

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

FORM 10-Q

☒ 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 000-09439

INTERNATIONAL BANCSHARES CORPORATION
(Exact name of registrant as specified in its charter)

Texas
(State or other jurisdiction of
incorporation or organization)

74-2157138
(I.R.S. Employer Identification No.)

1200 San Bernardo Avenue, Laredo, Texas 78042-1359
(Address of principal executive offices)
(Zip Code)

(956) 722-7611
(Registrant's telephone number, including area code)

None
(Former name, former address and former fiscal year, if changed since last report)

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

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

Indicate by check mark if 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.

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

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date

Class	Shares Issued and Outstanding
Common Stock, \$1.00 par value	67,222,937 shares outstanding at October 31, 2012

PART I - FINANCIAL INFORMATION

Item 1. Financial Statements

INTERNATIONAL BANCSHARES CORPORATION AND SUBSIDIARIES

Consolidated Statements of Condition (Unaudited)

(Dollars in Thousands)

	September 30, 2012	December 31, 2011
Assets		
Cash and due from banks	\$ 260,091	\$ 261,885
Investment securities:		
Held-to-maturity (Market value of \$2,400 on September 30, 2012 and \$2,450 on December 31, 2011)	2,400	2,450
Available-for-sale (Amortized cost of \$5,595,919 on September 30, 2012 and \$5,082,095 on December 31, 2011)	5,725,035	5,213,915
Total investment securities	5,727,435	5,216,365
Loans	4,883,028	5,053,475
Less allowance for probable loan losses	(72,681)	(84,192)
Net loans	4,810,347	4,969,283
Bank premises and equipment, net	453,304	453,050
Accrued interest receivable	30,486	32,002
Other investments	354,156	351,209
Identified intangible assets, net	8,887	12,190
Goodwill, net	282,532	282,532
Other assets	189,502	161,133
Total assets	\$ 12,116,740	\$ 11,739,649

INTERNATIONAL BANCSHARES CORPORATION AND SUBSIDIARIES

Consolidated Statements of Condition, continued (Unaudited)

(Dollars in Thousands)

	September 30, 2012	December 31, 2011
Liabilities and Shareholders' Equity		
Liabilities:		
Deposits:		
Demand — non-interest bearing	\$ 2,109,495	\$ 1,927,018
Savings and interest bearing demand	2,684,755	2,707,693
Time	<u>3,196,921</u>	<u>3,311,381</u>
Total deposits	7,991,171	7,946,092
Securities sold under repurchase agreements	1,173,612	1,348,629
Other borrowed funds	615,061	494,161
Junior subordinated deferrable interest debentures	190,726	190,726
Other liabilities	<u>540,829</u>	<u>159,876</u>
Total liabilities	<u>10,511,399</u>	<u>10,139,484</u>
Commitments, Contingent Liabilities and Other Tax Matters (Note 10)		
Shareholders' equity:		
Series A Cumulative perpetual preferred shares, \$.01 par value, \$1,000 per share liquidation value. Authorized 25,000,000 shares; issued 176,000 shares on September 30, 2012, net of discount of \$2,821, and issued 216,000 shares on December 31, 2011, net of discount of \$5,452	173,179	210,548
Common shares of \$1.00 par value. Authorized 275,000,000 shares; issued 95,723,817 shares on September 30, 2012 and 95,719,652 shares on December 31, 2011	95,724	95,720
Surplus	163,173	162,767
Retained earnings	1,347,892	1,302,964
Accumulated other comprehensive income (including \$(7,083) and \$(6,889) of comprehensive loss related to other-than-temporary impairment for non-credit related issues)	<u>83,258</u>	<u>84,959</u>
	1,863,226	1,856,958
Less cost of shares in treasury, 28,501,180 shares on September 30, 2012 and 28,441,714 December 31, 2011	<u>(257,885)</u>	<u>(256,793)</u>
Total shareholders' equity	<u>1,605,341</u>	<u>1,600,165</u>
Total liabilities and shareholders' equity	<u>\$ 12,116,740</u>	<u>\$ 11,739,649</u>

See accompanying notes to consolidated financial statements.

INTERNATIONAL BANCSHARES CORPORATION AND SUBSIDIARIES

Consolidated Statements of Income (Unaudited)

(Dollars in Thousands, except per share data)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Interest income:				
Loans, including fees	\$ 67,254	\$ 72,461	\$ 202,990	\$ 221,715
Investment securities:				
Taxable	23,388	28,427	71,128	87,890
Tax-exempt	2,972	2,694	8,682	7,208
Other interest income	<u>161</u>	<u>41</u>	<u>440</u>	<u>1,792</u>
Total interest income	<u>93,775</u>	<u>103,623</u>	<u>283,240</u>	<u>318,605</u>
Interest expense:				
Savings deposits	1,074	1,732	4,176	6,226
Time deposits	5,910	7,636	18,650	24,551
Securities sold under repurchase agreements	8,811	10,608	29,380	31,807
Other borrowings	195	332	541	1,427
Junior subordinated interest deferrable debentures	<u>1,430</u>	<u>2,771</u>	<u>5,378</u>	<u>8,806</u>
Total interest expense	<u>17,420</u>	<u>23,079</u>	<u>58,125</u>	<u>72,817</u>
Net interest income	76,355	80,544	225,115	245,788
Provision for probable loan losses	<u>5,349</u>	<u>5,670</u>	<u>16,741</u>	<u>7,833</u>
Net interest income after provision for probable loan losses	<u>71,006</u>	<u>74,874</u>	<u>208,374</u>	<u>237,955</u>
Non-interest income:				
Service charges on deposit accounts	23,748	24,205	69,601	72,905
Other service charges, commissions and fees				
Banking	9,492	13,749	28,980	41,187
Non-banking	2,038	1,677	4,971	4,346
Gain on investment securities transactions, net	32,935	6,587	35,527	9,448
Other investments, net	3,650	2,749	11,431	12,325
Other income	<u>2,144</u>	<u>2,244</u>	<u>7,493</u>	<u>7,230</u>
Total non-interest income	<u>74,007</u>	<u>51,211</u>	<u>158,003</u>	<u>147,441</u>

INTERNATIONAL BANCSHARES CORPORATION AND SUBSIDIARIES

Consolidated Statements of Income, continued (Unaudited)

(Dollars in Thousands, except per share data)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Non-interest expense:				
Employee compensation and benefits	\$ 30,541	\$ 32,034	\$ 90,152	\$ 96,689
Occupancy	8,032	10,640	24,873	28,256
Depreciation of bank premises and equipment	6,618	8,491	20,335	24,749
Professional fees	4,279	3,698	11,820	11,273
Deposit insurance assessments	2,289	2,472	5,346	7,521
Net expense, other real estate owned	3,065	1,954	5,631	11,218
Amortization of identified intangible assets	1,163	1,324	3,463	3,950
Advertising	1,713	1,794	5,510	5,421
Early termination fee — securities sold under repurchase agreements	31,550	—	31,550	—
Impairment charges (Total other-than-temporary impairment losses, \$(402), net of \$(641), \$152, net of \$(134), \$947, net of \$300, and \$1,206, net of \$505, included in other comprehensive income)	239	286	647	701
Other	16,955	17,597	47,351	49,919
Total non-interest expense	106,444	80,290	246,678	239,697
Income before income taxes	38,569	45,795	119,699	145,699
Provision for income taxes	12,691	15,164	37,584	48,923
Net income	25,878	30,631	82,115	96,776
Preferred stock dividends	3,845	3,324	10,543	9,944
Net income available to common shareholders	\$ 22,033	\$ 27,307	\$ 71,572	\$ 86,832
Basic earnings per common share:				
Weighted average number of shares outstanding:	67,225,701	67,423,857	67,246,793	67,583,449
Net income	\$.33	\$.41	\$ 1.06	\$ 1.28
Fully diluted earnings per common share:				
Weighted average number of shares outstanding:	67,301,701	67,469,889	67,326,856	67,645,411
Net income	\$.33	\$.40	\$ 1.06	\$ 1.28

See accompanying notes to consolidated financial statements.

INTERNATIONAL BANCSHARES CORPORATION AND SUBSIDIARIES

Consolidated Statements of Comprehensive Income (Unaudited)

(Dollars in Thousands)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Net income	\$ 25,878	\$ 30,631	\$ 82,115	\$ 96,776
Other comprehensive income (loss), net of tax				
Net unrealized holding gains on securities available for sale arising during period (net of tax effects of \$10,897, \$7,125, \$11,292 and \$39,003)	20,238	13,232	20,971	72,433
Reclassification adjustment for gains on securities available for sale included in net income (net of tax effects of \$(11,527), \$(2,306), \$(12,434) and \$(3,307))	(21,408)	(4,281)	(23,093)	(6,141)
Reclassification adjustment for impairment charges on available for sale securities included in net income (net of tax effects of \$84, \$100, \$226 and \$245)	155	186	421	456
	(1,015)	9,137	(1,701)	66,748
Comprehensive income	\$ 24,863	\$ 39,768	\$ 80,414	\$ 163,524

See accompanying notes to consolidated financial statements.

INTERNATIONAL BANCSHARES CORPORATION AND SUBSIDIARIES

Consolidated Statements of Cash Flows (Unaudited)

(Dollars in Thousands)

	Nine Months Ended September 30,	
	2012	2011
Operating activities:		
Net income	\$ 82,115	\$ 96,776
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for probable loan losses	16,741	7,833
Specific reserve, other real estate owned	2,032	8,075
Accretion of time deposit discounts	—	(11)
Depreciation of bank premises and equipment	20,335	24,749
Gain on sale of bank premises and equipment	(734)	(267)
Gain on sale of other real estate owned	(239)	(49)
Accretion of investment securities discounts	(2,346)	(1,387)
Amortization of investment securities premiums	20,290	13,968
Investment securities transactions	(35,527)	(9,448)
Impairment charges on available-for-sale investment securities	647	701
Amortization of junior subordinated debenture discounts	—	9
Amortization of identified intangible assets	3,463	3,950
Stock based compensation expense	366	280
Earnings from affiliates and other investments	(8,836)	(11,542)
Deferred tax expense	2,267	766
Decrease in accrued interest receivable	1,516	5,481
Net (increase) decrease in other assets	(271)	48,944
Net increase in other liabilities	16,793	7,976
Net cash provided by operating activities	<u>118,612</u>	<u>196,804</u>
Investing activities:		
Proceeds from maturities of held-to-maturity securities	1,125	1,300
Proceeds from sales and calls of available for sale securities	1,279,963	926,869
Purchases of available for sale securities	(2,383,774)	(1,596,603)
Principal collected on mortgage-backed securities	955,550	703,618
Net decrease in loans	86,501	181,902
Purchases of other investments	(2,956)	(1,941)
Distributions received on other investments	8,845	23,504
Purchases of bank premises and equipment	(23,650)	(13,450)
Proceeds from sales of other real estate owned	25,643	7,477
Proceeds from sale of bank premises and equipment	<u>3,795</u>	<u>1,180</u>
Net cash (used in) provided by investing activities	<u>(48,958)</u>	<u>233,856</u>

INTERNATIONAL BANCSHARES CORPORATION AND SUBSIDIARIES

Consolidated Statements of Cash Flows, continued (Unaudited)

(Dollars in Thousands)

	Nine Months Ended September 30,	
	2012	2011
Financing activities:		
Net increase in non-interest bearing demand deposits	\$ 182,477	\$ 163,707
Net (decrease) increase in savings and interest bearing demand deposits	(22,938)	102,312
Net decrease in time deposits	(114,460)	(111,980)
Net decrease in securities sold under repurchase agreements	(175,017)	(46,453)
Net increase (decrease) in other borrowed funds	120,900	(469,036)
Repayment of long-term debt	—	(10,400)
Purchase of treasury stock	(1,092)	(6,333)
Redemption of senior preferred shares	(40,000)	—
Proceeds from stock transactions	43	112
Payments of dividends on common stock	(13,450)	(12,864)
Payments of dividends on preferred stock	(7,911)	(8,100)
Net cash used in financing activities	(71,448)	(399,035)
(Decrease) increase in cash and cash equivalents	(1,794)	31,625
Cash and cash equivalents at beginning of period	261,885	197,814
Cash and cash equivalents at end of period	<u>\$ 260,091</u>	<u>\$ 229,439</u>
Supplemental cash flow information:		
Interest paid	\$ 60,651	\$ 75,533
Income taxes paid	22,271	45,022
Non-cash investing and financing activities:		
Accrued dividends, preferred shares	1,100	1,350
Dividends declared, not yet paid on common stock	13,445	12,784
Net transfer from loans to other real estate owned	55,694	46,119
Purchases of available-for-sale securities not yet settled	442,240	—
Sales of securities available-for-sale not yet settled	—	2,027

See accompanying notes to consolidated financial statements.

INTERNATIONAL BANCSHARES CORPORATION AND SUBSIDIARIES

Notes to Consolidated Financial Statements

(Unaudited)

Note 1 - Basis of Presentation

The accounting and reporting policies of International Bancshares Corporation (“Corporation”) and Subsidiaries (the Corporation and Subsidiaries collectively referred to herein as the “Company”) conform to accounting principles generally accepted in the United States of America and to general practices within the banking industry. The consolidated financial statements include the accounts of the Corporation and its wholly-owned subsidiaries, International Bank of Commerce, Laredo (“IBC”), Commerce Bank, International Bank of Commerce, Zapata, International Bank of Commerce, Brownsville and the Corporation’s wholly-owned non-bank subsidiaries, IBC Subsidiary Corporation, IBC Life Insurance Company, IBC Trading Company, IBC Capital Corporation and Premier Tierra Holdings, Inc. All significant inter-company balances and transactions have been eliminated in consolidation. The consolidated financial statements are unaudited, but include all adjustments, which, in the opinion of management, are necessary for a fair presentation of the results of the periods presented. All such adjustments were of a normal and recurring nature. It is suggested that these financial statements be read in conjunction with the financial statements and the notes thereto in the Company’s latest Annual Report on Form 10-K. The consolidated statement of condition at December 31, 2011 has been derived from the audited financial statements at that date but does not include all of the information and footnotes required by accounting principles generally accepted in the United States of America for complete financial statements. Certain reclassifications have been made to make prior periods comparable.

