

[Toggle SGML Header \(+\)](#)

## Section 1: 10-Q (10-Q)

[Table of Contents](#)

**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: **June 30, 2020**

Or

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number: 001-13221

### Cullen/Frost Bankers, Inc.

(Exact name of registrant as specified in its charter)

**Texas**

(State or other jurisdiction of incorporation or organization)

**111 W. Houston Street, San Antonio, Texas**

(Address of principal executive offices)

**74-1751768**

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

**78205**

(Zip code)

**(210) 220-4011**

(Registrant's telephone number, including area code)

**N/A**

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

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

| Title of each class                  | Trading Symbol(s) | Name of each exchange on which registered |
|--------------------------------------|-------------------|-------------------------------------------|
| <b>Common Stock, \$.01 Par Value</b> | <b>CFR</b>        | <b>New York Stock Exchange</b>            |

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 every Interactive Data File required to be submitted 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 such files). Yes ☒ No ☐

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, smaller reporting company, or an emerging growth company. See the definitions of “large accelerated filer,” “accelerated filer,” “smaller reporting company,” and “emerging growth company” in Rule 12b-2 of the Exchange Act.

|                         |                                     |                           |                          |
|-------------------------|-------------------------------------|---------------------------|--------------------------|
| Large accelerated filer | <input checked="" type="checkbox"/> | Accelerated filer         | <input type="checkbox"/> |
| Non-accelerated filer   | <input type="checkbox"/>            | Smaller reporting company | <input type="checkbox"/> |
|                         |                                     | Emerging growth company   | <input type="checkbox"/> |

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act. ☐

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

As of July 23, 2020 there were 62,700,880 shares of the registrant’s Common Stock, \$.01 par value, outstanding.

---

**Cullen/Frost Bankers, Inc.**  
**Quarterly Report on Form 10-Q**  
**June 30, 2020**

**Table of Contents**

|                                                                                                               | <b>Page</b>        |
|---------------------------------------------------------------------------------------------------------------|--------------------|
| <hr/>                                                                                                         |                    |
| <b><u>Part I - Financial Information</u></b>                                                                  |                    |
| Item 1. <a href="#">Financial Statements (Unaudited)</a>                                                      |                    |
| <a href="#">Consolidated Balance Sheets</a>                                                                   | <a href="#">3</a>  |
| <a href="#">Consolidated Statements of Income</a>                                                             | <a href="#">4</a>  |
| <a href="#">Consolidated Statements of Comprehensive Income (Loss)</a>                                        | <a href="#">5</a>  |
| <a href="#">Consolidated Statements of Changes in Shareholders' Equity</a>                                    | <a href="#">6</a>  |
| <a href="#">Consolidated Statements of Cash Flows</a>                                                         | <a href="#">8</a>  |
| <a href="#">Notes to Consolidated Financial Statements</a>                                                    | <a href="#">9</a>  |
| Item 2. <a href="#">Management's Discussion and Analysis of Financial Condition and Results of Operations</a> | <a href="#">41</a> |
| Item 3. <a href="#">Quantitative and Qualitative Disclosures About Market Risk</a>                            | <a href="#">72</a> |
| Item 4. <a href="#">Controls and Procedures</a>                                                               | <a href="#">73</a> |
| <br>                                                                                                          |                    |
| <b><u>Part II - Other Information</u></b>                                                                     |                    |
| Item 1. <a href="#">Legal Proceedings</a>                                                                     | <a href="#">74</a> |
| Item 1A. <a href="#">Risk Factors</a>                                                                         | <a href="#">74</a> |
| Item 2. <a href="#">Unregistered Sales of Equity Securities and Use of Proceeds</a>                           | <a href="#">75</a> |
| Item 3. <a href="#">Defaults Upon Senior Securities</a>                                                       | <a href="#">75</a> |
| Item 4. <a href="#">Mine Safety Disclosures</a>                                                               | <a href="#">75</a> |
| Item 5. <a href="#">Other Information</a>                                                                     | <a href="#">75</a> |
| Item 6. <a href="#">Exhibits</a>                                                                              | <a href="#">76</a> |
| <br>                                                                                                          |                    |
| <b><u>Signatures</u></b>                                                                                      | <a href="#">77</a> |

# Part I. Financial Information

## Item 1. Financial Statements (Unaudited)

### Cullen/Frost Bankers, Inc.

### Consolidated Balance Sheets

(Dollars in thousands, except per share amounts)

|                                                                                                                                                                | June 30,<br>2020     | December 31,<br>2019 |
|----------------------------------------------------------------------------------------------------------------------------------------------------------------|----------------------|----------------------|
| <b>Assets:</b>                                                                                                                                                 |                      |                      |
| Cash and due from banks                                                                                                                                        | \$ 558,422           | \$ 581,857           |
| Interest-bearing deposits                                                                                                                                      | 5,992,246            | 2,849,950            |
| Federal funds sold and resell agreements                                                                                                                       | 48,900               | 356,374              |
| Total cash and cash equivalents                                                                                                                                | 6,599,568            | 3,788,181            |
| Securities held to maturity, net of allowance for credit losses of \$172 at June 30, 2020                                                                      | 1,968,954            | 2,030,005            |
| Securities available for sale, at estimated fair value                                                                                                         | 10,606,696           | 11,269,591           |
| Trading account securities                                                                                                                                     | 24,495               | 24,298               |
| Loans, net of unearned discounts                                                                                                                               | 17,971,937           | 14,750,332           |
| Less: Allowance for credit losses on loans                                                                                                                     | (250,061)            | (132,167)            |
| Net loans                                                                                                                                                      | 17,721,876           | 14,618,165           |
| Premises and equipment, net                                                                                                                                    | 1,044,261            | 1,011,947            |
| Goodwill                                                                                                                                                       | 654,952              | 654,952              |
| Other intangible assets, net                                                                                                                                   | 1,983                | 2,481                |
| Cash surrender value of life insurance policies                                                                                                                | 189,091              | 187,156              |
| Accrued interest receivable and other assets                                                                                                                   | 565,677              | 440,652              |
| Total assets                                                                                                                                                   | <u>\$ 39,377,553</u> | <u>\$ 34,027,428</u> |
| <b>Liabilities:</b>                                                                                                                                            |                      |                      |
| Deposits:                                                                                                                                                      |                      |                      |
| Non-interest-bearing demand deposits                                                                                                                           | \$ 14,671,989        | \$ 10,873,629        |
| Interest-bearing deposits                                                                                                                                      | 18,007,107           | 16,765,935           |
| Total deposits                                                                                                                                                 | 32,679,096           | 27,639,564           |
| Federal funds purchased and repurchase agreements                                                                                                              | 1,589,384            | 1,695,342            |
| Junior subordinated deferrable interest debentures, net of unamortized issuance costs                                                                          | 136,328              | 136,299              |
| Subordinated notes, net of unamortized issuance costs                                                                                                          | 98,943               | 98,865               |
| Accrued interest payable and other liabilities                                                                                                                 | 865,001              | 545,690              |
| Total liabilities                                                                                                                                              | 35,368,752           | 30,115,760           |
| <b>Shareholders' Equity:</b>                                                                                                                                   |                      |                      |
| Preferred stock, par value \$0.01 per share; 10,000,000 shares authorized; 6,000,000 Series A shares (\$25 liquidation preference) issued at December 31, 2019 | —                    | 144,486              |
| Common stock, par value \$0.01 per share; 210,000,000 shares authorized; 64,236,306 shares issued at June 30, 2020 and December 31, 2019                       | 642                  | 642                  |
| Additional paid-in capital                                                                                                                                     | 989,034              | 983,250              |
| Retained earnings                                                                                                                                              | 2,678,686            | 2,667,534            |
| Accumulated other comprehensive income (loss), net of tax                                                                                                      | 488,264              | 267,370              |
| Treasury stock, at cost; 1,566,661 shares at June 30, 2020 and 1,567,302 shares at December 31, 2019                                                           | (147,825)            | (151,614)            |
| Total shareholders' equity                                                                                                                                     | 4,008,801            | 3,911,668            |
| Total liabilities and shareholders' equity                                                                                                                     | <u>\$ 39,377,553</u> | <u>\$ 34,027,428</u> |

See Notes to Consolidated Financial Statements.

