at December 31, 2014, and was included in total capital of Cullen/Frost.

The Common Equity Tier 1 (beginning in 2015), 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, among other things. The leverage ratio is calculated by dividing Tier 1 capital by adjusted quarterly average total assets, which exclude goodwill and other intangible assets, among other things.

When fully phased in on January 1, 2019, the Basel III Capital Rules will require Cullen/Frost and Frost Bank to maintain (i) a minimum ratio of Common Equity Tier 1 capital to risk-weighted assets of at least 4.5%, plus a 2.5% “capital conservation buffer” (which is added to the 4.5% Common Equity Tier 1 capital ratio as that buffer is phased in, effectively resulting in a minimum ratio of Common Equity Tier 1 capital to risk-weighted assets of at least 7.0% 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 4.0%, calculated as the ratio of Tier 1 capital to average quarterly assets.

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). The Basel III Capital Rules also provide for a “countercyclical capital buffer” that is applicable to only certain covered institutions and does not 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 Common Equity Tier 1 capital 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.

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The following table presents actual and required capital ratios as of March 31, 2015 for Cullen/Frost and Frost Bank under the Basel III Capital Rules. The minimum required capital amounts presented include the minimum required capital levels as of March 31, 2015 based on the phase-in provisions of the Basel III Capital Rules and the minimum required capital levels as of January 1, 2019 when the Basel III Capital Rules have been fully phased-in. Capital levels required to be considered well capitalized are based upon prompt corrective action regulations, as amended to reflect the changes under the Basel III Capital Rules.

	Actual			Minimum Capital Required - Basel III Phase-In Schedule			Minimum Capital Required - Basel III Fully Phased-In			Required to be Considered Well Capitalized		
	Capital Amount	Ratio		Capital Amount	Ratio		Capital Amount	Ratio		Capital Amount	Ratio	
March 31, 2015												
Common Equity Tier 1 to Risk-Weighted Assets												
Cullen/Frost	$1,957,452	11.55	%	$762,847	4.50	%	$1,186,195	7.00	%	$1,101,890	6.50	%
Frost Bank	2,018,046	11.95		760,250	4.50		1,182,155	7.00		1,098,139	6.50	
Tier 1 Capital to Risk-Weighted Assets												
Cullen/Frost	2,135,188	12.60		1,017,129	6.00		1,440,379	8.50		1,356,172	8.00	
Frost Bank	2,018,046	11.95		1,013,666	6.00		1,435,474	8.50		1,351,555	8.00	
Total Capital to Risk-Weighted Assets												
Cullen/Frost	2,360,646	13.93		1,356,172	8.00		1,779,292	10.50		1,695,215	10.00	
Frost Bank	2,123,754	12.57		1,351,555	8.00		1,773,232	10.50		1,689,444	10.00	
Leverage Ratio												
Cullen/Frost	2,135,188	7.89		1,083,075	4.00		1,082,814	4.00		1,353,843	5.00	
Frost Bank	2,018,046	7.46		1,081,781	4.00		1,081,520	4.00		1,352,226	5.00	

The following table presents actual and required capital ratios as of December 31, 2014 for Cullen/Frost and Frost Bank under the regulatory capital rules then in effect.

	Actual			Minimum Required for Capital Adequacy Purposes			Required to be Considered Well Capitalized		
	Capital Amount	Ratio		Capital Amount	Ratio		Capital Amount	Ratio	
December 31, 2014									
Tier 1 Capital to Risk-Weighted Assets									
Cullen/Frost	$2,186,276	13.68	%	$639,398	4.00	%	$959,098	6.00	%
Frost Bank	1,979,415	12.41		637,929	4.00		956,894	6.00	
Total Capital to Risk-Weighted Assets									
Cullen/Frost	2,325,818	14.55		1,278,797	8.00		1,598,496	10.00	
Frost Bank	2,071,012	12.99		1,275,858	8.00		1,594,823	10.00	
Leverage Ratio									
Cullen/Frost	2,186,276	8.16		1,072,035	4.00		1,340,043	5.00	
Frost Bank	1,979,415	7.40		1,070,109	4.00		1,337,636	5.00	

As of March 31, 2015, capital levels at Cullen/Frost and Frost Bank exceed all capital adequacy requirements under the Basel III Capital Rules on a fully phased-in basis. Based on the ratios presented above, capital levels as of

March 31, 2015 at Cullen/Frost and Frost Bank exceed the minimum levels necessary to be considered "well capitalized."
Cullen/Frost and Frost Bank are subject to the regulatory capital requirements administered by the Federal Reserve, and, for Frost Bank, the Federal Deposit Insurance Corporation ("FDIC"). Regulatory authorities can initiate certain mandatory actions if Cullen/Frost or Frost Bank fail to meet the minimum capital requirements, which could have a direct material effect on our financial statements. Management believes, as of March 31, 2015, that Cullen/Frost and Frost Bank meet all capital adequacy requirements to which they are subject.