The Company operates as one segment. The operating information used by the Company’s chief executive officer for purposes of assessing performance and making operating decisions about the Company is the consolidated statements presented in this report. The Company has four active operating subsidiaries, namely, the bank subsidiaries, otherwise known as International Bank of Commerce, Laredo, Commerce Bank, International Bank of Commerce, Zapata and International Bank of Commerce, Brownsville.

The Company has evaluated all events or transactions that occurred through the date the Company issued these financial statements. During this period, the Company did not have any material recognizable or non-recognizable subsequent events.

Note 2 — Fair Value Measurements

ASC Topic 820, “Fair Value Measurements and Disclosures” (“ASC 820”) defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. ASC 820 applies to all financial instruments that are being measured and reported on a fair value basis. ASC 820 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date; it also establishes a fair value hierarchy that prioritizes the inputs used in valuation methodologies into the following three levels:

- Level 1 Inputs — Unadjusted quoted prices in active markets for identical assets or liabilities.
- Level 2 Inputs — Observable inputs other than Level 1 prices, such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities.
- Level 3 Inputs — Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities. Level 3 assets and liabilities include financial instruments whose value is determined using pricing models, discounted cash flow methodologies, or other valuation techniques, as well as instruments for which the determination of fair value requires significant management judgment or estimation.

A description of the valuation methodologies used for instruments measured at fair value, as well as the general classification of such instruments pursuant to the valuation hierarchy is set forth below.

The following table represents assets and liabilities reported on the consolidated balance sheets at their fair value on a recurring basis as of September 30, 2012 by level within the fair value measurement hierarchy:

		Fair Value Measurements at Reporting Date Using		
		(in thousands)		
	Assets/Liabilities Measured at Fair Value September 30, 2012	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
<i>Measured on a recurring basis:</i>				
Assets:				
Available for sale securities				
Residential mortgage-backed securities	\$ 5,467,308	\$ —	\$ 5,433,020	\$ 34,288
States and political subdivisions	236,469	—	236,469	—
Other	21,258	21,258	—	—
Total	<u>\$ 5,725,035</u>	<u>\$ 21,258</u>	<u>\$ 5,669,489</u>	<u>\$ 34,288</u>

The following table represents assets and liabilities reported on the consolidated balance sheets at their fair value on a recurring basis as of December 31, 2011 by level within the fair value measurement hierarchy:

		Fair Value Measurements at Reporting Date Using		
		(in thousands)		
	Assets/Liabilities Measured at Fair Value December 31, 2011	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
<i>Measured on a recurring basis:</i>				
Assets:				
Available for sale securities				
Residential mortgage-backed securities	\$ 4,969,263	\$ —	\$ 4,929,658	\$ 39,605
States and political subdivisions	224,761	—	224,761	—
Other	19,891	19,891	—	—
Total	<u>\$ 5,213,915</u>	<u>\$ 19,891</u>	<u>\$ 5,154,419</u>	<u>\$ 39,605</u>

Investment securities available-for-sale are classified within level 2 and level 3 of the valuation hierarchy, with the exception of certain equity investments that are classified within level 1. For investments classified as level 2 in the fair value hierarchy, the Company obtains fair value measurements for investment securities from an independent pricing service. The fair value measurements consider observable data that may include dealer quotes, market spreads, cash flows, the U.S. Treasury yield curve, live trading levels, trade execution data, market consensus prepayment speeds, credit information and the bond’s terms and conditions, among other things. Investment securities classified as level 3 are non-agency mortgage-backed securities. The non-agency mortgage-backed securities held by the Company are traded in inactive markets and markets that have experienced significant decreases in volume and level of activity, as evidenced by few recent transactions, a significant decline or absence of new issuances, price quotations that are not based on comparable securities transactions and wide bid-ask spreads among other factors. As a result of the inability to use quoted market prices to determine fair value for these securities, the Company determined that fair value, as determined by level 3 inputs in the fair value hierarchy, is more appropriate for financial reporting and more consistent with the expected performance of the investments. For the investments classified within level 3 of the fair value hierarchy, the Company used a discounted cash flow model to determine fair value. Inputs in the model included both historical performance and expected future performance based on information currently available.

Assumptions used in the discounted cash flow model for the quarter and nine months ended September 30, 2012, were applied separately to those portions of the bond where the underlying residential mortgage loans had been performing under original contract terms for at least the prior 24 months and those where the underlying residential mortgages had not been meeting the original contractual obligation for the same period. Unobservable inputs included in the model are estimates on future principal prepayment rates, and default and loss severity rates. For that portion of the bond where the underlying residential mortgage had been meeting the original contract terms for at least 24 months, the Company used the following estimates in the model: (i) a voluntary prepayment rate of 7%, (ii) a 1% default rate, (iii) a loss severity rate of 25%, and (iv) a discount rate of 13%. The assumptions used in the model for the rest of the bond included the following estimates: (i) a voluntary prepayment rate of 2%, (ii) a default rate of 9%, (iii) a loss severity rate that starts at 60% for the first year then declines by 5% for the following five years and remains at 25% thereafter, and (iv) a discount rate of 13%. The estimates used in the model to determine fair value are based on observable historical data of the underlying collateral. The model anticipates that the housing market will gradually improve and that the underlying collateral will eventually all perform in accordance with the original contract terms on the bond. Should the number of loans in the underlying collateral that default and go into foreclosure or the severity of the losses in the underlying collateral significantly change, the results of the model would be impacted. The Company will continue to evaluate the actual historical performance of the underlying collateral and will modify the assumptions used in the model as necessary. As actual historical information has become more widely available to investors, the Company determined that this approach to the model was appropriate and therefore, modified the model that had been used in prior periods. The change did not significantly impact the results of the model.

Assumptions used in the model for the year ended December 31, 2011, included estimates on future principal prepayment rates, default and loss severity rates. The Company estimates that future principal prepayment rates will range from 4 — 5% and used a 13% discount rate. Default rates used in the model were 10 — 11% for the first year and 7% thereafter, and loss severity rates started at 60% for the first year and are decreased by 10% for the following three years, then remain at 20% thereafter.

The following table presents a reconciliation of activity for such mortgage-backed securities on a net basis (dollars in thousands):

Balance at December 31, 2011	\$ 39,605
Principal paydowns	(4,370)
Total unrealized losses included in:	
Other comprehensive income	(300)
Impairment realized in earnings	(647)
Balance at September 30, 2012	<u>\$ 34,288</u>

Certain assets and liabilities are measured at fair value on a nonrecurring basis. They 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).

The following table represents assets measured at fair value on a non-recurring basis as of and for the period ended September 30, 2012 by level within the fair value measurement hierarchy:

	Fair Value Measurements at Reporting Date				
	Using				
	(in thousands)				
Assets/Liabilities Measured at Fair Value Nine months ended September 30, 2012	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	(Credit) Provision During Period	
Measured on a non-recurring basis:					
Assets:					
Impaired loans	\$ 12,451	\$ —	\$ —	\$ 12,451	\$ (581)
Other real estate owned	7,469	—	—	7,469	1,874

The following table represents assets measured at fair value on a non-recurring basis as of and for the year ended December 31, 2011 by level within the fair value measurement hierarchy:

	Fair Value Measurements at Reporting Date				
	Using				
	(in thousands)				
Assets/Liabilities Measured at Fair Value Year ended December 31, 2011	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Provision During Period	
Measured on a non-recurring basis:					
Assets:					
Impaired loans	\$ 81,723	\$ —	\$ —	\$ 81,723	\$ 15,457
Other real estate owned	34,631	—	—	34,631	9,509

The Company's assets measured at fair value on a non-recurring basis are limited to impaired loans and other real estate owned. Impaired loans are classified within level 3 of the valuation hierarchy. The fair value of impaired loans is derived in accordance with FASB ASC 310, "Receivables". The fair value of impaired loans is based on the fair value of the collateral, as determined through an external appraisal process, discounted based on internal criteria. Impaired loans are primarily comprised of collateral-dependent commercial loans. Impaired loans are remeasured and reported at fair value through a specific valuation allowance allocation of the allowance for probable loan losses based upon the fair value of the underlying collateral.

Other real estate owned is comprised of real estate acquired by foreclosure and deeds in lieu of foreclosure. Other real estate owned is carried at the lower of the recorded investment in the property or its fair value less estimated costs to sell such property (as determined by independent appraisal) within level 3 of the fair value hierarchy. Prior to foreclosure, the value of the underlying loan is written down to the fair value of the real estate to be acquired by a charge to the allowance for probable loan losses, if necessary. The fair value is reviewed periodically and subsequent write downs are made accordingly through a charge to operations. Other real estate owned is included in other assets on the consolidated financial statements. For the nine months ended September 30, 2012 and the twelve months ended December 31, 2011, the Company recorded \$16,727,000 and \$1,100,000 in charges to the allowance for probable loan losses in connection with loans transferred to other real estate owned. For the nine months ended September 30, 2012 and twelve months ended December 31, 2011, the Company recorded charges to operations of \$1,874,000 and \$9,509,000 related to write downs in fair value in connection with other real estate owned.

The fair value estimates, methods, and assumptions for the Company's financial instruments at September 30, 2012 and December 31, 2011 are outlined below.

Cash and Due From Banks and Federal Funds Sold

For these short-term instruments, the carrying amount is a reasonable estimate of fair value.

Time Deposits with Banks

The carrying amounts of time deposits with banks approximate fair value.

Investment Securities Held-to-Maturity

The carrying amounts of investments held-to-maturity approximate fair value.

Investment Securities

For investment securities, which include U.S. Treasury securities, obligations of other U.S. government agencies, obligations of states and political subdivisions and mortgage pass through and related securities, fair values are from an independent pricing service. The fair value measurements consider observable data that may include dealer quotes, market spreads, cash flows, the U.S. Treasury yield curve, live trading levels, trade execution data, market consensus prepayment speeds, credit information and the bond's terms and conditions, among other things. See disclosures of fair value of investment securities in Note 6.

Loans

Fair values are estimated for portfolios of loans with similar financial characteristics. Loans are segregated by type such as commercial, real estate and consumer loans as outlined by regulatory reporting guidelines. Each category is segmented into fixed and variable interest rate terms and by performing and non-performing categories.

For variable rate performing loans, the carrying amount approximates the fair value. For fixed rate performing loans, excluding impaired loans and residential mortgage loans, the fair value is calculated by discounting scheduled cash flows through the estimated maturity using estimated market discount rates that reflect the credit and interest rate risk inherent in the loan. For performing residential mortgage loans, fair value is estimated by discounting contractual cash flows adjusted for prepayment estimates using discount rates based on secondary market sources or the primary origination market. Fixed rate performing loans are within Level 2 of the fair value hierarchy. At September 30, 2012, and December 31, 2011, the carrying amount of fixed rate performing loans was \$1,190,987,000 and \$1,273,989,000 respectively, and the estimated fair value was \$1,125,280,000 and \$1,200,837,000, respectively.

Accrued Interest

The carrying amounts of accrued interest approximate fair value.

Deposits

The fair value of deposits with no stated maturity, such as non-interest bearing demand deposit accounts, savings accounts and interest bearing demand deposit accounts, was equal to the amount payable on demand as of September 30, 2012 and December 31, 2011. The fair value of time deposits is based on the discounted value of contractual cash flows. The discount rate is based on currently offered rates. Time deposits are within Level 2 of the fair value hierarchy. At September 30, 2012 and December 31, 2011, the carrying amount of time deposits was \$3,196,921,000 and \$3,311,381,000, respectively, and the estimated fair value was \$3,206,909,000 and \$3,323,680,000, respectively.

Securities Sold Under Repurchase Agreements

Securities sold under repurchase agreements include both short and long-term maturities. Due to the contractual terms of the short-term instruments, the carrying amounts approximated fair value at September 30, 2012 and December 31, 2011. The fair value of the long-term instruments is based on established market spreads using option adjusted spreads methodology. Long-term repurchase agreements are within level 2 of the fair value hierarchy. At September 30, 2012 and December 31, 2011, the carrying amount of long-term repurchase agreements was \$800,000,000 and \$1,000,000,000, respectively, and the estimated fair value was \$937,543,000 and \$1,161,849,000, respectively.

Junior Subordinated Deferrable Interest Debentures

The Company currently has floating rate junior subordinated deferrable interest debentures outstanding. Due to the contractual terms of the floating rate junior subordinated deferrable interest debentures, the carrying amounts approximated fair value at September 30, 2012 and December 31, 2011. As of December 31, 2011, the Company had fixed rate junior subordinated deferrable interest debentures that converted from fixed to floating rate at various dates in 2012. The fair value of the fixed rate junior subordinated deferrable interest debentures was based on established market spreads to similar debt instruments with similar characteristics to the debentures. The fixed rate junior subordinated deferrable interest debentures were within level 2 of the fair value hierarchy. At December 31, 2011, the carrying amount of fixed rate junior subordinated deferrable interest debentures was \$87,630,000, and the estimated fair value was \$43,403,000.

Other Borrowed Funds

The company currently has short and long-term borrowings issued from the Federal Home Loan Bank ("FHLB"). Due to the contractual terms of the short-term borrowings, the carrying amounts approximated fair value at September 30, 2012 and December 31, 2011. The fair value of the long-term borrowings is based on established market spreads for similar types of borrowings. The long-term borrowings are included in Level 2 of the fair value hierarchy. At September 30, 2012 and December 31, 2011, the carrying amount of the long-term FHLB borrowings was \$6,561,000, and \$6,661,000, respectively, and the estimated fair value was \$7,348,000 and \$6,998,000, respectively.

Commitments to Extend Credit and Letters of Credit

Commitments to extend credit and fund letters of credit are principally at current interest rates, and, therefore, the carrying amount approximates fair value.

Limitations

Fair value estimates are made at a point in time, based on relevant market information and information about the financial instrument. These estimates do not reflect any premium or discount that could result from offering for sale at one time the Company's entire holdings of a particular financial instrument. Because no market exists for a significant portion of the Company's financial instruments, fair value estimates are based on judgments regarding future expected loss experience, current economic conditions, risk characteristics of various financial instruments and other factors. These estimates are subjective in nature and involve uncertainties and matters of significant judgment and therefore cannot be determined with precision. Changes in assumptions could significantly affect the estimates.

