

CULLEN/FROST BANKERS, INC.

Form 10-Q

October 24, 2012

Table of Contents

United States
Securities and Exchange Commission

Washington, D.C. 20549

Form 10-Q

x **Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**
For the quarterly period ended: September 30, 2012

Or

.. **Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**
For the transition period from to

Commission file number: 001-13221

Cullen/Frost Bankers, Inc.

(Exact name of registrant as specified in its charter)

Texas	74-1751768
(State or other jurisdiction of	(I.R.S. Employer
incorporation or organization)	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)

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

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate 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 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

Accelerated filer

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

Smaller reporting company

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

As of October 18, 2012, there were 61,463,049 shares of the registrant's Common Stock, \$.01 par value, outstanding.

Table of Contents

Cullen/Frost Bankers, Inc.

Quarterly Report on Form 10-Q

September 30, 2012

Table of Contents

	Page
<u>Part I - Financial Information</u>	
Item 1. <u>Financial Statements (Unaudited)</u>	
<u>Consolidated Balance Sheets</u>	3
<u>Consolidated Statements of Income</u>	4
<u>Consolidated Statements of Comprehensive Income</u>	5
<u>Consolidated Statements of Changes in Shareholders' Equity</u>	6
<u>Consolidated Statements of Cash Flows</u>	7
<u>Notes to Consolidated Financial Statements</u>	8
Item 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	40
Item 3. <u>Quantitative and Qualitative Disclosures About Market Risk</u>	68
Item 4. <u>Controls and Procedures</u>	69
<u>Part II - Other Information</u>	
Item 1. <u>Legal Proceedings</u>	70
Item 1A. <u>Risk Factors</u>	70
Item 2. <u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	70
Item 3. <u>Defaults Upon Senior Securities</u>	70
Item 4. <u>Mine Safety Disclosures</u>	70
Item 5. <u>Other Information</u>	70
Item 6. <u>Exhibits</u>	70
<u>Signatures</u>	71

Table of Contents**Part I. Financial Information****Item 1. Financial Statements (Unaudited)****Cullen/Frost Bankers, Inc.****Consolidated Balance Sheets**

(Dollars in thousands, except per share amounts)

	September 30, 2012	December 31, 2011	September 30, 2011
Assets:			
Cash and due from banks	\$ 637,042	\$ 574,039	\$ 571,332
Interest-bearing deposits	2,098,682	2,314,251	3,885,202
Federal funds sold and resell agreements	16,452	19,302	30,827
Total cash and cash equivalents	2,752,176	2,907,592	4,487,361
Securities held to maturity, at amortized cost	364,997	365,996	366,267
Securities available for sale, at estimated fair value	8,717,645	7,789,700	5,339,812
Trading account securities	14,823	13,609	15,823
Loans, net of unearned discounts	8,811,040	7,995,129	8,089,577
Less: Allowance for loan losses	(105,401)	(110,147)	(115,433)
Net loans	8,705,639	7,884,982	7,974,144
Premises and equipment, net	317,197	319,042	321,517
Goodwill	535,509	528,072	528,072
Other intangible assets, net	9,066	10,604	11,656
Cash surrender value of life insurance policies	137,009	133,967	132,899
Accrued interest receivable and other assets	293,480	363,681	312,091
Total assets	\$ 21,847,541	\$ 20,317,245	\$ 19,489,642
Liabilities:			
Deposits:			
Non-interest-bearing demand deposits	\$ 7,720,930	\$ 6,672,555	\$ 6,541,239
Interest-bearing deposits	10,524,267	10,084,193	9,522,634
Total deposits	18,245,197	16,756,748	16,063,873
Federal funds purchased and repurchase agreements	601,204	722,202	658,246
Junior subordinated deferrable interest debentures	123,712	123,712	123,712
Other long-term borrowings	100,012	100,026	100,031
Accrued interest payable and other liabilities	358,799	331,020	296,904
Total liabilities	19,428,924	18,033,708	17,242,766
Shareholders' Equity:			
Preferred stock, par value \$0.01 per share; 10,000,000 shares authorized; none issued			
Common stock, par value \$0.01 per share; 210,000,000 shares authorized; 61,461,924, shares issued at September 30, 2012, 61,271,603 shares issued at December 31, 2011 and 61,271,603 shares issued at September 30, 2011	615	613	613
Additional paid-in capital	698,038	680,803	676,079
Retained earnings	1,445,241	1,354,759	1,327,587
Accumulated other comprehensive income, net of tax	274,723	247,734	244,053
		(372)	(1,456)

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

Treasury stock, 7,640 shares at December 31, 2011 and 26,359 shares at September 30, 2011, at cost

Total shareholders' equity	2,418,617	2,283,537	2,246,876
Total liabilities and shareholders' equity	\$ 21,847,541	\$ 20,317,245	\$ 19,489,642

See Notes to Consolidated Financial Statements.

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

(Dollars in thousands, except per share amounts)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Interest income:				
Loans, including fees	\$ 101,643	\$ 99,737	\$ 297,330	\$ 298,036
Securities:				
Taxable	32,091	30,089	102,556	92,942
Tax-exempt	23,283	23,127	67,911	69,029
Interest-bearing deposits	1,115	1,811	2,948	4,454
Federal funds sold and resell agreements	27	15	75	44
Total interest income	158,159	154,779	470,820	464,505
Interest expense:				
Deposits	4,598	5,306	13,717	17,203
Federal funds purchased and repurchase agreements	37	63	105	277
Junior subordinated deferrable interest debentures	1,711	1,710	5,096	5,073
Other long-term borrowings	281	2,339	1,446	10,499
Total interest expense	6,627	9,418	20,364	33,052
Net interest income	151,532	145,361	450,456	431,453
Provision for loan losses	2,500	9,010	5,955	27,445
Net interest income after provision for loan losses	149,032	136,351	444,501	404,008
Non-interest income:				
Trust and investment management fees	20,843	19,652	62,774	59,436
Service charges on deposit accounts	20,797	22,072	62,230	64,650
Insurance commissions and fees	9,964	9,569	31,512	27,971
Interchange and debit card transaction fees	4,194	8,719	12,603	25,459
Other charges, commissions and fees	7,265	6,572	22,440	20,625
Net gain (loss) on securities transactions		6,409	(121)	6,414
Other	8,095	6,224	21,462	17,787
Total non-interest income	71,158	79,217	212,900	222,342
Non-interest expense:				
Salaries and wages	64,984	61,697	191,310	185,902
Employee benefits	14,019	12,004	44,768	40,365
Net occupancy	13,193	12,080	37,203	35,555
Furniture and equipment	14,193	13,106	41,347	38,015
Deposit insurance	2,593	2,583	7,928	9,941
Intangible amortization	973	1,108	2,978	3,335
Other	34,495	34,829	103,492	101,152
Total non-interest expense	144,450	137,407	429,026	414,265
Income before income taxes	75,740	78,161	228,375	212,085

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

Income taxes	17,071	23,654	50,611	49,964
Net income	\$ 58,669	\$ 54,507	\$ 177,764	\$ 162,121
Earnings per common share:				
Basic	\$ 0.95	\$ 0.89	\$ 2.89	\$ 2.64
Diluted	0.95	0.89	2.88	2.64

See Notes to Consolidated Financial Statements.

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

(Dollars in thousands)

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2012	2011	2012	2011
Net income	\$ 58,669	\$ 54,507	\$ 177,764	\$ 162,121
Other comprehensive income (loss), before tax:				
Securities available for sale:				
Change in net unrealized gain/loss during the period	40,122	78,552	62,972	169,516
Reclassification adjustment for net (gains) losses included in net income		(6,409)	121	(6,414)
Total securities available for sale	40,122	72,143	63,093	163,102
Defined-benefit post-retirement benefit plans:				
Change in the net actuarial gain/loss	1,427	783	4,084	2,348
Derivatives:				
Change in the accumulated gain/loss on effective cash flow hedge derivatives	(269)	(909)	(760)	(2,560)
Reclassification adjustments for (gains) losses included in net income:				
Interest rate swaps on variable-rate loans	(9,345)	(9,345)	(28,035)	(28,035)
Interest rate swap on junior subordinated deferrable interest debentures	1,063	1,118	3,140	3,304
Total derivatives	(8,551)	(9,136)	(25,655)	(27,291)
Other comprehensive income (loss), before tax	32,998	63,790	41,522	138,159
Deferred tax expense (benefit) related to other comprehensive income	11,550	22,326	14,533	48,356
Other comprehensive income (loss), net of tax	21,448	41,464	26,989	89,803
Comprehensive income	\$ 80,117	\$ 95,971	\$ 204,753	\$ 251,924

See Notes to Consolidated Financial Statements.

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

(Dollars in thousands, except per share amounts)

	Nine Months Ended September 30,	
	2012	2011
Total shareholders' equity at beginning of period	\$ 2,283,537	\$ 2,061,680
Net income	177,764	162,121
Other comprehensive income	26,989	89,803
Stock option exercises (197,961 shares in 2012 and 144,203 shares in 2011)	10,092	7,239
Stock compensation expense recognized in earnings	7,942	10,016
Tax benefits (deficiencies) related to stock compensation	(425)	304
Purchase of treasury stock (29,823 shares in 2011)		(1,657)
Common stock issued/sold to the 401(k) stock purchase plan (22,680 shares in 2011)		1,360
Cash dividends (\$1.42 per share in 2012 and \$1.37 per share in 2011)	(87,282)	(83,990)
Total shareholders' equity at end of period	\$ 2,418,617	\$ 2,246,876

See Notes to Consolidated Financial Statements.

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

(Dollars in thousands)

	Nine Months Ended September 30,	
	2012	2011
Operating Activities:		
Net income	\$ 177,764	\$ 162,121
Adjustments to reconcile net income to net cash from operating activities:		
Provision for loan losses	5,955	27,445
Deferred tax expense (benefit)	(5,020)	(137)
Accretion of loan discounts	(8,321)	(9,865)
Securities premium amortization (discount accretion), net	14,952	7,590
Net (gain) loss on securities transactions	121	(6,414)
Depreciation and amortization	28,374	28,082
Net loss on sale/write-down of assets/foreclosed assets	4,182	4,240
Stock-based compensation	7,942	10,016
Net tax benefit (deficiency) from stock-based compensation	(535)	(89)
Excess tax benefits from stock-based compensation	(110)	(393)
Earnings on life insurance policies	(3,042)	(2,977)
Net change in:		
Trading account securities	(1,214)	(722)
Accrued interest receivable and other assets	53,120	41,588
Accrued interest payable and other liabilities	(4,945)	(1,145)
Net cash from operating activities	269,223	259,340
Investing Activities:		
Securities held to maturity:		
Purchases		(83,184)
Maturities, calls and principal repayments	766	464
Securities available for sale:		
Purchases	(17,484,661)	(6,195,375)
Sales	15,987,480	5,587,391
Maturities, calls and principal repayments	617,489	587,650
Net change in loans	(823,627)	(17,748)
Net cash paid in acquisitions	(7,199)	(1,044)
Proceeds from sales of premises and equipment	3,765	1,256
Purchases of premises and equipment	(19,724)	(23,266)
Proceeds from sales of repossessed properties	10,715	11,825
Net cash from investing activities	(1,714,996)	(132,031)
Financing Activities:		
Net change in deposits	1,488,449	1,584,531
Net change in short-term borrowings	(120,998)	182,573
Principal payments on long-term borrowings	(14)	(150,014)
Proceeds from stock option exercises	10,092	7,239
Excess tax benefits from stock-based compensation	110	393
Purchase of treasury stock		(1,657)
Cash dividends paid	(87,282)	(83,990)
Net cash from financing activities	1,290,357	1,539,075

Net change in cash and cash equivalents	(155,416)	1,666,384
Cash and equivalents at beginning of period	2,907,592	2,820,977
Cash and equivalents at end of period	\$ 2,752,176	\$ 4,487,361

See Notes to Consolidated Financial Statements.

Table of Contents**Cullen/Frost Bankers, Inc.****Notes to Consolidated Financial Statements**

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

Note 1 - Significant Accounting Policies

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

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

The consolidated financial statements in this Quarterly Report on Form 10-Q have not been audited by an independent registered public accounting firm, but in the opinion of management, reflect all adjustments necessary for a fair presentation of the Corporation's financial position and results of operations. All such adjustments were of a normal and recurring nature. The consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and with the instructions to Form 10-Q adopted by the Securities and Exchange Commission (SEC). Accordingly, the financial statements do not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements and should be read in conjunction with the Corporation's consolidated financial statements, and notes thereto, for the year ended December 31, 2011, included in the Corporation's Annual Report on Form 10-K filed with the SEC on February 3, 2012 (the 2011 Form 10-K). Operating results for the interim periods disclosed herein are not necessarily indicative of the results that may be expected for a full year or any future period.

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

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

	Nine Months Ended	
	September 30,	
	2012	2011
Cash paid for interest	\$ 22,913	\$ 39,809
Cash paid for income tax	38,761	35,612
Significant non-cash transactions:		
Loans foreclosed and transferred to other real estate owned and foreclosed assets	5,336	16,803
Loans to facilitate the sale of other real estate owned		75
Common stock/treasury stock issued to the Corporation's 401(k) stock purchase plan		1,360

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

Table of Contents**Note 2 - Securities**

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

	September 30, 2012				December 31, 2011			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Held to Maturity								
U. S. Treasury	\$ 248,088	\$ 31,892	\$	\$ 279,980	\$ 247,797	\$ 31,715	\$	\$ 279,512
Residential mortgage-backed securities	11,074	360		11,434	11,874	153		12,027
States and political subdivisions	104,835	12,009		116,844	105,325	6,597		111,922
Other	1,000			1,000	1,000			1,000
Total	\$ 364,997	\$ 44,261	\$	\$ 409,258	\$ 365,996	\$ 38,465	\$	\$ 404,461
Available for Sale:								
U. S. Treasury	\$ 3,019,622	\$ 41,930	\$	\$ 3,061,552	\$ 2,020,621	\$ 36,111	\$	\$ 2,056,732
U.S. government agencies/corporations	250,000	145		250,145	250,000	884		250,884
Residential mortgage-backed securities	2,587,218	164,665		2,751,883	3,135,064	154,386	180	3,289,270
States and political subdivisions	2,412,514	205,676	12	2,618,178	1,996,703	158,133	23	2,154,813
Other	35,887			35,887	38,001			38,001
Total	\$ 8,305,241	\$ 412,416	\$ 12	\$ 8,717,645	\$ 7,440,389	\$ 349,514	\$ 203	\$ 7,789,700

All mortgage-backed securities included in the above table were issued by U.S. government agencies and corporations. At September 30, 2012, approximately 99% of the securities in the Corporation's municipal bond portfolio were issued by political subdivisions or agencies within the State of Texas, of which approximately 84% are either guaranteed by the Texas Permanent School Fund, which has a triple-A insurer financial strength, or secured by U.S. Treasury securities via defeasance of the debt by the issuers. Securities with limited marketability, such as stock in the Federal Reserve Bank and the Federal Home Loan Bank, are carried at cost and are reported as other available for sale securities in the above table. The carrying value of securities pledged to secure public funds, trust deposits, repurchase agreements and for other purposes, as required or permitted by law was \$2.2 billion at September 30, 2012 and \$2.4 billion at December 31, 2011.

As of September 30, 2012, 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
Available for Sale						
States and political subdivisions	\$ 16,761	\$ 12	\$	\$	\$ 16,761	\$ 12

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

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

Management has the ability and intent to hold the securities classified as held to maturity in the table above until they mature, at which time the Corporation expects to receive full value for the securities. Furthermore, as of September 30, 2012, management does not have the intent to sell any of the securities classified as available for sale in the table above and believes that it is more likely than not that the Corporation will not have to sell any such securities before a recovery of cost. Any unrealized losses are largely due to increases in market interest rates over the yields available at the time the underlying securities were purchased. The fair value is expected to recover as the bonds approach their maturity date or repricing date or if market yields for such investments decline. Management does not believe any of the securities are impaired due to reasons of credit quality. Accordingly, as of September 30, 2012, management believes the impairments detailed in the table above are temporary and no impairment loss has been realized in the Corporation's consolidated income statement.

Table of Contents

The amortized cost and estimated fair value of securities, excluding trading securities, at September 30, 2012 are presented below by contractual maturity. Expected maturities may differ from contractual maturities because issuers may have the right to call or prepay obligations. Residential mortgage-backed securities and equity securities are shown separately since they are not due at a single maturity date.

	Held to Maturity		Available for Sale	
	Amortized Cost	Estimated Fair Value	Amortized Cost	Estimated Fair Value
Due in one year or less	\$ 1,000	\$ 1,000	\$ 635,154	\$ 638,634
Due after one year through five years	248,088	279,980	2,900,392	2,949,445
Due after five years through ten years	3,301	3,672	215,664	234,329
Due after ten years	101,534	113,172	1,930,926	2,107,467
Residential mortgage-backed securities	11,074	11,434	2,587,218	2,751,883
Equity securities			35,887	35,887
Total	\$ 364,997	\$ 409,258	\$ 8,305,241	\$ 8,717,645

Sales of securities available for sale were as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Proceeds from sales	\$	\$ 39,005	\$ 15,987,480	\$ 5,587,391
Gross realized gains		6,409	2,508	6,418
Gross realized losses			(2,629)	4
Tax (expense) benefit of securities gains/losses		(2,243)	42	(2,245)

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

	September 30, 2012	December 31, 2011
U.S. Treasury	\$ 13,761	\$ 13,609
States and political subdivisions	1,062	
Total	\$ 14,823	\$ 13,609

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Net gain on sales transactions	\$ 310	\$ 303	\$ 932	\$ 772
Net mark-to-market gains (losses)	22	4	(57)	11
Net gain on trading account securities	\$ 332	\$ 307	\$ 875	\$ 783

Table of Contents**Note 3 Loans**

Loans were as follows:

	September 30, 2012	Percentage of Total	December 31, 2011	Percentage of Total	September 30, 2011	Percentage of Total
Commercial and industrial:						
Commercial	\$ 4,055,807	46.0%	\$ 3,553,989	44.5%	\$ 3,571,807	44.2%
Leases	247,210	2.8	193,412	2.4	184,614	2.3
Asset-based	183,284	2.1	169,466	2.1	175,120	2.1
Total commercial and industrial	4,486,301	50.9	3,916,867	49.0	3,931,541	48.6
Commercial real estate:						
Commercial mortgages	2,455,488	27.9	2,383,479	29.8	2,370,871	29.3
Construction	584,207	6.6	434,870	5.5	508,182	6.3
Land	210,440	2.4	202,478	2.5	214,436	2.6
Total commercial real estate	3,250,135	36.9	3,020,827	37.8	3,093,489	38.2
Consumer real estate:						
Home equity loans	295,735	3.4	282,244	3.5	277,284	3.4
Home equity lines of credit	188,993	2.1	191,960	2.4	190,958	2.4
1-4 family residential mortgages	39,836	0.4	45,943	0.6	47,455	0.6
Construction	18,057	0.2	17,544	0.2	17,965	0.2
Other	225,861	2.6	225,118	2.8	233,053	2.9
Total consumer real estate	768,482	8.7	762,809	9.5	766,715	9.5
Total real estate	4,018,617	45.6	3,783,636	47.3	3,860,204	47.7
Consumer and other:						
Consumer installment	311,898	3.5	301,518	3.8	299,417	3.7
Other	13,694	0.2	11,018	0.1	14,926	0.2
Total consumer and other	325,592	3.7	312,536	3.9	314,343	3.9
Unearned discounts	(19,470)	(0.2)	(17,910)	(0.2)	(16,511)	(0.2)
Total loans	\$ 8,811,040	100.0%	\$ 7,995,129	100.0%	\$ 8,089,577	100.0%

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

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

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

Commercial real estate loans are subject to underwriting standards and processes similar to commercial and industrial loans, in addition to those of real estate loans. These loans are viewed primarily as cash flow loans and secondarily as loans secured by real estate. Commercial real estate lending typically involves higher loan principal amounts and the repayment of these loans is generally largely dependent on the successful operation of the property securing the loan or the business conducted on the property securing the loan. Commercial real estate loans may be more adversely affected by conditions in the real estate markets or in the general economy. The properties securing the Corporation's commercial real estate portfolio are diverse in terms of type and geographic location. This diversity helps reduce the Corporation's exposure to adverse economic events that affect any single market or industry. Management monitors and evaluates commercial real estate loans based on collateral, geography and risk grade criteria. As a general rule, the Corporation avoids financing single-purpose

Table of Contents

projects unless other underwriting factors are present to help mitigate risk. The Corporation also utilizes third-party experts to provide insight and guidance about economic conditions and trends affecting market areas it serves. In addition, management tracks the level of owner-occupied commercial real estate loans versus non-owner occupied loans. At September 30, 2012, approximately 56.2% of the outstanding principal balance of the Corporation's commercial real estate loans were secured by owner-occupied properties.

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

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

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

Concentrations of Credit. Most of the Corporation's lending activity occurs within the State of Texas, including the four largest metropolitan areas of Austin, Dallas/Ft. Worth, Houston and San Antonio, as well as other markets. The majority of the Corporation's loan portfolio consists of commercial and industrial and commercial real estate loans. Other than energy loans, as of September 30, 2012 there were no concentrations of loans related to any single industry in excess of 10% of total loans.

Foreign Loans. The Corporation has U.S. dollar denominated loans and commitments to borrowers in Mexico. The outstanding balance of these loans and the unfunded amounts available under these commitments were not significant at September 30, 2012 or December 31, 2011.

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

Table of Contents

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

	September 30, 2012	December 31, 2011	September 30, 2011
Commercial and industrial:			
Energy	\$	\$	\$
Other commercial	52,819	43,874	58,208
Commercial real estate:			
Buildings, land and other	48,674	43,820	45,333
Construction	1,144	1,329	1,821
Consumer real estate	3,069	4,587	4,060
Consumer and other	701	728	756
Total	\$ 106,407	\$ 94,338	\$ 110,178

Had non-accrual loans performed in accordance with their original contract terms, the Corporation would have recognized additional interest income, net of tax, of approximately \$646 thousand and \$1.9 million for the three and nine months ended September 30, 2012, compared to \$823 thousand and \$2.6 million for the three and nine months ended September 30, 2011.