**Cullen/Frost Bankers, Inc.**  
**Consolidated Statements of Income**  
(Dollars in thousands, except per share amounts)

|                                                      | Three Months Ended<br>June 30, |                   | Six Months Ended<br>June 30, |                   |
|------------------------------------------------------|--------------------------------|-------------------|------------------------------|-------------------|
|                                                      | 2020                           | 2019              | 2020                         | 2019              |
| <b>Interest income:</b>                              |                                |                   |                              |                   |
| Loans, including fees                                | \$ 171,305                     | \$ 189,848        | \$ 343,442                   | \$ 375,120        |
| Securities:                                          |                                |                   |                              |                   |
| Taxable                                              | 23,360                         | 30,324            | 49,390                       | 55,003            |
| Tax-exempt                                           | 59,009                         | 58,596            | 117,895                      | 117,739           |
| Interest-bearing deposits                            | 1,257                          | 7,828             | 9,382                        | 18,467            |
| Federal funds sold and resell agreements             | 63                             | 1,541             | 865                          | 3,129             |
| Total interest income                                | 254,994                        | 288,137           | 520,974                      | 569,458           |
| <b>Interest expense:</b>                             |                                |                   |                              |                   |
| Deposits                                             | 6,227                          | 26,844            | 22,280                       | 54,018            |
| Federal funds purchased and repurchase agreements    | 486                            | 5,220             | 3,523                        | 10,236            |
| Junior subordinated deferrable interest debentures   | 988                            | 1,478             | 2,193                        | 2,976             |
| Subordinated notes                                   | 1,164                          | 1,164             | 2,328                        | 2,328             |
| Federal Home Loan Bank advances                      | 318                            | —                 | 318                          | —                 |
| Total interest expense                               | 9,183                          | 34,706            | 30,642                       | 69,558            |
| <b>Net interest income</b>                           | 245,811                        | 253,431           | 490,332                      | 499,900           |
| Credit loss expense                                  | 31,975                         | 6,400             | 207,172                      | 17,403            |
| <b>Net interest income after credit loss expense</b> | 213,836                        | 247,031           | 283,160                      | 482,497           |
| <b>Non-interest income:</b>                          |                                |                   |                              |                   |
| Trust and investment management fees                 | 31,060                         | 30,448            | 65,533                       | 62,145            |
| Service charges on deposit accounts                  | 17,580                         | 21,798            | 40,231                       | 42,588            |
| Insurance commissions and fees                       | 10,668                         | 10,118            | 27,153                       | 28,524            |
| Interchange and debit card transaction fees          | 2,966                          | 3,868             | 6,221                        | 7,148             |
| Other charges, commissions and fees                  | 7,663                          | 8,933             | 17,028                       | 17,995            |
| Net gain (loss) on securities transactions           | —                              | 169               | 108,989                      | 169               |
| Other                                                | 7,664                          | 7,304             | 25,361                       | 20,854            |
| Total non-interest income                            | 77,601                         | 82,638            | 290,516                      | 179,423           |
| <b>Non-interest expense:</b>                         |                                |                   |                              |                   |
| Salaries and wages                                   | 90,350                         | 90,790            | 189,162                      | 183,266           |
| Employee benefits                                    | 18,861                         | 20,051            | 43,750                       | 43,577            |
| Net occupancy                                        | 25,266                         | 21,133            | 50,650                       | 40,400            |
| Technology, furniture and equipment                  | 26,046                         | 22,157            | 51,286                       | 43,821            |
| Deposit insurance                                    | 2,800                          | 2,453             | 5,424                        | 5,261             |
| Intangible amortization                              | 241                            | 305               | 498                          | 630               |
| Other                                                | 36,115                         | 46,320            | 83,072                       | 88,054            |
| Total non-interest expense                           | 199,679                        | 203,209           | 423,842                      | 405,009           |
| <b>Income before income taxes</b>                    | 91,758                         | 126,460           | 149,834                      | 256,911           |
| Income taxes \ (benefits)                            | (1,314)                        | 14,874            | 2,009                        | 28,829            |
| <b>Net income</b>                                    | 93,072                         | 111,586           | 147,825                      | 228,082           |
| Preferred stock dividends                            | —                              | 2,015             | 2,016                        | 4,031             |
| Redemption of preferred stock                        | —                              | —                 | 5,514                        | —                 |
| <b>Net income available to common shareholders</b>   | <u>\$ 93,072</u>               | <u>\$ 109,571</u> | <u>\$ 140,295</u>            | <u>\$ 224,051</u> |
| <b>Earnings per common share:</b>                    |                                |                   |                              |                   |
| Basic                                                | \$ 1.47                        | \$ 1.73           | \$ 2.22                      | \$ 3.53           |
| Diluted                                              | 1.47                           | 1.72              | 2.21                         | 3.51              |

See Notes to Consolidated Financial Statements.



**Cullen/Frost Bankers, Inc.**  
**Consolidated Statements of Comprehensive Income (Loss)**  
(Dollars in thousands)

|                                                                                                                                              | Three Months Ended<br>June 30, |                   | Six Months Ended<br>June 30, |                   |
|----------------------------------------------------------------------------------------------------------------------------------------------|--------------------------------|-------------------|------------------------------|-------------------|
|                                                                                                                                              | 2020                           | 2019              | 2020                         | 2019              |
| <b>Net income</b>                                                                                                                            | \$ 93,072                      | \$ 111,586        | \$ 147,825                   | \$ 228,082        |
| <b>Other comprehensive income (loss), before tax:</b>                                                                                        |                                |                   |                              |                   |
| Securities available for sale and transferred securities:                                                                                    |                                |                   |                              |                   |
| Change in net unrealized gain/loss during the period                                                                                         | 156,509                        | 158,140           | 386,627                      | 356,286           |
| Change in net unrealized gain on securities transferred to held to maturity                                                                  | (308)                          | (308)             | (685)                        | (652)             |
| Reclassification adjustment for net (gains) losses included in net income                                                                    | —                              | (169)             | (108,989)                    | (169)             |
| Total securities available for sale and transferred securities                                                                               | 156,201                        | 157,663           | 276,953                      | 355,465           |
| Defined-benefit post-retirement benefit plans:                                                                                               |                                |                   |                              |                   |
| Reclassification adjustment for net amortization of actuarial gain/loss included in net income as a component of net periodic cost (benefit) | 1,329                          | 1,406             | 2,659                        | 2,812             |
| Total defined-benefit post-retirement benefit plans                                                                                          | 1,329                          | 1,406             | 2,659                        | 2,812             |
| <b>Other comprehensive income (loss), before tax</b>                                                                                         | 157,530                        | 159,069           | 279,612                      | 358,277           |
| Deferred tax expense (benefit)                                                                                                               | 33,081                         | 33,405            | 58,718                       | 75,239            |
| <b>Other comprehensive income (loss), net of tax</b>                                                                                         | 124,449                        | 125,664           | 220,894                      | 283,038           |
| <b>Comprehensive income (loss)</b>                                                                                                           | <u>\$ 217,521</u>              | <u>\$ 237,250</u> | <u>\$ 368,719</u>            | <u>\$ 511,120</u> |

See Notes to Consolidated Financial Statements.