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Stock Repurchase Plans. From time to time, our board of directors has authorized stock repurchase plans. In general, stock repurchase plans allow us to proactively manage our capital position and return excess capital to shareholders. Shares purchased under such plans also provide us with shares of common stock necessary to satisfy obligations related to stock compensation awards. We did not have any active stock repurchase plans as of March 31, 2015.
Dividend Restrictions. In the ordinary course of business, we are 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 March 31, 2015, Frost Bank could pay aggregate dividends of up to $307.7 million to Cullen/Frost without prior regulatory approval.
Under the terms of the junior subordinated deferrable interest debentures that we have issued to Cullen/Frost Capital Trust II and WNB Capital Trust I, we have the right at any time during the term of the debentures to defer the payment of interest at any time or from time to time for an extension period not exceeding 20 consecutive quarterly periods with respect to each extension period. In the event that we have elected to defer interest on the debentures, we may not, with certain exceptions, declare or pay any dividends or distributions on our capital stock or purchase or acquire any of our capital stock.
Under the terms of our Series A Preferred Stock, in the event that we do not declare and pay dividends on our Series A Preferred Stock for the most recent dividend period, we may not, with certain exceptions, declare or pay dividends on, or purchase, redeem or otherwise acquire, shares of our common stock or any of our securities that rank junior to our Series A Preferred Stock.
Note 9 - 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. We utilize interest rate swaps, caps and floors to mitigate exposure to interest rate risk and to facilitate the needs of our customers. Our objectives for utilizing these derivative instruments is described below:
We have entered into certain interest rate swap contracts that are matched to specific fixed-rate commercial loans or leases that we have entered into with our 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, we 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 our monthly interest receipts on a rolling portfolio of $1.2 billion of variable-rate loans outstanding throughout the 84-month period beginning in October 2007 and ending in October 2014 from the risk of variability of those cash flows such that the yield on the underlying loans would remain constant. As more fully discussed in the 2014 Form 10-K, we terminated portions of the hedges and settled portions of the interest rate swap contracts during November 2009 and terminated the remaining portions of the hedges and settled the remaining portions of the interest rate swap contracts during November 2010. The accumulated gain on the interest rate swaps upon settlement was deferred and amortized over the original lives of the underlying swap contracts. The amortization of the deferred accumulated gain ended in October 2014. As of March 31, 2014, the deferred accumulated gain applicable to the settled interest rate swap contracts included in accumulated other comprehensive income totaled $21.3 million ($13.8 million on an after-tax basis), all of which was recognized in interest income during 2014.
We have 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 we enter 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 a third party

financial institution. In connection with each swap transaction, we agree 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, we agree to pay a third-party 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 our customer to effectively convert a variable rate loan to a fixed rate. Because we act as an intermediary for our customer, changes in the fair value of the underlying derivative contracts for the most part offset each other and do not significantly impact our results of operations.

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The notional amounts and estimated fair values of interest rate derivative contracts are presented in the following table. We obtain dealer quotations to value our 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.

	March 31, 2015		December 31, 2014	
	Notional Amount	Estimated Fair Value	Notional Amount	Estimated Fair Value
Derivatives designated as hedges of fair value:				
Financial institution counterparties:				
Loan/lease interest rate swaps – assets	$23,422	$138	$31,614	$469
Loan/lease interest rate swaps – liabilities	40,740	(3,143)	37,672	(3,179)
Non-hedging interest rate derivatives:				
Financial institution counterparties:				
Loan/lease interest rate swaps – assets	—	—	69,842	719
Loan/lease interest rate swaps – liabilities	862,403	(47,039)	765,979	(38,952)
Loan/lease interest rate caps – assets	81,058	1,055	73,058	1,003
Customer counterparties:				
Loan/lease interest rate swaps – assets	862,403	46,995	765,979	38,910
Loan/lease interest rate swaps – liabilities	—	—	69,842	(719)
Loan/lease interest rate caps – liabilities	81,058	(1,055)	73,058	(1,003)

The weighted-average rates paid and received for interest rate swaps outstanding at March 31, 2015 were as follows:

	Weighted-Average	
	Interest Rate Paid	Interest Rate Received
Interest rate swaps:		
Fair value hedge loan/lease interest rate swaps	2.70%	0.17%
Non-hedging interest rate swaps – financial institution counterparties	4.04%	1.74%
Non-hedging interest rate swaps – customer counterparties	1.74%	4.04%

The weighted-average strike rate for outstanding interest rate caps was 2.98% at March 31, 2015.