An age analysis of past due loans (including both accruing and non-accruing loans), segregated by class of loans, as of September 30, 2012 was as follows:

	Loans 30-89 Days Past Due	Loans 90 or More Days Past Due	Total Past Due Loans	Current Loans	Total Loans	Accruing Loans 90 or More Days Past Due
Commercial and industrial:						
Energy	\$ 63	\$	\$ 63	\$ 1,130,840	\$ 1,130,903	\$
Other commercial	16,378	17,792	34,170	3,321,228	3,355,398	5,793
Commercial real estate:						
Buildings, land and other	14,668	11,547	26,215	2,639,713	2,665,928	400
Construction	467		467	583,740	584,207	
Consumer real estate	7,458	3,162	10,620	757,862	768,482	1,720
Consumer and other	4,147	579	4,726	320,866	325,592	537
Unearned discounts				(19,470)	(19,470)	
Total	\$ 43,181	\$ 33,080	\$ 76,261	\$ 8,734,779	\$ 8,811,040	\$ 8,450

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

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

valuation.

Table of Contents

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

	Unpaid Contractual Principal Balance	Recorded Investment With No Allowance	Recorded Investment With Allowance	Total Recorded Investment	Related Allowance	Average Recorded Investment Quarter To Date	Year To Date
September 30, 2012							
Commercial and industrial:							
Energy	\$	\$	\$	\$	\$	\$	\$
Other commercial	61,081	37,231	11,845	49,076	4,059	44,140	43,087
Commercial real estate:							
Buildings, land and other	54,690	39,691	6,401	46,092	823	42,569	41,283
Construction	1,515	1,144		1,144		1,671	1,465
Consumer real estate	974	894		894		1,087	1,805
Consumer and other	443	420		420		430	487
Total	\$ 118,703	\$ 79,380	\$ 18,246	\$ 97,626	\$ 4,882	\$ 89,897	\$ 88,127
December 31, 2011							
Commercial and industrial:							
Energy	\$	\$	\$	\$	\$	\$	\$
Other commercial	57,723	34,712	4,619	39,331	2,696	46,151	53,830
Commercial real estate:							
Buildings, land and other	51,163	38,686	2,243	40,929	1,113	41,522	48,635
Construction	1,568	1,281		1,281		1,527	4,339
Consumer real estate	2,499	1,719	751	2,470	95	2,484	1,845
Consumer and other	562	554		554		561	265
Total	\$ 113,515	\$ 76,952	\$ 7,613	\$ 84,565	\$ 3,904	\$ 92,245	\$ 108,914
September 30, 2011							
Commercial and industrial:							
Energy	\$	\$	\$	\$	\$	\$	\$
Other commercial	79,327	42,583	10,387	52,970	6,883	60,696	57,455
Commercial real estate:							
Buildings, land and other	52,193	34,267	7,848	42,115	1,283	44,453	50,562
Construction	2,162	1,773		1,773		2,265	5,104
Consumer real estate	2,510	2,498		2,498		2,227	1,689
Consumer and other	568	568		568		335	193
Total	\$ 136,760	\$ 81,689	\$ 18,235	\$ 99,924	\$ 8,166	\$ 109,976	\$ 115,003

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

During the nine months ended September 30, 2012, the Corporation had one troubled debt restructuring. The troubled debt restructuring related to an other commercial and industrial loan which had a restructuring date balance of \$445 thousand. During the nine months ended September 30, 2011, the Corporation had troubled debt restructurings with an aggregate restructuring date balance of \$9.1 million (including \$7.5 million related to commercial real estate—buildings, land and other; \$969 thousand related to consumer real estate; \$469 thousand related to consumer and \$191 thousand related to commercial and industrial—other). All of the loans identified as troubled debt restructurings by the Corporation during the reported periods were previously on non-accrual status and reported as impaired loans prior to restructuring. The modifications primarily related to extending the amortization periods of the loans. The Corporation did not grant interest-rate concessions on any

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

restructured loan. All loans restructured during the reported periods were on non-accrual status as of the end of those periods. Because the loans were classified and on non-accrual status both before and after restructuring, the modifications did not impact the Corporation's determination of the allowance for loan losses. During the nine months ended September 30, 2012, defaults on loans restructured during 2011 were not significant and such defaults did not significantly impact the Corporation's determination of the allowance for loan losses.

Table of Contents

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

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

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

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

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

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

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

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

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

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

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

forgiveness of debt.

Table of Contents

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

	September 30, 2012		December 31, 2011		September 30, 2011	
	Weighted Average Risk Grade	Loans	Weighted Average Risk Grade	Loans	Weighted Average Risk Grade	Loans
Commercial and industrial:						
Energy						
Risk grades 1-8	5.36	\$ 1,128,700	5.21	\$ 868,561	5.18	\$ 912,728
Risk grade 9	9.00	2,203	9.00	2,025	9.00	1,419
Risk grade 10	10.00		10.00		10.00	
Risk grade 11	11.00		11.00		11.00	
Risk grade 12	12.00		12.00		12.00	
Risk grade 13	13.00		13.00		13.00	
Total energy	5.37	\$ 1,130,903	5.22	\$ 870,586	5.19	\$ 914,147
Other commercial						
Risk grades 1-8	6.05	\$ 3,110,022	6.20	\$ 2,802,037	6.20	\$ 2,687,564
Risk grade 9	9.00	83,799	9.00	55,105	9.00	94,687
Risk grade 10	10.00	44,530	10.00	49,982	10.00	52,753
Risk grade 11	11.00	61,845	11.00	96,046	11.00	124,603
Risk grade 12	12.00	50,670	12.00	39,826	12.00	47,875
Risk grade 13	13.00	4,532	13.00	3,285	13.00	9,912
Total other commercial	6.37	\$ 3,355,398	6.55	\$ 3,046,281	6.67	\$ 3,017,394
Commercial real estate:						
Buildings, land and other						
Risk grades 1-8	6.64	\$ 2,397,984	6.69	\$ 2,266,576	6.65	\$ 2,259,305
Risk grade 9	9.00	102,689	9.00	103,894	9.00	91,035
Risk grade 10	10.00	31,755	10.00	45,278	10.00	72,975
Risk grade 11	11.00	83,818	11.00	126,594	11.00	116,659
Risk grade 12	12.00	48,859	12.00	41,747	12.00	42,391
Risk grade 13	13.00	823	13.00	1,868	13.00	2,942
Total commercial real estate	7.01	\$ 2,665,928	7.14	\$ 2,585,957	7.12	\$ 2,585,307
Construction						
Risk grades 1-8	6.92	\$ 548,019	6.95	\$ 378,530	6.98	\$ 439,502
Risk grade 9	9.00	31,366	9.00	30,376	9.00	30,358
Risk grade 10	10.00	1,754	10.00	16,186	10.00	28,255
Risk grade 11	11.00	1,924	11.00	8,449	11.00	8,246
Risk grade 12	12.00	1,144	12.00	1,329	12.00	1,821
Risk grade 13	13.00		13.00		13.00	
Total construction	7.06	\$ 584,207	7.30	\$ 434,870	7.35	\$ 508,182

The Corporation has established maximum loan to value standards to be applied during the origination process of commercial and consumer real estate loans. The Corporation does not subsequently monitor loan-to-value ratios (either individually or on a weighted-average basis) for loans that are subsequently considered to be of a pass grade (grades 9 or better) and/or current with respect to principal and interest payments. As stated above, when an individual commercial real estate loan has a calculated risk grade of 10 or higher, a special assets officer analyzes the loan to determine whether the loan is impaired. At that time, the Corporation reassesses the loan to value position in the loan. If the loan is determined to be collateral dependent, specific allocations of the allowance for loan losses are made for the amount of any collateral deficiency. If a collateral deficiency is ultimately deemed to be uncollectible, the amount is charged-off. These loans and related assessments of collateral position are monitored on an individual, case-by-case basis. The Corporation does not monitor loan-to-value ratios on a weighted-average basis for commercial real estate loans having a calculated risk grade of 10 or higher. Nonetheless, there were three commercial real estate loans having a calculated risk grade of 10 or higher in excess of \$5 million as of September 30, 2012, which totaled \$31.8 million and had a weighted-average loan-to-value ratio of

Table of Contents

68.0%. When an individual consumer real estate loan becomes past due by more than 10 days, the assigned relationship manager will begin collection efforts. The Corporation only reassesses the loan to value position in a consumer real estate loan if, during the course of the collection process, it is determined that the loan has become collateral dependent, and any collateral deficiency is recognized as a charge-off to the allowance for loan losses. Accordingly, the Corporation does not monitor loan-to-value ratios on a weighted-average basis for collateral dependent consumer real estate loans.

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

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Commercial and industrial:				
Energy	\$	\$ 1	\$ 4	\$ 5
Other commercial	(4,656)	(13,602)	(9,511)	(25,154)
Commercial real estate:				
Buildings, land and other	2,678	(1,162)	811	(8,689)
Construction	14	(121)	36	(473)
Consumer real estate	(156)	(750)	(441)	(1,642)
Consumer and other	(627)	(684)	(1,600)	(2,375)
Total	\$ (2,747)	\$ (16,318)	\$ (10,701)	\$ (38,328)

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 122.2 at July 31, 2012 (most recent date available), 120.3 at December 31, 2011 and 118.3 at September 30, 2011. A higher TLI value implies more favorable economic conditions.

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

the necessary increases in the allowance for loan losses related to newly identified criticized loans, but it also reflects actions taken related to other loans including, among other things, any necessary increases or decreases in required allowances for specific loans or loan pools.

Table of Contents

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

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

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

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

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

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

During the fourth quarter of 2011, the Corporation refined its methodology for the determination of the allowance for loan losses to provide reserves for loans to borrowers in distressed industries. To determine the amount of the allocation, management calculates the weighted-average risk grade for all loans to borrowers in distressed industries by loan portfolio segment. A multiple is then applied to the amount by which the weighted-average risk grade for loans to borrowers in distressed industries exceeds the weighted-average risk grade for all pass-grade loans within the loan portfolio segment to derive an allocation factor for loans to borrowers in distressed industries. The amount of the allocation for each loan portfolio

Table of Contents

segment is the product of this allocation factor and the outstanding balance of pass-grade loans within the identified distressed industries that have a risk grade of 6 or higher. This change in the Corporation's methodology for the determination of the allowance for loan losses did not significantly impact the provision for loan losses recorded during 2011. Management identifies potential distressed industries by analyzing industry trends related to delinquencies, classifications and charge-offs. At September 30, 2012 and December 31, 2011, contractors were considered to be a distressed industry based on elevated levels of delinquencies, classifications and charge-offs relative to other industries within the Corporation's loan portfolio. Furthermore, the Corporation determined, through a review of borrower financial information that, as a whole, contractors have experienced, among other things, decreased revenues, reduced backlog of work, compressed margins and little, if any, net income.

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

The following table presents details of the allowance for loan losses, segregated by loan portfolio segment. Prior to September 30, 2012, certain general valuation allowances were not allocated to specific loan portfolio segments.

	Commercial and Industrial	Commercial Real Estate	Consumer Real Estate	Consumer and Other	Unallocated	Total
September 30, 2012						
Historical valuation allowances	\$ 30,785	\$ 15,455	\$ 3,010	\$ 7,479	\$	\$ 56,729
Specific valuation allowances	4,059	823				4,882
General valuation allowances:						
Environmental risk adjustment	6,018	3,722	702	1,924		12,366
Distressed industries	4,998	1,173				6,171
Excessive industry concentrations	3,469	3,229				6,698
Large relationship concentrations	1,419	1,030				2,449
Highly-leveraged credit relationships	3,656	1,055				4,711
Policy exceptions					2,319	2,319
Credit and collateral exceptions					1,582	1,582
Loans not reviewed by concurrence	2,235	2,446	2,370	1,183		8,234
Adjustment for recoveries	(5,097)	(1,292)	(688)	(6,684)		(13,761)
General macroeconomic risk					13,021	13,021
Total	\$ 51,542	\$ 27,641	\$ 5,394	\$ 3,902	\$ 16,922	\$ 105,401
December 31, 2011						
Historical valuation allowances	\$ 30,368	\$ 15,153	\$ 2,742	\$ 9,876	\$	\$ 58,139
Specific valuation allowances	2,696	1,113	95			3,904
General valuation allowances:						
Environmental risk adjustment	5,656	3,724	703	2,759		12,842
Distressed industries	4,054	922				4,976
Excessive industry concentrations					6,995	6,995
Large relationship concentrations					2,232	2,232
Highly-leveraged credit relationships					3,530	3,530
Policy exceptions					2,121	2,121
Credit and collateral exceptions					1,603	1,603
Loans not reviewed by concurrence					9,030	9,030
Adjustment for recoveries					(13,071)	(13,071)

General macroeconomic risk					17,846	17,846
Total	\$ 42,774	\$ 20,912	\$ 3,540	\$ 12,635	\$ 30,286	\$ 110,147

Table of Contents

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

The following table details activity in the allowance for loan losses by portfolio segment for the three and nine months ended September 30, 2012 and 2011. 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:						
September 30, 2012						
Beginning balance	\$ 53,475	\$ 27,631	\$ 5,235	\$ 3,649	\$ 15,658	\$ 105,648
Provision for loan losses	2,723	(2,682)	315	880	1,264	2,500
Charge-offs	(5,837)	(520)	(209)	(2,391)		(8,957)
Recoveries	1,181	3,212	53	1,764		6,210
Net (charge-offs) recoveries	(4,656)	2,692	(156)	(627)		(2,747)
Ending balance	\$ 51,542	\$ 27,641	\$ 5,394	\$ 3,902	\$ 16,922	\$ 105,401
September 30, 2011						
Beginning balance	\$ 56,566	\$ 20,901	\$ 3,683	\$ 12,611	\$ 28,980	\$ 122,741
Provision for loan losses	3,920	1,194	513	880	2,503	9,010
Charge-offs	(15,084)	(1,689)	(834)	(2,359)		(19,966)
Recoveries	1,483	406	84	1,675		3,648
Net charge-offs	(13,601)	(1,283)	(750)	(684)		(16,318)
Ending balance	\$ 46,885	\$ 20,812	\$ 3,446	\$ 12,807	\$ 31,483	\$ 115,433
Nine months ended:						
September 30, 2012						
Beginning balance	\$ 42,774	\$ 20,912	\$ 3,540	\$ 12,635	\$ 30,286	\$ 110,147
Provision for loan losses	18,275	5,882	2,295	(7,133)	(13,364)	5,955
Charge-offs	(13,323)	(3,715)	(1,104)	(6,605)		(24,747)
Recoveries	3,816	4,562	663	5,005		14,046
Net (charge-offs) recoveries	(9,507)	847	(441)	(1,600)		(10,701)
Ending balance	\$ 51,542	\$ 27,641	\$ 5,394	\$ 3,902	\$ 16,922	\$ 105,401
September 30, 2011						
Beginning balance	\$ 57,789	\$ 28,534	\$ 3,223	\$ 11,974	\$ 24,796	\$ 126,316
Provision for loan losses	14,245	1,440	1,865	3,208	6,687	27,445
Charge-offs	(28,258)	(10,261)	(2,113)	(7,058)		(47,690)
Recoveries	3,109	1,099	471	4,683		9,362

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

Net charge-offs	(25,149)	(9,162)	(1,642)	(2,375)	(38,328)	
Ending balance	\$ 46,885	\$ 20,812	\$ 3,446	\$ 12,807	\$ 31,483	\$ 115,433

Table of Contents

The following table details the amount of the allowance for loan losses allocated to each portfolio segment as of September 30, 2012, December 31, 2011 and September 30, 2011, detailed on the basis of the impairment methodology used by the Corporation.

	Commercial and Industrial	Commercial Real Estate	Consumer Real Estate	Consumer and Other	Unallocated	Total
September 30, 2012						
Loans individually evaluated for impairment	\$ 14,301	\$ 2,149	\$	\$	\$	\$ 16,450
Loans collectively evaluated for impairment	37,241	25,492	5,394	3,902	16,922	88,951
Balance at September 30, 2012	\$ 51,542	\$ 27,641	\$ 5,394	\$ 3,902	\$ 16,922	\$ 105,401
December 31, 2011						
Loans individually evaluated for impairment	\$ 15,829	\$ 3,625	\$ 95	\$	\$	\$ 19,549
Loans collectively evaluated for impairment	26,945	17,287	3,445	12,635	30,286	90,598
Balance at December 31, 2011	\$ 42,774	\$ 20,912	\$ 3,540	\$ 12,635	\$ 30,286	\$ 110,147
September 30, 2011						
Loans individually evaluated for impairment	\$ 23,263	\$ 4,075	\$	\$	\$	\$ 27,338
Loans collectively evaluated for impairment	23,622	16,737	3,446	12,807	31,483	88,095
Balance at September 30, 2011	\$ 46,885	\$ 20,812	\$ 3,446	\$ 12,807	\$ 31,483	\$ 115,433

The Corporation's recorded investment in loans as of September 30, 2012, December 31, 2011 and September 30, 2011 related to each balance in the allowance for loan losses by portfolio segment and detailed on the basis of the impairment methodology used by the Corporation was as follows:

	Commercial and Industrial	Commercial Real Estate	Consumer Real Estate	Consumer and Other	Unearned Discounts	Total
September 30, 2012						
Loans individually evaluated for impairment	\$ 161,577	\$ 170,077	\$ 894	\$ 420	\$	\$ 332,968
Loans collectively evaluated for impairment	4,324,724	3,080,058	767,588	325,172	(19,470)	8,478,072
Ending balance	\$ 4,486,301	\$ 3,250,135	\$ 768,482	\$ 325,592	\$ (19,470)	\$ 8,811,040
December 31, 2011						
Loans individually evaluated for impairment	\$ 189,139	\$ 241,451	\$ 2,470	\$ 554	\$	\$ 433,614
Loans collectively evaluated for impairment	3,727,728	2,779,376	760,339	311,982	(17,910)	7,561,515
Ending balance	\$ 3,916,867	\$ 3,020,827	\$ 762,809	\$ 312,536	\$ (17,910)	\$ 7,995,129
September 30, 2011						
Loans individually evaluated for impairment	\$ 235,143	\$ 273,289	\$	\$	\$	\$ 508,432
Loans collectively evaluated for impairment	3,696,398	2,820,200	766,715	314,343	(16,511)	7,581,145
Ending balance	\$ 3,931,541	\$ 3,093,489	\$ 766,715	\$ 314,343	\$ (16,511)	\$ 8,089,577

Table of Contents**Note 4 - Goodwill and Other Intangible Assets**

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

	September 30, 2012	December 31, 2011
Goodwill	\$ 535,509	\$ 528,072
Other intangible assets:		
Core deposits	\$ 5,990	\$ 8,234
Customer relationship	2,433	2,113
Non-compete agreements	643	257
	\$ 9,066	\$ 10,604

The estimated aggregate future amortization expense for intangible assets remaining as of September 30, 2012 is as follows:

Remainder of 2012	\$ 919
2013	3,115
2014	2,270
2015	1,490
2016	777
Thereafter	495
	\$ 9,066

Note 5 - Deposits

Deposits were as follows:

	September 30, 2012	Percentage of Total	December 31, 2011	Percentage of Total	September 30, 2011	Percentage of Total
Non-interest-bearing demand deposits:						
Commercial and individual	\$ 6,907,201	37.9%	\$ 5,848,840	34.9%	\$ 5,759,723	35.8%
Correspondent banks	350,895	1.9	370,275	2.2	350,082	2.2
Public funds	462,834	2.5	453,440	2.7	431,434	2.7
Total non-interest-bearing demand deposits	7,720,930	42.3	6,672,555	39.8	6,541,239	40.7
Interest-bearing deposits:						
Private accounts:						
Savings and interest checking	3,198,939	17.5	2,912,937	17.4	2,579,745	16.1
Money market accounts	5,906,083	32.4	5,664,780	33.8	5,469,492	34.0
Time accounts of \$100,000 or more	535,308	3.0	533,682	3.2	581,192	3.6
Time accounts under \$100,000	477,168	2.6	522,887	3.1	546,583	3.4

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

Total private accounts	10,117,498	55.5	9,634,286	57.5	9,177,012	57.1
Public funds:						
Savings and interest checking	224,427	1.2	265,747	1.6	164,183	1.0
Money market accounts	49,709	0.3	44,590	0.3	46,099	0.3
Time accounts of \$100,000 or more	129,843	0.7	136,422	0.8	132,657	0.9
Time accounts under \$100,000	2,790		3,148		2,683	
Total public funds	406,769	2.2	449,907	2.7	345,622	2.2
Total interest-bearing deposits	10,524,267	57.7	10,084,193	60.2	9,522,634	59.3
Total deposits	\$ 18,245,197	100.0%	\$ 16,756,748	100.0%	\$ 16,063,873	100.0%

Table of Contents

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

	September 30, 2012	December 31, 2011	September 30, 2011
Money market deposits obtained through brokers	\$	\$ 24,500	\$ 28,246
Deposits from the Certificate of Deposit Account Registry Service (CDARS) deposits	9,399	45,005	60,979
Deposits from foreign sources (primarily Mexico)	787,304	744,669	729,933

Note 6 - Commitments and Contingencies

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

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

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

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

	September 30, 2012	December 31, 2011
Commitments to extend credit	\$ 5,569,362	\$ 5,147,363
Standby letters of credit	195,216	235,903
Deferred standby letter of credit fees	1,305	1,488

Lease Commitments. The Corporation leases certain office facilities and office equipment under operating leases. Rent expense for all operating leases totaled \$5.9 million and \$16.9 million during the three and nine months ended September 30, 2012 and \$5.3 million and \$16.1 million during the three and nine months ended September 30, 2011. There has been no significant change in the future minimum lease payments payable by the Corporation since December 31, 2011. See the 2011 Form 10-K for information regarding these commitments.

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

Table of Contents**Note 7 - Regulatory Matters**

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

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

Cullen/Frost's and Frost Bank's Tier 1 capital consists of shareholders' equity excluding unrealized gains and losses on securities available for sale, the accumulated gain or loss on effective cash flow hedging derivatives, the net actuarial gain/loss on the Corporation's defined benefit post-retirement benefit plans, goodwill and other intangible assets. Tier 1 capital for Cullen/Frost also includes \$120 million of trust preferred securities issued by its unconsolidated subsidiary trust. Cullen/Frost's and Frost Bank's total capital is comprised of Tier 1 capital for each entity plus a permissible portion of the allowance for loan losses. The Corporation's aggregate \$100 million of floating rate subordinated notes are not included in Tier 1 capital but the permissible portion (which decreases 20% per year during the final five years of the term of the notes) totaling \$80 million at September 30, 2012, is included in total capital of Cullen/Frost.