**Cullen/Frost Bankers, Inc.**  
**Consolidated Statements of Changes in Shareholders' Equity**  
(Dollars in thousands, except per share amounts)

|                                                                          | Preferred<br>Stock | Common<br>Stock | Additional<br>Paid-In<br>Capital | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Income (Loss),<br>Net of Tax | Treasury<br>Stock   | Total               |
|--------------------------------------------------------------------------|--------------------|-----------------|----------------------------------|----------------------|-----------------------------------------------------------------------|---------------------|---------------------|
| <b>Three months ended:</b>                                               |                    |                 |                                  |                      |                                                                       |                     |                     |
| <b>June 30, 2020</b>                                                     |                    |                 |                                  |                      |                                                                       |                     |                     |
| <b>Balance at beginning of period</b>                                    | \$ —               | \$ 642          | \$ 985,762                       | \$ 2,635,588         | \$ 363,815                                                            | \$ (159,141)        | \$ 3,826,666        |
| Net income                                                               | —                  | —               | —                                | 93,072               | —                                                                     | —                   | 93,072              |
| Other comprehensive income, net of tax                                   | —                  | —               | —                                | —                    | 124,449                                                               | —                   | 124,449             |
| Stock option exercises/stock unit conversions (77,308 shares)            | —                  | —               | —                                | (4,142)              | —                                                                     | 7,525               | 3,383               |
| Stock-based compensation expense recognized in earnings                  | —                  | —               | 3,272                            | —                    | —                                                                     | —                   | 3,272               |
| Treasury stock issued to the 401(k) stock purchase plan ( 38,943 shares) | —                  | —               | —                                | (961)                | —                                                                     | 3,791               | 2,830               |
| Cash dividends – common stock (\$0.71 per share)                         | —                  | —               | —                                | (44,871)             | —                                                                     | —                   | (44,871)            |
| <b>Balance at end of period</b>                                          | <u>\$ —</u>        | <u>\$ 642</u>   | <u>\$ 989,034</u>                | <u>\$ 2,678,686</u>  | <u>\$ 488,264</u>                                                     | <u>\$ (147,825)</u> | <u>\$ 4,008,801</u> |
| <b>June 30, 2019</b>                                                     |                    |                 |                                  |                      |                                                                       |                     |                     |
| <b>Balance at beginning of period</b>                                    | \$ 144,486         | \$ 642          | \$ 970,958                       | \$ 2,493,207         | \$ 93,774                                                             | \$ (111,550)        | \$ 3,591,517        |
| Net income                                                               | —                  | —               | —                                | 111,586              | —                                                                     | —                   | 111,586             |
| Other comprehensive loss, net of tax                                     | —                  | —               | —                                | —                    | 125,664                                                               | —                   | 125,664             |
| Stock option exercises/stock unit conversions (53,035 shares)            | —                  | —               | —                                | (1,717)              | —                                                                     | 4,673               | 2,956               |
| Stock-based compensation expense recognized in earnings                  | —                  | —               | 4,364                            | —                    | —                                                                     | —                   | 4,364               |
| Purchase of treasury stock (496,307 shares)                              | —                  | —               | —                                | —                    | —                                                                     | (50,000)            | (50,000)            |
| Cash dividends – preferred stock (approximately \$0.33 per share)        | —                  | —               | —                                | (2,015)              | —                                                                     | —                   | (2,015)             |
| Cash dividends – common stock (\$0.71 per share)                         | —                  | —               | —                                | (44,826)             | —                                                                     | —                   | (44,826)            |
| <b>Balance at end of period</b>                                          | <u>\$ 144,486</u>  | <u>\$ 642</u>   | <u>\$ 975,322</u>                | <u>\$ 2,556,235</u>  | <u>\$ 219,438</u>                                                     | <u>\$ (156,877)</u> | <u>\$ 3,739,246</u> |

See accompanying Notes to Consolidated Financial Statements

**Cullen/Frost Bankers, Inc.**  
**Consolidated Statements of Changes in Shareholders' Equity (continued)**  
(Dollars in thousands, except per share amounts)

|                                                                         | Preferred<br>Stock | Common<br>Stock | Additional<br>Paid-In<br>Capital | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Income (Loss),<br>Net of Tax | Treasury<br>Stock   | Total               |
|-------------------------------------------------------------------------|--------------------|-----------------|----------------------------------|----------------------|-----------------------------------------------------------------------|---------------------|---------------------|
| <b>Six months ended:</b>                                                |                    |                 |                                  |                      |                                                                       |                     |                     |
| <b>June 30, 2020</b>                                                    |                    |                 |                                  |                      |                                                                       |                     |                     |
| <b>Balance at beginning of period</b>                                   | \$ 144,486         | \$ 642          | \$ 983,250                       | \$ 2,667,534         | \$ 267,370                                                            | \$ (151,614)        | \$ 3,911,668        |
| Cumulative effect of accounting change                                  | —                  | —               | —                                | (29,252)             | —                                                                     | —                   | (29,252)            |
| Total shareholders' equity at beginning of period, as adjusted          | 144,486            | 642             | 983,250                          | 2,638,282            | 267,370                                                               | (151,614)           | 3,882,416           |
| Net income                                                              | —                  | —               | —                                | 147,825              | —                                                                     | —                   | 147,825             |
| Other comprehensive income, net of tax                                  | —                  | —               | —                                | —                    | 220,894                                                               | —                   | 220,894             |
| Stock option exercises/stock unit conversions (143,523 shares)          | —                  | —               | —                                | (9,125)              | —                                                                     | 13,971              | 4,846               |
| Stock-based compensation expense recognized in earnings                 | —                  | —               | 5,784                            | —                    | —                                                                     | —                   | 5,784               |
| Redemption of preferred stock (6,000,000 shares)                        | (144,486)          | —               | —                                | (5,514)              | —                                                                     | —                   | (150,000)           |
| Purchase of treasury stock (181,825 shares)                             | —                  | —               | —                                | —                    | —                                                                     | (13,973)            | (13,973)            |
| Treasury stock issued to the 401(k) stock purchase plan (38,943 shares) | —                  | —               | —                                | (961)                | —                                                                     | 3,791               | 2,830               |
| Cash dividends – preferred stock (approximately \$0.34 per share)       | —                  | —               | —                                | (2,016)              | —                                                                     | —                   | (2,016)             |
| Cash dividends – common stock (\$1.42 per share)                        | —                  | —               | —                                | (89,805)             | —                                                                     | —                   | (89,805)            |
| <b>Balance at end of period</b>                                         | <u>\$ —</u>        | <u>\$ 642</u>   | <u>\$ 989,034</u>                | <u>\$ 2,678,686</u>  | <u>\$ 488,264</u>                                                     | <u>\$ (147,825)</u> | <u>\$ 4,008,801</u> |
| <b>June 30, 2019</b>                                                    |                    |                 |                                  |                      |                                                                       |                     |                     |
| <b>Balance at beginning of period</b>                                   | \$ 144,486         | \$ 642          | \$ 967,304                       | \$ 2,440,002         | \$ (63,600)                                                           | \$ (119,917)        | \$ 3,368,917        |
| Cumulative effect of accounting change                                  | —                  | —               | —                                | (14,672)             | —                                                                     | —                   | (14,672)            |
| Total shareholders' equity at beginning of period, as adjusted          | 144,486            | 642             | 967,304                          | 2,425,330            | (63,600)                                                              | (119,917)           | 3,354,245           |
| Net income                                                              | —                  | —               | —                                | 228,082              | —                                                                     | —                   | 228,082             |
| Other comprehensive loss, net of tax                                    | —                  | —               | —                                | —                    | 283,038                                                               | —                   | 283,038             |
| Stock option exercises/stock unit conversions (153,900 shares)          | —                  | —               | —                                | (5,718)              | —                                                                     | 13,559              | 7,841               |
| Stock-based compensation expense recognized in earnings                 | —                  | —               | 8,018                            | —                    | —                                                                     | —                   | 8,018               |
| Purchase of treasury stock (501,658 shares)                             | —                  | —               | —                                | —                    | —                                                                     | (50,519)            | (50,519)            |
| Cash dividends – preferred stock (approximately \$0.67 per share)       | —                  | —               | —                                | (4,031)              | —                                                                     | —                   | (4,031)             |
| Cash dividends – common stock (\$1.38 per share)                        | —                  | —               | —                                | (87,428)             | —                                                                     | —                   | (87,428)            |
| <b>Balance at end of period</b>                                         | <u>\$ 144,486</u>  | <u>\$ 642</u>   | <u>\$ 975,322</u>                | <u>\$ 2,556,235</u>  | <u>\$ 219,438</u>                                                     | <u>\$ (156,877)</u> | <u>\$ 3,739,246</u> |