Fair value estimates are based on existing on-and off-statement of condition financial instruments without attempting to estimate the value of anticipated future business and the value of assets and liabilities that are not considered financial instruments. Other significant assets and liabilities that are not considered financial assets or liabilities include the bank premises and equipment and core deposit value. In addition, the tax ramifications related to the effect of fair value estimates have not been considered in the above estimates.

Note 3— Loans

A summary of loans, by loan type at September 30, 2012 and December 31, 2011 is as follows:

	September 30, 2012	December 31, 2011
	(Dollars in Thousands)	
Commercial, financial and agricultural	\$ 2,585,180	\$ 2,560,102
Real estate — mortgage	833,139	895,870
Real estate — construction	1,192,273	1,273,389
Consumer	79,454	94,109
Foreign	192,982	230,005
Total loans	<u>\$ 4,883,028</u>	<u>\$ 5,053,475</u>

Note 4 - Allowance for Probable Loan Losses

The allowance for probable loan losses primarily consists of the aggregate loan loss allowances of the bank subsidiaries. The allowances are established through charges to operations in the form of provisions for probable loan losses. Loan losses or recoveries are charged or credited directly to the allowances. The allowance for probable loan losses of each bank subsidiary is maintained at a level considered appropriate by management, based on estimated probable losses in the loan portfolio. The allowance for probable loan losses is derived from the following elements: (i) allowances established on specific impaired loans, which are based on a review of the individual characteristics of each loan, including the customer’s ability to repay the loan, the underlying collateral values, and the industry in which the customer operates, (ii) allowances based on actual historical loss experience for similar types of loans in the Company’s loan portfolio, and (iii) allowances based on general economic conditions, changes in the mix of loans, company resources, border risk and credit quality indicators, among other things. All segments of the loan portfolio continue to be impacted by the prolonged economic downturn. Loans secured by real estate could be impacted negatively by the continued economic environment and resulting decrease in collateral values. Consumer loans may be impacted by continued and prolonged unemployment rates.

The Company’s management continually reviews the allowance for loan losses of the bank subsidiaries using the amounts determined from the allowances established on specific loans, the allowance established on quantitative historical loss percentages, and the allowance based on qualitative data to establish an appropriate amount to maintain in the Company’s allowance for loan losses. Should any of the factors considered by management in evaluating the adequacy of the allowance for probable loan losses change, the Company’s estimate of probable loan losses could also change, which could affect the level of future provisions for probable loan losses. While the calculation of the allowance for probable loan losses utilizes management’s best judgment and all information available, the adequacy of the allowance is dependent on a variety of factors beyond the Company’s control, including, among other things, the performance of the entire loan portfolio, the economy, changes in interest rates and the view of regulatory authorities towards loan classifications.

The specific loan loss provision is determined using the following methods. On a weekly basis, loan past due reports are reviewed by the servicing loan officer to determine if a loan has any potential problems and if a loan should be placed on the Company’s internal classified report. Additionally, the Company’s credit department reviews the majority of the Company’s loans regardless of whether they are past due and segregates any loans with potential problems for further review. The credit department will discuss the potential problem loans with the servicing loan officers to determine any relevant issues that were not discovered in the evaluation. Also, an analysis of loans that is provided through examinations by regulatory authorities is considered in the review process. After the above analysis is completed, the Company will determine if a loan should be placed on an internal classified report because of issues related to the analysis of the credit, credit documents, collateral and/or payment history.

A summary of the transactions in the allowance for probable loan losses by loan class is as follows:

	Quarter ended September 30, 2012									
	Domestic							Foreign		
	Commercial	Commercial real estate: other construction & land development	Commercial real estate: farmland & commercial	Commercial real estate: multifamily	Residential: first lien	Residential: junior lien	Consumer	Foreign	Total	
(Dollars in Thousands)										
Balance at June 30,	\$ 24,688	\$ 13,242	\$ 20,551	\$ 803	\$ 3,987	\$ 4,410	\$ 1,476	\$ 1,221	\$ 70,378	
Losses charge to allowance	(3,521)	(3)	(1)	—	(63)	(282)	(159)	(7)	(4,036)	
Recoveries credited to allowance	821	13	32	—	4	62	58	—	990	
Net losses charged to allowance	(2,700)	10	31	—	(59)	(220)	(101)	(7)	(3,046)	
Provision (credit) charged to operations	3,312	44	1,138	(27)	272	626	31	(47)	5,349	
Balance at September 30,	<u>\$ 25,300</u>	<u>\$ 13,296</u>	<u>\$ 21,720</u>	<u>\$ 776</u>	<u>\$ 4,200</u>	<u>\$ 4,816</u>	<u>\$ 1,406</u>	<u>\$ 1,167</u>	<u>\$ 72,681</u>	
	Quarter ended September 30, 2011									
	Domestic							Foreign		
	Commercial	Commercial real estate: other construction & land development	Commercial real estate: farmland & commercial	Commercial real estate: multifamily	Residential: first lien	Residential: junior lien	Consumer	Foreign	Total	
(Dollars in Thousands)										
Balance at June 30,	\$ 20,627	\$ 20,076	\$ 21,328	\$ 854	\$ 6,110	\$ 5,533	\$ 2,378	\$ 1,575	\$ 78,481	
Losses charge to allowance	(5,054)	(240)	(1,310)	—	(42)	(413)	(180)	—	(7,239)	
Recoveries credited to allowance	1,311	59	41	—	1	15	63	4	1,494	
Net losses charged to allowance	(3,743)	(181)	(1,269)	—	(41)	(398)	(117)	4	(5,745)	
Provision (credit) charged to operations	2,696	(1,613)	3,885	195	(270)	991	(143)	(71)	5,670	
Balance at September 30,	<u>\$ 19,580</u>	<u>\$ 18,282</u>	<u>\$ 23,944</u>	<u>\$ 1,049</u>	<u>\$ 5,799</u>	<u>\$ 6,126</u>	<u>\$ 2,118</u>	<u>\$ 1,508</u>	<u>\$ 78,406</u>	

Nine Months Ended September 30, 2012									
Domestic								Foreign	
Commercial	Commercial real estate: other construction & land development	Commercial real estate: farmland & commercial	Commercial real estate: multifamily	Residential: first lien	Residential: junior lien	Consumer	Foreign	Total	
(Dollars in Thousands)									
Balance at									
December 31,	\$ 26,617	\$ 19,940	\$ 24,227	\$ 1,003	\$ 4,562	\$ 4,760	\$ 1,724	\$ 1,359	\$ 84,192
Losses charge to allowance	(10,009)	(7,574)	(12,477)	—	(129)	(993)	(595)	(12)	(31,789)
Recoveries credited to allowance	2,823	225	163	—	7	168	151	—	3,537
Net losses charged to allowance	(7,186)	(7,349)	(12,314)	—	(122)	(825)	(444)	(12)	(28,252)
Provision (credit) charged to operations	5,869	705	9,807	(227)	(240)	881	126	(180)	16,741
Balance at September 30,	<u>\$ 25,300</u>	<u>\$ 13,296</u>	<u>\$ 21,720</u>	<u>\$ 776</u>	<u>\$ 4,200</u>	<u>\$ 4,816</u>	<u>\$ 1,406</u>	<u>\$ 1,167</u>	<u>\$ 72,681</u>
Nine Months Ended September 30, 2011									
Domestic								Foreign	
Commercial	Commercial real estate: other construction & land development	Commercial real estate: farmland & commercial	Commercial real estate: multifamily	Residential: first lien	Residential: junior lien	Consumer	Foreign	Total	
(Dollars in Thousands)									
Balance at									
December 31,	\$ 22,046	\$ 26,695	\$ 16,340	\$ 53	\$ 10,059	\$ 2,611	\$ 6,241	\$ 437	\$ 84,482
Losses charge to allowance	(11,873)	(1,458)	(1,955)	—	(701)	(979)	(750)	(13)	(17,729)
Recoveries credited to allowance	2,982	133	235	—	5	279	181	5	3,820
Net losses charged to allowance	(8,891)	(1,325)	(1,720)	—	(696)	(700)	(569)	(8)	(13,909)
Provision (credit) charged to operations	6,425	(7,088)	9,324	996	(3,564)	4,215	(3,554)	1,079	7,833
Balance at September 30,	<u>\$ 19,580</u>	<u>\$ 18,282</u>	<u>\$ 23,944</u>	<u>\$ 1,049</u>	<u>\$ 5,799</u>	<u>\$ 6,126</u>	<u>\$ 2,118</u>	<u>\$ 1,508</u>	<u>\$ 78,406</u>

The allowance for probable loan losses is a reserve established through a provision for probable loan losses charged to expense, which represents management’s best estimate of probable loan losses when evaluating loans (i) individually or (ii) collectively.

The table below provides additional information on the balance of loans individually or collectively evaluated for impairment and their related allowance, by loan class as of September 30, 2012 and December 31, 2011:

	September 30, 2012			
	Loans individually evaluated for impairment		Loans collectively evaluated for impairment	
	(Dollars in Thousands)			
	Recorded Investment	Allowance	Recorded Investment	Allowance
Domestic				
Commercial	\$ 23,516	\$ 13,966	\$ 793,200	\$ 11,334
Commercial real estate: other construction & land development	33,949	568	1,158,324	12,728
Commercial real estate: farmland & commercial	20,882	3,234	1,650,049	18,486
Commercial real estate: multifamily	368	—	97,165	776
Residential: first lien	3,487	23	447,821	4,177
Residential: junior lien	1,857	—	379,974	4,816
Consumer	1,273	—	78,181	1,406
Foreign	92	—	192,890	1,167
Total	<u>\$ 85,424</u>	<u>\$ 17,791</u>	<u>\$ 4,797,604</u>	<u>\$ 54,890</u>
	December 31, 2011			
	Loans individually evaluated for impairment		Loans collectively evaluated for impairment	
	(Dollars in Thousands)			
	Recorded Investment	Allowance	Recorded Investment	Allowance
Domestic				
Commercial	\$ 27,603	\$ 14,402	\$ 746,213	\$ 12,215
Commercial real estate: other construction & land development	60,428	3,073	1,212,961	16,867
Commercial real estate: farmland & commercial	42,231	9,754	1,622,456	14,473
Commercial real estate: multifamily	411	—	121,188	1,003
Residential: first lien	2,290	23	493,432	4,539
Residential: junior lien	1,962	—	398,186	4,760
Consumer	1,334	—	92,775	1,724
Foreign	46	—	229,959	1,359
Total	<u>\$ 136,305</u>	<u>\$ 27,252</u>	<u>\$ 4,917,170</u>	<u>\$ 56,940</u>

The table below provides additional information on loans accounted for on a non-accrual basis by loan class at September 30, 2012 and December 31, 2011:

	<u>September 30, 2012</u>	<u>December 31, 2011</u>
	(Dollars in Thousands)	
Domestic		
Commercial	\$ 22,662	\$ 26,819
Commercial real estate: other construction & land development	31,698	54,336
Commercial real estate: farmland & commercial	18,619	34,910
Commercial real estate: multifamily	368	411
Residential: first lien	1,796	1,848
Residential: junior lien	235	135
Consumer	42	46
Foreign	47	—
Total non-accrual loans	<u>\$ 75,467</u>	<u>\$ 118,505</u>

Impaired loans are those loans where it is probable that all amounts due according to contractual terms of the loan agreement will not be collected. The Company has identified these loans through its normal loan review procedures. Impaired loans are measured based on (1) the present value of expected future cash flows discounted at the loan’s effective interest rate; (2) the loan’s observable market price; or (3) the fair value of the collateral if the loan is collateral dependent. Substantially all of the Company’s impaired loans are measured at the fair value of the collateral. In limited cases the Company may use other methods to determine the level of impairment of a loan if such loan is not collateral dependent.

The following tables detail key information regarding the Company’s impaired loans by loan class at September 30, 2012 and December 31, 2011:

	September 30, 2012							
			Quarter to Date			Year to Date		
	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Recognized	Average Recorded Investment	Interest Recognized	
	(Dollars in Thousands)							
Loans with Related Allowance								
Domestic								
Commercial	\$ 22,704	\$ 22,704	\$ 13,966	\$ 22,729	\$ 10	\$ 22,517	\$ 29	
Commercial real estate: other construction & land development	3,671	3,671	568	3,671	—	23,479	—	
Commercial real estate: farmland & commercial	6,284	9,439	3,234	7,117	23	11,518	69	
Residential: first lien	197	276	23	198	—	202	—	
Total impaired loans with related allowance	\$ 32,856	\$ 36,090	\$ 17,791	\$ 33,715	\$ 33	\$ 57,716	\$ 98	

	September 30, 2012					
	Recorded Investment	Unpaid Principal Balance	Quarter to Date		Year to Date	
			Average Recorded Investment	Interest Recognized	Average Recorded Investment	Interest Recognized
			(Dollars in Thousands)			
Loans with No Related Allowance						
Domestic						
Commercial	\$ 812	\$ 956	\$ 840	\$ 1	\$ 538	\$ 3
Commercial real estate: other construction & land development	30,278	30,417	26,689	23	27,632	122
Commercial real estate: farmland & commercial	14,598	15,315	14,069	—	14,850	8
Commercial real estate: multifamily	368	368	374	—	388	—
Residential: first lien	3,290	3,402	2,957	15	2,485	31
Residential: junior lien	1,857	1,950	1,836	25	1,958	79
Consumer	1,273	1,276	1,271	—	1,149	—
Foreign	92	92	92	—	61	1
Total impaired loans with no related allowance	\$ 52,568	\$ 53,776	\$ 48,128	\$ 64	\$ 49,061	\$ 244