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

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

	Actual		Minimum Required for Capital Adequacy Purposes		Required to be Considered Well Capitalized	
	Capital Amount	Ratio	Capital Amount	Ratio	Capital Amount	Ratio
September 30, 2012						
Total Capital to Risk-Weighted Assets						
Cullen/Frost	\$ 1,912,550	15.62%	\$ 979,742	8.00%	\$ 1,224,678	10.00%
Frost Bank	1,705,199	13.93	979,294	8.00	1,224,117	10.00
Tier 1 Capital to Risk-Weighted Assets						
Cullen/Frost	1,727,149	14.10	489,871	4.00	734,807	6.00
Frost Bank	1,599,798	13.07	489,647	4.00	734,470	6.00
Leverage Ratio						
Cullen/Frost	1,727,149	8.59	804,371	4.00	1,005,464	5.00
Frost Bank	1,599,798	7.96	803,878	4.00	1,004,848	5.00
December 31, 2011						
Total Capital to Risk-Weighted Assets						
Cullen/Frost	\$ 1,835,428	16.24%	\$ 903,970	8.00%	\$ 1,129,962	10.00%
Frost Bank	1,641,921	14.54	903,427	8.00	1,129,284	10.00
Tier 1 Capital to Risk-Weighted Assets						
Cullen/Frost	1,625,281	14.38	451,985	4.00	677,977	6.00
Frost Bank	1,531,774	13.56	451,713	4.00	677,570	6.00
Leverage Ratio						
Cullen/Frost	1,625,281	8.66	750,643	4.00	938,304	5.00
Frost Bank	1,531,774	8.17	750,249	4.00	937,811	5.00

Management believes that, as of September 30, 2012, Cullen/Frost and its bank subsidiary, Frost Bank, were well capitalized based on the ratios presented above.

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

Cullen/Frost and Frost Bank are subject to the regulatory capital requirements administered by the Federal Reserve (see the section captioned "Charter Conversion" below) and, for Frost Bank, the Federal Deposit Insurance Corporation (FDIC). Regulatory authorities can initiate certain mandatory actions if Cullen/Frost or Frost Bank fail to meet the minimum capital requirements, which could have a direct material effect on the Corporation's financial statements. Management believes, as of September 30, 2012, that Cullen/Frost and Frost Bank meet all capital adequacy requirements to which they are subject.

Table of Contents

Dividend Restrictions. In the ordinary course of business, Cullen/Frost is dependent upon dividends from Frost Bank to provide funds for the payment of dividends to shareholders and to provide for other cash requirements. Banking regulations may limit the amount of dividends that may be paid. Approval by regulatory authorities is required if the effect of dividends declared would cause the regulatory capital of Frost Bank to fall below specified minimum levels. Approval is also required if dividends declared exceed the net profits for that year combined with the retained net profits for the preceding two years. Under the foregoing dividend restrictions and while maintaining its well capitalized status, at September 30, 2012, Frost Bank could pay aggregate dividends of up to \$281.1 million to Cullen/Frost without prior regulatory approval.

Trust Preferred Securities. In accordance with the applicable accounting standard related to variable interest entities, the accounts of the Corporation's wholly owned subsidiary trust, Cullen/Frost Capital Trust II, have not been included in the Corporation's consolidated financial statements. However, the \$120.0 million in trust preferred securities issued by this subsidiary trust have been included in the Tier 1 capital of Cullen/Frost for regulatory capital purposes pursuant to guidance from the Federal Reserve. On July 21, 2010, financial regulatory reform legislation entitled the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act) was signed into law. Certain provisions of the Dodd-Frank Act will require the Corporation to deduct, over three years beginning on January 1, 2013, all trust preferred securities from the Corporation's Tier 1 capital. Nonetheless, excluding trust preferred securities from Tier 1 capital at September 30, 2012 would not affect the Corporation's ability to meet all capital adequacy requirements to which it is subject.

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

Note 8 - Derivative Financial Instruments

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

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

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

In October 2007, the Corporation entered into three interest rate swap contracts on variable-rate loans with a total notional amount of \$1.2 billion. The interest rate swap contracts were designated as hedging instruments in cash flow hedges with the objective of protecting the overall cash flows from the Corporation's monthly interest receipts on a rolling portfolio of \$1.2 billion of variable-rate loans outstanding throughout the 84-month period beginning in October 2007 and ending in October 2014 from the risk of variability of those cash flows such that the yield on the underlying loans would remain constant. As more fully discussed in the 2011 Form 10-K, the Corporation terminated portions of the hedges and settled portions of the interest rate swap contracts during November 2009 and terminated the remaining portions of the hedges and settled the remaining portions of the interest rate swap contracts during November 2010. The deferred accumulated gain applicable to the settled interest rate swap contracts included in accumulated other comprehensive income totaled \$77.3 million (\$50.3 million on an after-tax basis) at September 30, 2012. The deferred gain will be recognized ratably in earnings through October 2014.

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

Table of Contents

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

The notional amounts and estimated fair values of interest rate derivative contracts outstanding at September 30, 2012 and December 31, 2011 are presented in the following table. The Corporation obtains dealer quotations to value its interest rate derivative contracts designated as hedges of cash flows, while the fair values of other interest rate derivative contracts are estimated utilizing internal valuation models with observable market data inputs.

	September 30, 2012		December 31, 2011	
	Notional Amount	Estimated Fair Value	Notional Amount	Estimated Fair Value
Interest rate derivatives designated as hedges of fair value:				
Commercial loan/lease interest rate swaps	\$ 90,284	\$ (7,952)	\$ 71,181	\$ (8,376)
Interest rate derivatives designated as hedges of cash flows:				
Interest rate swap on junior subordinated deferrable interest debentures	120,000	(5,392)	120,000	(7,807)
Non-hedging interest rate derivatives:				
Commercial loan/lease interest rate swaps	721,036	64,571	613,883	61,137
Commercial loan/lease interest rate swaps	721,036	(64,775)	613,883	(61,393)
Commercial loan/lease interest rate caps	22,500	16	20,000	50
Commercial loan/lease interest rate caps	22,500	(16)	20,000	(50)

The weighted-average rates paid and received for interest rate swaps outstanding at September 30, 2012 were as follows:

	Weighted-Average	
	Interest Rate Paid	Interest Rate Received
Interest rate swaps:		
Fair value hedge commercial loan/lease interest rate swaps	3.12%	0.22%
Cash flow hedge interest rate swaps on junior subordinated deferrable interest debentures	5.47	1.97
Non-hedging interest rate swaps	1.77	4.54
Non-hedging interest rate swaps	4.54	1.77

The weighted-average strike rate for outstanding interest rate caps was 2.98% at September 30, 2012.

Table of Contents

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

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

	Notional Units	September 30, 2012		December 31, 2011	
		Notional Amount	Estimated Fair Value	Notional Amount	Estimated Fair Value
Non-hedging commodity swaps:					
Oil	Barrels	508	\$ 504	459	\$ 1,068
Oil	Barrels	508	(401)	459	(963)
Natural gas	MMBTUs	830	236	1,905	3,540
Natural gas	MMBTUs	830	(222)	1,905	(3,480)
Non-hedging commodity options:					
Oil	Barrels	1,410	5,830	2,920	18,206
Oil	Barrels	1,410	(5,830)	2,920	(18,206)
Natural gas	MMBTUs	360	180	480	490
Natural gas	MMBTUs	360	(180)	480	(490)

Foreign Currency Derivatives. The Corporation enters into foreign currency forward contracts that are not designated as hedging instruments primarily to accommodate the business needs of its customers. Upon the origination of a foreign currency denominated transaction with a customer, the Corporation simultaneously enters into an offsetting contract with a third party to negate the exposure to fluctuations in foreign currency exchange rates. The Corporation also utilizes foreign currency forward contracts that are not designated as hedging instruments to mitigate the economic effect of fluctuations in foreign currency exchange rates on certain short-term, non-U.S. dollar denominated loans. The notional amounts and fair values of open foreign currency forward contracts were not significant at September 30, 2012 and December 31, 2011.

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

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Commercial loan/lease interest rate swaps:				
Amount of gain (loss) included in interest income on loans	\$ (632)	\$ (874)	\$ (1,947)	\$ (2,848)
Amount of (gain) loss included in other non-interest expense	31	(7)	48	(10)

Table of Contents

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Interest rate swaps/caps/floors on variable-rate loans:				
Amount reclassified from accumulated other comprehensive income to interest income on loans	\$ 9,345	\$ 9,345	\$ 28,035	\$ 28,035
Interest rate swaps on junior subordinated deferrable interest debentures:				
Amount reclassified from accumulated other comprehensive income to interest expense on junior subordinated deferrable interest debentures	1,063	1,117	3,140	3,304
Amount of gain (loss) recognized in other comprehensive income	(269)	(908)	(760)	(2,560)

No ineffectiveness related to interest rate derivatives designated as hedges of cash flows was recognized in the consolidated statements of income during the reported periods. The accumulated net after-tax gain related to effective cash flow hedges included in accumulated other comprehensive income totaled \$47.0 million at September 30, 2012 and \$63.6 million at December 31, 2011. The Corporation currently expects approximately \$5.4 million of the net after-tax gain related to effective cash flow hedges included in accumulated other comprehensive income at September 30, 2012 will be recognized in earnings during the remainder of 2012. This amount represents management's best estimate given current expectations about market interest rates and volumes related to loan pools underlying the terminated cash flow hedges. Because actual market interest rates and volumes related to loan pools underlying the terminated cash flow hedges may differ from management's expectations, there can be no assurance as to the ultimate amount that will be recognized in earnings during 2012.

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

Amounts included in the consolidated statements of income related to non-hedging interest rate and commodity derivative instruments are presented in the table below. Amounts included in the consolidated statements of income related to foreign currency derivatives during the reported periods were not significant.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Non-hedging interest rate derivatives:				
Other non-interest income	\$ 1,284	\$ 90	\$ 2,263	\$ 826
Other non-interest expense	(15)	79	(52)	(49)
Non-hedging commodity derivatives:				
Other non-interest income	52	82	116	544

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

Table of Contents

The Corporation's credit exposure relating to interest rate swaps and commodity swaps/options with bank customers was approximately \$65.9 million at September 30, 2012. This credit exposure is partly mitigated as transactions with customers are generally secured by the collateral, if any, securing the underlying transaction being hedged. The Corporation's credit exposure, net of collateral pledged, relating to interest rate swaps and commodity swaps/options with upstream financial institution counterparties was approximately \$708 thousand at September 30, 2012. Collateral levels for upstream financial institution counterparties are monitored and adjusted as necessary.

The aggregate fair value of securities posted as collateral by the Corporation related to derivative contracts totaled \$68.8 million at September 30, 2012. At such date, the Corporation also had \$4.4 million in cash collateral on deposit with other financial institution counterparties.

Note 9 - Earnings Per Common Share

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

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Distributed earnings allocated to common stock	\$ 29,430	\$ 28,123	\$ 87,005	\$ 83,695
Undistributed earnings allocated to common stock	29,051	26,238	90,195	77,868
Net earnings allocated to common stock	\$ 58,481	\$ 54,361	\$ 177,200	\$ 161,563
Weighted-average shares outstanding for basic earnings per common share	61,316,854	61,137,054	61,269,850	61,083,390
Dilutive effect of stock compensation	369,596	102,092	347,204	199,013
Weighted-average shares outstanding for diluted earnings per common share	61,686,450	61,239,146	61,617,054	61,282,403

Note 10 - Stock-Based Compensation

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

	Shares Available for Grant	Director Deferred Stock Units Outstanding	Non-Vested Stock Awards/Stock Units Outstanding		Stock Options Outstanding	
			Number of Shares	Weighted-Average Grant-Date Fair Value	Number of Shares	Weighted-Average Exercise Price
Balance, January 1, 2012	1,963,455	22,092	169,530	\$ 50.33	4,968,822	\$ 51.49
Granted	(5,632)	5,632				
Stock options exercised					(197,961)	50.98

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

Stock awards vested							
Forfeited	19,000				(19,000)		50.51
Cancelled/expired	(250)						
Balance, September 30, 2012	1,976,573	27,724	169,530	\$ 50.33	4,751,861	\$ 51.51	

Table of Contents

Proceeds from stock option exercises totaled \$10.1 million and \$7.2 million during the nine months ended September 30, 2012 and 2011. During the nine months ended September 30, 2012, 190,321 shares issued in connection with stock option exercises were new shares issued from available authorized shares, while 7,640 shares were issued from available treasury stock.

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

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2012	2011	2012	2011
Stock options	\$ 2,190	\$ 2,073	\$ 6,549	\$ 6,686
Non-vested stock awards/stock units	354	360	1,063	3,000
Deferred stock units			330	330
Total	\$ 2,544	\$ 2,433	\$ 7,942	\$ 10,016

Unrecognized stock-based compensation expense at September 30, 2012 was as follows:

Stock options	\$ 12,267
Non-vested stock awards/stock units	2,033
Total	\$ 14,300

Note 11 - Defined Benefit Plans

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

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2012	2011	2012	2011
Expected return on plan assets, net of expenses	\$ (2,603)	\$ (2,859)	\$ (7,809)	\$ (8,576)
Interest cost on projected benefit obligation	1,951	1,973	5,851	5,919
Net amortization and deferral	1,427	783	4,084	2,348
Net periodic cost (benefit)	\$ 775	\$ (103)	\$ 2,126	\$ (309)

The Corporation's non-qualified defined benefit pension plan is not funded. No contributions to the qualified defined benefit pension plan were made during the nine months ended September 30, 2012. The Corporation does not expect to make any contributions to the qualified defined benefit pension plan during the remainder of 2012.

Note 12 - Income Taxes

Income tax expense was as follows:

Three Months Ended	Nine Months Ended
September 30,	September 30,

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

	2012	2011	2012	2011
Current income tax expense	\$ 18,114	\$ 24,036	\$ 55,631	\$ 50,101
Deferred income tax expense (benefit)	(1,043)	(382)	(5,020)	(137)
Income tax expense, as reported	\$ 17,071	\$ 23,654	\$ 50,611	\$ 49,964
Effective tax rate	22.5%	30.3%	22.2%	23.6%

Net deferred tax liabilities totaled \$133.2 million at September 30, 2012 and \$123.7 million at December 31, 2011. No valuation allowance was recorded against deferred tax assets at September 30, 2012 as management believes that it is more likely than not that all of the deferred tax assets will be realized because they were supported by recoverable taxes paid in prior years. There were no unrecognized tax benefits during any of the reported periods. Interest and/or penalties related to income taxes are reported as a component of income tax expense. Such amounts were not significant during the reported periods.

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

Table of Contents**Note 13 - Other Comprehensive Income (Loss)**

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

	Three Months Ended September 30, 2012			Three Months Ended September 30, 2011		
	Before Tax Amount	Tax Expense, (Benefit)	Net of Tax Amount	Before Tax Amount	Tax Expense, (Benefit)	Net of Tax Amount
Securities available for sale:						
Change in net unrealized gain/loss during the period	\$ 40,122	\$ 14,043	\$ 26,079	\$ 78,552	\$ 27,493	\$ 51,059
Reclassification adjustment for net (gains) losses included in net income				(6,409)	(2,243)	(4,166)
Total securities available for sale	40,122	14,043	26,079	72,143	25,250	46,893
Defined-benefit post-retirement benefit plans:						
Change in the net actuarial gain/loss	1,427	499	928	783	274	509
Derivatives:						
Change in the accumulated gain/loss on effective cash flow hedge derivatives	(269)	(93)	(176)	(909)	(318)	(591)
Reclassification adjustments for (gains) losses included in net income:						
Interest rate swaps on variable-rate loans	(9,345)	(3,271)	(6,074)	(9,345)	(3,271)	(6,074)
Interest rate swap on junior subordinated deferrable interest debentures	1,063	372	691	1,118	391	727
Total derivatives	(8,551)	(2,992)	(5,559)	(9,136)	(3,198)	(5,938)
Total other comprehensive income	\$ 32,998	\$ 11,550	\$ 21,448	\$ 63,790	\$ 22,326	\$ 41,464

	Nine Months Ended September 30, 2012			Nine Months Ended September 30, 2011		
	Before Tax Amount	Tax Expense, (Benefit)	Net of Tax Amount	Before Tax Amount	Tax Expense, (Benefit)	Net of Tax Amount
Securities available for sale:						
Change in net unrealized gain/loss during the period	\$ 62,972	\$ 22,041	\$ 40,931	\$ 169,516	\$ 59,331	\$ 110,185
Reclassification adjustment for net (gains) losses included in net income	121	42	79	(6,414)	(2,245)	(4,169)
Total securities available for sale	63,093	22,083	41,010	163,102	57,086	106,016
Defined-benefit post-retirement benefit plans:						
Change in the net actuarial gain/loss	4,084	1,429	2,655	2,348	822	1,526
Derivatives:						
Change in the accumulated gain/loss on effective cash flow hedge derivatives	(760)	(266)	(494)	(2,560)	(896)	(1,664)
Reclassification adjustments for (gains) losses included in net income:						
Interest rate swaps on variable-rate loans	(28,035)	(9,812)	(18,223)	(28,035)	(9,812)	(18,223)
Interest rate swap on junior subordinated deferrable interest debentures	3,140	1,099	2,041	3,304	1,156	2,148
Total derivatives	(25,655)	(8,979)	(16,676)	(27,291)	(9,552)	(17,739)

Total other comprehensive income	\$ 41,522	\$ 14,533	\$ 26,989	\$ 138,159	\$ 48,356	\$ 89,803
----------------------------------	-----------	-----------	-----------	------------	-----------	-----------

Table of Contents

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

	Securities Available For Sale	Defined Benefit Plans	Derivatives	Accumulated Other Comprehensive Income
Balance January 1, 2012	\$ 227,052	\$ (42,958)	\$ 63,640	\$ 247,734
Other comprehensive income (loss)	41,010	2,655	(16,676)	26,989
Balance September 30, 2012	\$ 268,062	\$ (40,303)	\$ 46,964	\$ 274,723
Balance January 1, 2011	\$ 96,012	\$ (28,357)	\$ 86,595	\$ 154,250
Other comprehensive income (loss)	106,016	1,526	(17,739)	89,803
Balance September 30, 2011	\$ 202,028	\$ (26,831)	\$ 68,856	\$ 244,053

Note 14 - Operating Segments

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

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

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

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

Table of Contents

Summarized operating results by segment were as follows:

	Banking	Frost Wealth Advisors	Non-Banks	Consolidated
Revenues from (expenses to) external customers:				
Three months ended:				
September 30, 2012	\$ 198,244	\$ 26,000	\$ (1,554)	\$ 222,690
September 30, 2011	202,520	24,548	(2,490)	224,578
Nine months ended:				
September 30, 2012	\$ 588,151	\$ 78,595	\$ (3,390)	\$ 663,356
September 30, 2011	587,382	74,256	(7,843)	653,795
Net income (loss):				
Three months ended:				
September 30, 2012	\$ 56,878	\$ 3,298	\$ (1,507)	\$ 58,669
September 30, 2011	53,497	2,696	(1,686)	54,507
Nine months ended:				
September 30, 2012	\$ 171,152	\$ 10,917	\$ (4,305)	\$ 177,764
September 30, 2011	160,788	7,299	(5,966)	162,121

Note 15 - Fair Value Measurements

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

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

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

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

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

Table of Contents

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

Securities Available for Sale. U.S. Treasury securities are reported at fair value utilizing Level 1 inputs. Other securities classified as available for sale are reported at fair value utilizing Level 2 inputs. For these securities, the Corporation obtains fair value measurements from an independent pricing service. The fair value measurements consider observable data that may include dealer quotes, market spreads, cash flows, the U.S. Treasury yield curve, live trading levels, trade execution data, market consensus prepayment speeds, credit information and the bond terms and conditions, among other things.

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

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

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

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

Table of Contents

The following table summarizes financial assets and financial liabilities measured at fair value on a recurring basis as of September 30, 2012 and December 31, 2011, segregated by the level of the valuation inputs within the fair value hierarchy utilized to measure fair value:

	Level 1 Inputs	Level 2 Inputs	Level 3 Inputs	Total Fair Value
September 30, 2012				
Securities available for sale:				
U.S. Treasury	\$ 3,061,552	\$	\$	\$ 3,061,552
U.S. government agencies/corporations		250,145		250,145
Residential mortgage-backed securities		2,751,883		2,751,883
States and political subdivisions		2,618,178		2,618,178
Other		35,887		35,887
Trading account securities:				
U.S. Treasury	13,761			13,761
States and political subdivisions		1,062		1,062
Derivative assets:				
Interest rate swaps, caps and floors		63,904	683	64,587
Commodity and foreign exchange derivatives		6,750		6,750
Derivative liabilities:				
Interest rate swaps, caps and floors		78,135		78,135
Commodity and foreign exchange derivatives		6,633		6,633

December 31, 2011

Securities available for sale:				
U.S. Treasury	\$ 2,056,732	\$	\$	\$ 2,056,732
U.S. government agencies/corporations		250,884		250,884
Residential mortgage-backed securities		3,289,270		3,289,270
States and political subdivisions		2,154,813		2,154,813
Other		38,001		38,001
Trading account securities:				
U.S. Treasury	13,609			13,609
Derivative assets:				
Interest rate swaps, caps and floors		60,498	689	61,187
Commodity and foreign exchange derivatives	7	23,304		23,311
Derivative liabilities:				
Interest rate swaps, caps and floors		77,626		77,626
Commodity and foreign exchange derivatives		23,139		23,139

The following table reconciles the beginning and ending balances of derivative assets, which consist of interest rate swaps sold to loan customers, measured at fair value on a recurring basis using significant unobservable (Level 3) inputs during the nine months ended September 30, 2012 and 2011:

	Nine Months Ended September 30,	
	2012	2011
Balance, beginning of period	\$ 689	\$ 1,090
Transfers to Level 3		457
Cash settlements	(266)	(1,393)
Realized gains (losses) included in other non-interest income	208	515
Realized gains (losses) included in other non-interest expense	52	49
Balance, end of period	\$ 683	\$ 718

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

The significant unobservable (Level 3) inputs used in the fair value measurement of the Corporation's interest rate swaps sold to loan customers included in the above table primarily relate to the probability of default and loss severity in the event of default. The probability of default is determined by the underlying risk grade of the loan (see Note 3 - Loans) underlying the interest rate swap in that the probability of default increases as a loan's risk grade deteriorates, while the loss severity is estimated through an analysis of the collateral supporting both the underlying loan and interest rate swap. Generally, a change

Table of Contents

in the assumption used for the probability of default is accompanied by a directionally similar change in the assumption used for the loss severity. As of September 30, 2012, the weighted-average risk grade of loans underlying interest rate swaps measured at fair value using significant unobservable (Level 3) inputs was 11.1. The loss severity in the event of default on the interest rate swaps ranged from 10.0% to 50.0%, with the weighted-average loss severity being 20.1%.