See accompanying Notes to Consolidated Financial Statements

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

|                                                                            | Six Months Ended<br>June 30, |                     |
|----------------------------------------------------------------------------|------------------------------|---------------------|
|                                                                            | 2020                         | 2019                |
| <b>Operating Activities:</b>                                               |                              |                     |
| Net income                                                                 | \$ 147,825                   | \$ 228,082          |
| Adjustments to reconcile net income to net cash from operating activities: |                              |                     |
| Credit loss expense                                                        | 207,172                      | 17,403              |
| Deferred tax expense (benefit)                                             | (51,933)                     | (675)               |
| Accretion of loan discounts                                                | (7,680)                      | (7,325)             |
| Securities premium amortization (discount accretion), net                  | 62,177                       | 56,726              |
| Net (gain) loss on securities transactions                                 | (108,989)                    | (169)               |
| Depreciation and amortization                                              | 31,489                       | 25,705              |
| Net (gain) loss on sale/write-down of assets/foreclosed assets             | (139)                        | (5,135)             |
| Stock-based compensation                                                   | 5,784                        | 8,018               |
| Net tax benefit from stock-based compensation                              | 556                          | 1,131               |
| Earnings on life insurance policies                                        | (1,935)                      | (1,830)             |
| Net change in:                                                             |                              |                     |
| Trading account securities                                                 | (197)                        | (1,068)             |
| Lease right-of-use assets                                                  | 11,491                       | 9,167               |
| Accrued interest receivable and other assets                               | (131,772)                    | (18,107)            |
| Accrued interest payable and other liabilities                             | 43,111                       | (20,008)            |
| <b>Net cash from operating activities</b>                                  | <b>206,960</b>               | <b>291,915</b>      |
| <b>Investing Activities:</b>                                               |                              |                     |
| Securities held to maturity:                                               |                              |                     |
| Purchases                                                                  | (1,500)                      | —                   |
| Maturities, calls and principal repayments                                 | 51,232                       | 60,077              |
| Securities available for sale:                                             |                              |                     |
| Purchases                                                                  | (3,739,598)                  | (4,555,448)         |
| Sales                                                                      | 1,162,352                    | 3,291,529           |
| Maturities, calls and principal repayments                                 | 3,791,908                    | 708,273             |
| Proceeds from sale of loans                                                | —                            | 24,036              |
| Net change in loans                                                        | (3,293,619)                  | (390,452)           |
| Proceeds from sales of premises and equipment                              | 3,054                        | 4,677               |
| Purchases of premises and equipment                                        | (52,036)                     | (98,622)            |
| Proceeds from sales of repossessed properties                              | 8                            | 5                   |
| <b>Net cash from investing activities</b>                                  | <b>(2,078,199)</b>           | <b>(955,925)</b>    |
| <b>Financing Activities:</b>                                               |                              |                     |
| Net change in deposits                                                     | 5,039,532                    | (1,164,181)         |
| Net change in short-term borrowings                                        | (105,958)                    | (48,041)            |
| Proceeds from Federal Home Loan Bank advances                              | 1,250,000                    | —                   |
| Principal payments on Federal Home Loan Bank advances                      | (1,250,000)                  | —                   |
| Redemption of preferred stock                                              | (150,000)                    | —                   |
| Proceeds from stock option exercises                                       | 4,846                        | 7,841               |
| Purchase of treasury stock                                                 | (13,973)                     | (50,519)            |
| Cash dividends paid on preferred stock                                     | (2,016)                      | (4,031)             |
| Cash dividends paid on common stock                                        | (89,805)                     | (87,428)            |
| <b>Net cash from financing activities</b>                                  | <b>4,682,626</b>             | <b>(1,346,359)</b>  |
| <b>Net change in cash and cash equivalents</b>                             | <b>2,811,387</b>             | <b>(2,010,369)</b>  |
| Cash and cash equivalents at beginning of period                           | 3,788,181                    | 3,955,779           |
| <b>Cash and cash equivalents at end of period</b>                          | <b>\$ 6,599,568</b>          | <b>\$ 1,945,410</b> |



**Notes to Consolidated Financial Statements**

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

**Note 1 - Significant Accounting Policies**

*Nature of Operations.* Cullen/Frost Bankers, Inc. (“Cullen/Frost”) is a financial holding company and a bank holding company headquartered in San Antonio, Texas that provides, through its subsidiaries, a broad array of products and services throughout numerous Texas markets. The terms “Cullen/Frost,” “the Corporation,” “we,” “us” and “our” mean Cullen/Frost Bankers, Inc. and its subsidiaries, when appropriate. In addition to general commercial and consumer banking, other products and services offered include trust and investment management, insurance, brokerage, mutual funds, leasing, treasury management, capital markets advisory and item processing.

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

The consolidated financial statements in this Quarterly Report on Form 10-Q have not been audited by an independent registered public accounting firm, but in the opinion of management, reflect all adjustments necessary for a fair presentation of our financial position and results of operations. All such adjustments were of a normal and recurring nature. The consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and with the instructions to Form 10-Q adopted by the Securities and Exchange Commission (“SEC”). Accordingly, the financial statements do not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements and should be read in conjunction with our consolidated financial statements, and notes thereto, for the year ended December 31, 2019, included in our Annual Report on Form 10-K filed with the SEC on February 4, 2020 (the “2019 Form 10-K”). Operating results for the interim periods disclosed herein are not necessarily indicative of the results that may be expected for a full year or any future period.