	December 31, 2011				
	Recorded Investment	Unpaid Principal Balance	Related Allowance	Year to Date	
				Average Recorded Investment	Interest Recognized
	(Dollars in Thousands)				
Loans with Related Allowance					
Domestic					
Commercial	\$ 24,108	\$ 24,108	\$ 14,402	\$ 24,145	\$ 41
Commercial real estate: other construction & land development	34,417	34,432	3,073	34,709	—
Commercial real estate: farmland & commercial	28,636	28,671	9,754	28,883	817
Residential: first lien	208	208	23	214	—
Total impaired loans with related allowance	<u>\$ 87,369</u>	<u>\$ 87,419</u>	<u>\$ 27,252</u>	<u>\$ 87,951</u>	<u>\$ 858</u>

	December 31, 2011			
	Recorded Investment	Unpaid Principal Balance	Year to Date	
			Average Recorded Investment	Interest Recognized
	(Dollars in Thousands)			
Loans with No Related Allowance				
Domestic				
Commercial	\$ 3,495	\$ 3,932	\$ 3,942	\$ 20
Commercial real estate: other construction & land development	26,011	26,112	27,722	128
Commercial real estate: farmland & commercial	13,595	15,394	16,271	102
Commercial real estate: multifamily	411	411	439	—
Residential: first lien	2,082	2,220	2,230	27
Residential: junior lien	1,962	1,970	1,980	118
Consumer	1,334	1,338	1,729	—
Foreign	46	46	46	4
Total impaired loans with no related allowance	\$ 48,936	\$ 51,423	\$ 54,359	\$ 399

The following tables detail key information regarding the Company’s average recorded investment in impaired loans and interest recognized on impaired loans by loan class at September 30, 2011:

September 30, 2011				
	Quarter to Date		Year to Date	
	Average Recorded Investment	Interest Recognized	Average Recorded Investment	Interest Recognized
(Dollars in Thousands)				
Loans with Related Allowance				
Domestic				
Commercial	\$ 23,007	\$ 10	\$ 23,036	\$ 30
Commercial real estate: other construction & land development	34,258	—	31,132	—
Commercial real estate: farmland & commercial	24,833	194	22,759	607
Residential: first lien	389	—	1,205	—
Total impaired loans with related allowance	<u>\$ 82,487</u>	<u>\$ 204</u>	<u>\$ 78,132</u>	<u>\$ 637</u>

September 30, 2011				
	Quarter to Date		Year to Date	
	Average Recorded Investment	Interest Recognized (Dollars in Thousands)	Average Recorded Investment	Interest Recognized
Loans with No Related Allowance				
Domestic				
Commercial	\$ 572	\$ —	\$ 459	\$ —
Commercial real estate: other construction & land development	21,153	58	25,972	58
Commercial real estate: farmland & commercial	11,686	48	7,487	48
Commercial real estate: multifamily	432	—	447	—
Residential: first lien	1,470	10	1,720	15
Residential: junior lien	1,725	34	1,749	86
Consumer	1,288	—	1,192	—
Foreign	—	—	2	—
Total impaired loans with no related allowance	<u>\$ 38,326</u>	<u>\$ 150</u>	<u>\$ 39,028</u>	<u>\$ 207</u>

The level of impaired loans is reflective of the economic weakness that has been created by the financial crisis and the subsequent economic downturn. Management's decision to place a loan in this category does not mean that losses will occur. In the current environment, troubled loan management can be protracted because of legal and process problems that delay the collection of an otherwise collectible loan. From time to time, the bank subsidiaries foreclose on property by transferring title of the property used as collateral for a loan as a means of paying off the debt when all other means of repayment are extinguished. For the nine months ended September 30, 2012, the level of impaired other construction and land development loans and commercial real estate and farmland loans was significantly impacted primarily by the transfer of loans to other assets through the foreclosure process when compared to balances at December 31, 2011. Management is confident the Company's loss exposure regarding these credits will be significantly reduced due to the Company's long-standing practices that emphasize secured lending with strong collateral positions and guarantor support. Management is likewise confident the reserve for probable loan losses is adequate. The Company has no direct exposure to sub-prime loans in its loan portfolio, but the sub-prime crisis has affected the credit markets on a national level, and as a result, the Company has experienced an increasing amount of impaired loans; however, management's decision to place loans in this category does not necessarily mean that the Company will experience significant losses from these loans or significant increases in impaired loans from these levels.

Management of the Company recognizes the risks associated with these impaired loans. Additionally, management believes that the collateral related to these impaired loans and/or the secondary support from guarantors mitigates the potential for losses from impaired loans. It is also important to note that even though the economic conditions in Texas and Oklahoma are weakened, we believe these markets are improving and better positioned to recover than many other areas of the country. Loans accounted for as "troubled debt restructuring," which are included in impaired loans, were not significant.

The bank subsidiaries charge off that portion of any loan which management considers to represent a loss as well as that portion of any other loan which is classified as a "loss" by bank examiners. Commercial and industrial or real estate loans are generally considered by management to represent a loss, in whole or part, when an exposure beyond any collateral coverage is apparent and when no further collection of the loss portion is anticipated based on the borrower's financial condition and general economic conditions in the borrower's industry. Generally, unsecured consumer loans are charged-off when 90 days past due.

While management of the Company considers that it is generally able to identify borrowers with financial problems reasonably early and to monitor credit extended to such borrowers carefully, there is no precise method of predicting loan losses. The determination that a loan is likely to be uncollectible and that it should be wholly or partially charged-off as a loss is an exercise of judgment. Similarly, the determination of the adequacy of the allowance for probable loan losses can be made only on a subjective basis. It is the judgment of the Company’s management that the allowance for probable loan losses at September 30, 2012 was adequate to absorb probable losses from loans in the portfolio at that date.

The following table presents information regarding the aging of past due loans by loan class at September 30, 2012 and December 31, 2011:

	September 30, 2012						
	30 – 59 Days	60 – 89 Days	90 Days or Greater	90 Days or greater & still accruing (Dollars in Thousands)	Total Past due	Current	Total Portfolio
Domestic							
Commercial	\$ 6,497	\$ 6,764	\$ 24,902	\$ 24,239	\$ 38,163	\$ 778,553	\$ 816,716
Commercial real estate: other construction & land development	3,855	25,458	18,716	864	48,029	1,144,244	1,192,273
Commercial real estate: farmland & commercial	3,288	2,298	8,486	537	14,072	1,656,859	1,670,931
Commercial real estate: multifamily	161	—	504	137	665	96,868	97,533
Residential: first lien	3,754	2,272	10,892	9,470	16,918	434,390	451,308
Residential: junior lien	1,007	354	442	223	1,803	380,028	381,831
Consumer	1,926	348	809	793	3,083	76,371	79,454
Foreign	2,194	931	151	104	3,276	189,706	192,982
Total past due loans	<u>\$ 22,682</u>	<u>\$ 38,425</u>	<u>\$ 64,902</u>	<u>\$ 36,367</u>	<u>\$126,009</u>	<u>\$ 4,757,019</u>	<u>\$ 4,883,028</u>

December 31, 2011							
	30 – 59 Days	60 – 89 Days	90 Days or Greater	90 Days or greater & still accruing (Dollars in Thousands)	Total Past due	Current	Total Portfolio
Domestic							
Commercial	\$ 5,180	\$ 1,369	\$ 1,842	\$ 1,490	\$ 8,391	\$ 765,425	\$ 773,816
Commercial real estate: other construction & land development	23,426	4,360	49,887	979	77,673	1,195,716	1,273,389
Commercial real estate: farmland & commercial	9,467	10,269	7,879	1,231	27,615	1,637,072	1,664,687
Commercial real estate: multifamily	450	—	411	—	861	120,738	121,599
Residential: first lien	6,207	2,757	10,295	9,382	19,259	476,463	495,722
Residential: junior lien	1,433	378	368	320	2,179	397,969	400,148
Consumer	1,643	408	912	866	2,963	91,146	94,109
Foreign	666	53	20	20	739	229,266	230,005
Total past due loans	<u>\$ 48,472</u>	<u>\$ 19,594</u>	<u>\$ 71,614</u>	<u>\$ 14,288</u>	<u>\$ 139,680</u>	<u>\$ 4,913,795</u>	<u>\$ 5,053,475</u>

The Company's internal classified report is segregated into the following categories: (i) "Special Review Credits," (ii) "Watch List - Pass Credits," or (iii) "Watch List - Substandard Credits." The loans placed in the "Special Review Credits" category reflect the Company's opinion that the loans reflect potential weakness which require monitoring on a more frequent basis. The "Special Review Credits" are reviewed and discussed on a regular basis with the credit department and the lending staff to determine if a change in category is warranted. The loans placed in the "Watch List - Pass Credits" category reflect the Company's opinion that the credit contains weaknesses which represent a greater degree of risk, which warrant "extra attention." The "Watch List — Pass Credits" are reviewed and discussed on a regular basis with the credit department and the lending staff to determine if a change in category is warranted. The loans placed in the "Watch List — Substandard Credits" classification are considered to be potentially inadequately protected by the current sound worth and debt service capacity of the borrower or of any pledged collateral. These credit obligations, even if apparently protected by collateral value, have shown defined weaknesses related to adverse financial, managerial, economic, market or political conditions which may jeopardize repayment of principal and interest. Furthermore, there is the possibility that some future loss could be sustained by the Company if such weaknesses are not corrected. For loans that are classified as impaired, management evaluates these credits under Statement of Financial Accounting Standards No. 114, "Accounting by Creditors for Impairment of a Loan," now included as part of ASC 310-10, "Receivables," criteria and, if deemed necessary, a specific reserve is allocated to the credit. The specific reserve allocated under ASC 310-10, is based on (i) the present value of expected future cash flows discounted at the loan's effective interest rate; (ii) the loan's observable market price; or (iii) the fair value of the collateral if the loan is collateral dependent. Substantially all of the Company's loans evaluated as impaired under ASC 310-10 are measured using the fair value of collateral method. In limited cases, the Company may use other methods to determine the specific reserve of a loan under ASC 310-10 if such loan is not collateral dependent.

The allowance based on historical loss experience on the Company's remaining loan portfolio, which includes the "Special Review Credits," "Watch List - Pass Credits," and "Watch List - Substandard Credits" is determined by segregating the remaining loan portfolio into certain categories such as commercial loans, installment loans, international loans, loan concentrations and overdrafts. Installment loans are then further segregated by number of days past due. A historical loss percentage, adjusted for (i) management's evaluation of changes in lending policies and procedures, (ii) current economic conditions in the market area served by the Company, (iii) other risk factors, (iv) the effectiveness of the internal loan review function, (v) changes in loan portfolios, and (vi) the composition and concentration of credit volume is applied to each category. Each category is then added together to determine the allowance allocated under ASC 450-20.

A summary of the loan portfolio by credit quality indicator by loan class at September 30, 2012 and December 31, 2011 is as follows:

		September 30, 2012								
		Pass	Special Review	Watch List - Pass	Watch List - Substandard	Watch List - Impaired				
		(Dollars in Thousands)								
Domestic										
Commercial	\$	698,626	\$	5,154	\$	4,956	\$	84,464	\$	23,516
Commercial real estate: other construction & land development		1,116,692		14,810		6,711		20,111		33,949
Commercial real estate: farmland & commercial		1,500,498		87,246		41,935		20,370		20,882
Commercial real estate: multifamily		97,111		—		—		54		368
Residential: first lien		440,959		526		—		6,336		3,487
Residential: junior lien		378,087		78		309		1,500		1,857
Consumer		78,146		—		35		—		1,273
Foreign		192,852		—		38		—		92
Total	\$	4,502,971	\$	107,814	\$	53,984	\$	132,835	\$	85,424
		December 31, 2011								
		Pass	Special Review	Watch List - Pass	Watch List - Substandard	Watch List - Impaired				
		(Dollars in Thousands)								
Domestic										
Commercial	\$	655,154	\$	5,279	\$	6,361	\$	79,419	\$	27,603
Commercial real estate: other construction & land development		1,058,843		76,722		11,083		66,313		60,428
Commercial real estate: farmland & commercial		1,449,822		83,581		40,510		48,543		42,231
Commercial real estate: multifamily		121,188		—		—		—		411
Residential: first lien		490,924		132		974		1,402		2,290
Residential: junior lien		397,861		—		319		6		1,962
Consumer		92,714		—		41		20		1,334
Foreign		229,898		—		61		—		46
Total	\$	4,496,404	\$	165,714	\$	59,349	\$	195,703	\$	136,305

Note 5 — Stock Options

On April 5, 2012, the Board of Directors adopted the 2012 International Bancshares Corporation Stock Option Plan (the “2012 Plan”), subject to shareholder approval of the 2012 Plan. The Company’s shareholders approved the 2012 Plan on May 21, 2012. There are 800,000 shares available for stock option grants under the 2012 Plan. The 2005 International Bancshares Corporation Stock Option Plan (the “2005 Plan”) was terminated for the purpose of future stock option grants upon adoption of the 2012 Plan. Under the 2012 Plan, both qualified incentive stock options (“ISOs”) and non-qualified stock options (“NQSOs”) may be granted. Options granted may be exercisable for a period of up to 10 years from the date of grant, excluding ISOs granted to 10% shareholders, which may be exercisable for a period of up to only five years. As of September 30, 2012, 800,000 shares were available for future grants under the 2012 Plan.

A summary of option activity under the stock option plans for the nine months ended September 30, 2012 is as follows:

	<u>Number of options</u>	<u>Weighted average exercise price</u>	<u>Weighted average remaining contractual term (years)</u>	<u>Aggregate intrinsic value (\$)</u>
				(Dollars in Thousands)
Options outstanding at December 31, 2011	844,721	\$ 19.08		
Plus: Options granted	—	—		
Less:				
Options exercised	4,165	10.40		
Options expired	—	—		
Options forfeited	75,951	19.31		
Options outstanding at September 30, 2012	<u>764,605</u>	19.11	3.79	\$ 2,478
Options fully vested and exercisable at September 30, 2012	396,303	\$ 23.82	1.88	\$ 472

Stock-based compensation expense included in the consolidated statements of income for the three and nine months ended September 30, 2012 was approximately \$113,000 and \$366,000, respectively. Stock-based compensation expense included in the consolidated statements of income for the three and nine months ended September 30, 2011 was approximately \$85,000 and \$280,000, respectively. As of September 30, 2012, there was approximately \$947,000 of total unrecognized stock-based compensation cost related to non-vested options granted under the Company plans that will be recognized over a weighted average period of 1.76 years.