Certain financial assets and financial liabilities are measured at fair value on a nonrecurring basis; that is, the instruments are not measured at fair value on an ongoing basis but are subject to fair value adjustments in certain circumstances (for example, when there is evidence of impairment). Financial assets measured at fair value on a non-recurring basis during the reported periods include certain impaired loans reported at the fair value of the underlying collateral if repayment is expected solely from the collateral. Collateral values are estimated using Level 2 inputs based on observable market data, typically in the case of real estate collateral, or Level 3 inputs based on customized discounting criteria, typically in the case of non-real estate collateral such as inventory, accounts receivable, equipment or other business assets.

The following table presents impaired loans that were remeasured and reported at fair value through a specific valuation allowance allocation of the allowance for loan losses based upon the fair value of the underlying collateral during the nine months ended September 30, 2012 and 2011.

	Nine Months Ended September 30, 2012		Nine Months Ended September 30, 2011	
	Level 2	Level 3	Level 2	Level 3
Carrying value of impaired loans before allocations	\$ 13,227	\$ 384	\$ 9,638	\$ 3,899
Specific valuation allowance allocations	(2,922)	(61)	(3,649)	(2,431)
Fair value	\$ 10,305	\$ 323	\$ 5,989	\$ 1,468

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

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

Table of Contents

The following table presents foreclosed assets that were remeasured and reported at fair value during the nine months ended September 30, 2012 and 2011:

	Nine Months Ended September 30,	
	2012	2011
Foreclosed assets remeasured at initial recognition:		
Carrying value of foreclosed assets prior to remeasurement	\$ 6,627	\$ 20,396
Charge-offs recognized in the allowance for loan losses	(1,291)	(3,593)
 Fair value	 \$ 5,336	 \$ 16,803
Foreclosed assets remeasured subsequent to initial recognition:		
Carrying value of foreclosed assets prior to remeasurement	\$ 10,183	\$ 6,023
Write-downs included in other non-interest expense	(1,528)	(2,173)
 Fair value	 \$ 8,655	 \$ 3,850

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

FASB ASC Topic 825 requires disclosure of the fair value of financial assets and financial liabilities, including those financial assets and financial liabilities that are not measured and reported at fair value on a recurring basis or non-recurring basis. A detailed description of the valuation methodologies used in estimating the fair value of financial instruments is set forth in the 2011 Form 10-K.

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

	September 30, 2012		December 31, 2011	
	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
Financial assets:				
Level 2 inputs:				
Cash and cash equivalents	\$ 2,752,176	\$ 2,752,176	\$ 2,907,592	\$ 2,907,592
Securities held to maturity	364,997	409,258	365,996	404,461
Cash surrender value of life insurance policies	137,009	137,009	133,967	133,967
Accrued interest receivable	63,216	63,216	78,869	78,869
Level 3 inputs:				
Loans, net	8,705,639	8,812,390	7,884,982	7,951,742
Financial liabilities:				
Level 2 inputs:				
Deposits	18,245,197	18,245,906	16,756,748	16,757,708
Federal funds purchased and repurchase agreements	601,204	601,204	722,202	722,202
Junior subordinated deferrable interest debentures	123,712	123,712	123,712	123,712
Subordinated notes payable and other borrowings	100,012	89,506	100,026	100,101
Accrued interest payable	1,882	1,882	4,431	4,431

Under ASC Topic 825, entities may choose to measure eligible financial instruments at fair value at specified election dates. The fair value measurement option (i) may be applied instrument by instrument, with certain exceptions, (ii) is generally irrevocable and (iii) is applied only to entire instruments and not to portions of instruments. Unrealized gains and losses on items for which the fair value measurement option has been

elected must be reported in earnings at each subsequent reporting date. During the reported periods, the Corporation had no financial instruments measured at fair value under the fair value measurement option.

Table of Contents**Note 16 - Accounting Standards Updates**

ASU No. 2011-03, Transfers and Servicing (Topic 860) Reconsideration of Effective Control for Repurchase Agreements. ASU 2011-03 is intended to improve financial reporting of repurchase agreements and other agreements that both entitle and obligate a transferor to repurchase or redeem financial assets before their maturity. ASU 2011-03 removes from the assessment of effective control (i) the criterion requiring the transferor to have the ability to repurchase or redeem the financial assets on substantially the agreed terms, even in the event of default by the transferee, and (ii) the collateral maintenance guidance related to that criterion. ASU 2011-03 became effective for the Corporation on January 1, 2012 and did not have a significant impact on the Corporation's financial statements.

ASU 2011-04, Fair Value Measurement (Topic 820) Amendments to Achieve Common Fair Value Measurements and Disclosure Requirements in U.S. GAAP and IFRSs. ASU 2011-04 amends Topic 820, Fair Value Measurements and Disclosures, to converge the fair value measurement guidance in U.S. generally accepted accounting principles and International Financial Reporting Standards. ASU 2011-04 clarifies the application of existing fair value measurement requirements, changes certain principles in Topic 820 and requires additional fair value disclosures. ASU 2011-04 became effective for the Corporation on January 1, 2012 and, aside from new disclosures included in Note 15 Fair Value Measurements, did not have a significant impact on the Corporation's financial statements.

ASU 2011-05, Comprehensive Income (Topic 220) Presentation of Comprehensive Income. ASU 2011-05 amends Topic 220, Comprehensive Income, to require that all non-owner changes in stockholders' equity be presented in either a single continuous statement of comprehensive income or in two separate but consecutive statements. Additionally, ASU 2011-05 requires entities to present, on the face of the financial statements, reclassification adjustments for items that are reclassified from other comprehensive income to net income in the statement or statements where the components of net income and the components of other comprehensive income are presented. The option to present components of other comprehensive income as part of the statement of changes in stockholders' equity was eliminated. ASU 2011-05 became effective for the Corporation on January 1, 2012; however, certain provisions related to the presentation of reclassification adjustments have been deferred by ASU 2011-12 Comprehensive Income (Topic 220) Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in Accounting Standards Update No. 2011-05, as further discussed below. In connection with the application of ASU 2011-05, the Corporation's financial statements now include separate statements of comprehensive income and additional footnote disclosures (see Note 13 Other Comprehensive Income).

ASU 2011-08, Intangibles Goodwill and Other (Topic 350) Testing Goodwill for Impairment. ASU 2011-08 amends Topic 350, Intangibles Goodwill and Other, to give entities the option to first assess qualitative factors to determine whether the existence of events or circumstances leads to a determination that it is more likely than not that the fair value of a reporting unit is less than its carrying amount. If, after assessing the totality of events or circumstances, an entity determines it is not more likely than not that the fair value of a reporting unit is less than its carrying amount, then performing the two-step impairment test is unnecessary. However, if an entity concludes otherwise, then it is required to perform the first step of the two-step impairment test by calculating the fair value of the reporting unit and comparing the fair value with the carrying amount of the reporting unit. ASU 2011-08 became effective for the Corporation on January 1, 2012 and did not have a significant impact on the Corporation's financial statements.

ASU 2011-11, Balance Sheet (Topic 210) Disclosures about Offsetting Assets and Liabilities. ASU 2011-11 amends Topic 210, Balance Sheet, to require an entity to disclose both gross and net information about financial instruments, such as sales and repurchase agreements and reverse sale and repurchase agreements and securities borrowing/lending arrangements, and derivative instruments that are eligible for offset in the statement of financial position and/or subject to a master netting arrangement or similar agreement. ASU 2011-11 is effective for annual and interim periods beginning on January 1, 2013, and is not expected to have a significant impact on the Corporation's financial statements.

ASU 2011-12 Comprehensive Income (Topic 220) Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in Accounting Standards Update No. 2011-05. ASU 2011-12 defers changes in ASU No. 2011-05 that relate to the presentation of reclassification adjustments to allow the FASB time to redeliberate whether to require presentation of such adjustments on the face of the financial statements to show the effects of reclassifications out of accumulated other comprehensive income on the components of net income and other comprehensive income. ASU 2011-12 allows entities to continue to report reclassifications out of accumulated other comprehensive income consistent with the presentation requirements in effect before ASU No. 2011-05. All other requirements in ASU No. 2011-05 are not affected by ASU No. 2011-12. ASU 2011-12 became effective for the Corporation on January 1, 2012 and did not have a significant impact on the Corporation's financial statements.

Table of Contents

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

Table of Contents

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

Financial Review

Cullen/Frost Bankers, Inc.

The following discussion should be read in conjunction with the Corporation's consolidated financial statements, and notes thereto, for the year ended December 31, 2011, included in the 2011 Form 10-K. Operating results for the three and nine months ended September 30, 2012 are not necessarily indicative of the results for the year ending December 31, 2012 or any future period.

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

Forward-Looking Statements and Factors that Could Affect Future Results

Certain statements contained in this Quarterly Report on Form 10-Q that are not statements of historical fact constitute forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995 (the "Act"), notwithstanding that such statements are not specifically identified as such. In addition, certain statements may be contained in the Corporation's future filings with the SEC, in press releases, and in oral and written statements made by or with the approval of the Corporation that are not statements of historical fact and constitute forward-looking statements within the meaning of the Act. Examples of forward-looking statements include, but are not limited to:

(i) projections of revenues, expenses, income or loss, earnings or loss per share, the payment or nonpayment of dividends, capital structure and other financial items; (ii) statements of plans, objectives and expectations of Cullen/Frost or its management or Board of Directors, including those relating to products or services; (iii) statements of future economic performance; and (iv) statements of assumptions underlying such statements. Words such as "believes", "anticipates", "expects", "intends", "targeted", "continue", "remain", "will", "should", "may" and other similar words are intended to identify forward-looking statements but are not the exclusive means of identifying such statements.

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

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

Volatility and disruption in national and international financial markets.

Government intervention in the U.S. financial system.

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

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

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

Inflation, interest rate, securities market and monetary fluctuations.

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

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

The soundness of other financial institutions.

Political instability.

Impairment of the Corporation's goodwill or other intangible assets.

Acts of God or of war or terrorism.

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

Changes in consumer spending, borrowings and savings habits.

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

Technological changes.

Acquisitions and integration of acquired businesses.

The ability to increase market share and control expenses.

The Corporation's ability to attract and retain qualified employees.

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

The effect of changes in accounting policies and practices, as may be adopted by the regulatory agencies, as well as the Public Company Accounting Oversight Board, the Financial Accounting Standards Board and other accounting standard setters.

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

Table of Contents

Changes in the Corporation's liquidity position.

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

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

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

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

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

Application of Critical Accounting Policies and Accounting Estimates

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

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

For additional information regarding critical accounting policies, refer to Note 1 - Summary of Significant Accounting Policies in the notes to consolidated financial statements and the sections captioned "Application of Critical Accounting Policies" and "Allowance for Loan Losses" in Management's Discussion and Analysis of Financial Condition and Results of Operations included in the 2011 Form 10-K. There have been no significant changes in the Corporation's application of critical accounting policies related to the allowance for loan losses since December 31, 2011.

Overview

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

Table of Contents**Results of Operations**

Net income totaled \$58.7 million, or \$0.95 diluted per share, for the three months ended September 30, 2012 compared to \$54.5 million, or \$0.89 diluted per share, for the three months ended September 30, 2011 and \$58.1 million, or \$0.94 diluted per common share, for the three months ended June 30, 2012. Net income totaled \$177.8 million, or \$2.88 diluted per share, for the nine months ended September 30, 2012 compared to \$162.1 million, or \$2.64 diluted per share, for the nine months ended September 30, 2011.

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

	Three Months Ended			Nine Months Ended	
	September 30, 2012	June 30, 2012	September 30, 2011	September 30, 2012	September 30, 2011
Taxable-equivalent net interest income	\$ 167,341	\$ 163,972	\$ 160,579	\$ 496,020	\$ 476,725
Taxable-equivalent adjustment	15,809	14,755	15,218	45,564	45,272
Net interest income	151,532	149,217	145,361	450,456	431,453
Provision for loan losses	2,500	2,355	9,010	5,955	27,445
Net interest income after provision for loan losses	149,032	146,862	136,351	444,501	404,008
Non-interest income	71,158	69,763	79,217	212,900	222,342
Non-interest expense	144,450	142,536	137,407	429,026	414,265
Income before income taxes	75,740	74,089	78,161	228,375	212,085
Income taxes	17,071	16,027	23,654	50,611	49,964
Net income	\$ 58,669	\$ 58,062	\$ 54,507	\$ 177,764	\$ 162,121
Earnings per common share basic	\$ 0.95	\$ 0.94	\$ 0.89	\$ 2.89	\$ 2.64
Earnings per common share diluted	0.95	0.94	0.89	2.88	2.64
Dividends per common share	0.48	0.48	0.46	1.42	1.37
Return on average assets	1.11%	1.14%	1.15%	1.16%	1.19%
Return on average equity	9.75	9.95	9.79	10.09	10.11
Average shareholders equity to average total assets	11.39	11.51	11.73	11.51	11.76

Net income increased \$4.2 million, or 7.6%, for the three months ended September 30, 2012 and increased \$15.6 million, or 9.6%, for the nine months ended September 30, 2012 compared to the same periods in 2011. The increase during the three months ended September 30, 2012 was primarily the result of a \$6.5 million decrease in the provision for loan losses, a \$6.6 million decrease in income tax expense and a \$6.2 million increase in net interest income partly offset by an \$8.1 million decrease in non-interest income and a \$7.0 million increase in non-interest expense. The increase during the nine months ended September 30, 2012 was primarily the result of a \$21.5 million decrease in the provision for loan losses and a \$19.0 million increase in net interest income partly offset by a \$14.8 million increase in non-interest expense, a \$9.4 million decrease in non-interest income and a \$647 thousand increase in income tax expense.

Net income for the third quarter of 2012 increased \$607 thousand, or 1.0 %, from the second quarter of 2012. The increase was primarily the result of a \$2.3 million increase in net interest income and a \$1.4 million increase in non-interest income partly offset by a \$1.9 million increase in non-interest expense, a \$1.0 million increase in income tax expense and a \$145 thousand increase in the provision for loan losses.

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

Net Interest Income

Net interest income is the difference between interest income on earning assets, such as loans and securities, and interest expense on liabilities, such as deposits and borrowings, which are used to fund those assets. Net interest income is the Corporation's largest source of revenue, representing 67.9% of total revenue during the first nine months of 2012. Net interest margin is the ratio of taxable-equivalent net interest income to average earning assets for the period. The level of interest rates and the volume and mix of earning assets and interest-bearing liabilities impact net interest income and net interest margin.

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

The Federal Reserve influences the general market rates of interest, including the deposit and loan rates offered by many financial institutions. The Corporation's loan portfolio is significantly affected by changes in the prime interest rate. The

Table of Contents

prime interest rate, which is the rate offered on loans to borrowers with strong credit, remained at 3.25% for the entire year in 2011 and through the third quarter of 2012. The Corporation's loan portfolio is also impacted, to a lesser extent, by changes in the London Interbank Offered Rate (LIBOR). At September 30, 2012, the one-month and three-month U.S. dollar LIBOR rates were 0.21% and 0.36%, respectively, while at September 30, 2011, the one-month and three-month U.S. dollar LIBOR rates were 0.24% and 0.37%, respectively. The intended federal funds rate, which is the cost of immediately available overnight funds, remained at zero to 0.25% for the entire year in 2011 and through the third quarter of 2012.

The Corporation's balance sheet has historically been asset sensitive, meaning that earning assets generally reprice more quickly than interest-bearing liabilities. Therefore, the Corporation's net interest margin was likely to increase in sustained periods of rising interest rates and decrease in sustained periods of declining interest rates. During the fourth quarter of 2007, in an effort to make the Corporation's balance sheet less sensitive to changes in interest rates, the Corporation entered into various interest rate swaps which effectively converted certain variable-rate loans into fixed-rate instruments for a period of time. During the fourth quarter of 2008, the Corporation also entered into an interest rate swap which effectively converted variable-rate debt into fixed-rate debt for a period of time. As a result of these actions, the Corporation's balance sheet was more interest-rate neutral and changes in interest rates had a less significant impact on the Corporation's net interest margin than would have otherwise been the case. During the fourth quarter of 2009, a portion of the interest rate swaps on variable-rate loans were terminated, while the remaining interest rate swaps on variable-rate loans were terminated during the fourth quarter of 2010. These actions increased the asset sensitivity of the Corporation's balance sheet. The deferred accumulated gain applicable to the settled interest rate contracts included in accumulated other comprehensive income totaled \$77.3 million (\$50.3 million on an after-tax basis) at September 30, 2012. The deferred gain will be recognized ratably in earnings through October 2014. See Note 8 -Derivative Financial Instruments in the accompanying notes to consolidated financial statements included elsewhere in this report for additional information related to these interest rate swaps.

The Corporation is primarily funded by core deposits, with non-interest-bearing demand deposits historically being a significant source of funds. This lower-cost funding base is expected to have a positive impact on the Corporation's net interest income and net interest margin in a rising interest rate environment. As discussed in the section captioned "Supervision and Regulation" included in Item 1. Business, of the 2011 Form 10-K, the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") repealed the federal prohibitions on the payment of interest on demand deposits, thereby permitting depository institutions to pay interest on business transaction and other accounts beginning July 21, 2011. Although the ultimate impact of this legislation on the Corporation has not yet been determined, the Corporation may begin to incur interest costs associated with demand deposits in the future as market conditions warrant. See Item 3. Quantitative and Qualitative Disclosures About Market Risk elsewhere in this report for information about the expected impact of this legislation on the Corporation's sensitivity to interest rates. Further analysis of the components of the Corporation's net interest margin is presented below.

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

	Third Quarter 2012 vs. Third Quarter 2011	Third Quarter 2012 vs. Second Quarter 2012	First Nine Months 2012 vs. First Nine Months 2011
Due to changes in average volumes	\$ 18,575	\$ 4,960	\$ 26,059
Due to changes in average interest rates	(11,813)	(3,410)	(8,574)
Due to difference in the number days in each of the comparable periods		1,819	1,810
Total change	\$ 6,762	\$ 3,369	\$ 19,295

Taxable-equivalent net interest income for the three months ended September 30, 2012 increased \$6.8 million, or 4.2%, while taxable-equivalent net interest income for the nine months ended September 30, 2012 increased \$19.3 million, or 4.0%, compared to the same periods in 2011, respectively. The increase during the three months ended September 30, 2012 was primarily related to an increase in the average volume of interest-earning assets partly offset by a decrease in the net interest margin. Taxable-equivalent net interest income for the first nine months of 2012 included an additional day compared to the first nine months of 2011 as a result of leap year. The additional day added approximately

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

\$1.8 million to taxable-equivalent net interest income during the first nine months of 2012. Excluding the impact of the additional day during 2012 results in an effective increase in taxable-equivalent net interest income of approximately \$17.5 million during the first nine months of 2012, which was primarily related to an increase in the average volume of interest-earning assets partly offset by a decrease

Table of Contents

in the net interest margin. The average volume of interest-earning assets for the three and nine months ended September 30, 2012 increased \$2.2 billion during each respective period compared to the same periods in 2011. The net interest margin decreased 27 basis points from 3.81% during the three months ended September 30, 2011 to 3.54% during the three months ended September 30, 2012 and decreased 30 basis points from 3.93% during the nine months ended September 30, 2011 to 3.63% during the nine months ended September 30, 2012. The decrease in the net interest margin during the comparable periods was partly due to an increase in the relative proportion of average interest-earning assets invested in lower-yielding, taxable securities during 2012 compared to 2011 while the relative proportion of average interest-earning assets invested in higher-yielding loans decreased. The impact of this shift was partly mitigated by a decrease in the relative proportion of average interest-earning assets invested in lower-yielding interest-bearing deposits. The net interest margin was also negatively impacted by a decrease in the average yield on securities, as further discussed below. The average yield on interest-earning assets decreased 42 basis points from 4.20% in the first nine months of 2011 to 3.78% in the first nine months of 2012 while the average cost of funds decreased 18 basis points from 0.43% in the first nine months of 2011 to 0.25% in the first nine months of 2012. The average yield on interest-earning assets is primarily impacted by changes in market interest rates as well as changes in the volume and relative mix of interest-earning assets. As stated above, market interest rates have remained at historically low levels during the reported periods. The effect of lower average market interest rates during the reported periods on the average yield on average interest-earning assets was partly limited by the aforementioned interest rate swaps on variable-rate loans.

Taxable-equivalent net interest income for the third quarter of 2012 increased \$3.4 million, or 2.1%, from the second quarter of 2012. Taxable-equivalent net interest income for the third quarter of 2012 included an additional day compared to the second quarter of 2012. The additional day added approximately \$1.8 million to taxable-equivalent net interest income during the third quarter of 2012. Excluding the impact of the additional day results in an effective increase in taxable-equivalent net interest income of approximately \$1.6 million during the third quarter of 2012, which was primarily related to an increase in the average volume of interest-earning assets partly offset by a decrease in the net interest margin. The average volume of interest-earning assets for the third quarter of 2012 increased \$613.2 million compared to the second quarter of 2012. The average volume of funds invested in interest-bearing deposits increased \$274.9 million from \$1.4 billion during the second quarter of 2012 to \$1.7 billion during third quarter of 2012. The average volume of funds invested in securities did not significantly fluctuate during the third quarter of 2012 compared to the second quarter of 2012, though a larger proportion of such funds were invested in higher-yielding tax-exempt securities during the third quarter of 2012, while the average volume of funds invested in loans increased \$367.5 million. The net interest margin decreased 7 basis points from 3.61% in the second quarter of 2012 to 3.54% in the third quarter of 2012. The average yield on interest-earning assets decreased 7 basis points from 3.75% in the second quarter of 2012 to 3.68% in the third quarter of 2012 primarily due to decreases in the average yields on tax-exempt securities (down 25 basis points) and loans (down 10 basis points). The impact of the declines in average yields on these categories of assets on the overall average yield on interest-earning assets was partly mitigated by growth in the average volumes of these higher-yielding assets. Average tax-exempt securities increased \$223.4 million while, as stated previously, average loans increased \$367.5 million in the third quarter of 2012 compared to the second quarter of 2012. The decrease in the net interest margin primarily resulted as the decrease in the overall yield on interest-earning assets was not matched by a corresponding decrease in the average cost of funds. The average cost of funds remained unchanged at 0.24% during both the second and third quarters of 2012.