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

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

|                                                                                       | Six Months Ended<br>June 30, |           |
|---------------------------------------------------------------------------------------|------------------------------|-----------|
|                                                                                       | 2020                         | 2019      |
| Cash paid for interest                                                                | \$ 31,712                    | \$ 66,657 |
| Cash paid for income taxes                                                            | 32,174                       | 31,858    |
| Significant non-cash transactions:                                                    |                              |           |
| Unsettled securities transactions                                                     | 216,855                      | 39,896    |
| Loans foreclosed and transferred to other real estate owned and foreclosed assets     | —                            | 616       |
| Loans to facilitate the sale of other real estate owned                               | —                            | 847       |
| Right-of-use lease assets obtained in exchange for lessee operating lease liabilities | 18,679                       | 295,109   |
| Treasury stock issued to 401(k) stock purchase plan                                   | 2,830                        | —         |

*Accounting Changes, Reclassifications and Restatements.* Certain items in prior financial statements have been reclassified to conform to the current presentation. In addition, on January 1, 2020, we adopted Accounting Standards Update (“ASU”) 2016-13, “Financial Instruments - Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments,” as subsequently updated for certain clarifications, targeted relief and codification improvements. Accounting Standards Codification (“ASC”) Topic 326 (“ASC 326”) replaces the previous “incurred loss” model for measuring credit losses, which encompassed allowances for current known and inherent losses within the portfolio, with an “expected loss” model, which encompasses allowances for losses expected to be incurred over the life of the portfolio. The new current expected credit loss (“CECL”) model requires the measurement of all expected credit losses for financial assets measured at amortized cost and certain off-balance-sheet credit exposures based on historical experience, current conditions, and reasonable and supportable forecasts. ASC 326 also requires enhanced disclosures related to the significant estimates and judgments used in estimating credit losses, as well as the credit quality and underwriting standards of an organization’s portfolio. In addition, ASC 326 includes certain changes to the accounting for available-for-sale securities including the requirement to present credit losses as

an allowance rather than as a direct write-down for available-for-sale securities management does not intend to sell or believes that it is more likely than not they will be required to sell.

We adopted ASC 326 using the modified retrospective method for all financial assets measured at amortized cost and off-balance-sheet credit exposures. Upon adoption, we recognized an after-tax cumulative effect reduction to retained earnings totaling \$29.3 million, as detailed in the table below. Operating results for periods after January 1, 2020 are presented in accordance with ASC 326 while prior period amounts continue to be reported in accordance with previously applicable standards and the accounting policies described in our 2019 Form 10-K.

The following table details the impact of the adoption of ASC 326 on the allowance for credit losses as of January 1, 2020.

|                                        | January 1, 2020        |                    |                         |                                        |
|----------------------------------------|------------------------|--------------------|-------------------------|----------------------------------------|
|                                        | Pre-Adoption Allowance | Impact of Adoption | Post-Adoption Allowance | Cumulative Effect on Retained Earnings |
| Securities held to maturity:           |                        |                    |                         |                                        |
| U.S. Treasury                          | \$ —                   | \$ —               | \$ —                    | \$ —                                   |
| Residential mortgage-backed securities | —                      | —                  | —                       | —                                      |
| States and political subdivisions      | —                      | 215                | 215                     | (170)                                  |
| Other                                  | —                      | —                  | —                       | —                                      |
| Total                                  | \$ —                   | \$ 215             | \$ 215                  | \$ (170)                               |
| Loans:                                 |                        |                    |                         |                                        |
| Commercial and industrial              | \$ 51,593              | \$ 21,263          | \$ 72,856               | \$ (16,798)                            |
| Energy                                 | 37,382                 | (10,453)           | 26,929                  | 8,258                                  |
| Commercial real estate                 | 31,037                 | (13,519)           | 17,518                  | 10,680                                 |
| Consumer real estate                   | 4,113                  | 2,392              | 6,505                   | (1,890)                                |
| Consumer and other                     | 8,042                  | (2,248)            | 5,794                   | 1,776                                  |
| Total                                  | \$ 132,167             | \$ (2,565)         | \$ 129,602              | \$ 2,026                               |
| Off-balance-sheet credit exposures     | \$ 500                 | \$ 39,377          | \$ 39,877               | \$ (31,108)                            |

In connection with the adoption of ASC 326, we revised certain accounting policies and implemented certain accounting policy elections. The revised accounting policies are described below.

**Securities:** Securities are classified as held to maturity and carried at amortized cost when management has the positive intent and ability to hold them until maturity. Securities to be held for indefinite periods of time are classified as available for sale and carried at fair value, with the unrealized holding gains and losses (those for which no allowance for credit losses are recorded) reported as a component of other comprehensive income, net of tax. Securities held for resale in anticipation of short-term market movements are classified as trading and are carried at fair value, with changes in unrealized holding gains and losses included in income. Management determines the appropriate classification of securities at the time of purchase. Securities with limited marketability, such as stock in the Federal Reserve Bank and the Federal Home Loan Bank, are carried at cost.

Interest income on securities includes amortization of purchase premiums and discounts. Premiums and discounts on securities are generally amortized using the interest method with a constant effective yield without anticipating prepayments, except for mortgage-backed securities where prepayments are anticipated. Premiums on callable securities are amortized to their earliest call date. A security is placed on non-accrual status if (i) principal or interest has been in default for a period of 90 days or more or (ii) full payment of principal and interest is not expected. Interest accrued but not received for a security placed on non-accrual status is reversed against interest income. Gains and losses on sales are recorded on the trade date and are derived from the amortized cost of the security sold.

**Allowance For Credit Losses - Held-to-Maturity Securities:** The allowance for credit losses on held-to-maturity securities is a contra-asset valuation account, calculated in accordance with ASC 326, that is deducted from the amortized cost basis of held-to-maturity securities to present management's best estimate of the net amount expected to be collected. Held-to-maturity securities are charged-off against the allowance when deemed uncollectible by management. Adjustments to the allowance are reported in our income statement as a component of credit loss expense. Management measures expected credit losses on held-to-maturity securities on a collective basis by major security type with each type sharing similar risk characteristics, and considers historical credit loss information that is adjusted for current conditions and reasonable and supportable forecasts. Management has made the accounting policy election to exclude accrued interest receivable on held-to-maturity securities from the estimate of credit losses. Further information regarding our policies and methodology used to estimate the allowance for credit losses on held-to-maturity securities is presented in Note 2 - Securities.

**Allowance For Credit Losses - Available-for-Sale Securities:** For available-for sale securities in an unrealized loss position, we first assess whether (i) we intend to sell, or (ii) it is more likely than not that we will be required to sell the security before recovery of its amortized cost basis. If either case is affirmative, any previously recognized allowances are charged-off and the security's amortized cost is written down to fair value through income. If neither case is affirmative, the security is evaluated to determine whether the decline in fair value has resulted from credit losses or other factors. In making this assessment, management considers the extent to which fair value is less than amortized cost, any changes to the rating of the security by a rating agency and any adverse conditions specifically related to the security, among other factors. If this assessment indicates that a credit loss exists, the present value of cash flows expected to be collected from the security are compared to the amortized cost basis of the security. If the present value of cash flows expected to be collected is less than the amortized cost basis, a credit loss exists and an allowance for credit losses is recorded for the credit loss, limited by the amount that the fair value is less than the amortized cost basis. Any impairment that has not been recorded through an allowance for credit losses is recognized in other comprehensive income. Adjustments to the allowance are reported in our income statement as a component of credit loss expense. Management has made the accounting policy election to exclude accrued interest receivable on available-for-sale securities from the estimate of credit losses. Available-for-sale securities are charged-off against the allowance or, in the absence of any allowance, written down through income when deemed uncollectible by management or when either of the aforementioned criteria regarding intent or requirement to sell is met.