Note 6 - Investment Securities

The Company classifies debt and equity securities into one of three categories: held-to maturity, available-for-sale, or trading. Such securities are reassessed for appropriate classification at each reporting date. Securities classified as “held-to-maturity” are carried at amortized cost for financial statement reporting, while securities classified as “available-for-sale” and “trading” are carried at their fair value. Unrealized holding gains and losses are included in net income for those securities classified as “trading”, while unrealized holding gains and losses related to those securities classified as “available-for-sale” are excluded from net income and reported net of tax as other comprehensive income (loss) and accumulated other comprehensive income (loss) until realized, or in the case of losses, when deemed other than temporary.

The amortized cost and estimated fair value by type of investment security at September 30, 2012 are as follows:

	<u>Held to Maturity</u>			
	<u>Amortized cost</u>	<u>Gross unrealized gains</u>	<u>Gross unrealized losses</u>	<u>Estimated fair value</u>
				<u>Carrying value</u>
				(Dollars in Thousands)
Other securities	\$ 2,400	\$ —	\$ —	\$ 2,400
Total investment securities	<u>\$ 2,400</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ 2,400</u>

	Available for Sale				
	Amortized cost	Gross unrealized gains	Gross unrealized losses	Estimated fair value	Carrying value (1)
	(Dollars in Thousands)				
Residential mortgage-backed securities	\$ 5,360,990	\$ 118,970	\$ (12,652)	\$ 5,467,308	\$ 5,467,308
Obligations of states and political subdivisions	215,354	22,564	(1,449)	236,469	236,469
Equity securities	19,575	1,705	(22)	21,258	21,258
Total investment securities	<u>\$ 5,595,919</u>	<u>\$ 143,239</u>	<u>\$ (14,123)</u>	<u>\$ 5,725,035</u>	<u>\$ 5,725,035</u>

(1) Included in the carrying value of residential mortgage-backed securities are \$2,182,038 of mortgage-backed securities issued by Ginnie Mae, \$3,250,982 of mortgage-backed securities issued by Fannie Mae and Freddie Mac and \$34,288 issued by non-government entities

The amortized cost and estimated fair value by type of investment security at December 31, 2011 are as follows:

	Held to Maturity				
	Amortized cost	Gross unrealized gains	Gross unrealized losses	Estimated fair value	Carrying value
	(Dollars in Thousands)				
Other securities	\$ 2,450	\$ —	\$ —	\$ 2,450	\$ 2,450
Total investment securities	<u>\$ 2,450</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ 2,450</u>	<u>\$ 2,450</u>

	Available for Sale				
	Amortized cost	Gross unrealized gains	Gross unrealized losses	Estimated fair value	Carrying value (1)
	(Dollars in Thousands)				
Residential mortgage-backed securities	\$ 4,851,747	\$ 128,196	\$ (10,680)	\$ 4,969,263	\$ 4,969,263
Obligations of states and political subdivisions	211,523	14,449	(1,211)	224,761	224,761
Equity securities	18,825	1,115	(49)	19,891	19,891
Total investment securities	<u>\$ 5,082,095</u>	<u>\$ 143,760</u>	<u>\$ (11,940)</u>	<u>\$ 5,213,915</u>	<u>\$ 5,213,915</u>

(1) Included in the carrying value of residential mortgage-backed securities are \$3,008,935 of mortgage-backed securities issued by Ginnie Mae, \$1,920,723 of mortgage-backed securities issued by Fannie Mae and Freddie Mac and \$39,605 issued by non-government entities

The amortized cost and estimated fair value of investment securities at September 30, 2012, by contractual maturity, are shown below. Expected maturities will differ from contractual maturities because borrowers may have the right to prepay obligations with or without prepayment penalties.

	Held to Maturity		Available for Sale	
	Amortized Cost	Estimated fair value	Amortized Cost	Estimated fair value
	(Dollars in Thousands)			
Due in one year or less	\$ —	\$ —	\$ —	\$ —
Due after one year through five years	2,400	2,400	—	—
Due after five years through ten years	—	—	1,281	1,387
Due after ten years	—	—	214,073	235,082
Residential mortgage-backed securities	—	—	5,360,990	5,467,308
Equity securities	—	—	19,575	21,258
Total investment securities	<u>\$ 2,400</u>	<u>\$ 2,400</u>	<u>\$ 5,595,919</u>	<u>\$ 5,725,035</u>

Residential mortgage-backed securities are securities issued by Freddie Mac, Fannie Mae, Ginnie Mae or non-government entities. Investments in residential mortgage-backed securities issued by Ginnie Mae are fully guaranteed by the U.S. Government. Investments in mortgage-backed securities issued by Freddie Mac and Fannie Mae are not fully guaranteed by the U.S. Government, however, the Company believes that the quality of the bonds is similar to other AAA rated bonds with limited credit risk, particularly given the placement of Fannie Mae and Freddie Mac into conservatorship by the federal government in early September 2008.

The amortized cost and fair value of available for sale investment securities pledged to qualify for fiduciary powers, to secure public monies as required by law, repurchase agreements and short-term fixed borrowings was \$2,338,166,000 and \$2,417,979,000 at September 30, 2012.

Proceeds from the sale of securities available-for-sale were \$1,207,581,000 and \$1,279,963,000 for the three and nine months ended September 30, 2012, which included \$1,205,556,000 and \$1,237,071,000 of mortgage-backed securities. Gross gains of \$32,935,000 and \$35,528,000 and gross losses of \$0 and \$(1,000) were realized on the sales for the three and nine months ended September 30, 2012, respectively. Proceeds from the sale of securities available-for-sale were \$152,013,000 and \$926,869,000 for the three and nine months ended September 30, 2011, which included \$150,325,000 and \$920,569,000 of mortgage-backed securities. Gross gains of \$6,588,000 and \$9,481,000 and gross losses of \$(1,000) and \$(33,000) were realized on the sales for the three and nine months ended September 30, 2011, respectively.

Gross unrealized losses on investment securities and the fair value of the related securities, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position at September 30, 2012, were as follows:

	Less than 12 months		12 months or more		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
(Dollars in Thousands)						
Available for sale:						
Residential mortgage-backed securities	\$ 231,625	\$ (1,672)	\$ 34,288	\$ (10,980)	\$ 265,913	\$ (12,652)
Obligations of states and political subdivisions	4,441	(91)	8,386	(1,358)	12,827	(1,449)
Other equity securities	—	—	54	(22)	54	(22)
	<u>\$ 236,066</u>	<u>\$ (1,763)</u>	<u>\$ 42,728</u>	<u>\$ (12,360)</u>	<u>\$ 278,794</u>	<u>\$ (14,123)</u>

Gross unrealized losses on investment securities and the fair value of the related securities, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, at December 31, 2011 were as follows:

	Less than 12 months		12 months or more		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
(Dollars in Thousands)						
Available for sale:						
Residential mortgage-backed securities	\$ —	\$ —	\$ 39,605	\$ (10,680)	\$ 39,605	\$ (10,680)
Obligations of states and political subdivisions	9,531	(315)	3,398	(896)	12,929	(1,211)
Equity securities	3,485	(16)	42	(33)	3,527	(49)
	<u>\$ 13,016</u>	<u>\$ (331)</u>	<u>\$ 43,045</u>	<u>\$ (11,609)</u>	<u>\$ 56,061</u>	<u>\$ (11,940)</u>

The unrealized losses on investments in residential mortgage-backed securities are primarily caused by changes in market interest rates. Residential mortgage-backed securities are primarily securities issued by Freddie Mac, Fannie Mae and Ginnie Mae. Investments in mortgage-backed securities issued by Ginnie Mae are fully guaranteed by the U.S. Government. Investments in mortgage-backed securities issued by Freddie Mac and Fannie Mae are not fully guaranteed by the U.S. Government; however, the Company believes the quality of the bonds is similar to other AAA rated bonds with limited credit risk, particularly given the placement of Fannie Mae and Freddie Mac into conservatorship by the federal government in early September 2008. The decrease in fair value on residential mortgage-backed securities issued by Freddie Mac, Fannie Mae and Ginnie Mae is due to market interest rates. The Company has no intent to sell and will more than likely not be required to sell before a market price recovery or maturity of the securities; therefore, it is the conclusion of the Company that the investments in residential mortgage-backed securities issued by Freddie Mac, Fannie Mae and Ginnie Mae are not considered other-than-temporarily impaired. In addition, the Company has a small investment in non-agency residential mortgage-backed securities that have strong credit backgrounds and include additional credit enhancements to protect the Company from losses arising from high foreclosure rates. These securities have additional market volatility beyond economically induced interest rate events. It is the conclusion of the Company that the investments in non-agency residential mortgage-backed securities are other-than-temporarily impaired due to both credit and other than credit issues. Impairment charges of \$239,000 (\$155,350, after tax) and \$647,000 (\$420,550, after tax) were recorded for the three and nine months ended September 30, 2012. Impairment charges of \$286,000 (\$185,900, after tax) and \$701,000 (\$455,650, after tax) were recorded for the three and nine months ended September 30, 2011. The impairment charge represents the credit related impairment on the securities.

The unrealized losses on investments in other securities are caused by fluctuations in market interest rates. The underlying cash obligations of the securities are guaranteed by the entity underwriting the debt instrument. It is the belief of the Company that the entity issuing the debt will honor its interest payment schedule, as well as the full debt at maturity. The securities are purchased by the Company for their economic value. The decrease in fair value is primarily due to market interest rates and not other factors, and because the Company has no intent to sell and will more than likely not be required to sell before a market price recovery or maturity of the securities, it is the conclusion of the Company that the investments are not considered other-than-temporarily impaired.

The following table presents a reconciliation of credit-related impairment charges on available-for-sale investments recognized in earnings for the three months ended September 30, 2012 (Dollars in Thousands):

Balance at June 30, 2012	\$	9,801
Impairment charges recognized during period		239
Balance at September 30, 2012	\$	10,040

The following table presents a reconciliation of credit-related impairment charges on available-for-sale investments recognized in earnings for the nine months ended September 30, 2012 (Dollars in Thousands):

Balance at December 31, 2011	\$	9,393
Impairment charges recognized during period		647
Balance at September 30, 2012	\$	10,040

The following table presents a reconciliation of credit-related impairment charges on available-for-sale investment recognized in earnings for the three months ended September 30, 2011 (Dollars in Thousands):

Balance at June 30, 2011	\$ 8,831
Impairment charges recognized during period	286
Balance at September 30, 2011	<u>\$ 9,117</u>

The following table presents a reconciliation of credit-related impairment charges on available-for-sale investment recognized in earnings for the nine months ended September 30, 2011 (Dollars in Thousands):

Balance at December 31, 2010	\$ 8,416
Impairment charges recognized during period	701
Balance at September 30, 2011	<u>\$ 9,117</u>

Note 7 — Other Borrowed Funds

Other borrowed funds include Federal Home Loan Bank borrowings, which are short-term and long-term borrowings issued by the FHLB of Dallas at the market price offered at the time of funding. These borrowings are secured by residential mortgage-backed investment securities and a portion of the Company’s loan portfolio. At September 30, 2012, other borrowed funds totaled \$615,061,000, an increase of 24.5% from \$494,161,000 at December 31, 2011.

Note 8 — Junior Subordinated Interest Deferrable Debentures

The Company has formed eight statutory business trusts under the laws of the State of Delaware, for the purpose of issuing trust preferred securities. The eight statutory business trusts formed by the Company (the “Trusts”) have each issued Capital and Common Securities and invested the proceeds thereof in an equivalent amount of junior subordinated debentures (the “Debentures”) issued by the Company. As of September 30, 2012 and December 31, 2011, the principal amount of debentures outstanding totaled \$190,726,000. As a result of the participation in the TARP Capital Purchase Program, the Company was not permitted, without the consent of the Treasury Department, to redeem any of the Debentures. This restriction ceased to exist on December 23, 2011. One half of the Trust I securities were redeemed on June 8, 2011 and the remaining one half of the Trust I securities were redeemed on July 1, 2011 with the consent of the Treasury Department.

The Debentures are subordinated and junior in right of payment to all present and future senior indebtedness (as defined in the respective indentures) of the Company, and are *pari passu* with one another. The interest rate payable on, and the payment terms of the Debentures are the same as the distribution rate and payment terms of the respective issues of Capital and Common Securities issued by the Trusts. The Company has fully and unconditionally guaranteed the obligations of each of the Trusts with respect to the Capital and Common Securities. The Company has the right, unless an Event of Default (as defined in the Indentures) has occurred and is continuing, to defer payment of interest on the Debentures for up to twenty consecutive quarterly periods on Trusts VI, VII, VIII, IX, X, XI and XII. If interest payments on any of the Debentures are deferred, distributions on both the Capital and Common Securities related to that Debenture would also be deferred. The redemption prior to maturity of any of the Debentures may require the prior approval of the Federal Reserve and/or other regulatory bodies.

For financial reporting purposes, the Trusts are treated as investments of the Company and not consolidated in the consolidated financial statements. Although the Capital Securities issued by each of the Trusts are not included as a component of shareholders’ equity on the consolidated statement of condition, the Capital Securities are treated as capital for regulatory purposes. Specifically, under applicable regulatory guidelines, the Capital Securities issued by the Trusts qualify as Tier 1 capital up to a maximum of 25% of Tier 1 capital on an aggregate basis. Any amount that exceeds the 25% threshold would qualify as Tier 2 capital. At September 30, 2012 and December 31, 2011, the total \$190,726,000, of the Capital Securities outstanding qualified as Tier 1 capital.