The average volume of loans during the first nine months of 2012 increased \$253.0 million compared to the same period in 2011. Loans made up approximately 44.6% of average interest-earning assets during the first nine months of 2012 compared to 49.1% during the first nine months of 2011. The average yield on loans was 4.85% during the first nine months of 2012 compared to 5.01% during the first nine months of 2011. Loans generally have significantly higher yields compared to securities, interest-bearing deposits and federal funds sold and resell agreements and, as such, have a more positive effect on the net interest margin.

The average volume of securities increased \$3.1 billion during the first nine months of 2012 compared to the same period in 2011. Securities made up approximately 47.8% of average interest-earning assets during the first nine months of 2012 compared to 35.6% during the first nine months of 2011. The average yield on securities was 3.31% in the first nine months of 2012 compared to 4.80% in the first nine months of 2011. The decrease in the average yield on securities was partly due to a decrease in the yield on taxable securities as proceeds from principal repayments and excess liquidity were reinvested at lower market rates. Furthermore, a large portion of the growth in taxable securities was in lower-yielding U.S. Treasury securities. The decrease in the average yield on securities was also partly related to a decrease in the relative proportion of higher-yielding, tax-exempt municipal securities in the first nine months of 2012 compared to the same period in 2011. The relative proportion of higher-yielding, tax-exempt municipal securities totaled 25.9% of average securities during the first nine months of 2012 compared to 37.2% during the first nine months of 2011. The average yield on taxable securities was 2.13% in the first nine months of 2012 compared to 3.50% in first nine months of 2011, while the average taxable-equivalent yield on tax-exempt securities was 6.85% in the first nine months of 2012 compared to 6.98% in first nine months of 2011.

Average federal funds sold, resell agreements and interest-bearing deposits during the first nine months of 2012 decreased \$1.1 billion compared to the same period in 2011. Federal funds sold, resell agreements and interest-bearing deposits made

Table of Contents

up approximately 7.5% of average interest-earning assets during the first nine months of 2012 compared to 15.3% during the first nine months of 2011. The combined average yield on federal funds sold, resell agreements and interest-bearing deposits was 0.29% during the first nine months of 2012 compared to 0.24% during the first nine months of 2011. The decrease in average federal funds sold, resell agreements and interest-bearing deposits the first nine months of 2012 compared to the same period in 2011 was due to the reinvestment of funds into higher-yielding securities and loans.

Average deposits increased \$2.0 billion during the first nine months of 2012 compared to the first nine months of 2011. Average interest-bearing deposits for the first nine months of 2012 increased \$738.0 million compared to the same period in 2011, while average non-interest-bearing deposits for the first nine months of 2012 increased \$1.3 billion compared to the same period in 2011. The ratio of average interest-bearing deposits to total average deposits was 59.8% during the first nine months of 2012 compared to 62.9% during the same period in 2011. The average cost of deposits is primarily impacted by changes in market interest rates as well as changes in the volume and relative mix of interest-bearing deposits. The average cost of interest-bearing deposits and total deposits was 0.18% and 0.11% during the first nine months of 2012 compared to 0.25% and 0.15% during the same period in 2011. The decrease in the average cost of interest-bearing deposits during the comparable periods was primarily the result of decreases in interest rates offered on certain deposit products due to decreases in average market interest rates and decreases in renewal interest rates on maturing certificates of deposit given the current low interest rate environment. Additionally, the relative proportion of higher-cost certificates of deposit to total average interest-bearing deposits decreased from 12.2% during the first nine months of 2011, to 10.2% during the first nine months of 2012.

The Corporation's net interest spread, which represents the difference between the average rate earned on earning assets and the average rate paid on interest-bearing liabilities, was 3.53% during the first nine months of 2012 compared to 3.77% during the first nine months of 2011. The net interest spread, as well as the net interest margin, will be impacted by future changes in short-term and long-term interest rate levels, as well as the impact from the competitive environment. A discussion of the effects of changing interest rates on net interest income is set forth in Item 3. Quantitative and Qualitative Disclosures About Market Risk included elsewhere in this report.

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

Provision for Loan Losses

The provision for loan losses is determined by management as the amount to be added to the allowance for loan losses after net charge-offs have been deducted to bring the allowance to a level which, in management's best estimate, is necessary to absorb probable losses within the existing loan portfolio. The provision for loan losses totaled \$2.5 million and \$6.0 million for the three and nine months ended September 30, 2012 compared to \$9.0 million and \$27.4 million for the three and nine months ended September 30, 2011. See the section captioned Allowance for Loan Losses elsewhere in this discussion for further analysis of the provision for loan losses.

Non-Interest Income

The components of non-interest income were as follows:

	Three Months Ended			Nine Months Ended	
	September 30, 2012	June 30, 2012	September 30, 2011	September 30, 2012	September 30, 2011
Trust and investment management fees	\$ 20,843	\$ 21,279	\$ 19,652	\$ 62,774	\$ 59,436
Service charges on deposit accounts	20,797	20,639	22,072	62,230	64,650
Insurance commissions and fees	9,964	9,171	9,569	31,512	27,971
Interchange and debit card transaction fees	4,194	4,292	8,719	12,603	25,459
Other charges, commissions and fees	7,265	7,825	6,572	22,440	20,625
Net gain (loss) on securities transactions		370	6,409	(121)	6,414
Other	8,095	6,187	6,224	21,462	17,787
Total	\$ 71,158	\$ 69,763	\$ 79,217	\$ 212,900	\$ 222,342

Total non-interest income for the three and nine months ended September 30, 2012 decreased \$8.1 million, or 10.2%, and \$9.4 million, or 4.2%, compared to the same periods in 2011. Total non-interest income for the third quarter of 2012 increased \$1.4 million, or 2.0%, compared to the second quarter of 2012. Changes in the components of non-interest income are discussed below.

Table of Contents

Trust and Investment Management Fees. Trust and investment management fees for the three and nine months ended September 30, 2012 increased \$1.2 million, or 6.1%, and \$3.3 million, or 5.6%, compared to the same periods in 2011. Trust investment fees are the most significant component of trust and investment management fees, making up approximately 66% of total trust and investment management fees for the first nine months of 2012. Investment and other custodial account fees are generally based on the market value of assets within a trust account. Volatility in the equity and bond markets impacts the market value of trust assets and the related trust investment fees.

The \$1.2 million increase in trust and investment management fee income during the three months ended September 30, 2012 compared to the same period in 2011 was primarily the result of an increase in trust investment fees (up \$622 thousand), custody fees (up \$247 thousand) and securities lending income (up \$230 thousand). The \$3.3 million increase in trust and investment management fee income during the nine months ended September 30, 2012 compared to the same period in 2011 was primarily the result of an increase in trust investment fees (up \$1.3 million), oil and gas trust management fees (up \$681 thousand), custody fees (up \$457 thousand), securities lending income (up \$349 thousand), estate fees (up \$338 thousand) and mutual fund management fees (up \$212 thousand). The increases in trust investment fees and custody fees were partly related to the general appreciation in the market values of assets in trust accounts on which these fees are generally based. The increases in trust investment fees were also partly related to increases in the number of managed trust accounts. The increases in securities lending income were partly related to new business and increased loan spreads. Estate fees are transactional in nature and can vary from quarter to quarter.

Trust and investment management fee income for the third quarter of 2012 decreased \$436 thousand, or 2.0%, from the second quarter of 2012. The decrease was primarily due to decreases in tax fees, which are seasonally higher during the second quarter (down \$752 thousand), and oil and gas trust management fees (down \$295 thousand) partly offset by an increase in trust investment fees (up \$417 thousand).

At September 30, 2012, trust assets, including both managed assets and custody assets, were primarily composed of fixed income securities (42.0% of trust assets), equity securities (42.0% of trust assets) and cash equivalents (9.7% of trust assets). The estimated fair value of trust assets was \$26.7 billion (including managed assets of \$10.9 billion and custody assets of \$15.8 billion) at September 30, 2012, compared to \$25.2 billion (including managed assets of \$10.3 billion and custody assets of \$14.9 billion) at December 31, 2011 and \$24.1 billion (including managed assets of \$9.8 billion and custody assets of \$14.3 billion) at September 30, 2011.

Service Charges on Deposit Accounts. Service charges on deposit accounts for the three and nine months ended September 30, 2012 decreased \$1.3 million, or 5.8%, and \$2.4 million, or 3.7%, compared to the same periods in 2011. The decreases were primarily due to decreases in service charges on commercial accounts (down \$874 thousand and \$1.4 million during the three and nine months ended September 30, 2012, respectively) and decreases in overdraft/insufficient funds charges on both consumer and commercial accounts (down \$427 thousand and \$1.1 million on a combined basis during the three and nine months ended September 30, 2012, respectively). Overdraft/insufficient funds charges totaled \$8.6 million (\$6.8 million consumer and \$1.8 million commercial) during the third quarter of 2012 compared to \$9.0 million (\$7.2 million consumer and \$1.8 million commercial) during the third quarter of 2011 and \$8.2 million (\$6.5 million consumer and \$1.7 million commercial) during the second quarter of 2012. Overdraft/insufficient funds charges totaled \$24.9 million (\$19.7 million consumer and \$5.2 million commercial) during the nine months ended September 30, 2012 compared to \$26.0 million (\$20.6 million consumer and \$5.4 million commercial) during the nine months ended September 30, 2011.

Service charges on deposit accounts for the third quarter of 2012 increased \$158 thousand, or 0.8%, compared to the second quarter of 2012. The increase was due to increases in overdraft/insufficient funds charges on both consumer and commercial accounts (up \$311 thousand) partly offset by decreases in service charges on commercial accounts (down \$170 thousand).

Insurance Commissions and Fees. Insurance commissions and fees for the three and nine months ended September 30, 2012 increased \$395 thousand, or 4.1%, and \$3.5 million, or 12.7%, compared to the same periods in 2011. The increase during the three months ended September 30, 2012 was related to increases in contingent commissions (up \$246 thousand) and commission income (up \$149 thousand). The increase during the nine months ended September 30, 2012 was primarily related to an increase in commission income (up \$3.6 million). The increases in commission income during the three and nine months ended September 30, 2012 compared to the same periods in 2011 were partly related to an increase in employee benefit commissions and fees, which was partly related to the acquisitions of Clark Benefits Group during the second quarter of 2011 and Stone Partners, Inc. during the first quarter of 2012. The increase in commission income was also partly related to an increase in property and casualty commissions resulting from normal variation in the market demand for insurance products and rate increases.

Table of Contents

Insurance commissions and fees include contingent commissions totaling \$672 thousand and \$3.5 million during the three and nine months ended September 30, 2012 and \$426 thousand and \$3.5 million during the three and nine months ended September 30, 2011. Contingent commissions primarily consist of amounts received from various property and casualty insurance carriers related to the loss performance of insurance policies previously placed. Such commissions are seasonal in nature and are generally received during the first quarter of each year. These commissions totaled \$2.1 million and \$2.2 million during the nine months ended September 30, 2012 and 2011. Contingent commissions also include amounts received from various benefit plan insurance companies related to the volume of business generated and/or the subsequent retention of such business. These benefit plan related commissions totaled \$619 thousand and \$1.4 million during the three and nine months ended September 30, 2012 and \$417 thousand and \$1.3 million during the three and nine months ended September 30, 2011.

Insurance commissions and fees for the third quarter of 2012 increased \$793 thousand, or 8.6%, compared to the second quarter of 2012. The increase was related to an increase in commission income (up \$586 thousand) compared to the second quarter of 2012 primarily due to normal variation in the timing of renewals and the market demand for insurance products. The increase was also partly related to an increase in contingent commissions (up \$207 thousand) that were primarily received from various benefit plan insurance companies related to the volume of business generated and/or the subsequent retention of such business.

Interchange and Debit Card Transaction Fees. Interchange and debit card transaction fees consist of income from Visa check card usage, point of sale income from PIN-based debit card transactions and ATM service fees. Interchange and debit card transaction fees for the three and nine months ended September 30, 2012 decreased \$4.5 million, or 51.9%, and \$12.9 million, or 50.5%, compared to the same periods in 2011. Income from signature-based debit card transactions totaled \$2.3 million and \$6.8 million, during the three and nine months ended September 30, 2012, decreasing \$3.8 million, or 62.2%, and \$10.8 million, or 61.5%, respectively, compared to \$6.1 million and \$17.6 million during the three and nine months ended September 30, 2011. Income from PIN-based debit card transactions totaled \$1.2 million and \$3.7 million, during the three and nine months ended September 30, 2012, decreasing \$648 thousand, or 34.4%, and \$1.9 million, or 33.6%, respectively, compared to \$1.9 million and \$5.6 million during the three and nine months ended September 30, 2011. The decreases in income from both signature-based and PIN-based debit card transactions were primarily related to new rules that significantly impacted the level of interchange fees that may be charged, as further discussed below. Interchange and debit card transaction fees for the third quarter of 2012 decreased \$98 thousand, or 2.3%, from the second quarter of 2012. The decrease was primarily due to a decrease in ATM service fees (down \$67 thousand).

As discussed in the section captioned *Supervision and Regulation* included in Item 1. Business, of the 2011 Form 10-K, the Dodd-Frank Act amended the Electronic Fund Transfer Act (EFTA) which, among other things, gave the Federal Reserve the authority to establish rules regarding interchange fees charged for electronic debit transactions by payment card issuers, such as Frost Bank. In June 2011, the Federal Reserve issued a final rule that, among other things, established standards for determining whether an interchange fee received or charged by an issuer with respect to an electronic debit transaction is reasonable and proportional to the cost incurred by the issuer with respect to the transaction. These new standards took effect on October 1, 2011 and apply to issuers, such as the Corporation, that, together with their affiliates, have assets of \$10 billion or more. Under the rule, the maximum permissible interchange fee for an electronic debit transaction will be the sum of 21 cents per transaction and 5 basis points multiplied by the value of the transaction. The Federal Reserve also issued an interim final rule, effective on October 1, 2011, that allows for an upward adjustment of no more than 1 cent to an issuer's debit card interchange fee if the issuer develops and implements policies and procedures reasonably designed to achieve the fraud-prevention standards set out in the interim final rule. This limitation has been confirmed by the final rule issued by the Federal Reserve in July 2012.

Other Charges, Commissions and Fees. Other charges, commissions and fees for the three and nine months ended September 30, 2012 increased \$693 thousand, or 10.5%, and \$1.8 million, or 8.8%, compared to the same periods in 2011. The increase in other charges, commissions and fees during the three months ended September 30, 2012 included increases in consulting revenues, primarily related to the acquisition of Stone Partners, Inc. (up \$364 thousand); referral fees from the Corporation's merchant services payment processor (up \$222 thousand) and income from the sale of mutual funds (up \$158 thousand), among other things. These increases were partly offset by a decrease in income related to the sale of annuities (down \$273 thousand).

The increase in other charges, commissions and fees during the nine months ended September 30, 2012 included increases in consulting revenues, primarily related to the acquisition of Stone Partners, Inc. (up \$1.2 million); referral fees from the Corporation's merchant services payment processor (up \$556 thousand); an increase in unused balance fees on loan commitments (up \$543 thousand); other service charges, primarily related to early termination fees on lines of credit held by Frost Capital (up \$453 thousand) and service charges on funds transfers (up \$433 thousand), among other things. These increases were partly offset by decreases in income related to the sale of annuities (down \$816 thousand) and investment banking fees related to corporate advisory services (down \$536 thousand).

Table of Contents

Other charges, commissions and fees for the third quarter of 2012 decreased \$560 thousand, or 7.2%, compared to the second quarter of 2012. The decrease was primarily due to decreases in letter of credit fees (down \$179 thousand), income related to the sale of annuities (down \$137 thousand), referral fees from the Corporation's merchant services payment processor (down \$113 thousand) and consulting revenues (down \$113 thousand), among other things.

Net Gain/Loss on Securities Transactions. During the first nine months of 2012, the Corporation realized a net loss of \$121 thousand on the sale of available-for-sale securities. During January 2012, the Corporation purchased \$996.4 million of U.S. Treasury securities utilizing excess liquidity as a defensive strategy to lock in the yield on those funds in case the Federal Reserve lowered the rate paid on funds deposited in the Federal Reserve account. Shortly thereafter, U.S. Treasury prices rallied and the Corporation sold the securities, realizing a \$2.1 million gain, and concurrently purchased \$998.4 million of U.S. Treasury securities having a shorter term to maturity. In March 2012, U.S. Treasury yields increased and the Corporation sold the aforementioned position in U.S. Treasury securities and recognized a \$2.6 million loss. The proceeds were concurrently reinvested in U.S. Treasury securities that had a similar yield to the original, longer-term position purchased in January 2012, but with a shorter term to maturity. During the second quarter of 2012, the Corporation sold a municipal security with an amortized cost totaling \$5.6 million and realized a \$367 thousand gain on the sale. During the first nine months of 2012, the Corporation also sold available-for-sale securities with an amortized cost totaling \$14.0 billion and realized a net gain of \$2 thousand on those sales. These securities were primarily purchased during 2012 and subsequently sold in connection with the Corporation's tax planning strategies related to the Texas franchise tax. The gross proceeds from the sales of these securities outside of Texas are included in total revenues/receipts from all sources reported for Texas franchise tax purposes, which results in a reduction in the overall percentage of revenues/receipts apportioned to Texas and subjected to taxation under the Texas franchise tax. During the first nine months of 2011, the Corporation sold available-for-sale securities with an amortized cost totaling \$5.6 billion and realized a net gain of \$6.4 million on those sales. During the third quarter of 2011, the Corporation sold available-for-sale securities with an amortized cost totaling \$32.6 million and realized a net gain of \$6.4 million on those sales. The Corporation sold certain longer-duration municipal securities. The remainder of the sales related to securities that were primarily purchased and subsequently sold during the first quarter of 2011 in connection with the aforementioned tax planning strategies related to the Texas franchise tax.

Other Non-Interest Income. Other non-interest income for the three and nine months ended September 30, 2012 increased \$1.9 million, or 30.1% and \$3.7 million, or 20.7%, compared to the same periods in 2011. The increase during the three months ended September 30, 2012 was primarily related to an increase in income from securities trading and customer derivative activities (up \$1.1 million) and sundry income from various miscellaneous items (up \$865 thousand) partly offset by a decrease in mineral interest income (down \$248 thousand). The increase during the nine months ended September 30, 2012 was primarily related to an increase in mineral interest income (up \$1.6 million), sundry income from various miscellaneous items (up \$1.4 million) and income from securities trading and customer derivative activities (up \$869 thousand) partly offset by a decrease in gains on the sale of assets/foreclosed assets (down \$579 thousand). The increases in income from securities trading and customer derivative activities were primarily related to increased fees on customer interest rate swap transactions. The increases in sundry income from various miscellaneous items were partly related to the reversal of a prior contingency accrual totaling \$765 thousand in the second quarter of 2012 and proceeds realized in a legal settlement totaling \$1.4 million in the third quarter of 2012. Mineral interest income is related to bonus, rental and shut-in payments and oil and gas royalties received from severed mineral interests on property owned by Main Plaza Corporation, a wholly owned non-banking subsidiary of the Corporation.

Other non-interest income for the third quarter of 2012 increased \$1.9 million, or 30.8%, compared to the second quarter of 2012. The increase was primarily related to increases in income from securities trading and customer derivative activities (up \$1.2 million) and an increase in sundry income from various miscellaneous items (up \$767 thousand). The increase in income from securities trading and customer derivative activities was primarily related to increased fees on customer interest rate swap transactions. The increase in sundry income from various miscellaneous items was primarily related to the proceeds from the aforementioned legal settlement.

Table of Contents**Non-Interest Expense**

The components of non-interest expense were as follows:

	Three Months Ended			Nine Months Ended	
	September 30, 2012	June 30, 2012	September 30, 2011	September 30, 2012	September 30, 2011
Salaries and wages	\$ 64,984	\$ 62,624	\$ 61,697	\$ 191,310	\$ 185,902
Employee benefits	14,019	14,048	12,004	44,768	40,365
Net occupancy	13,193	12,213	12,080	37,203	35,555
Furniture and equipment	14,193	13,734	13,106	41,347	38,015
Deposit insurance	2,593	2,838	2,583	7,928	9,941
Intangible amortization	973	994	1,108	2,978	3,335
Other	34,495	36,085	34,829	103,492	101,152
Total	\$ 144,450	\$ 142,536	\$ 137,407	\$ 429,026	\$ 414,265

Total non-interest expense for the three and nine months ended September 30, 2012 increased \$7.0 million, or 5.1%, and \$14.8 million, or 3.6%, compared to the same periods in 2011. Total non-interest expense for the third quarter of 2012 increased \$1.9 million, or 1.3%, compared to the second quarter of 2012. Changes in the components of non-interest expense are discussed below.

Salaries and Wages. Salaries and wages for the three and nine months ended September 30, 2012 increased \$3.3 million, or 5.3%, and \$5.4 million, or 2.9%, compared to the same periods in 2011. These increases were primarily related to normal annual merit and market increases and increased commissions related to higher insurance revenues partly offset by a decrease in stock-based compensation expense and an increase in cost deferrals related to lending activity.

Salaries and wages expense for the third quarter of 2012 increased or \$2.4 million, or 3.8%, compared to the second quarter of 2012. This increase was primarily related to an increase in salaries and wages resulting from normal annual merit and market increases and a decrease in cost deferrals related to lending activity.

Employee Benefits. Employee benefits expense for the three and nine months ended September 30, 2012 increased \$2.0 million, or 16.8%, and \$4.4 million, or 10.9%, compared to the same periods in 2011. The increase during the three months ended September 30, 2012 was primarily related to increases in expenses related to the Corporation's defined benefit retirement plans (up \$877 thousand), medical expense (up \$520 thousand) and expenses related to the Corporation's 401(k) and profit sharing plans (up \$335 thousand). The increase during the nine months ended September 30, 2012 was primarily related to increases in expenses related to the Corporation's defined benefit retirement plans (up \$2.6 million) and medical expense (up \$1.8 million) partly offset by a decrease in expenses related to the Corporation's 401(k) and profit sharing plans (down \$709 thousand).