**Loans:** Loans are reported at the principal balance outstanding net of unearned discounts. Interest income on loans is reported on the level-yield method and includes amortization of deferred loan fees and costs over the terms of the individual loans to which they relate, or, in certain cases, over the average expected term for loans where deferred fees and costs are accounted for on a pooled basis. Net loan commitment fees or costs for commitment periods greater than one year are deferred and amortized into fee income or other expense on a straight-line basis over the commitment period. Income on direct financing leases is recognized on a basis that achieves a constant periodic rate of return on the outstanding investment. Further information regarding our accounting policies related to past due loans, non-accrual loans, collateral dependent loans and troubled-debt restructurings is presented in Note 3 - Loans.

**Allowance For Credit Losses - Loans:** The allowance for credit losses on loans is a contra-asset valuation account, calculated in accordance with ASC 326, that is deducted from the amortized cost basis of loans to present management's best estimate of the net amount expected to be collected. Loans are charged-off against the allowance when deemed uncollectible by management. Expected recoveries do not exceed the aggregate of amounts previously charged-off and expected to be charged-off. Adjustments to the allowance are reported in our income statement as a component of credit loss expense. Management has made the accounting policy election to exclude accrued interest receivable on loans from the estimate of credit losses. Further information regarding our policies and methodology used to estimate the allowance for credit losses on loans is presented in Note 3 - Loans.

**Allowance For Credit Losses - Off-Balance-Sheet Credit Exposures:** The allowance for credit losses on off-balance-sheet credit exposures is a liability account, calculated in accordance with ASC 326, representing expected credit losses over the contractual period for which we are exposed to credit risk resulting from a contractual obligation to extend credit. No allowance is recognized if we have the unconditional right to cancel the obligation. The allowance is reported as a component of accrued interest payable and other liabilities in our consolidated balance sheets. Adjustments to the allowance are reported in our income statement as a component of credit loss expense. Further information regarding our policies and methodology used to estimate the allowance for credit losses on off-balance-sheet credit exposures is presented in Note 6 - Off-Balance-Sheet Arrangements, Commitments, Guarantees and Contingencies.

As more fully discussed in our 2019 Form 10-K, we adopted certain accounting standard updates related to accounting for leases as of January 1, 2019 using a modified-retrospective transition approach and recognized right-of-use lease assets and related lease liabilities totaling \$170.5 million and \$174.4 million, respectively, as of that date. We also adopted an accounting standard update which shortened the amortization period for certain callable debt securities held at a premium as of January 1, 2019 using a modified retrospective transition adoption approach and recognized a cumulative effect reduction to retained earnings totaling \$14.7 million.

## Note 2 - Securities

*Securities - Held to Maturity.* A summary of the amortized cost, fair value and allowance for credit losses related to securities held to maturity as of June 30, 2020 and December 31, 2019 is presented below.

|                                        | Amortized<br>Cost   | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Estimated<br>Fair Value | Allowance<br>for Credit<br>Losses | Net<br>Carrying<br>Amount |
|----------------------------------------|---------------------|------------------------------|-------------------------------|-------------------------|-----------------------------------|---------------------------|
| <b>June 30, 2020</b>                   |                     |                              |                               |                         |                                   |                           |
| Residential mortgage-backed securities | \$ 529,868          | \$ 45,243                    | \$ —                          | \$ 575,111              | \$ —                              | \$ 529,868                |
| States and political subdivisions      | 1,437,758           | 59,072                       | —                             | 1,496,830               | (172)                             | 1,437,586                 |
| Other                                  | 1,500               | —                            | —                             | 1,500                   | —                                 | 1,500                     |
| Total                                  | <u>\$ 1,969,126</u> | <u>\$ 104,315</u>            | <u>\$ —</u>                   | <u>\$ 2,073,441</u>     | <u>\$ (172)</u>                   | <u>\$ 1,968,954</u>       |
| <b>December 31, 2019</b>               |                     |                              |                               |                         |                                   |                           |
| Residential mortgage-backed securities | \$ 530,861          | \$ 22                        | \$ 9,365                      | \$ 521,518              | \$ —                              | \$ 530,861                |
| States and political subdivisions      | 1,497,644           | 28,909                       | 896                           | 1,525,657               | —                                 | 1,497,644                 |
| Other                                  | 1,500               | —                            | —                             | 1,500                   | —                                 | 1,500                     |
| Total                                  | <u>\$ 2,030,005</u> | <u>\$ 28,931</u>             | <u>\$ 10,261</u>              | <u>\$ 2,048,675</u>     | <u>\$ —</u>                       | <u>\$ 2,030,005</u>       |

All mortgage-backed securities included in the above table were issued by U.S. government agencies and corporations. The carrying value of held-to-maturity securities pledged to secure public funds, trust deposits, repurchase agreements and for other purposes, as required or permitted by law was \$557.7 million and \$561.4 million at June 30, 2020 and December 31, 2019, respectively. Accrued interest receivable on held-to-maturity securities totaled \$22.1 million and \$21.1 million at June 30, 2020 and December 31, 2019, respectively and is included in accrued interest receivable and other assets in the accompanying consolidated balance sheets.

From time to time, we have reclassified certain securities from available for sale to held to maturity. During the fourth quarter of 2019, we reclassified securities with an aggregate fair value of \$377.8 million and an aggregate net unrealized gain of \$3.3 million (\$2.6 million, net of tax) on the date of the transfer. The net unamortized, unrealized gain remaining on transferred securities, including those transferred in 2019 and in years prior, included in accumulated other comprehensive income in the accompanying balance sheet totaled \$4.1 million (\$3.2 million, net of tax) at June 30, 2020 and \$4.8 million (\$3.8 million, net of tax) at December 31, 2019. This amount will be amortized out of accumulated other comprehensive income over the remaining life of the underlying securities as an adjustment of the yield on those securities.

The allowance for credit losses on held-to-maturity securities is a contra-asset valuation account that is deducted from the amortized cost basis of held-to-maturity securities to present the net amount expected to be collected. Management measures expected credit losses on held-to-maturity securities on a collective basis by major security type with each type sharing similar risk characteristics, and considers historical credit loss information that is adjusted for current conditions and reasonable and supportable forecasts. With regard to U.S. Treasury and residential mortgage-backed securities issued by the U.S. government, or agencies thereof, it is expected that the securities will not be settled at prices less than the amortized cost bases of the securities as such securities are backed by the full faith and credit of and/or guaranteed by the U.S. government. Accordingly, no allowance for credit losses has been recorded for these securities. With regard to securities issued by States and political subdivisions and other held-to-maturity securities, management considers (i) issuer bond ratings, (ii) historical loss rates for given bond ratings, (iii) whether issuers continue to make timely principal and interest payments under the contractual terms of the securities, (iv) internal forecasts and (v) whether or not such securities are guaranteed by the Texas Permanent School Fund ("PSF") or pre-refunded by the issuers.