The following table illustrates key information about each of the Capital and Common Securities and their interest rate at September 30, 2012:

	Junior Subordinated Deferrable Interest Debentures	Repricing Frequency	Interest Rate	Interest Rate Index	Maturity Date	Optional Redemption Date
	(In Thousands)					
Trust VI	\$ 25,774	Quarterly	3.88% LIBOR + 3.45		November 2032	February 2013
Trust VII	10,310	Quarterly	3.69% LIBOR + 3.25		April 2033	January 2013
Trust VIII	25,774	Quarterly	3.51% LIBOR + 3.05		October 2033	January 2013
Trust IX	41,238	Quarterly	2.08% LIBOR + 1.62		October 2036	January 2013
Trust X	34,021	Quarterly	2.09% LIBOR + 1.65		February 2037	February 2013
Trust XI	32,990	Quarterly	2.08% LIBOR + 1.62		July 2037	January 2013
Trust XII	20,619	Quarterly	1.87% LIBOR + 1.45		September 2037	March 2013
	<u>\$ 190,726</u>					

Note 9 — Preferred Stock, Common Stock and Dividends

The Company has outstanding 176,000 shares of Series A cumulative perpetual preferred stock (the “Senior Preferred Stock”), issued to the US Treasury under the Company’s participation in the Troubled Asset Relief Program Capital Purchase Program (the “TARP Capital Purchase Program”). On July 11, 2012 and November 1, 2012, the Company repurchased 40,000 and 45,000 shares, respectively, of the total 216,000 shares of Senior Preferred Stock originally issued to the U.S. Treasury. On July 11, 2012, the Company paid the U.S. Treasury a total of \$40 million of the \$216 million it received under the TARP Capital Purchase Program, plus an accrued dividend of approximately \$311,111. On November 1, 2012, the Company paid the U.S. Treasury a total of \$45 million plus an accrued dividend of approximately \$475,000. The remaining 131,000 shares of Senior Preferred Stock have a par value of \$.01 per share and a liquidation preference of \$1,000 per share, for a total price of \$131,000,000. The Senior Preferred Stock pays dividends at a rate of 5% per year for the first five years and 9% per year thereafter. The Senior Preferred Stock has no maturity date and ranks senior to the Company’s common stock with respect to the payment of dividends and distributions and amounts payable upon liquidation, dissolution and winding up of the Company. In conjunction with the purchase of the Senior Preferred Stock, the US Treasury received a warrant (the “Warrant”) to purchase 1,326,238 shares of the Company’s common stock (the “Warrant Shares”) at \$24.43 per share, which would represent an aggregate common stock investment in the Company on exercise of the warrant in full equal to 15% of the Senior Preferred Stock investment. The term of the Warrant is ten years and was immediately exercisable. Both the Senior Preferred Stock and Warrant are included as components of Tier 1 capital. As of September 30, 2012, none of the Warrant had been exercised. The Company paid dividends on the Senior Preferred Stock on February 16 and May 15, 2012, in the amount of \$2,700,000 each and on August 15, 2012 in the amount of \$2,200,000 and will pay a dividend on the Senior Preferred Stock on November 15, 2012, in the amount of \$1,637,500.

Upon issuance, the fair value of the Series A shares and the associated warrants were computed as if the instruments were issued on a stand-alone basis. The fair value of the Series A shares were estimated based on discounted cash flows, resulting in a stand-alone fair value of approximately \$130.9 million. The Company used the Black-Sholes-Merton option pricing model to estimate the fair value of the warrants, resulting in a stand-alone fair value of approximately \$8.0 million. The fair values of both were then used to record the Series A shares and Warrant on a relative fair value basis, with the warrants being recorded in Surplus as permanent equity and the Series A shares being recorded at a discount of approximately \$12.4 million. Accretion of the discount associated with the preferred stock is recognized as an increase to preferred stock dividends in determining net income available to common shareholders. The discount is being amortized over a five year period from the respective issuance date using the effective-yield method and totaled \$1,333,000 and \$2,632,000 (including additional amortization for the partial redemption) for the three and nine months ended September 30, 2012 and \$624,000 and \$1,844,000 for the three and nine months ended September 30, 2011, respectively.

The Company paid cash dividends to the common shareholders of \$.20 per share on April 20, 2012 to all holders of record on April 2, 2012 and \$.20 per share on October 15, 2012 to all holders of record on September 28, 2012. Cash dividends of \$.19 per share were paid to common shareholders on April 18, and October 17, 2011 to all holders of record on March 28, 2011 and September 30, 2011, respectively.

The Company terminated its stock repurchase program on December 19, 2008, in connection with participating in the TARP Capital Purchase Program, which program prohibited stock repurchases, except for repurchases made in connection with the administration of an employee benefit plan in the ordinary course of business and consistent with past practices or those consented to by the Treasury Department. The stock repurchase restrictions of the TARP Capital Purchase Program ceased to exist on December 23, 2011. In April 2009, the Board of Directors established a formal stock repurchase program that authorized the repurchase of up to \$40 million of common stock within the following twelve months and on March 22, 2012, the Board of Directors extended the repurchase program and again authorized the repurchase of up to \$40 million of common stock during the twelve month period expiring on April 10, 2013, which repurchase cap the Board is inclined to increase over time. Stock repurchases may be made from time to time, on the open market or through private transactions. Shares repurchased in this program will be held in treasury for reissue for various corporate purposes, including employee stock option plans. As of October 31, 2012, a total of 7,807,293 shares had been repurchased under all programs at a cost of \$236,912,000.

Note 10 - Commitments and Contingent Liabilities and Other Tax Matters

The Company is involved in various legal proceedings that are in various stages of litigation. Some of these actions allege “lender liability” claims on a variety of theories and claim substantial actual and punitive damages. The Company has determined, based on discussions with its counsel that any material loss in such actions, individually or in the aggregate, is remote or the damages sought, even if fully recovered, would not be considered material to the consolidated financial position or results of operations of the Company. However, many of these matters are in various stages of proceedings and further developments could cause management to revise its assessment of these matters.

The Company was involved in a dispute related to certain tax matters that were inherited by the Company in its 2004 acquisition of LFIN. The dispute involved claims by the former controlling shareholders of LFIN related to approximately \$14 million of tax refunds received by the Company based on deductions taken in 2003 by LFIN in connection with losses on loans acquired from a failed thrift and a dispute LFIN had with the FDIC regarding the tax benefits related to the failed thrift acquisition which originated in 1988. On March 5, 2010, judgment was entered on a jury verdict rendered against the Company in the U.S. District Court for the Western District of Oklahoma (the “Court”). Other than the tax refunds that were in dispute, the Company does not have any other disputes regarding tax refunds received by the Company in connection with the LFIN acquisition. An amended judgment was entered in the case on November 19, 2010, in the amount of approximately \$24.25 million and it was final and appealable. During December 2010, the Company deposited \$24.4 million with the Court in lieu of a supersedeas bond and the Company commenced appealing the judgment. On January 5, 2012, the United States Court of Appeals Tenth Circuit affirmed the amended judgment. On February 28, 2012, the previously deposited \$24.4 million was paid to the former controlling shareholders of LFIN and a Release and Satisfaction of Judgment was filed with the Court concluding the matter.

During the first quarter of 2012, the Texas State Comptroller refunded approximately \$1.2 million in tax in connection with the Company’s 2011 consolidated Franchise Tax Return. The tax was included as a credit to provision for income tax expense on the consolidated statement of income. The recording of the tax refund resulted in a decrease in the Company’s effective tax rate to 31% for the nine months ended September 30, 2012.

Note 11 — Capital Ratios

The Company had a Tier 1 capital to average total asset (leverage) ratio of 12.79% and 12.74%, risk-weighted Tier 1 capital ratio of 21.77% and 22.73% and risk-weighted total capital ratio of 22.93% and 23.99% at September 30, 2012 and December 31, 2011, respectively. The identified intangibles and goodwill of \$291,419,000 as of September 30, 2012, recorded in connection with the acquisitions made by the Company, are deducted from the sum of core capital elements when determining the capital ratios of the Company. Under applicable regulatory guidelines, the Capital Securities issued by the Trusts qualify as Tier 1 capital up to a maximum of 25% of tier 1 capital on an aggregate basis. Any amount that exceeds the 25% threshold qualifies as Tier 2 capital. As of September 30, 2012, the total of \$190,726,000 of the Capital Securities outstanding qualified as Tier 1 capital. The Company actively monitors the regulatory capital ratios to ensure that the Company’s bank subsidiaries are well capitalized under the regulatory framework.

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

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

Special Cautionary Notice Regarding Forward Looking Information

Certain matters discussed in this report, excluding historical information, include forward-looking statements, within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, and are subject to the safe harbor created by these sections. Although the Company believes such forward-looking statements are based on reasonable assumptions, no assurance can be given that every objective will be reached. The words "estimate," "expect," "intend," "believe" and "project," as well as other words or expressions of a similar meaning are intended to identify forward-looking statements. Readers are cautioned not to place undue reliance on forward-looking statements, which speak only as of the date of this report. Such statements are based on current expectations, are inherently uncertain, are subject to risks and should be viewed with caution. Actual results and experience may differ materially from the forward-looking statements as a result of many factors.

Risk factors that could cause actual results to differ materially from any results that are projected, forecasted, estimated or budgeted by the Company in forward-looking statements include, among others, the following possibilities:

- Local, regional, national and international economic business conditions and the impact they may have on the Company, the Company's customers, and such customers' ability to transact profitable business with the Company, including the ability of its borrowers to repay their loans according to their terms or a change in the value of the related collateral.
- Volatility and disruption in national and international financial markets.
- Government intervention in the U.S. financial system.
- The Company relies, in part, on external financing to fund the Company's operations and the unavailability of such funds in the future could adversely impact the Company's growth strategy and prospects.
- Changes in consumer spending, borrowings and savings habits.
- Changes in interest rates and market prices, which could reduce the Company's net interest margins, asset valuations and expense expectations, including, without limitation, the repeal of federal prohibitions on the payment of interest on demand deposits.
- Changes in the capital markets utilized by the Company and its subsidiaries, including changes in the interest rate environment that may reduce margins.
- Changes in state and/or federal laws and regulations to which the Company and its subsidiaries, as well as their customers, competitors and potential competitors, are subject, including, without limitation, the impact of the Consumer Financial Protection Bureau as a new regulator of financial institutions, changes in the accounting, tax and regulatory treatment of trust preferred securities, as well as changes in banking, tax, securities, insurance, employment, environmental and immigration laws and regulations and the risk of litigation that may follow.
- Changes in U.S. — Mexico trade, including, without limitation, reductions in border crossings and commerce resulting from the Homeland Security Programs called "US-VISIT," which is derived from Section 110 of the Illegal Immigration Reform and Immigrant Responsibility Act of 1996.
- The loss of senior management or operating personnel.
- Increased competition from both within and outside the banking industry.
- The timing, impact and other uncertainties of the Company's potential future acquisitions including the Company's ability to identify suitable potential future acquisition candidates, the success or failure in the integration of their operations and the Company's ability to maintain its current branch network and to enter new markets successfully and capitalize on growth opportunities.
- Changes in the Company's ability to pay dividends on its Preferred Stock or Common Stock.
- Additions to the Company's loan loss allowance as a result of changes in local, national or international conditions which adversely affect the Company's customers, including, without limitation, lower real estate values or environmental liability risks associated with foreclosed properties.
- Greater than expected costs or difficulties related to the development and integration of new products and lines of business.
- Impairment of carrying value of goodwill could negatively impact our earnings and capital.
- Changes in the soundness of other financial institutions with which the Company interacts.
- Political instability in the United States or Mexico.

- Technological changes or system failure or breaches of our network security could subject us to increased operating costs as well as litigation and other liabilities.
- Acts of war or terrorism.
- Natural disasters.
- Reduced earnings resulting from the write down of the carrying value of securities held in our securities available-for-sale portfolio following a determination that the securities are other-than-temporarily impaired.
- 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 standards setters.
- The costs and effects of regulatory developments, including the resolution of regulatory or other governmental inquiries and the results of regulatory examinations or reviews.
- The effect of final rules amending Regulation E that prohibit financial institutions from charging consumer fees for paying overdrafts on ATM and one-time debit card transactions, unless the consumer consents or opts-in to the overdraft service for those types of transactions, as well as the effect of any other regulatory or legal developments that limit overdraft services.
- The reduction of income and possible increase in required capital levels related to the adoption of new legislation, including, without limitation, the Dodd-Frank Regulatory Reform Act and the implementing rules and regulations, including the Federal Reserve's new interim final rule that establishes debit card interchange fee standards and prohibits network exclusivity arrangements and routing restrictions that is negatively affecting interchange revenue from debit card transactions as well as revenue from consumer services.
- The possible increase in required capital levels related to the proposed capital rules of the federal banking agencies that address the Basel III capital standards.
- The enhanced due diligence burden imposed on banks under the proposed rules of the banking agencies related to the banks' inability to rely on credit ratings under Dodd-Frank which may result in a limitation on the types of securities certain banks will be able to purchase as a result of the due diligence burden.
- The Company may be adversely affected by its continued participation in the Capital Purchase Program (the "CPP").
- The Company's success at managing the risks involved in the foregoing items, or a failure or circumvention of the Company's internal controls and risk management, policies and procedures.

Forward-looking statements speak only as of the date on which such statements are made. It is not possible to foresee or identify all such factors. The Company makes no commitment to update any forward-looking statement, or to disclose any facts, events or circumstances after the date hereof that may affect the accuracy of any forward-looking statement, unless required by law.

Overview

The Company, which is headquartered in Laredo, Texas, with 215 facilities and more than 335 ATMs, provides banking services for commercial, consumer and international customers of South, Central and Southeast Texas and the State of Oklahoma. The Company is one of the largest independent commercial bank holding companies headquartered in Texas. The Company, through its bank subsidiaries, is in the business of gathering funds from various sources and investing those funds in order to earn a return. The Company either directly or through a bank subsidiary owns two insurance agencies, a liquidating subsidiary, a broker/dealer and a fifty percent interest in an investment banking unit that owns a broker/dealer. The Company's primary earnings come from the spread between the interest earned on interest-bearing assets and the interest paid on interest-bearing liabilities. In addition, the Company generates income from fees on products offered to commercial, consumer and international customers.

The Company is very active in facilitating trade along the United States border with Mexico. The Company does a large amount of business with customers domiciled in Mexico. Deposits from persons and entities domiciled in Mexico comprise a large and stable portion of the deposit base of the Company's bank subsidiaries. The Company also serves the growing Hispanic population through the Company's facilities located throughout South, Central and Southeast Texas and the State of Oklahoma.