Employee benefits expense for the third quarter of 2012 did not significantly fluctuate compared to the second quarter of 2012 as decreases in payroll taxes (down \$304 thousand) were mostly offset by an increase in expenses related to the Corporation's 401(k) and profit sharing plans (up \$274 thousand).

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

Net Occupancy. Net occupancy expense for the three and nine months ended September 30, 2012 increased \$1.1 million, or 9.2%, and \$1.6 million, or 4.6%, compared to the same periods in 2011. The increase during the three months ended September 30, 2012 was primarily related to increases in lease expense (up \$643 thousand), building maintenance and repair expense (up \$154 thousand) and depreciation expense related to leasehold improvements (up \$116 thousand). The increase during the nine months ended September 30, 2012 was primarily related to increases in lease expense (up \$832 thousand), depreciation expense related to leasehold improvements (up \$273 thousand), building maintenance and repair expense (up \$186 thousand) and property taxes (up \$172 thousand), among other things. These increases were partly offset by a decrease in utilities expense (down \$292 thousand) and an increase in parking garage income (up \$100 thousand).

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

Net occupancy expense for the third quarter of 2012 increased \$980 thousand, or 8.0%, compared to the second quarter of 2012. The increase was primarily related to increases in lease expense (up \$341 thousand) and building maintenance and repair expense (up \$210 thousand) and a decrease in rental income from tenants (down \$174 thousand).

Table of Contents

Furniture and Equipment. Furniture and equipment expense for the three and nine months ended September 30, 2012 increased \$1.1 million, or 8.3%, and \$3.3 million, or 8.8%, compared to the same periods in 2011. The increase during the three months ended September 30, 2012 was primarily related to increases in software maintenance (up \$864 thousand) and service contracts expense (up \$301 thousand). The increase during the nine months ended September 30, 2012 was primarily related to increases in software maintenance (up \$2.1 million), service contracts expense (up \$803 thousand) and software amortization (up \$540 thousand).

Furniture and equipment expense for the third quarter of 2012 increased \$459 thousand, or 3.3%, compared to the second quarter of 2012 primarily related to increases in software maintenance expense (up \$353 thousand) and service contracts expense (up \$108 thousand).

Deposit Insurance. Deposit insurance expense totaled \$2.6 million and \$7.9 million for the three and nine months ended September 30, 2012 compared to \$2.6 million and \$9.9 million for the three and nine months ended September 30, 2011. The decrease in deposit insurance expense during the first nine months of 2012 compared to the same period in 2011 was primarily related to a change in the deposit insurance assessment base and a change in the method by which the assessment rate is determined for large financial institutions which became effective on April 1, 2011, as more fully discussed in the 2011 Form 10-K. Deposit insurance expense decreased \$245 thousand to \$2.6 million in the third quarter of 2012 from \$2.8 million in the second quarter of 2012. The decrease was related to an accrual adjustment.

Intangible Amortization. Intangible amortization is primarily related to core deposit intangibles and, to a lesser extent, intangibles related to customer relationships and non-compete agreements. Intangible amortization for the three and nine months ended September 30, 2012 decreased \$135 thousand, or 12.2% and \$357 thousand, or 10.7% compared to the same periods in 2011. The decreases in amortization expense are primarily the result of the completion of amortization of certain intangible assets and a reduction in the annual amortization rate of certain intangible assets as the Corporation uses an accelerated amortization approach which results in higher amortization rates during the earlier years of the useful lives of intangible assets. The decreases in amortization were partly offset by the additional amortization related to intangible assets recorded in connection with an acquisition in 2011 and the acquisition of Stone Partners Inc. on January 1, 2012. Intangible amortization expense during the third quarter of 2012 did not significantly fluctuate compared to the second quarter of 2012.

Other Non-Interest Expense. Other non-interest expense for the three and nine months ended September 30, 2012 decreased \$334 thousand, or 1.0%, and increased \$2.3 million, or 2.3%, compared to the same periods in 2011. Components of other non-interest expense with significant decreases during the three months ended September 30, 2012 included sundry losses from various miscellaneous items (down \$1.8 million), regulatory examination fees (down \$514 thousand) and losses on the sale/write-down of assets/foreclosed assets (down \$337 thousand). Sundry losses from miscellaneous items during the third quarter of 2011 included a \$1.4 million write-down related to an interest in a limited partnership as well as several other one-time charges for various write-offs and losses which contributed to a higher level of expense in 2011. The decrease in regulatory examination fees is related to the conversion to a state charter in June 2012. The decreases in the aforementioned items were partly offset by an increase in professional services expense (up \$1.0 million). Components of other non-interest expense with significant increases during the nine months ended September 30, 2012 included advertising/promotions expense (up \$1.6 million), professional services expense (up \$1.4 million), travel/meals and entertainment (up \$791 thousand) and amortization of net deferred costs related to loan commitments (up \$759 thousand). The increase in advertising/promotions expense is primarily related to the continuation of the marketing campaign that began during the first quarter of 2011. The Corporation expects advertising/promotions expense for the remainder of 2012 to be at levels comparable to 2011. The increase in the amortization of net deferred costs related to loan commitments is primarily related to an increase in commitments outstanding. The increases in the aforementioned items were partly offset by decreases in sundry losses from various miscellaneous items (down \$2.0 million) and losses on the sale/write-down of assets/foreclosed assets (down \$567 thousand).

Total other non-interest expense for the third quarter of 2012 decreased \$1.6 million, or 4.4%, compared to the second quarter of 2012. Significant components of the decrease included decreases in travel/meals and entertainment (down \$671 thousand), regulatory examination fees (down \$581 thousand), losses on the sale/write-down of assets/foreclosed assets (down \$551 thousand), outside-director stock-based compensation (down \$330 thousand) and sundry losses from various miscellaneous items (down \$214 thousand). These decreases were partly offset by increases in professional services expense (up \$683 thousand) and web-site maintenance expense (up \$381 thousand). Losses on the sale/write-down of assets/foreclosed assets during the period included non-recurring write-downs of certain equipment assets totaling \$700 thousand in the second quarter of 2012 and \$896 thousand in the third quarter of 2012.

Table of Contents**Results of Segment Operations**

The Corporation's operations are managed along two primary operating segments: Banking and Frost Wealth Advisors. A description of each business and the methodologies used to measure financial performance is described in Note 14 - Operating Segments in the accompanying notes to consolidated financial statements included elsewhere in this report. Net income (loss) by operating segment is presented below:

	Three Months Ended			Nine Months Ended	
	September 30, 2012	June 30, 2012	September 30, 2011	September 30, 2012	September 30, 2011
Banking	\$ 56,878	\$ 55,984	\$ 53,497	\$ 171,152	\$ 160,788
Frost Wealth Advisors	3,298	4,228	2,696	10,917	7,299
Non-Banks	(1,507)	(2,150)	(1,686)	(4,305)	(5,966)
Consolidated net income	\$ 58,669	\$ 58,062	\$ 54,507	\$ 177,764	\$ 162,121

Banking

Net income for the three and nine months ended September 30, 2012 increased \$3.4 million, or 6.3%, and \$10.4 million, or 6.4%, compared to the same periods in 2011. The increase during the three months ended September 30, 2012 was primarily the result of a \$6.5 million decrease in the provision for loan losses, a \$7.1 million decrease in income tax expense and a \$4.5 million increase in net interest income partly offset by an \$8.8 million decrease in non-interest income and a \$5.9 million increase in non-interest expense. The increase during the nine months ended September 30, 2012 was primarily the result of a \$21.5 million decrease in the provision for loan losses, a \$14.4 million increase in net interest income and a \$2.2 million decrease in income tax expense partly offset by a \$14.1 million increase in non-interest expense and a \$13.6 million decrease in non-interest income.

Net interest income for the three and nine months ended September 30, 2012 increased \$4.5 million, or 3.1%, and \$14.4 million, or 3.3%, compared to the same periods in 2011. The increases primarily resulted from increases in the average volume of interest-earning assets partly offset by decreases in the net interest margin. See the analysis of net interest income included in the section captioned *Net Interest Income* included elsewhere in this discussion.

The provision for loan losses for the three and nine months ended September 30, 2012 totaled \$2.5 million and \$6.0 million compared to \$9.0 million and \$27.4 million for the same periods in 2011. See the analysis of the provision for loan losses included in the section captioned *Allowance for Loan Losses* included elsewhere in this discussion.

Non-interest income for the three and nine months ended September 30, 2012 decreased \$8.8 million, or 15.8%, and \$13.6 million, or 9.0%, compared to the same periods in 2011. The decreases during the three and nine months ended September 30, 2012 were primarily due to decreases in the net gain on securities transactions, interchange and debit card transaction fees and service charges on deposit accounts partly offset by increases in insurance commissions and fees, other charges, commissions and fees and other non-interest income. See the analysis of these categories of non-interest income included in the section captioned *Non-Interest Income* included elsewhere in this discussion.

Non-interest expense for the three months and nine months ended September 30, 2012 increased \$5.9 million, or 5.1%, and increased \$14.1 million, or 4.1%, compared to the same periods in 2011. The increase during the three months ended September 30, 2012 was primarily related to increases in salaries and wages, employee benefits, occupancy expense and furniture and equipment expense. The increase during the nine months ended September 30, 2012 was primarily related to increases in salaries and wages, employee benefits, furniture and equipment expense, other non-interest expense and occupancy expense partly offset by a decrease in deposit insurance expense. The increases in salaries and wages were primarily related to normal annual merit and market increases and increased commissions related to higher insurance revenues partly offset by a decrease in stock-based compensation expense and an increase in cost deferrals related to lending activity. The increases in employee benefits expense were primarily related to increases in expenses related to the Corporation's defined benefit retirement plans and medical expense partly offset, during the nine months ended September 30, 2012, by a decrease in expense related to the Corporation's 401(k) and profit sharing plans. The increases in furniture and equipment expense were due to increases in software maintenance, service contract expenses and software amortization. The increases in net occupancy expense were due to increases in lease expense, depreciation expense related to leasehold improvements and building maintenance and repair expense. The increase in other non-interest expense during the nine months ended September 30, 2012 was related to increases in advertising/promotions expense, professional services expense, travel/meals and entertainment and amortization of net deferred costs related to loan commitments, among other things, as well as increases in overhead cost

allocations. The decrease in deposit insurance expense during the nine months ended September 30, 2012 was primarily related to a change in the deposit insurance assessment base and a change in the method by which the assessment rate is determined for large financial institutions which became effective on April 1, 2011. See the analysis of these items included in the section captioned "Non-Interest Expense" included elsewhere in this discussion.

Table of Contents

Frost Insurance Agency, which is included in the Banking operating segment, had gross commission revenues of \$10.0 million and \$31.6 million during the three and nine months ended September 30, 2012 and \$9.6 million and \$28.1 million during the three and nine months ended September 30, 2011. The increases in commission revenues were primarily related to increases in employee benefit commissions and fees, which were partly related to the acquisitions of Clark Benefits Group during the second quarter of 2011 and Stone Partners, Inc. (Stone) during the first quarter of 2012. See the analysis of insurance commissions and fees included in the section captioned Non-Interest Income included elsewhere in this discussion. Frost Insurance Agency also had consulting revenues totaling \$364 thousand and \$1.2 million during the three and nine months ended September 30, 2012. Consulting revenues are reported as a component of other charges, commissions and fees and were primarily related to the acquisition of Stone.

Income tax expense for the three and nine months ended September 30, 2012 decreased \$7.1 million, or 29.6%, and \$2.2 million, or 4.4%, compared to the same periods in 2011. The decreases were primarily due to the correction, during the third quarter of 2011, of an under-accrual of taxes that resulted from incorrectly deducting premium amortization on municipal securities for federal income tax purposes since 2008. See the analysis of these items included in the section captioned Income Taxes included elsewhere in this discussion.

Frost Wealth Advisors

Net income for the three and nine months ended September 30, 2012 increased \$602 thousand, or 22.3% and \$3.6 million, or 49.6%, compared to the same periods in 2011. The increase during the three months ended September 30, 2012 was primarily due to a \$980 thousand increase in non-interest income and a \$472 thousand increase in net interest income partly offset by a \$525 thousand increase in non-interest expense and a \$324 thousand increase in income tax expense. The increase during the nine months ended September 30, 2012 was primarily due to a \$2.6 million increase in non-interest income, a \$1.7 million increase in net interest income and a \$1.2 million decrease in non-interest expense partly offset by a \$1.9 million increase in income tax expense.

Net interest income for the three and nine months ended September 30, 2012 increased \$472 thousand, or 29.8%, and \$1.7 million, or 38.4%, compared to the same periods in 2011. The increase in net interest income was due to an increase in the average volume of funds provided due to an increase in the average volume of Frost Wealth Advisor s repurchase agreements combined with an increase in the funds transfer price received for providing those funds.

Non-interest income for the three and nine months ended September 30, 2012 increased \$980 thousand, or 4.3%, and \$2.6 million, or 3.8%, compared to the same periods in 2011. The increases during the three and nine months ended September 30, 2012 were primarily due to increases in trust and investment management fees (up \$1.2 million during the three months ended September 30, 2012 and \$3.5 million during the nine months ended September 30, 2012) partly offset by decreases in other charges, commissions and fees (down \$177 thousand during the three months ended September 30, 2012 and \$781 thousand during the nine months ended September 30, 2012).

Trust and investment management fee income is the most significant income component for Frost Wealth Advisors. Investment fees are the most significant component of trust and investment management fees, making up approximately 66% of total trust and investment management fees for the first nine months of 2012. Investment and other custodial account fees are generally based on the market value of assets within a trust account. Volatility in the equity and bond markets impacts the market value of trust assets and the related investment fees. The increase in trust and investment management fee income during the three months ended September 30, 2012 compared to the same period in 2011 was primarily the result of an increase in trust investment fees, custody fees and securities lending income. The increase in trust and investment management fee income during the nine months ended September 30, 2012 compared to the same period in 2011 was primarily the result of an increase in trust investment fees, oil and gas trust management fees, custody fees, securities lending income, estate fees and mutual fund management fees. See the analysis of trust and investment management fees included in the section captioned Non-Interest Income included elsewhere in this discussion.

The decreases in other charges, commissions and fees during the three and nine months ended September 30, 2012 compared to the same periods in 2011 were primarily due to decreases in income related to the sale of annuities.

Non-interest expense for the three and nine months ended September 30, 2012 increased \$525 thousand, or 2.6%, and decreased \$1.2 million, or 2.0%, compared to the same periods in 2011. The increase during the three months ended September 30, 2012 was primarily due to increases in salaries and wages and employee benefits (up \$753 thousand on a combined basis). The decrease during the nine months ended September 30, 2012 was primarily due to a decrease in other

Table of Contents

non-interest expense (down \$2.2 million) partly offset by increases in salaries and wages and employee benefits (up \$923 thousand on a combined basis). The decrease in other non-interest expense was related to decreases in various overhead cost allocations as well as decreases in sundry losses from various miscellaneous items, professional services expense and sub-advisor investment management fees related to Frost Investment Advisors, LLC, among other things.

Non-Banks

The net loss for the Non-Banks operating segment for the three and nine months ended September 30, 2012 decreased \$179 thousand, or 10.6%, and \$1.7 million, or 27.8%, respectively, compared to the same periods in 2011. The decrease in the net loss during the three months ended September 30, 2012 was primarily due to a \$1.2 million decrease in net interest expense partly offset by a \$575 thousand increase in non-interest expense, a \$249 thousand decrease in non-interest income and a \$182 thousand decrease in the net income tax benefit. The decrease in the net loss during the nine months ended September 30, 2012 was primarily due to a \$2.9 million decrease in net interest expense and a \$1.5 million increase in non-interest income partly offset by a \$1.8 million increase in non-interest expense and a \$946 thousand decrease in the net income tax benefit. The decreases in net interest expense were related to a decrease in the interest rate paid on the Corporation's \$100 million fixed-to-floating rate subordinated notes, which changed to a floating interest rate during the first quarter of 2012. The increase in non-interest income during the nine months ended September 30, 2012 was primarily related to increased mineral interest income related to bonus, rental and shut-in payments and oil and gas royalties received from severed mineral interests on property owned by Main Plaza Corporation, a wholly-owned non-banking subsidiary of the Corporation. The increases in non-interest expense were partly related to non-recurring write-downs of certain equipment assets totaling \$700 thousand in the second quarter of 2012 and \$302 thousand in the third quarter of 2012.

Income Taxes

The Corporation recognized income tax expense of \$17.1 million and \$50.6 million, for an effective tax rate of 22.5% and 22.2% for the three and nine months ended September 30, 2012 compared to \$23.7 million and \$50.0 million, for an effective tax rate of 30.3% and 23.6% for the three and nine months ended September 30, 2011. The effective income tax rates differed from the U.S. statutory rate of 35% during the comparable periods primarily due to the effect of tax-exempt income from loans, securities and life insurance policies. The higher effective tax rate for the three and nine months ended September 30, 2011 was primarily due to the correction, during the third quarter of 2011, of an under-accrual of taxes that resulted from incorrectly deducting premium amortization on municipal securities for federal income tax purposes since 2008. As a result, the Corporation recognized additional income tax expense totaling \$4.3 million, which included interest and penalties, related to the 2010, 2009 and 2008 tax years. Additionally, income tax expense for the third quarter of 2011 also included an accrual of \$1.7 million related to premium amortization on municipal securities for the first and second quarters of 2011. Excluding the effect of the correction related to prior year amounts, the Corporation's effective tax rate would have been 21.5% for the nine months ended September 30, 2011.

Average Balance Sheet

Average assets totaled \$20.4 billion for the nine months ended September 30, 2012 representing an increase of \$2.2 billion, or 12.2%, compared to average assets for the same period in 2011. The increase was primarily reflected in earning assets, which increased \$2.2 billion, or 13.5%, during the first nine months of 2012 compared to the first nine months of 2011. The increase in earning assets was primarily due to a \$3.1 billion increase in average securities and a \$253.0 million increase in average loans partly offset by a \$1.1 billion decrease in average interest-bearing deposits and federal funds sold and resale agreements. The growth in average interest-earning assets was primarily funded by an increase in deposits. Total deposits averaged \$16.9 billion for the first nine months of 2012, increasing \$2.0 billion, or 13.4%, compared to the same period in 2011. Average interest-bearing accounts totaled 59.8% and 62.9% of average total deposits during the first nine months of 2012 and 2011, respectively.

Table of Contents**Loans**

Loans were as follows as of the dates indicated:

	September 30, 2012	Percentage of Total	June 30, 2012	December 31, 2011	September 30, 2011
Commercial and industrial:					
Commercial	\$ 4,055,807	46.0%	\$ 3,911,502	\$ 3,553,989	\$ 3,571,807
Leases	247,210	2.8	236,891	193,412	184,614
Asset-based	183,284	2.1	161,496	169,466	175,120
Total commercial and industrial	4,486,301	50.9	4,309,889	3,916,867	3,931,541
Commercial real estate:					
Commercial mortgages	2,455,488	27.9	2,396,609	2,383,479	2,370,871
Construction	584,207	6.6	538,681	434,870	508,182
Land	210,440	2.4	184,612	202,478	214,436
Total commercial real estate	3,250,135	36.9	3,119,902	3,020,827	3,093,489
Consumer real estate:					
Home equity loans	295,735	3.4	288,917	282,244	277,284
Home equity lines of credit	188,993	2.1	189,910	191,960	190,958
1-4 family residential mortgages	39,836	0.4	39,006	45,943	47,455
Construction	18,057	0.2	19,498	17,544	17,965
Other	225,861	2.6	224,729	225,118	233,053
Total consumer real estate	768,482	8.7	762,060	762,809	766,715
Total real estate	4,018,617	45.6	3,881,962	3,783,636	3,860,204
Consumer and other:					
Consumer installment	311,898	3.5	306,130	301,518	299,417
Other	13,694	0.2	10,873	11,018	14,926
Total consumer and other	325,592	3.7	317,003	312,536	314,343
Unearned discounts	(19,470)	(0.2)	(19,091)	(17,910)	(16,511)
Total loans	\$ 8,811,040	100.0%	\$ 8,489,763	\$ 7,995,129	\$ 8,089,577

Loans increased \$815.9 million, or 10.2%, compared to December 31, 2011. The majority of the Corporation's loan portfolio is comprised of commercial and industrial loans and real estate loans. Commercial and industrial loans made up 50.9% and 49.0% of total loans at September 30, 2012 and December 31, 2011, respectively while real estate loans made up 45.6% and 47.3% of total loans, respectively, at those dates. Real estate loans include both commercial and consumer balances.

Commercial and industrial loans increased \$569.4 million, or 14.5%, during the first nine months of 2012. The Corporation's commercial and industrial loans are a diverse group of loans to small, medium and large businesses. The purpose of these loans varies from supporting seasonal working capital needs to term financing of equipment. While some short-term loans may be made on an unsecured basis, most are secured by the assets being financed with collateral margins that are consistent with the Corporation's loan policy guidelines. The commercial and industrial loan portfolio also includes the commercial lease and asset-based lending portfolios as well as purchased shared national credits (SNCs) which are discussed in more detail below.

Purchased shared national credits are participations purchased from upstream financial organizations and tend to be larger in size than the Corporation's originated portfolio. The Corporation's purchased SNC portfolio totaled \$712.5 million at September 30, 2012, increasing

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

\$175.1 million, or 32.6%, from \$537.4 million at December 31, 2011. At September 30, 2012, 67.9% of outstanding purchased SNCs was related to the energy industry. The remaining purchased SNCs were diversified throughout various other industries, with no other single industry exceeding 10% of the total purchased SNC portfolio. Additionally, almost all of the outstanding balance of purchased SNCs was included in the commercial and industrial portfolio, with the remainder included in the real estate categories. SNC participations are originated in the normal course of business to meet the needs of the Corporation's customers. As a matter of policy, the Corporation generally only participates in SNCs for companies headquartered in or which have significant operations within the Corporation's market areas. In addition, the Corporation must have direct access to the company's management, an existing banking relationship or the expectation of broadening the relationship with other banking products and services within the following 12 to 24 months. SNCs are reviewed at least quarterly for credit quality and business development successes.