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

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

		March 31, 2015		December 31, 2014	
	Notional Units	Notional Amount	Estimated Fair Value	Notional Amount	Estimated Fair Value
Financial institution counterparties:					
Oil – assets	Barrels	724	$15,137	470	$14,357
Oil – liabilities	Barrels	538	(2,121)	197	(1,670)
Natural gas – assets	MMBTUs	9,385	11,489	12,235	12,707
Natural gas – liabilities	MMBTUs	11,985	(3,591)	16,755	(4,095)
Customer counterparties:					
Oil – assets	Barrels	547	2,124	197	1,670
Oil – liabilities	Barrels	715	(15,100)	470	(14,318)
Natural gas – assets	MMBTUs	11,985	3,591	16,755	4,095

Natural gas – liabilities	MMBTUs	9,385	(11,435)	12,235	(12,646)

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

		March 31, 2015		December 31, 2014	
	Notional Currency	Notional Amount	Estimated Fair Value	Notional Amount	Estimated Fair Value
Financial institution counterparties:					
Forward contracts – assets	EUR	790	$11	936	$7
Forward contracts – assets	CAD	22,384	329	24,724	659
Forward contracts - assets	GBP	486	2	—	—
Forward contracts – liabilities	GBP	—	—	544	(2)
Customer counterparties:					
Forward contracts – liabilities	CAD	22,339	(284)	24,680	(615)

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. 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:

	Three Months Ended March 31,	
	2015	2014
Commercial loan/lease interest rate swaps:		
Amount of gain (loss) included in interest income on loans	$(425)	$(539)
Amount of (gain) loss included in other non-interest expense	—	9

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

	Three Months Ended March 31,	
	2015	2014
Interest rate swaps/caps/floors on variable-rate loans:		
Amount reclassified from accumulated other comprehensive income to interest income on loans	$—	$9,345

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 amortization of the deferred accumulated gain applicable to settled interest rate swap contracts ended in October 2014. As of March 31, 2014, the deferred

accumulated gain applicable to the settled interest rate swap contracts included in accumulated other comprehensive income totaled $21.3 million ($13.8 million on an after-tax basis), all of which was recognized in interest income during 2014.

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

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

	Three Months Ended March 31,	
	2015	2014
Non-hedging interest rate derivatives:		
Other non-interest income	$ 1,322	$ 221
Other non-interest expense	2	—
Non-hedging commodity derivatives:		
Other non-interest income	28	82
Non-hedging foreign currency derivatives:		
Other non-interest income	45	37

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 our Asset/Liability Management Committee. Our credit exposure on interest rate swaps is limited to the net favorable value and interest payments of all swaps by each counterparty, while our credit exposure on commodity swaps/options and foreign currency forward contracts is limited to the net favorable value of all contracts by each counterparty. Credit exposure may be reduced by the amount of collateral pledged by the counterparty. There are no credit-risk-related contingent features associated with any of our 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.

Our credit exposure relating to interest rate swaps, commodity swaps/options and foreign currency forward contracts with bank customers was approximately $47.0 million at March 31, 2015. This credit exposure is partly mitigated as transactions with customers are generally secured by the collateral, if any, securing the underlying transaction being hedged. Our credit exposure, net of collateral pledged, relating to interest rate swaps, commodity swaps/options and foreign currency forward contracts with upstream financial institution counterparties was approximately $9.2 million at March 31, 2015. This amount was primarily related to excess collateral we posted to counterparties. Collateral levels for upstream financial institution counterparties are monitored and adjusted as necessary. See Note 10 – Balance Sheet Offsetting for additional information regarding our credit exposure with upstream financial institution counterparties.

The aggregate fair value of securities we posted as collateral related to derivative contracts totaled $23.6 million at March 31, 2015. At such date, we also had $19.4 million in cash collateral on deposit with other financial institution counterparties.

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Note 10 - Balance Sheet Offsetting and Repurchase Agreements

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

Information about financial instruments that are eligible for offset in the consolidated balance sheet as of March 31, 2015 is presented in the following tables.

	Gross Amount Recognized	Gross Amount Offset	Net Amount Recognized
March 31, 2015			
Financial assets:			
Derivatives:			
Loan/lease interest rate swaps and caps	$1,193	$—	$1,193
Commodity swaps and options	26,626	—	26,626
Foreign currency forward contracts	342	—	342
Total derivatives	28,161	—	28,161
Resell agreements	9,642	—	9,642
Total	$37,803	$—	$37,803
Financial liabilities:			
Derivatives:			
Loan/lease interest rate swaps	$50,182	$—	$50,182
Commodity swaps and options	5,712	—	5,712
Total derivatives	55,894	—	55,894
Repurchase agreements	593,107	—	593,107
Total	$649,001	$—	$649,001

		Gross Amounts Not Offset		
	Net Amount Recognized	Financial Instruments	Collateral	Net Amount
March 31, 2015				
Financial assets:				
Derivatives:				
Counterparty A	$695	$(695)	$—	$