The following table summarizes Moody's and/or Standard & Poor's bond ratings for our portfolio of held-to-maturity securities issued by States and political subdivisions and other securities as of June 30, 2020:

|           | States and Political Subdivisions |                                |                   |                     | Other<br>Securities |
|-----------|-----------------------------------|--------------------------------|-------------------|---------------------|---------------------|
|           | Not Guaranteed or<br>Pre-Refunded | Guaranteed by the<br>Texas PSF | Pre-Refunded      | Total               |                     |
| Aaa/AAA   | \$ 131,304                        | \$ 840,004                     | \$ 292,036        | \$ 1,263,344        | \$ —                |
| Aa/AA     | 111,427                           | —                              | —                 | 111,427             | —                   |
| A         | 62,987                            | —                              | —                 | 62,987              | —                   |
| Not rated | —                                 | —                              | —                 | —                   | 1,500               |
| Total     | <u>\$ 305,718</u>                 | <u>\$ 840,004</u>              | <u>\$ 292,036</u> | <u>\$ 1,437,758</u> | <u>\$ 1,500</u>     |

Historical loss rates associated with securities having similar grades as those in our portfolio have generally not been significant. Furthermore, as of June 30, 2020, there were no past due principal or interest payments associated with these securities. The PSF is a sovereign wealth fund which serves to provide revenues for funding of public primary and secondary education in the State of Texas. Based upon (i) the PSF's AAA insurer financial strength rating, (ii) the PSF's substantial capitalization and excess guarantee capacity and (iii) a zero historical loss rate, no allowance for credit losses has been recorded for securities guaranteed by the PSF as there is no current expectation of credit losses related to these securities. Pre-refunded securities have been defeased by the issuer and are fully secured by cash and/or U.S. Treasury securities held in escrow for payment to holders when the underlying call dates of the securities are reached. Accordingly, no allowance for credit losses has been recorded for securities that have been defeased as there is no current expectation of credit losses related to these securities.

The following table details activity in the allowance for credit losses on held-to-maturity securities during the three and six months ended June 30, 2020.

|                               | Three Months<br>Ended<br>June 30, 2020 | Six Months Ended<br>June 30, 2020 |
|-------------------------------|----------------------------------------|-----------------------------------|
| Beginning balance             | \$ 200                                 | \$ —                              |
| Impact of adopting ASC 326    | —                                      | 215                               |
| Credit loss expense (benefit) | (28)                                   | (43)                              |
| Ending balance                | <u>\$ 172</u>                          | <u>\$ 172</u>                     |

*Securities - Available for Sale.* A summary of the amortized cost, fair value and allowance for credit losses related to securities available for sale as of June 30, 2020 and December 31, 2019 is presented below.

|                                        | Amortized<br>Cost    | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Allowance<br>for Credit<br>Losses | Estimated<br>Fair Value |
|----------------------------------------|----------------------|------------------------------|-------------------------------|-----------------------------------|-------------------------|
| <b>June 30, 2020</b>                   |                      |                              |                               |                                   |                         |
| U.S. Treasury                          | \$ 1,117,867         | \$ 45,768                    | \$ —                          | \$ —                              | \$ 1,163,635            |
| Residential mortgage-backed securities | 2,051,686            | 79,604                       | 3                             | —                                 | 2,131,287               |
| States and political subdivisions      | 6,725,404            | 544,091                      | —                             | —                                 | 7,269,495               |
| Other                                  | 42,279               | —                            | —                             | —                                 | 42,279                  |
| Total                                  | <u>\$ 9,937,236</u>  | <u>\$ 669,463</u>            | <u>\$ 3</u>                   | <u>\$ —</u>                       | <u>\$ 10,606,696</u>    |
| <b>December 31, 2019</b>               |                      |                              |                               |                                   |                         |
| U.S. Treasury                          | \$ 1,941,283         | \$ 18,934                    | \$ 12,084                     | \$ —                              | \$ 1,948,133            |
| Residential mortgage-backed securities | 2,176,275            | 32,608                       | 1,289                         | —                                 | 2,207,594               |
| States and political subdivisions      | 6,717,344            | 353,857                      | 204                           | —                                 | 7,070,997               |
| Other                                  | 42,867               | —                            | —                             | —                                 | 42,867                  |
| Total                                  | <u>\$ 10,877,769</u> | <u>\$ 405,399</u>            | <u>\$ 13,577</u>              | <u>\$ —</u>                       | <u>\$ 11,269,591</u>    |

All mortgage-backed securities included in the above table were issued by U.S. government agencies and corporations. At June 30, 2020, nearly all of the securities in our available for sale municipal bond portfolio were issued by the State of Texas or political subdivisions or agencies within the State of Texas, of which approximately 70.7% are either guaranteed by the PSF or have been pre-refunded. Securities with limited marketability, such as stock in the Federal Reserve Bank and the Federal Home Loan Bank, are carried at cost and are reported as other available for sale securities in the table above. The carrying value of available-for-sale securities pledged to secure public funds, trust deposits, repurchase agreements and for other purposes, as required or permitted by law was \$3.2 billion and \$3.4 billion at June 30, 2020 and December 31, 2019, respectively. Accrued interest receivable on available-for-sale securities totaled \$114.3 million and \$115.9 million at June 30, 2020 and December 31, 2019, respectively, and is included in accrued interest receivable and other assets in the accompanying consolidated balance sheets.

The table below summarizes, as of June 30, 2020, securities available for sale in an unrealized loss position for which an allowance for credit losses has not been recorded, aggregated by type of security and length of time in a continuous unrealized loss position.

|                                        | Less than 12 Months     |                      | More than 12 Months     |                      | Total                   |                      |
|----------------------------------------|-------------------------|----------------------|-------------------------|----------------------|-------------------------|----------------------|
|                                        | Estimated<br>Fair Value | Unrealized<br>Losses | Estimated<br>Fair Value | Unrealized<br>Losses | Estimated<br>Fair Value | Unrealized<br>Losses |
| Residential mortgage-backed securities | \$ 1,243                | \$ 2                 | \$ 127                  | \$ 1                 | \$ 1,370                | \$ 3                 |
| Total                                  | <u>\$ 1,243</u>         | <u>\$ 2</u>          | <u>\$ 127</u>           | <u>\$ 1</u>          | <u>\$ 1,370</u>         | <u>\$ 3</u>          |

As of June 30, 2020, no allowance for credit losses has been recognized on available for sale securities in an unrealized loss position as management does not believe any of the securities are impaired due to reasons of credit quality. This is based upon our analysis of the underlying risk characteristics, including credit ratings, and other qualitative factors (such as a PSF guarantee) related to our available for sale securities and in consideration of our historical credit loss experience and internal forecasts. The issuers of these securities continue to make timely principal and interest payments under the contractual terms of the securities. Furthermore, management does not have the intent to sell any of the securities classified as available for sale in the table above and believes that it is more likely than not that we will not have to sell any such securities before a recovery of cost. The unrealized losses are due to increases in market interest rates over the yields available at the time the underlying securities were purchased. The fair value is expected to recover as the securities approach their maturity date or repricing date or if market yields for such investments decline.