Expense control is an essential element in the Company’s long-term profitability. As a result, the Company monitors the efficiency ratio, which is a measure of non-interest expense to net interest income plus non-interest income closely. As the Company adjusts to regulatory changes related to the adoption of the Dodd-Frank Regulatory Reform Act, the Company’s efficiency ratio may suffer because the additional regulatory compliance costs are expected to increase non-interest expense. The Company monitors this ratio over time to assess the Company’s efficiency relative to its peers. The Company uses this measure as one factor in determining if the Company is accomplishing its long-term goals of providing superior returns to the Company’s shareholders. On September 22, 2011, the Company announced the approval of a restructuring plan that resulted in the closing of fifty-five (55) in store branches by December 31, 2011. The branch closures are a result of reduced levels of revenue resulting from regulatory changes related to interchange fee income. The branches were closed in order to align the Company’s expenses with reduced levels of revenue, protecting the Company’s financial strength while preserving IBC’s free products program.

Results of Operations

Summary

Consolidated Statements of Condition Information

	<u>September 30, 2012</u>	<u>December 31, 2011</u>	<u>Percent Increase (Decrease)</u>
	<u>(Dollars in Thousands)</u>		
Assets	\$ 12,116,740	\$ 11,739,649	3.2%
Net loans	4,810,347	4,969,283	(3.2)
Deposits	7,991,171	7,946,092	.6
Other borrowed funds	615,061	494,161	24.5
Junior subordinated deferrable interest debentures	190,726	190,726	—
Shareholders’ equity	1,605,341	1,600,165	.3

Consolidated Statements of Income Information

	<u>Three Months Ended September 30, (Dollars in Thousands)</u>		<u>Percent Increase (Decrease)</u>	<u>Nine Months Ended September 30, (Dollars in Thousands)</u>		<u>Percent Increase (Decrease)</u>
	<u>2012</u>	<u>2011</u>		<u>2012</u>	<u>2011</u>	
Interest income	\$ 93,775	\$ 103,623	(9.5)%	\$ 283,240	\$ 318,605	(11.1)%
Interest expense	17,420	23,079	(24.5)	58,125	72,817	(20.2)
Net interest income	76,355	80,544	(5.2)	225,115	245,788	(8.4)
Provision for probable loan losses	5,349	5,670	(5.7)	16,741	7,833	113.7
Non-interest income	74,007	51,211	44.5	158,003	147,441	7.2
Non-interest expense	106,444	80,290	32.6	246,678	239,697	2.9
Net income available to common shareholders	22,033	27,307	(19.3)	71,572	86,832	(17.6)
Per common share:						
Basic	\$.33	\$.41	(19.5)%	\$ 1.06	\$ 1.28	(17.2)%
Diluted	.33	.40	(17.5)	1.06	1.28	(17.2)

Net Income

Net income available to common shareholders for the third quarter of 2012 decreased by 19.3% and net income available to common shareholders for the nine months ended September 30, 2012 decreased by 17.6% when compared to the same period in 2011. Net income during the first nine months of 2011 was positively affected by a lower provision for probable loan losses of approximately \$2.2 million, \$1.4 million after tax. Net income for the first nine months of 2012 was negatively impacted by narrowing interest margins caused by slow loan demand and declining yields in the bond markets coupled with lower levels of revenues on interchange fee income and overdraft programs due to regulatory changes, as well as the burden of increasing compliance costs arising from the Dodd-Frank Act and heightened regulatory oversight.

Net Interest Income

	Three Months Ended September 30, (in Thousands)		Percent Increase (Decrease)	Nine Months Ended September 30, (in Thousands)		Percent Increase (Decrease)
	2012	2011		2012	2011	
Interest income:						
Loans, including fees	\$ 67,254	\$ 72,461	(7.2)%	\$ 202,990	\$ 221,715	(8.4)%
Investment securities:						
Taxable	23,388	28,427	(17.7)	71,128	87,890	(19.1)
Tax-exempt	2,972	2,694	10.3	8,682	7,208	20.4
Other interest income	161	41	292.7	440	1,792	(75.4)
Total interest income	93,775	103,623	(9.5)	283,240	318,605	(11.1)
Interest expense:						
Savings deposits	1,074	1,732	(38.0)	4,176	6,226	(32.9)
Time deposits	5,910	7,636	(22.6)	18,650	24,551	(24.0)
Securities sold under repurchase agreements	8,811	10,608	(16.9)	29,380	31,807	(7.6)
Other borrowings	195	332	(41.3)	541	1,427	(62.1)
Junior subordinated interest deferrable debentures	1,430	2,771	(48.4)	5,378	8,806	(38.9)
Total interest expense	17,420	23,079	(24.5)	58,125	72,817	(20.2)
Net interest income	\$ 76,355	\$ 80,544	(5.2)%	\$ 225,115	\$ 245,788	(8.4)%

Net interest income is the spread between income on interest earning assets, such as loans and securities, and the interest expense on liabilities used to fund those assets, such as deposits, repurchase agreements and funds borrowed. As part of its strategy to manage interest rate risk, the Company strives to manage both assets and liabilities so that interest sensitivities match. One method of calculating interest rate sensitivity is through gap analysis. A gap is the difference between the amount of interest rate sensitive assets and interest rate sensitive liabilities that re-price or mature in a given time period. Positive gaps occur when interest rate sensitive assets exceed interest rate sensitive liabilities, and negative gaps occur when interest rate sensitive liabilities exceed interest rate sensitive assets. A positive gap position in a period of rising interest rates should have a positive effect on net interest income as assets will re-price faster than liabilities. Conversely, net interest income should contract somewhat in a period of falling interest rates. Additionally, interest rate changes do not affect all categories of assets and liabilities equally or at the same time. Analytical techniques employed by the Company to supplement gap analysis include simulation analysis to quantify interest rate risk exposure. The gap analysis prepared by management is reviewed by the Investment Committee of the Company twice a year (see table on page 39 for the September 30, 2012 gap analysis). Management currently believes that the Company is properly positioned for interest rate changes; however if management determines at any time that the Company is not properly positioned, it will strive to adjust the interest rate sensitive assets and liabilities in order to manage the effect of interest rate changes.

Non-Interest Income

	Three Months Ended September 30, (in Thousands)		Percent Increase (Decrease)	Nine Months Ended September 30, (in Thousands)		Percent Increase (Decrease)
	2012	2011		2012	2011	
Service charges on deposit accounts	\$ 23,748	\$ 24,205	(1.9)%	\$ 69,601	\$ 72,905	(4.5)%
Other service charges, commissions and fees						
Banking	9,492	13,749	(31.0)	28,980	41,187	(29.6)
Non-banking	2,038	1,677	21.5	4,971	4,346	14.4
Investment securities transactions, net	32,935	6,587	400.0	35,527	9,448	276.0
Other investments, net	3,650	2,749	32.8	11,431	12,325	(7.3)
Other income	2,144	2,244	(4.5)	7,493	7,230	3.6
Total non-interest income	\$ 74,007	\$ 51,211	44.5%	\$ 158,003	\$ 147,441	7.2%

Total non-interest income increased 44.5% for the quarter ended September 30, 2012 compared to the same period of 2011. Total non-interest income increased by 7.2% for the nine months ended September 30, 2012 from the same period of 2011. Investments securities transactions increased for the three and nine months ended September 30, 2012 from the same periods of 2011 primarily due to sales of available for sale securities. The investment securities were sold as a result of the Company re-positioning a portion of the investment portfolio. Banking service charges, commissions and fees decreased for the three and nine months ended September 30, 2012 from the same periods of 2011 primarily due to the impact of regulatory changes related to interchange fee income and overdraft programs.

Non-Interest Expense

	Three Months Ended September 30, (in Thousands)		Percent Increase (Decrease)	Nine Months Ended September 30, (in Thousands)		Percent Increase (Decrease)
	2012	2011		2012	2011	
Employee compensation and benefits	\$ 30,541	\$ 32,034	(4.7)%	\$ 90,152	\$ 96,689	(6.8)%
Occupancy	8,032	10,640	(24.5)	24,873	28,256	(12.0)
Depreciation of bank premises and equipment	6,618	8,491	(22.1)	20,335	24,749	(17.8)
Professional fees	4,279	3,698	15.7	11,820	11,273	4.9
Deposit insurance assessments	2,289	2,472	(7.4)	5,346	7,521	(28.9)
Net expense, other real estate owned	3,065	1,954	56.9	5,631	11,218	(49.8)
Amortization of identified intangible assets	1,163	1,324	(12.2)	3,463	3,950	(12.3)
Advertising	1,713	1,794	(4.5)	5,510	5,421	1.6
Early termination fee — securities sold under repurchase agreements	31,550	—	100.00	31,550	—	100.00
Impairment charges (Total other-than- temporary impairment losses, \$(402), net of \$(641), \$152, net of \$(134), \$947, net of \$300 and \$1,206, net of \$505 included in other comprehensive income)	239	286	(16.4)	647	701	(7.7)
Other	16,955	17,597	(3.6)	47,351	49,919	(5.1)
Total non-interest expense	\$ 106,444	\$ 80,290	32.6%	\$ 246,678	\$ 239,697	2.9%

Non-interest expense increased 32.6% for the three months ended September 30, 2012 and 2.9% for the nine months ended September 30, 2012 compared to the same periods of 2011. In the third quarter of 2012, the Company's lead bank subsidiary terminated a portion of its long-term repurchase agreements outstanding in order to help manage its long-term funding costs. The early termination of the long-term repurchase agreements resulted in a one-time charge of \$31,550,000. In December 2011, the Company closed fifty-five (55) in store branches, as a result of reduced levels of revenue arising from regulatory changes related to interchange fee income and overdraft programs. The branches were closed in order to align the Company's expenses with reduced levels of revenue, protecting the Company's financial strength while preserving IBC's free products.

Financial Condition

Allowance for Probable Loan Losses

The allowance for probable loan losses decreased 13.7% to \$72,681,000 at September 30, 2012 from \$84,192,000 at December 31, 2011 primarily due to a decrease in the Company's charge-off experience and a decrease in the loan portfolio. The provision for probable loan losses charged to expense increased 113.7% to \$16,741,000 for the nine months ended September 30, 2012 from \$7,833,000 for the same period in 2011. The allowance for probable loan losses was 1.5% and 1.7% of total loans at September 30, 2012 and December 31, 2011, respectively.

Investment Securities

Mortgage-backed securities are securities primarily issued by the Federal Home Loan Mortgage Corporation ("Freddie Mac"), Federal National Mortgage Association ("Fannie Mae"), and the Government National Mortgage Association ("Ginnie Mae"). Investments in residential mortgage-backed securities issued by Ginnie Mae are fully guaranteed by the U.S. Government. Investments in residential mortgage-backed securities issued by Freddie Mac and Fannie Mae are not fully guaranteed by the U.S. Government, however, the Company believes that the quality of the bonds is similar to other AAA rated bonds with limited credit risk, particularly given the placement of Fannie Mae and Freddie Mac into conservatorship by the federal government in early September 2008.

Loans

Net loans decreased 3.2% to \$4,810,347,000 at September 30, 2012, from \$4,969,283,000 at December 31, 2011. The decrease in loans can be attributed to the lack of demand for loans that the Company is experiencing as the result of the negative economic conditions.

Deposits

Deposits increased by .6% to \$7,991,171,000 at September 30, 2012, from \$7,946,092,000 at December 31, 2011. The increase in deposits is the result of the increased demand for deposits and the result of the increased availability of deposits in the banking market. Even though the Company increased its deposits, the Company is still experiencing a substantial amount of competition for deposits at higher than market rates. As a result, the Company has attempted to maintain certain deposit relationships but has allowed certain deposits to leave as the result of aggressive pricing.

Foreign Operations

On September 30, 2012, the Company had \$12,116,740,000 of consolidated assets, of which approximately \$192,982,000, or 1.6%, was related to loans outstanding to borrowers domiciled in foreign countries, compared to \$230,005,000, or 2.0%, at December 31, 2011. Of the \$192,982,000, 89.4% is directly or indirectly secured by U.S. assets, certificates of deposits and real estate; 10.3% is secured by foreign real estate; and .3% is unsecured.

Critical Accounting Policies

The Company has established various accounting policies which govern the application of accounting principles in the preparation of the Company's consolidated financial statements. The significant accounting policies are described in the notes to the consolidated financial statements. Certain accounting policies involve significant subjective judgments and assumptions by management which have a material impact on the carrying value of certain assets and liabilities; management considers such accounting policies to be critical accounting policies.

The Company considers its Allowance for Probable Loan Losses as a policy critical to the sound operations of the bank subsidiaries. The allowance for probable loan losses consists of the aggregate loan loss allowances of the bank subsidiaries. The allowances are established through charges to operations in the form of provisions for probable loan losses. Loan losses or recoveries are charged or credited directly to the allowances. The allowance for probable loan losses of each bank subsidiary is maintained at a level considered appropriate by management, based on estimated probable losses in the loan portfolio. The allowance is derived from the following elements: (i) allowances established on specific loans, which are based on a review of the individual characteristics of each loan, including the customer's ability to repay the loan, the underlying collateral values, and the industry in which the customer operates (ii) allowances based on actual historical loss experience for similar types of loans in the Company's loan portfolio and (iii) allowances based on general economic conditions, changes in the mix of loans, Company resources, border risk and credit quality indicators, among other things. See also discussion regarding the allowance for probable loan losses and provision for probable loan losses included in the results of operations and "Provision and Allowance for Probable Loan Losses" included in Notes 1 and 4 of the notes to Consolidated Financial Statements in the Company's latest Annual Report on Form 10-K for further information regarding the Company's provision and allowance for probable loan losses policy.