Table of Contents

Real estate loans increased \$235.0 million, or 6.2%, during the first nine months of 2012. Real estate loans include both commercial and consumer balances. Commercial real estate loans totaled \$3.3 billion at September 30, 2012 and represented 80.9% of total real estate loans. The majority of this portfolio consists of commercial real estate mortgages, which includes both permanent and intermediate term loans. The Corporation's primary focus for its commercial real estate portfolio has been growth in loans secured by owner-occupied properties. These loans are viewed primarily as cash flow loans and secondarily as loans secured by real estate. Consequently, these loans must undergo the analysis and underwriting process of a commercial and industrial loan, as well as that of a real estate loan.

The consumer loan portfolio, including all consumer real estate, increased \$16.1 million, or 1.5%, from December 31, 2011. As the following table illustrates, the consumer loan portfolio has two distinct segments, including consumer real estate and consumer installment.

	September 30, 2012	June 30, 2012	December 31, 2011	September 30, 2011
Consumer real estate:				
Home equity loans	\$ 295,735	\$ 288,917	\$ 282,244	\$ 277,284
Home equity lines of credit	188,993	189,910	191,960	190,958
1-4 family residential mortgages	39,836	39,006	45,943	47,455
Construction	18,057	19,498	17,544	17,965
Other	225,861	224,729	225,118	233,053
Total consumer real estate	768,482	762,060	762,809	766,715
Consumer installment	311,898	306,130	301,518	299,417
Total consumer loans	\$ 1,080,380	\$ 1,068,190	\$ 1,064,327	\$ 1,066,132

Consumer real estate loans, increased \$5.7 million, or 0.7%, from December 31, 2011. Combined, home equity loans and lines of credit made up 63.1% and 62.2% of the consumer real estate loan total at September 30, 2012 and December 31, 2011, respectively. The Corporation offers home equity loans up to 80% of the estimated value of the personal residence of the borrower, less the value of existing mortgages and home improvement loans. In general, the Corporation no longer originates 1-4 family mortgage loans, however, from time to time, the Corporation may invest in such loans to meet the needs of its customers.

The consumer installment loan portfolio primarily consists of automobile loans, unsecured revolving credit products, personal loans secured by cash and cash equivalents, and other similar types of credit facilities.

Table of Contents**Non-Performing Assets**

Non-performing assets and accruing past due loans are presented in the table below. All troubled debt restructurings are reported as non-accrual loans.

	September 30, 2012	June 30, 2012	December 31, 2011	September 30, 2011
Non-accrual loans:				
Commercial and industrial	\$ 52,819	\$ 43,855	\$ 43,874	\$ 58,208
Commercial real estate	49,818	44,471	45,149	47,154
Consumer real estate	3,069	3,241	4,587	4,060
Consumer and other	701	688	728	756
Total non-accrual loans	106,407	92,255	94,338	110,178
Foreclosed assets:				
Real estate	18,524	19,818	26,608	29,114
Other				
Total foreclosed assets	18,524	19,818	26,608	29,114
Total non-performing assets	\$ 124,931	\$ 112,073	\$ 120,946	\$ 139,292
Ratio of non-performing assets to:				
Total loans and foreclosed assets	1.41%	1.32%	1.51%	1.72%
Total assets	0.57	0.54	0.60	0.71
Accruing past due loans:				
30 to 89 days past due	\$ 30,780	\$ 30,878	\$ 42,463	\$ 54,728
90 or more days past due	8,450	12,824	17,417	17,682
Total accruing past due loans	\$ 39,230	\$ 43,702	\$ 59,880	\$ 72,410
Ratio of accruing past due loans to total loans:				
30 to 89 days past due	0.35%	0.36%	0.53%	0.68%
90 or more days past due	0.10	0.15	0.22	0.22
Total accruing past due loans	0.45%	0.51%	0.75%	0.90%

Non-performing assets include non-accrual loans and foreclosed assets. Non-performing assets at September 30, 2012 increased \$12.9 million from June 30, 2012 and \$4.0 million from December 31, 2011 and decreased \$14.4 million from September 30, 2011. In general, the level of non-performing assets during the comparable periods is reflective of weaker economic conditions which began in the latter part of 2008, although the Corporation has experienced decreases in the levels of classified assets in recent quarters. The increase in non-accrual loans during the third quarter of 2012 was primarily related to a single credit relationship totaling \$28.2 million (\$15.3 million commercial and industrial and \$12.9 million commercial real estate). This credit relationship was previously reported as a potential problem loan. Non-accrual commercial and industrial loans included four credit relationships in excess of \$5 million totaling \$36.6 million at September 30, 2012 and two credit relationships in excess of \$5 million totaling \$17.3 million at December 31, 2011. Non-accrual real estate loans primarily consist of land development, 1-4 family residential construction credit relationships and loans secured by office buildings and religious facilities. Non-accrual commercial real estate loans included two credit relationship in excess of \$5 million totaling \$18.5 million at September 30, 2012 and one credit relationship in excess of \$5 million totaling \$5.8 million at December 31, 2011.

Generally, loans are placed on non-accrual status if principal or interest payments become 90 days past due and/or management deems the collectibility of the principal and/or interest to be in question, as well as when required by regulatory requirements. Once interest accruals are discontinued, accrued but uncollected interest is charged to current year operations. Subsequent receipts on non-accrual loans are recorded as a reduction of principal, and interest income is recorded only after principal recovery is reasonably assured. Classification of a loan as non-accrual

does not preclude the ultimate collection of loan principal or interest.

Foreclosed assets represent property acquired as the result of borrower defaults on loans. Foreclosed assets are recorded at estimated fair value, less estimated selling costs, at the time of foreclosure. Write-downs occurring at foreclosure are charged against the allowance for loan losses. Regulatory guidelines require the Corporation to reevaluate the fair value of foreclosed assets on at least an annual basis. The Corporation's policy is to comply with the regulatory guidelines. Write-downs are provided for subsequent declines in value and are included in other non-interest expense along with other expenses related to maintaining the properties. During 2012 and 2011, foreclosed assets, particularly among certain classes of property (primarily land), experienced significant deterioration in fair values as a result of the prevailing weaker economic conditions. Write-downs of foreclosed assets totaled \$1.5 million and \$2.2 million, during the nine months ended September 30, 2012 and 2011, respectively. There were no significant concentrations of any properties, to which the aforementioned write-downs relate, in any single geographic region.

Table of Contents

Potential problem loans consist of loans that are performing in accordance with contractual terms but for which management has concerns about the ability of an obligor to continue to comply with repayment terms because of the obligor's potential operating or financial difficulties. Management monitors these loans closely and reviews their performance on a regular basis. At September 30, 2012 and December 31, 2011, the Corporation had \$10.8 million and \$42.6 million in loans of this type which are not included in either of the non-accrual or 90 days past due loan categories. At September 30, 2012, potential problem loans consisted of 6 credit relationships. Of the total outstanding balance at September 30, 2012, 27.3% related to a customer in the broadcasting industry, 25.7% related to two customers with commercial real estate properties and 19.4% related to a customer in manufacturing. Weakness in these companies' operating performance has caused the Corporation to heighten the attention given to these credits.

Allowance for Loan Losses

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

The table below provides, as of the dates indicated, an allocation of the allowance for loan losses by loan type; however, allocation of a portion of the allowance to one category of loans does not preclude its availability to absorb losses in other categories. Prior to June 30, 2012, certain general valuation allowances were not allocated to specific loan portfolio segments and were included in unallocated allowances. See Note 3 - Loans for details of amounts allocated to specific portfolio segments.

	September 30, 2012	June 30, 2012	December 31, 2011	September 30, 2011
Commercial and industrial	\$ 51,542	\$ 53,475	\$ 42,774	\$ 46,885
Commercial real estate	27,641	27,631	20,912	20,812
Consumer real estate	5,394	5,235	3,540	3,446
Consumer and other	3,902	3,649	12,635	12,807
Unallocated	16,922	15,658	30,286	31,483
Total	\$ 105,401	\$ 105,648	\$ 110,147	\$ 115,433

As of September 30, 2012, the reserve allocated to commercial and industrial loans increased \$8.8 million compared to December 31, 2011 and \$4.7 million compared to September 30, 2011. As of September 30, 2012, the reserve allocated to commercial and industrial loans included \$5.7 million related to certain general valuation allowances that were previously reported as components of the unallocated portion of the allowance for loan losses (see Note 3 - Loans for details). Excluding the impact of this reclassification of certain general valuation allowances, the reserve allocated to commercial and industrial loans at September 30, 2012 increased \$3.1 million from December 31, 2011, which was primarily related to an increase in historical valuation allowances due to an increase in the volume of non-classified commercial and industrial loans, an increase in allocations for specific loans, an increase in the allocation for distressed industries and an increase in the environmental risk adjustment partly offset by a decrease in classified loans. Excluding the impact of the aforementioned \$5.7 million reclassification of certain general valuation allowances, the reserve allocated to commercial and industrial loans at September 30, 2012 decreased \$1.0 million from September 30, 2011. This decrease was primarily related to a decrease in classified loans and a decrease in allocations for specific loans partly offset by the allocation for distressed industries, which was not a part of the Corporation's allowance for loan loss methodology as of September 30, 2011, and an increase in

Table of Contents

historical valuation allowances due to an increase in the volume of non-classified commercial and industrial loans. Classified commercial and industrial loans (loans having a risk grade of 11, 12 or 13) totaled \$117.0 million at September 30, 2012 compared to \$139.2 million at December 31, 2011 and \$182.4 million at September 30, 2011. Specific allocations of the allowance for loan losses related to commercial and industrial loans totaled \$4.1 million at September 30, 2012 compared to \$2.7 million at December 31, 2011 and \$6.9 million at September 30, 2011. The environmental adjustment factor resulted in additional general valuation allowances for commercial and industrial loans totaling \$6.0 million at September 30, 2012, \$5.7 million at December 31, 2011 and \$6.0 million at September 30, 2011. Although the environmental risk adjustment factor at September 30, 2012 decreased compared to December 31, 2011 and September 30, 2011, the dollar amount of the environmental risk adjustment increased compared to December 31, 2011 and was flat compared to September 30, 2011 as a result of an increase in the volume of non-classified commercial and industrial loans. The distressed industries allocation related to commercial and industrial loans totaled \$5.0 million at September 30, 2012 and \$4.1 million at December 31, 2011. As more fully discussed in Note 3 Loans in the accompanying notes to consolidated financial statements, the distressed industries allocation was added to the Corporation's methodology for the determination of reserves allocated to specific loan portfolio segments in the fourth quarter of 2011.

As of September 30, 2012, the reserve allocated to commercial real estate loans increased \$6.7 million compared to December 31, 2011 and \$6.8 million compared to September 30, 2011. As of September 30, 2012, the reserve allocated to commercial real estate loans included \$6.5 million related to certain general valuation allowances that were previously reported as components of the unallocated portion of the allowance for loan losses (see Note 3 Loans for details). Excluding the impact of this reclassification of certain general valuation allowances, the reserve allocated to commercial real estate loans at September 30, 2012 did not significantly fluctuate compared to December 31, 2011 as an increase in historical valuation allowances due to an increase in the volume of non-classified commercial real estate loans and an increase in the allocation for distressed industries were mostly offset by the effect of a decrease in classified loans and a decrease in allocations for specific loans. Excluding the impact of the aforementioned \$6.5 million reclassification of certain general valuation allowances, the reserve allocated to commercial real estate loans at September 30, 2012 did not significantly fluctuate compared to September 30, 2011 as an increase in the allocation for distressed industries, which was not a part of the Corporation's allowance for loan loss methodology as of September 30, 2011, and an increase in historical valuation allowances due to an increase in the volume of non-classified commercial real estate loans were mostly offset by the effect of a decrease in classified loans and decreases in allocations for specific loans and the environmental risk adjustment. The allowance allocated to commercial real estate loans at September 30, 2012 was also impacted by a decrease in the historical loss allocation factors applied to certain categories of non-classified and classified commercial real estate loans compared to the historical loss allocation factors used in 2011. Classified commercial real estate loans totaled \$136.6 million at September 30, 2012 compared to \$180.0 million at December 31, 2011 and \$172.1 million at September 30, 2011. Specific allocations of the allowance for loan losses related to commercial real estate loans totaled \$823 thousand at September 30, 2012, \$1.1 million at December 31, 2011 and \$1.3 million at September 30, 2011. The environmental adjustment factor resulted in additional general valuation allowances for commercial real estate loans totaling \$3.7 million at both September 30, 2012 and December 31, 2011 and \$4.0 million at September 30, 2011. Although the environmental risk adjustment factor at September 30, 2012 decreased compared to December 31, 2011, the dollar amount of the environmental risk adjustment was flat compared to December 31, 2011 as a result of an increase in the volume of non-classified commercial real estate loans. The distressed industries allocation related to commercial real estate loans totaled \$1.2 million at September 30, 2012 and \$922 thousand at December 31, 2011.

The reserve allocated to consumer real estate loans at September 30, 2012 increased \$1.9 million compared to both December 31, 2011 and September 30, 2011. As of September 30, 2012, the reserve allocated to consumer real estate loans included \$1.7 million related to certain general valuation allowances that were previously reported as components of the unallocated portion of the allowance for loan losses (see Note 3 Loans for details). Excluding the impact of this reclassification of certain general valuation allowances, the reserve allocated to consumer real estate loans at September 30, 2012 did not significantly fluctuate compared to both December 31, 2011 and September 30, 2011 as the impact of increases in historical valuation allowances due to an increase in the volume of non-classified consumer real estate loans combined with the effect of an increase in the historical loss allocation factor applied to pass-grade loans at September 30, 2012 compared to the historical loss allocation factors used in 2011 were partly offset by the effect of decreases in certain categories of classified loans, the effect of decreases in the historical loss allocation factors applied to certain categories of classified loans and special mention grade loans at September 30, 2012 compared to the historical loss allocation factors used in 2011, a decrease in allocations for specific loans compared to December 31, 2011 and a decrease in the environmental risk adjustment compared to September 30, 2011.

The reserve allocated to consumer and other loans at September 30, 2012 decreased \$8.7 million compared to December 31, 2011 and \$8.9 million compared to September 30, 2011. As of September 30, 2012, the reserve allocated to consumer and other loans included a reduction of \$5.5 million related to certain general valuation allowances that were previously reported as components of the unallocated portion of the allowance for loan losses (see Note 3 Loans for details). Excluding the impact of this reclassification of certain general valuation allowances, the reserve allocated to

Table of Contents

consumer and other loans at September 30, 2012 decreased \$3.2 million compared to December 31, 2011 and \$3.4 million compared to September 30, 2011. The decreases were primarily related to a decrease in the historical loss allocation factor applied to consumer and other loans combined with a decrease in the environmental risk adjustment factor partly offset by the effect of an increase in the volume of consumer and other loans.

The unallocated portion of the allowance for loan losses represents certain general valuation allowances that are not allocated to specific loan portfolio segments. See Note 3 Loans in the accompanying notes to consolidated financial statements for information regarding the components of the unallocated portion of the allowance. The unallocated portion of the allowance for loan losses at September 30, 2012 decreased \$13.4 million compared to December 31, 2011 and \$14.6 million compared to September 30, 2011. Excluding certain general valuation allowances that were reclassified to specific loan portfolio segments, as discussed above, the unallocated portion of the allowance for loan losses at September 30, 2012 would have decreased \$4.6 million compared to December 31, 2011 and \$9.6 million compared to September 30, 2011 primarily due to decreases in the allocation for general macroeconomic risk (down \$4.8 million and \$9.5 million at September 30, 2012 compared to December 31, 2011 and September 30, 2011, respectively). The decrease in the allocation for general macroeconomic risk is reflective of improving trends in certain components of the Texas Leading Index and an improved outlook on the credit quality of the Corporation's loan portfolio.

Aggregated components of the Corporation's overall general valuation allowance (those allocated amongst the various loan portfolio segments and the unallocated portion of the allowance for loan losses) with significant fluctuations at September 30, 2012 compared to December 31, 2011 and September 30, 2011 included allocations for excessive industry concentrations (down \$297 thousand and up \$4.7 million, in aggregate, at September 30, 2012 compared to December 31, 2011 and September 30, 2011, respectively), the adjustment for recoveries (up \$690 thousand and \$1.8 million, in aggregate, at September 30, 2012 compared to December 31, 2011 and September 30, 2011, respectively), allocations for highly-leveraged credit relationships (up \$1.2 million and \$948 thousand, in aggregate, at September 30, 2012 compared to December 31, 2011 and September 30, 2011, respectively), and allocations for loans that did not undergo a separate, independent concurrence review during the underwriting process (down \$796 thousand and \$805 thousand, in aggregate, at September 30, 2012 compared to December 31, 2011 and September 30, 2011, respectively). The increase in the aggregate allocation for excessive industry concentrations at September 30, 2012 compared to September 30, 2011 was partly related to new industry concentrations that were not considered to be excessive industry concentrations in 2011. The increase in the aggregate adjustment for recoveries reflects the recent trend of higher recoveries, primarily due to the higher level of charge-offs in recent years. The increase in the aggregate allocation for highly-leveraged transactions was primarily related to an increase in the volume of such loans. The decrease in the aggregate allocation for loans that did not undergo a separate, independent concurrence review during the underwriting process was primarily related to a decrease in the volume of such loans.

Table of Contents

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

	Three Months Ended			Nine Months Ended	
	September 30, 2012	June 30, 2012	September 30, 2011	September 30, 2012	September 30, 2011
Balance at beginning of period	\$ 105,648	\$ 107,181	\$ 122,741	\$ 110,147	\$ 126,316
Provision for loan losses	2,500	2,355	9,010	5,955	27,445
Charge-offs:					
Commercial and industrial	(5,837)	(4,474)	(15,085)	(13,323)	(28,258)
Commercial real estate	(520)	(353)	(1,689)	(3,715)	(10,261)
Consumer real estate	(209)	(606)	(834)	(1,104)	(2,113)
Consumer and other	(2,391)	(2,229)	(2,359)	(6,605)	(7,058)
Total charge-offs	(8,957)	(7,662)	(19,967)	(24,747)	(47,690)
Recoveries:					
Commercial and industrial	1,181	1,294	1,484	3,816	3,109
Commercial real estate	3,212	858	406	4,562	1,099
Consumer real estate	53	87	84	663	471
Consumer and other	1,764	1,535	1,675	5,005	4,683
Total recoveries	6,210	3,774	3,649	14,046	9,362
Net charge-offs	(2,747)	(3,888)	(16,318)	(10,701)	(38,328)
Balance at end of period	\$ 105,401	\$ 105,648	\$ 115,433	\$ 105,401	\$ 115,433
Ratio of allowance for loan losses to:					
Total loans	1.20%	1.24%	1.43%	1.20%	1.43%
Non-accrual loans	99.05	114.52	104.77	99.05	104.77
Ratio of annualized net charge-offs to					
average total loans	0.13	0.19	0.81	0.17	0.64

The provision for loan losses decreased \$6.5 million, or 72.3%, during the three months ended September 30, 2012 and decreased \$21.5 million, or 78.3%, during the nine months ended September 30, 2012 compared to the same periods in 2011. The level of the provision for loan losses during 2012 is reflective of the decreasing trend in classified loans and a decrease in net charge-offs. Net charge-offs during the three months ended September 30, 2012 decreased \$13.6 million while net charge-offs during the nine months ended September 30, 2012 decreased \$27.6 million, compared in each case, to the same periods in 2011. The overall trend in net charge-offs reflects the continued improvement in the level of classified loans. Net charge-offs for the third quarter of 2012 decreased \$1.1 million compared to the second quarter of 2012. The provision for loan losses increased \$145 thousand during the third quarter of 2012 compared to the second quarter of 2012, in part due to an increase in the overall volume of loans. The Corporation expects the level of net charge-offs to continue to trend downward as the overall credit quality of the loan portfolio continues to improve. The ratio of the allowance for loan losses to total loans decreased 18 basis points from 1.38% at December 31, 2011 to 1.20% at September 30, 2012. Management believes the recorded amount of the allowance for loan losses is appropriate based upon management's best estimate of probable losses that have been incurred within the existing portfolio of loans. Should any of the factors considered by management in evaluating the appropriate level of the allowance for loan losses change, the Corporation's estimate of probable loan losses could also change, which could affect the level of future provisions for loan losses.

Capital and Liquidity

Capital. Shareholders' equity totaled \$2.4 billion at September 30, 2012, \$2.3 billion at December 31, 2011 and \$2.2 billion at September 30, 2011. In addition to net income of \$177.8 million, other changes in shareholders' equity during the first nine months of 2012 included \$87.3 million of dividends paid, other comprehensive income, net of tax, of \$27.0 million, \$10.1 million in proceeds from stock option exercises and the related net tax deficiency of \$425 thousand and \$7.9 million related to stock-based compensation.

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

The accumulated other comprehensive income/loss component of shareholders' equity totaled a net, after-tax, unrealized gain of \$274.7 million at September 30, 2012 compared to a net, after-tax, unrealized gain of \$247.7 million at December 31, 2011. During the first nine months of 2012, a \$41.0 million net after-tax increase in the accumulated net unrealized gain on securities available for sale and a \$2.7 million net after-tax decrease in the accumulated net actuarial loss on defined-benefit post-retirement benefit plans was partly offset by a \$16.7 million net after-tax decrease in the accumulated net gain on

Table of Contents

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

The Corporation paid quarterly dividends of \$0.46, \$0.48 and \$0.48 per common share during the first, second and third quarters of 2012 and quarterly dividends of \$0.45, \$0.46 and \$0.46 per common share during the first, second and third quarters of 2011. This equates to a dividend payout ratio of 46.3%, 50.8% and 50.3% during the first, second and third quarters of 2012 and 53.1%, 50.7% and 51.7% during the first, second and third quarters of 2011.

From time to time, the Corporation's board of directors has authorized stock repurchase plans. Stock repurchase plans allow the Corporation to proactively manage its capital position and return excess capital to shareholders. Shares purchased under such plans also provide the Corporation with shares of common stock necessary to satisfy obligations related to stock compensation awards. No shares were repurchased under stock repurchase plans during any of the reported periods. See Part II, Item 2 - Unregistered Sales of Equity Securities and Use of Proceeds, included elsewhere in this report, for details of stock repurchases during the quarter.

Capital Proposals. In June 2012, the Corporation's primary federal regulator, the Federal Reserve, published two notices of proposed rulemaking (the 2012 Capital Proposals) that would substantially revise the risk-based capital requirements applicable to bank holding companies and depository institutions, including Cullen/Frost and Frost Bank, compared to the current U.S. risk-based capital rules, which are based on the international capital accords of the Basel Committee on Banking Supervision (the Basel Committee) generally referred to as Basel I. One of the 2012 Capital Proposals (the Basel III Proposal) deals with the components of capital and other issues affecting the numerator in banking institutions' regulatory capital ratios and would implement the Basel Committee's December 2010 framework known as Basel III for strengthening international capital standards. The other proposal (the Standardized Approach Proposal) deals with risk weights and other issues affecting the denominator in banking institutions' regulatory capital ratios and would replace the existing Basel I-derived risk-weighting approach with a more risk-sensitive approach based, in part, on the standardized approach in the Basel Committee's 2004 Basel II capital accords. The 2012 Capital Proposals would also implement the requirements of Section 939A of the Dodd-Frank Act to remove references to credit ratings from the federal banking agencies' rules. As proposed, the Basel III Proposal and the Standardized Approach Proposal would come into effect on January 1, 2013 (subject to a phase-in period) and January 1, 2015 (with an option for early adoption), respectively.

The federal banking agencies have not proposed rules implementing the final liquidity framework of Basel III and have not determined to what extent they will apply to U.S. banks that are not large, internationally active banks.

The Basel III Proposal is generally consistent with the final Basel III capital framework, as described in the Corporation's Annual Report on Form 10-K under Item 1. Business Supervision and Regulation Capital Requirements.

In addition to the requirements of the Basel III final capital framework, the Basel III Proposal, among other things requires the phase-out of certain hybrid securities, such as trust preferred securities, as Tier 1 capital of bank holding companies in equal installments between 2013 and 2016, consistent with Section 171 of the Dodd-Frank Act.

With respect to Frost Bank, the Basel III Proposal would also revise the prompt corrective action regulations pursuant to Section 38 of the Federal Deposit Insurance Act, by (i) introducing a Common Equity Tier 1 (CET1) ratio requirement at each level (other than critically undercapitalized), with the required CET1 ratio being 6.5% for well-capitalized status; (ii) increasing the minimum Tier 1 capital ratio requirement for each category, with the minimum Tier 1 capital ratio for well-capitalized status being 8% (as compared to the current 6%); and (iii) eliminating the current provision that provides that a bank with a composite supervisory rating of 1 may have a 3% leverage ratio and still be well capitalized.

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

Table of Contents

This proposal would expand the risk-weighting categories from the current four Basel I-derived categories (0%, 20%, 50% and 100%) to a much larger and more risk-sensitive number of categories, depending on the nature of the assets, generally ranging from 0% for U.S. government and agency securities, to 600% for certain equity exposures, and resulting in higher risk weights for a variety of asset categories, including many residential mortgages and certain commercial real estate. Specifics include, among other things:

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

For residential mortgage exposures, the current approach of a 50% risk weight for high-quality seasoned mortgages and a 100% risk-weight for all other mortgages is replaced with a risk weight of between 35% and 200% depending upon the mortgage's loan-to-value ratio and whether the mortgage is a category 1 or category 2 residential mortgage exposure (based on eight criteria that include the term, use of negative amortization, balloon payments and certain rate increases).

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

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

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

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

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

In addition, the Standardized Approach Proposal also provides more advantageous risk weights for derivatives and repurchase-style transactions cleared through a qualifying central counterparty and increases the scope of eligible guarantors and eligible collateral for purposes of credit risk mitigation.

Management believes that, as of September 30, 2012, Cullen/Frost and Frost Bank would meet all capital adequacy requirements under the Basel III and Standardized Approach Proposals on a fully phased-in basis if such requirements were currently effective. There can be no guarantee that the Basel III and the Standardized Approach Proposals will be adopted in their current form, what changes may be made before adoption, or when ultimate adoption will occur.

Liquidity. Liquidity measures the ability to meet current and future cash flow needs as they become due. The liquidity of a financial institution reflects its ability to meet loan requests, to accommodate possible outflows in deposits and to take advantage of interest rate market opportunities. The ability of a financial institution to meet its current financial obligations is a function of its balance sheet structure, its ability to liquidate assets and its access to alternative sources of funds. The objective of the Corporation's liquidity management is to manage cash flow and liquidity reserves so that they are adequate to fund the Corporation's operations and to meet obligations and other commitments on a timely basis and at a reasonable cost. The Corporation seeks to achieve this objective and ensure that funding needs are met by maintaining an appropriate level of liquid funds through asset/liability management, which includes managing the mix and time to maturity of financial assets and financial liabilities on the Corporation's balance sheet. The Company's liquidity position is enhanced by its ability to raise additional funds as needed in the wholesale markets.

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

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

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

The liquidity position of the Corporation is continuously monitored and adjustments are made to the balance between sources and uses of funds as deemed appropriate. Liquidity risk management is an important element in the Corporation's asset/liability management process. The Corporation regularly models liquidity stress scenarios to assess potential liquidity outflows or funding problems resulting from economic disruptions, volatility in the financial markets, unexpected credit events or other significant occurrences deemed problematic by management. These scenarios are incorporated into the Corporation's contingency funding plan, which provides the basis for the identification of the Corporation's liquidity needs. As of September 30, 2012, management is not aware of any events that are reasonably likely to have a material adverse effect on the Corporation's liquidity, capital resources or operations. In addition, management is not aware of any regulatory recommendations regarding liquidity, including the Basel III liquidity framework, which, if implemented, would have a material adverse effect on the Corporation.

Table of Contents

The Corporation's operating and strategic objectives include expansion, diversification within its markets, growth of its fee-based income, and growth internally and through acquisitions of financial institutions, branches and financial services businesses. The Corporation generally seeks merger or acquisition partners that are culturally similar and have experienced management and possess either significant market presence or have potential for improved profitability through financial management, economies of scale and expanded services. The Corporation regularly evaluates merger and acquisition opportunities and conducts due diligence activities related to possible transactions with other financial institutions and financial services companies. As a result, merger or acquisition discussions and, in some cases, negotiations may take place and future mergers or acquisitions involving cash, debt or equity securities may occur. Acquisitions typically involve the payment of a premium over book and market values, and, therefore, some dilution of the Corporation's tangible book value and net income per common share may occur in connection with any future transaction.

Since Cullen/Frost is a holding company and does not conduct operations, its primary sources of liquidity are dividends upstreamed from Frost Bank and borrowings from outside sources. Banking regulations may limit the amount of dividends that may be paid by Frost Bank. See Note 7 - Regulatory Matters in the accompanying notes to consolidated financial statements included elsewhere in this report regarding such dividends. At September 30, 2012, Cullen/Frost had liquid assets, including cash and resell agreements, totaling \$221.7 million, which included \$4.4 million in cash collateral on deposit with other financial institution counterparties to interest rate swap transactions.

Accounting Standards Updates

See Note 16 - Accounting Standards Updates in the accompanying notes to consolidated financial statements included elsewhere in this report for details of recently issued accounting pronouncements and their expected impact on the Corporation's financial statements.

Table of Contents**Consolidated Average Balance Sheets and Interest Income Analysis - Year-to-Date**

(Dollars in thousands taxable-equivalent basis)

	September 30, 2012			September 30, 2011		
	Average Balance	Interest Income/ Expense	Yield/ Cost	Average Balance	Interest Income/ Expense	Yield/ Cost
Assets:						
Interest-bearing deposits	\$ 1,379,857	\$ 2,948	0.29%	\$ 2,488,736	\$ 4,454	0.24%
Federal funds sold and resell agreements	24,310	75	0.41	14,662	44	0.40
Securities:						
Taxable	6,609,862	102,556	2.13	3,671,698	92,942	3.50
Tax-exempt	2,306,217	109,069	6.85	2,174,072	110,117	6.98
Total securities	8,916,079	211,625	3.31	5,845,770	203,059	4.80
Loans, net of unearned discounts	8,318,783	301,736	4.85	8,065,806	302,220	5.01
Total Earning Assets and Average Rate Earned	18,639,029	516,384	3.78	16,414,974	509,777	4.20
Cash and due from banks	560,471			614,113		
Allowance for loan losses	(108,887)			(124,540)		
Premises and equipment, net	322,379			316,421		
Accrued interest and other assets	1,033,033			1,007,915		
Total Assets	\$ 20,446,025			\$ 18,228,883		
Liabilities:						
Non-interest-bearing demand deposits:						
Commercial and individual	\$ 6,083,552			\$ 4,928,636		
Correspondent banks	325,819			324,247		
Public funds	388,380			288,478		
Total non-interest-bearing demand deposits	6,797,751			5,541,361		
Interest-bearing deposits:						
Private accounts						
Savings and interest checking	2,944,602	1,239	0.06	2,488,906	1,683	0.09
Money market deposit accounts	5,751,364	9,105	0.21	5,330,493	11,045	0.28
Time accounts	1,032,779	2,917	0.38	1,141,042	3,912	0.46
Public funds	385,042	456	0.16	415,331	563	0.18
Total interest-bearing deposits	10,113,787	13,717	0.18	9,375,772	17,203	0.25
Total deposits	16,911,538			14,917,133		
Federal funds purchased and repurchase agreements	619,185	105	0.02	579,813	277	0.06
Junior subordinated deferrable interest debentures	123,712	5,096	5.49	123,712	5,073	5.47
Subordinated notes payable and other notes	100,000	1,445	1.93	216,484	10,497	6.47
Federal Home Loan Bank advances	18	1	6.00	37	2	6.00
Total Interest-Bearing Funds and Average Rate Paid	10,956,702	20,364	0.25	10,295,818	33,052	0.43
Accrued interest and other liabilities	339,090			248,535		
Total Liabilities	18,093,543			16,085,714		

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

Shareholders Equity	2,352,482	2,143,169
Total Liabilities and Shareholders Equity	\$ 20,446,025	\$ 18,228,883
Net interest income	\$ 496,020	\$ 476,725
Net interest spread	3.53%	3.77%
Net interest income to total average earning assets	3.63%	3.93%

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

Table of Contents**Consolidated Average Balance Sheets and Interest Income Analysis-By-Quarter**

(Dollars in thousands - taxable-equivalent basis)

	September 30, 2012			June 30, 2012		
	Average Balance	Interest Income/Expense	Yield/Cost	Average Balance	Interest Income/Expense	Yield/Cost
Assets:						
Interest-bearing deposits	\$ 1,655,297	\$ 1,115	0.27%	\$ 1,380,380	\$ 903	0.26%
Federal funds sold and resell agreements	25,852	27	0.41	33,039	33	0.40
Securities:						
Taxable	6,460,229	32,091	2.05	6,705,624	34,399	2.11
Tax-exempt	2,441,874	37,606	6.69	2,218,519	35,440	6.94
Total securities	8,902,103	69,697	3.28	8,924,143	69,839	3.27
Loans, net of unearned discounts	8,635,181	103,129	4.75	8,267,721	99,776	4.85
Total Earning Assets and Average Rate Earned	19,218,433	173,968	3.68	18,605,283	170,551	3.75
Cash and due from banks	551,711			551,863		
Allowance for loan losses	(107,195)			(107,697)		
Premises and equipment, net	319,997			324,350		
Accrued interest and other assets	1,026,898			1,027,443		
Total Assets	\$ 21,009,844			\$ 20,401,242		
Liabilities:						
Non-interest-bearing demand deposits:						
Commercial and individual	\$ 6,486,325			\$ 6,116,737		
Correspondent banks	324,034			323,003		
Public funds	350,731			389,461		
Total non-interest-bearing demand deposits	7,161,090			6,829,201		
Interest-bearing deposits:						
Private accounts						
Savings and interest checking	3,034,198	398	0.05	2,944,130	416	0.06
Money market deposit accounts	5,853,895	3,116	0.21	5,716,406	3,020	0.21
Time accounts	1,024,817	932	0.36	1,028,597	959	0.37
Public funds	375,937	152	0.16	363,332	152	0.17
Total interest-bearing deposits	10,288,847	4,598	0.18	10,052,465	4,547	0.18
Total deposits	17,449,937			16,881,666		
Federal funds purchased and repurchase agreements	603,313	37	0.02	621,114	34	0.02
Junior subordinated deferrable interest debentures	123,712	1,711	5.53	123,712	1,711	5.53
Subordinated notes payable and other notes	100,000	281	1.12	100,000	287	1.15
Federal Home Loan Bank advances	14		6.00	18		6.00
Total Interest-Bearing Funds and Average Rate Paid	11,115,886	6,627	0.24	10,897,309	6,579	0.24
Accrued interest and other liabilities	340,131			327,559		
Total Liabilities	18,617,107			18,054,069		

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

Shareholders Equity	2,392,737	2,347,173
Total Liabilities and Shareholders Equity	\$ 21,009,844	\$ 20,401,242
Net interest income	\$ 167,341	\$ 163,972
Net interest spread	3.44%	3.51%
Net interest income to total average earning assets	3.54%	3.61%

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

Table of Contents**Consolidated Average Balance Sheets and Interest Income Analysis-By-Quarter**

(Dollars in thousands - taxable-equivalent basis)

	March 31, 2012			December 31, 2011		
	Average Balance	Interest Income/ Expense	Yield/ Cost	Average Balance	Interest Income/ Expense	Yield/ Cost
Assets:						
Interest-bearing deposits	\$ 1,100,867	\$ 930	0.34%	\$ 2,515,512	\$ 1,903	0.30%
Federal funds sold and resell agreements	14,021	15	0.43	14,055	17	0.48
Securities:						
Taxable	6,665,378	36,066	2.23	5,080,515	34,130	2.78
Tax-exempt	2,256,766	36,023	6.94	2,220,231	36,221	6.94
Total securities	8,922,144	72,089	3.37	7,300,746	70,351	4.02
Loans, net of unearned discounts	8,049,968	98,831	4.94	7,975,198	101,258	5.04
Total Earning Assets and Average Rate Earned	18,087,000	171,865	3.89	17,805,511	173,529	3.95
Cash and due from banks	577,936			545,367		
Allowance for loan losses	(111,788)			(117,006)		
Premises and equipment, net	322,831			321,776		
Accrued interest and other assets	1,044,067			1,023,297		
Total Assets	\$ 19,920,046			\$ 19,578,945		
Liabilities:						
Non-interest-bearing demand deposits:						
Commercial and individual	\$ 5,643,167			\$ 5,584,493		
Correspondent banks	330,440			327,053		
Public funds	425,363			413,854		
Total non-interest-bearing demand deposits	6,398,970			6,325,400		
Interest-bearing deposits:						
Private accounts						
Savings and interest checking	2,854,493	425	0.06	2,698,273	432	0.06
Money market deposit accounts	5,682,663	2,969	0.21	5,634,846	3,286	0.23
Time accounts	1,045,009	1,026	0.39	1,088,230	1,102	0.40
Public funds	415,959	152	0.15	382,349	156	0.16
Total interest-bearing deposits	9,998,124	4,572	0.18	9,803,698	4,976	0.20
Total deposits	16,397,094			16,129,098		
Federal funds purchased and repurchase agreements	633,303	34	0.02	644,662	35	0.02
Junior subordinated deferrable interest debentures	123,712	1,674	5.41	123,712	1,710	5.53
Subordinated notes payable and other notes	100,000	878	3.51	100,000	1,468	5.87
Federal Home Loan Bank advances	23		6.00	28		6.00
Total Interest-Bearing Funds and Average Rate Paid	10,855,162	7,158	0.26	10,672,100	8,189	0.31
Accrued interest and other liabilities	348,807			323,513		
Total Liabilities	17,602,939			17,321,013		

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

Shareholders Equity	2,317,107	2,257,932
Total Liabilities and Shareholders Equity	\$ 19,920,046	\$ 19,578,945
Net interest income	\$ 164,707	\$ 165,340
Net interest spread	3.63%	3.64%
Net interest income to total average earning assets	3.73%	3.76%

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

Table of Contents**Consolidated Average Balance Sheets and Interest Income Analysis-By-Quarter**

(Dollars in thousands - taxable-equivalent basis)

	September 30, 2011		
	Average Balance	Interest Income/ Expense	Yield/ Cost
Assets:			
Interest-bearing deposits	\$ 3,243,562	\$ 1,811	0.22%
Federal funds sold and resell agreements	15,957	15	0.38
Securities:			
Taxable	3,538,329	30,089	3.57
Tax-exempt	2,219,092	36,916	6.98
Total securities	5,757,421	67,005	4.88
Loans, net of unearned discounts	8,036,183	101,166	4.99
Total Earning Assets and Average Rate Earned	17,053,123	169,997	4.03
Cash and due from banks	582,192		
Allowance for loan losses	(120,908)		
Premises and equipment, net	318,443		
Accrued interest and other assets	992,153		
Total Assets	\$ 18,825,003		
Liabilities:			
Non-interest-bearing demand deposits:			
Commercial and individual	\$ 5,232,235		
Correspondent banks	319,471		
Public funds	353,660		
Total non-interest-bearing demand deposits	5,905,366		
Interest-bearing deposits:			
Private accounts			
Savings and interest checking	2,527,855	430	0.07
Money market deposit accounts	5,501,921	3,498	0.25
Time accounts	1,122,534	1,211	0.43
Public funds	371,440	167	0.18
Total interest-bearing deposits	9,523,750	5,306	0.22
Total deposits	15,429,116		
Federal funds purchased and repurchase agreements	645,794	63	0.04
Junior subordinated deferrable interest debentures	123,712	1,710	5.53
Subordinated notes payable and other notes	150,543	2,338	6.21
Federal Home Loan Bank advances	33	1	6.00
Total Interest-Bearing Funds and Average Rate Paid	10,443,832	9,418	0.36
Accrued interest and other liabilities	267,016		

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

Total Liabilities	16,616,214
Shareholders' Equity	2,208,789
Total Liabilities and Shareholders' Equity	\$ 18,825,003
Net interest income	\$ 160,579
Net interest spread	3.67%
Net interest income to total average earning assets	3.81%

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

Table of Contents**Item 3. Quantitative and Qualitative Disclosures About Market Risk**

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

Refer to the discussion of market risks included in Item 7A. Quantitative and Qualitative Disclosures About Market Risk in the 2011 Form 10-K. There has been no significant change in the types of market risks faced by the Corporation since December 31, 2011.

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

For modeling purposes, as of September 30, 2012, the model simulations projected that 100 and 200 basis point increases in interest rates would result in negative variances in net interest income of 1.0% and 1.1%, respectively, relative to the base case over the next 12 months, while a decrease in interest rates of 25 basis points would result in a negative variance in net interest income of 1.7% relative to the base case over the next 12 months. The September 30, 2012 model simulations were impacted by the assumption, for modeling purposes, that the Corporation will begin to pay interest on demand deposits in the fourth quarter of 2012, as further discussed below. As of September 30, 2011, the model simulations projected that a 100 basis point increase in interest rates would result in a positive variance in net interest income of 0.4% and a 200 basis point increase in interest rates would result in negative variance in net interest income of 0.6% relative to the base case over the next 12 months, while a decrease in interest rates of 25 basis points would result in a negative variance in net interest income of 1.5% relative to the base case over the next 12 months. The likelihood of a decrease in interest rates beyond 25 basis points as of September 30, 2012 and 2011 was considered remote given prevailing interest rate levels.

The Corporation has experienced significant growth in deposits in 2012 compared to 2011 which funded a significant increase in fixed-rate securities. This increase in fixed-rate securities coupled with the assumption, for modeling purposes, that the Corporation will begin paying interest on demand deposits that were previously non-interest-bearing as a result of recent legislation, as further discussed below, resulted in the model simulations indicating that the Corporation's balance sheet will become more liability sensitive relative to the base case over the next 12 months.

As mentioned above, financial regulatory reform legislation entitled the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act) repealed the federal prohibition on the payment of interest on demand deposits, thereby permitting depository institutions to pay interest on business transaction and other accounts beginning July 21, 2011. Although the ultimate impact of this legislation on the Corporation has not yet been determined, the Corporation may begin to incur interest costs associated with demand deposits in the future as market conditions warrant. If this were to occur, the Corporation's balance sheet would likely become more liability sensitive. Because the interest rate that will ultimately be paid on these demand deposits depends upon a variety of factors, some of which are beyond the Corporation's control, the Corporation assumed an aggressive pricing structure for the purposes of the model simulations discussed above with interest payments beginning in the fourth quarter of 2012. Should the actual interest rate paid on demand deposits be less than the rate assumed in the model simulations, or should the interest rate paid for such deposits become an administered rate with less direct correlation to movements in general market interest rates, the Corporation's balance sheet could be less liability sensitive than the model simulations currently indicate.

As of September 30, 2012, the effects of a 200 basis point increase and a 25 basis point decrease in interest rates on the Corporation's derivative holdings would not result in a significant variance in the Corporation's net interest income.

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

Table of Contents

Item 4. Controls and Procedures

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

Table of Contents**Part II. Other Information****Item 1. Legal Proceedings**

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

Item 1A. Risk Factors

There has been no material change in the risk factors previously disclosed under Item 1A. of the Corporation's 2011 Form 10-K.

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

The following table provides information with respect to purchases made by or on behalf of the Corporation or any affiliated purchaser (as defined in Rule 10b-18(a)(3) under the Securities Exchange Act of 1934), of the Corporation's common stock during the three months ended September 30, 2012.

Period	Total Number of Shares Purchased	Average Price Paid Per Share	Total Number of Shares Purchased as Part of Publicly Announced Plan	Maximum Number of Shares That May Yet Be Purchased Under the Plan at the End of the Period
July 1, 2012 to July 31, 2012		\$		
August 1, 2012 to August 31, 2012				
September 1, 2012 to September 30, 2012				
Total		\$		

Item 3. Defaults Upon Senior Securities

None.

Item 4. Mine Safety Disclosures

None.

Item 5. Other Information

None.

Item 6. Exhibits

(a) Exhibits

Exhibit Number	Description
31.1	Rule 13a-14(a) Certification of the Corporation's Chief Executive Officer
31.2	Rule 13a-14(a) Certification of the Corporation's Chief Financial Officer
32.1+	Section 1350 Certification of the Corporation's Chief Executive Officer
32.2+	Section 1350 Certification of the Corporation's Chief Financial Officer
101	Interactive Data File
+	This exhibit shall not be deemed filed for purposes of Section 18 of the Securities Exchange Act of 1934, or otherwise subject to the liability of that section, and shall not be deemed to be incorporated by reference into any filing under the Securities Act of 1933 or the Securities Exchange Act of 1934.

Table of Contents

Signatures

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

Cullen/Frost Bankers, Inc.
(Registrant)

Date: October 24, 2012

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