Liquidity and Capital Resources

The maintenance of adequate liquidity provides the Company's bank subsidiaries with the ability to meet potential depositor withdrawals, provide for customer credit needs, maintain adequate statutory reserve levels and take full advantage of high-yield investment opportunities as they arise. Liquidity is afforded by access to financial markets and by holding appropriate amounts of liquid assets. The Company's bank subsidiaries derive their liquidity largely from deposits of individuals and business entities. Deposits from persons and entities domiciled in Mexico comprise a stable portion of the deposit base of the Company's bank subsidiaries. Other important funding sources for the Company's bank subsidiaries during 2012 and 2011 were borrowings from FHLB, securities sold under repurchase agreements and large certificates of deposit, requiring management to closely monitor its asset/liability mix in terms of both rate sensitivity and maturity distribution. Primary liquidity of the Company and its subsidiaries has been maintained by means of increased investment in shorter-term securities, certificates of deposit and repurchase agreements. As in the past, the Company will continue to monitor the volatility and cost of funds in an attempt to match maturities of rate-sensitive assets and liabilities and respond accordingly to anticipated fluctuations in interest rates over reasonable periods of time.

The Company maintains an adequate level of capital as a margin of safety for its depositors and shareholders. At September 30, 2012, shareholders' equity was \$1,605,341,000 compared to \$1,600,165,000 at December 31, 2011, an increase of \$5,176,000, or .3%. The increase is primarily due to the retention of earnings, offset by dividends paid to the preferred and common shareholders, as well as the repurchase of 40,000 Senior Preferred Shares during the third quarter of 2012.

The Company had a leverage ratio of 12.79% and 12.74%, risk-weighted Tier 1 capital ratio of 21.77% and 22.73% and risk-weighted total capital ratio of 22.93% and 23.99% at September 30, 2012 and December 31, 2011, respectively. The identified intangibles and goodwill of \$291,419,000 as of September 30, 2012, recorded in connection with the Company's acquisitions, are deducted from the sum of core capital elements when determining the capital ratios of the Company.

As in the past, the Company will continue to monitor the volatility and cost of funds in an attempt to match maturities of rate-sensitive assets and liabilities, and respond accordingly to anticipate fluctuations in interest rates by adjusting the balance between sources and uses of funds as deemed appropriate. The net-interest rate sensitivity as of September 30, 2012 is illustrated in the table on the following page. This information reflects the balances of assets and liabilities for which rates are subject to change. A mix of assets and liabilities that are roughly equal in volume and re-pricing characteristics represents a matched interest rate sensitivity position. Any excess of assets or liabilities results in an interest rate sensitivity gap.

The Company undertakes an interest rate sensitivity analysis to monitor the potential risk on future earnings resulting from the impact of possible future changes in interest rates on currently existing net asset or net liability positions. However, this type of analysis is as of a point-in-time position, when in fact that position can quickly change as market conditions, customer needs, and management strategies change. Thus, interest rate changes do not affect all categories of asset and liabilities equally or at the same time. As indicated in the table, the Company is liability sensitive during the early time periods and asset sensitive in the longer periods. The Company’s Asset and Liability Committee semi-annually reviews the consolidated position along with simulation and duration models, and makes adjustments as needed to control the Company’s interest rate risk position. The Company uses modeling of future events as a primary tool for monitoring interest rate risk.

Interest Rate Sensitivity (Dollars in Thousands)					
September 30, 2012	Rate/Maturity				
	3 Months or Less	Over 3 Months to 1 Year	Over 1 Year to 5 Years	Over 5 Years	Total
Rate sensitive assets					
Investment securities	\$ 551,284	\$ 1,629,630	\$ 3,310,052	\$ 236,469	\$ 5,727,435
Loans, net of non-accruals	3,660,879	212,683	274,408	659,591	4,807,561
Total earning assets	\$ 4,212,163	\$ 1,842,313	\$ 3,584,460	\$ 896,060	\$ 10,534,996
Cumulative earning assets	\$ 4,212,163	\$ 6,054,476	\$ 9,638,936	\$ 10,534,996	
Rate sensitive liabilities					
Time deposits	\$ 1,260,393	\$ 1,566,777	\$ 369,284	\$ 467	\$ 3,196,921
Other interest bearing deposits	2,684,755	—	—	—	2,684,755
Securities sold under repurchase agreements	331,485	33,823	408,304	400,000	1,173,612
Other borrowed funds	608,500	—	—	6,561	615,061
Junior subordinated deferrable interest debentures	190,726	—	—	—	190,726
Total interest bearing liabilities	\$ 5,075,859	\$ 1,600,600	\$ 777,588	\$ 407,028	\$ 7,861,075
Cumulative sensitive liabilities	\$ 5,075,859	\$ 6,676,459	\$ 7,454,047	\$ 7,861,075	
Repricing gap	\$ (863,696)	\$ 241,713	\$ 2,806,872	\$ 489,032	\$ 2,673,921
Cumulative repricing gap	(863,696)	(621,983)	2,184,889	2,673,921	
Ratio of interest-sensitive assets to liabilities	.83	1.15	4.61	2.20	1.34
Ratio of cumulative, interest- sensitive assets to liabilities	.83	.91	1.29	1.34	

Item 3. Quantitative and Qualitative Disclosures about Market Risk

During the first nine months of 2012, there were no material changes in market risk exposures that affected the quantitative and qualitative disclosures regarding market risk presented under the caption “Liquidity and Capital Resources” located on pages 21 through 26 of the Company’s 2011 Annual Report as filed as an exhibit to the Company’s Form 10-K for the year ended December 31, 2011.

Item 4. Controls and Procedures

Disclosure Controls and Procedures

The Company maintains disclosure controls and procedures designed to ensure that information required to be disclosed in reports filed under the Securities Exchange Act of 1934, as amended, is recorded, processed, summarized and reported within specified time periods. As of the end of the period covered by this Quarterly Report on Form 10-Q, the Company's principal executive officer and principal financial officer evaluated, with the participation of the Company's management, the effectiveness of the Company's disclosure controls and procedures (as defined in Exchange Act rules 13a-15(e) and 15d-15(e)). Based on the evaluation, which disclosed no material weaknesses, the Company's principal executive officer and principal financial officer concluded that the Company's disclosure controls and procedures were effective as of the end of the period covered by this report.

Internal Control Over Financial Reporting

There were no changes in the Company's internal control over financial reporting that occurred during the Company's most recent fiscal quarter that have materially affected or are reasonably likely to materially affect the Company's internal control over financial reporting.

PART II - OTHER INFORMATION

Item 1. Legal Proceedings

The Company is involved in various legal proceedings that are in various stages of litigation. Some of these actions allege "lender liability" claims on a variety of theories and claim substantial actual and punitive damages. The Company has determined, based on discussions with its counsel that any material loss in such actions, individually or in the aggregate, is remote or the damages sought, even if fully recovered, would not be considered material to the consolidated financial position or results of operations of the Company. However, many of these matters are in various stages of proceedings and further developments could cause management to revise its assessment of these matters.

The Company was involved in a dispute related to certain tax matters that were inherited by the Company in its 2004 acquisition of LFIN. The dispute involved claims by the former controlling shareholders of LFIN related to approximately \$14 million of tax refunds received by the Company based on deductions taken in 2003 by LFIN in connection with losses on loans acquired from a failed thrift and a dispute LFIN had with the FDIC regarding the tax benefits related to the failed thrift acquisition which originated in 1988. On March 5, 2010, judgment was entered on a jury verdict rendered against the Company in the U.S. District Court for the Western District of Oklahoma (the "Court"). Other than the tax refunds that were in dispute, the Company does not have any other disputes regarding tax refunds received by the Company in connection with the LFIN acquisition. An amended judgment was entered in the case on November 19, 2010, in the amount of approximately \$24.25 million and it was final and appealable. During December 2010, the Company deposited \$24.4 million with the Court in lieu of a supersedeas bond and the Company commenced appealing the judgment. On January 5, 2012, the United States Court of Appeals Tenth Circuit affirmed the amended judgment. On February 28, 2012, the previously deposited \$24.4 million was paid to the former controlling shareholders of LFIN and a Release and Satisfaction of Judgment was filed with the Court concluding the matter.

1A. Risk Factors

There were no material changes in the risk factors as previously disclosed in Item 1A to Part I of the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2011.

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

From time to time, the Company’s Board of Directors has authorized stock repurchase plans. The Company terminated its stock repurchase program on December 19, 2008, in connection with participating in the TARP Capital Purchase Program, which program prohibited stock repurchases, except for repurchases made in connection with the administration of an employee benefit plan in the ordinary course of business and consistent with past practices or those consented to by the Treasury Department, which restrictions ceased to exist on December 23, 2011. In April 2009, the Board of Directors established a formal stock repurchase program that authorized the repurchase of up to \$40 million of common stock within the following twelve months and on March 22, 2012, the Board of Directors extended the repurchase program and again authorized the repurchase of up to \$40 million of common stock during the twelve month period expiring on April 9, 2013, which repurchase cap the Board is inclined to increase over time. Stock repurchases may be made from time to time, on the open market or through private transactions. During the third quarter, the Company’s Board of Directors adopted a Rule 10b5-1 plan and intends to adopt additional Rule 10b5-1 trading plans that will allow the Company to purchase its shares of common stock during certain trading blackout periods when the Company ordinarily would not be in the market due to trading restrictions in its internal trading policy. Shares repurchased in this program will be held in treasury for reissue for various corporate purposes, including employee stock option plans. As of October 31, 2012, a total of 7,807,293 shares had been repurchased under all programs at a cost of \$236,912,000. The Company is not obligated to repurchase shares under its stock purchase program or to enter into additional Rule 10b5-1 plans. The timing, actual number and value of shares purchased will depend on many factors, including the Company’s cash flow and the liquidity and price performance of its shares of common stock.

Except for repurchases in connection with the administration of an employee benefit plan in the ordinary course of business and consistent with past practices, common stock repurchases are only conducted under publicly announced repurchase programs approved by the Board of Directors. The following table includes information about common stock share repurchases for the quarter ended September 30, 2012.

	Total Number of Shares Purchased	Average Price Paid Per Share	Shares Purchased as Part of a Publicly- Announced Program	Approximate Dollar Value of Shares Available for Repurchase (1)
July 1 — July 31, 2012	—	—	—	\$ 39,587,000
August 1 — August 31, 2012	6,894	17.58	6,894	39,466,000
September 1 — September 30, 2012	—	—	—	39,466,000
	<u>6,894</u>	<u>17.58</u>	<u>6,894</u>	

(1) The repurchase program was extended on March 22, 2012 and allows for the repurchase of up to an additional \$40,000,000 of treasury stock through April 9, 2013.

Item 6. Exhibits

The following exhibits are filed as a part of this Report:

- 31(a) —Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 31(b) —Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 32(a) —Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- 32(b) —Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- 101++ — Interactive Data File

++ Attached as Exhibit 101 to this report are the following documents formatted in XBRL (Extensible Business Reporting Language): (i) the Condensed Consolidated Statement of Earnings for the three and nine months ended September 30, 2012 and 2011, (ii) the Condensed Consolidated Balance Sheet as of September 30, 2012 and December 31, 2011, and (iii) the Condensed Consolidated Statement of Cash Flows for the nine months ended September 30, 2012 and 2011. Users of this data are advised pursuant to Rule 406T of Regulation S-T that this interactive data file is deemed not filed or part of a registration statement or prospectus for purposes of sections 11 or 12 of the Securities Act of 1933, is deemed not filed for purposes of section 18 of the Securities and Exchange Act of 1934, and otherwise is not subject to liability under these sections.

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.

INTERNATIONAL BANCSHARES CORPORATION

Date:	<u>November 5, 2012</u>	<u>/s/ Dennis E. Nixon</u>
		Dennis E. Nixon
		President

Date:	<u>November 5, 2012</u>	<u>/s/ Imelda Navarro</u>
		Imelda Navarro
		Treasurer

**Certification of Chief Executive Officer
pursuant to Section 302 of the Sarbanes-Oxley Act of 2002**

I, Dennis E. Nixon, certify that:

1. I have reviewed this report on form 10-Q of International Bancshares Corporation;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - a. Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - b. Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of the financial statements for external purposes in accordance with generally accepted accounting principles;
 - c. Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - d. Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):
 - a. All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b. Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: November 5, 2012

/s/ Dennis E. Nixon
Dennis E. Nixon
President (Chief Executive Officer)

**Certification of Chief Financial Officer
pursuant to Section 302 of the Sarbanes-Oxley Act of 2002**

I, Imelda Navarro, certify that:

1. I have reviewed this report on form 10-Q of International Bancshares Corporation;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - a. Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - b. Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - c. Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - d. Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):
 - a. All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b. Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: November 5, 2012

/s/ Imelda Navarro
Imelda Navarro
Treasurer (Chief Financial Officer)

CERTIFICATION PURSUANT TO
18 U.S.C. 1350,
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the Quarterly Report of International Bancshares Corporation (the “Company”) on Form 10-Q for the period ended September 30, 2012, as filed with the Securities and Exchange Commission on the date hereof (the “Report”), I, Dennis E. Nixon, Chief Executive Officer of the Company, certify, pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

- (1) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78m or 78o(d)), as applicable; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

By: /s/ Dennis E. Nixon
Dennis E. Nixon
President

Date: November 5, 2012

The foregoing certification is being furnished solely to accompany the Report pursuant to 18 U.S.C. 1350, and not being filed for purposes of Section 18 of the Securities Exchange Act, as amended, and is not to be incorporated by reference into any filing of the Company, whether on, before or after the date hereof, regardless of any general incorporation language in such filing.

A signed original of this written statement required by Section 906 has been provided to the Company and will be retained by the Company and furnished to the Securities and Exchange Commission or its staff upon request.

CERTIFICATION PURSUANT TO
18 U.S.C. 1350,
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the Quarterly Report of International Bancshares Corporation (the “Company”) on Form 10-Q for the period ended September 30, 2012 as filed with the Securities and Exchange Commission on the date hereof (the “Report”), I, Imelda Navarro, Chief Financial Officer of the Company, certify, pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

- (1) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78m or 78o(d)), as applicable; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

By: /s/ Imelda Navarro
Imelda Navarro
Treasurer

Date: November 5, 2012

The foregoing certification is being furnished solely to accompany the Report pursuant to 18 U.S.C. 1350, and not being filed for purposes of Section 18 of the Securities Exchange Act, as amended, and is not to be incorporated by reference into any filing of the Company, whether on, before or after the date hereof, regardless of any general incorporation language in such filing.

A signed original of this written statement required by Section 906 has been provided to the Company and will be retained by the Company and furnished to the Securities and Exchange Commission or its staff upon request.

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