*Contractual Maturities.* The following table summarizes the maturity distribution schedule of securities held to maturity and securities available for sale as of June 30, 2020. Mortgage-backed securities are included in maturity categories based on their stated maturity date. Expected maturities may differ from contractual maturities because issuers may have the right to call or prepay obligations. Other securities classified as available for sale include stock in the Federal Reserve Bank and the Federal Home Loan Bank, which have no maturity date. These securities have been included in the total column only.

|                                        | Within 1 Year     | 1 - 5 Years         | 5 - 10 Years        | After 10 Years      | Total                |
|----------------------------------------|-------------------|---------------------|---------------------|---------------------|----------------------|
| <b>Held To Maturity</b>                |                   |                     |                     |                     |                      |
| <i>Amortized Cost</i>                  |                   |                     |                     |                     |                      |
| Residential mortgage-backed securities | \$ —              | \$ 285              | \$ 516,618          | \$ 12,965           | \$ 529,868           |
| States and political subdivisions      | 25,717            | 339,996             | 425,582             | 646,463             | 1,437,758            |
| Other                                  | —                 | 1,500               | —                   | —                   | 1,500                |
| Total                                  | <u>\$ 25,717</u>  | <u>\$ 341,781</u>   | <u>\$ 942,200</u>   | <u>\$ 659,428</u>   | <u>\$ 1,969,126</u>  |
| <i>Estimated Fair Value</i>            |                   |                     |                     |                     |                      |
| Residential mortgage-backed securities | \$ —              | \$ 287              | \$ 560,606          | \$ 14,218           | \$ 575,111           |
| States and political subdivisions      | 25,991            | 353,852             | 439,542             | 677,445             | 1,496,830            |
| Other                                  | —                 | 1,500               | —                   | —                   | 1,500                |
| Total                                  | <u>\$ 25,991</u>  | <u>\$ 355,639</u>   | <u>\$ 1,000,148</u> | <u>\$ 691,663</u>   | <u>\$ 2,073,441</u>  |
| <b>Available For Sale</b>              |                   |                     |                     |                     |                      |
| <i>Amortized Cost</i>                  |                   |                     |                     |                     |                      |
| U. S. Treasury                         | \$ 33,986         | \$ 1,083,881        | \$ —                | \$ —                | \$ 1,117,867         |
| Residential mortgage-backed securities | 126               | 57,223              | 5,424               | 1,988,913           | 2,051,686            |
| States and political subdivisions      | 241,102           | 411,156             | 658,064             | 5,415,082           | 6,725,404            |
| Other                                  | —                 | —                   | —                   | —                   | 42,279               |
| Total                                  | <u>\$ 275,214</u> | <u>\$ 1,552,260</u> | <u>\$ 663,488</u>   | <u>\$ 7,403,995</u> | <u>\$ 9,937,236</u>  |
| <i>Estimated Fair Value</i>            |                   |                     |                     |                     |                      |
| U. S. Treasury                         | \$ 34,067         | \$ 1,129,568        | \$ —                | \$ —                | \$ 1,163,635         |
| Residential mortgage-backed securities | 133               | 59,793              | 5,967               | 2,065,394           | 2,131,287            |
| States and political subdivisions      | 243,001           | 444,100             | 714,089             | 5,868,305           | 7,269,495            |
| Other                                  | —                 | —                   | —                   | —                   | 42,279               |
| Total                                  | <u>\$ 277,201</u> | <u>\$ 1,633,461</u> | <u>\$ 720,056</u>   | <u>\$ 7,933,699</u> | <u>\$ 10,606,696</u> |

*Sales of Securities.* Sales of securities available for sale were as follows:

|                                                  | Three Months Ended<br>June 30, |              | Six Months Ended<br>June 30, |              |
|--------------------------------------------------|--------------------------------|--------------|------------------------------|--------------|
|                                                  | 2020                           | 2019         | 2020                         | 2019         |
| Proceeds from sales                              | \$ 51,250                      | \$ 2,346,626 | \$ 1,162,352                 | \$ 3,291,529 |
| Gross realized gains                             | —                              | 803          | 108,989                      | 803          |
| Gross realized losses                            | —                              | (634)        | —                            | (634)        |
| Tax (expense) benefit of securities gains/losses | —                              | (35)         | (22,888)                     | (35)         |

*Premiums and Discounts.* Premium amortization and discount accretion included in interest income on securities was as follows:

|                                               | Three Months Ended<br>June 30, |                    | Six Months Ended<br>June 30, |                    |
|-----------------------------------------------|--------------------------------|--------------------|------------------------------|--------------------|
|                                               | 2020                           | 2019               | 2020                         | 2019               |
| Premium amortization                          | \$ (30,988)                    | \$ (29,408)        | \$ (63,333)                  | \$ (59,287)        |
| Discount accretion                            | 571                            | 1,378              | 1,156                        | 2,561              |
| Net (premium amortization) discount accretion | <u>\$ (30,417)</u>             | <u>\$ (28,030)</u> | <u>\$ (62,177)</u>           | <u>\$ (56,726)</u> |

*Trading Account Securities.* Trading account securities, at estimated fair value, were as follows:

|               | June 30,<br>2020 | December 31,<br>2019 |
|---------------|------------------|----------------------|
| U.S. Treasury | \$ 24,495        | \$ 24,298            |
| Total         | <u>\$ 24,495</u> | <u>\$ 24,298</u>     |

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

|                                               | Three Months Ended<br>June 30, |               | Six Months Ended<br>June 30, |                 |
|-----------------------------------------------|--------------------------------|---------------|------------------------------|-----------------|
|                                               | 2020                           | 2019          | 2020                         | 2019            |
| Net gain on sales transactions                | \$ 304                         | \$ 552        | \$ 774                       | \$ 1,058        |
| Net mark-to-market gains (losses)             | (22)                           | 27            | 93                           | 31              |
| Net gain (loss) on trading account securities | <u>\$ 282</u>                  | <u>\$ 579</u> | <u>\$ 867</u>                | <u>\$ 1,089</u> |

### Note 3 - Loans

Loans were as follows:

|                              | June 30,<br>2020     | Percentage<br>of Total | December 31,<br>2019 | Percentage<br>of Total |
|------------------------------|----------------------|------------------------|----------------------|------------------------|
| Commercial and industrial    | \$ 5,004,229         | 27.9 %                 | \$ 5,187,466         | 35.2 %                 |
| Energy:                      |                      |                        |                      |                        |
| Production                   | 1,162,673            | 6.5                    | 1,348,900            | 9.2                    |
| Service                      | 164,597              | 0.9                    | 192,996              | 1.3                    |
| Other                        | 97,610               | 0.5                    | 110,986              | 0.8                    |
| Total energy                 | 1,424,880            | 7.9                    | 1,652,882            | 11.2                   |
| Paycheck Protection Program  | 3,162,279            | 17.6                   | —                    | —                      |
| Commercial real estate:      |                      |                        |                      |                        |
| Commercial mortgages         | 5,042,546            | 28.1                   | 4,594,113            | 31.1                   |
| Construction                 | 1,265,550            | 7.0                    | 1,312,659            | 8.9                    |
| Land                         | 316,839              | 1.8                    | 289,467              | 2.0                    |
| Total commercial real estate | 6,624,935            | 36.9                   | 6,196,239            | 42.0                   |
| Consumer real estate:        |                      |                        |                      |                        |
| Home equity loans            | 346,210              | 1.9                    | 375,596              | 2.6                    |
| Home equity lines of credit  | 395,099              | 2.2                    | 354,671              | 2.4                    |
| Other                        | 508,876              | 2.8                    | 464,146              | 3.1                    |
| Total consumer real estate   | 1,250,185            | 6.9                    | 1,194,413            | 8.1                    |
| Total real estate            | 7,875,120            | 43.8                   | 7,390,652            | 50.1                   |
| Consumer and other           | 505,429              | 2.8                    | 519,332              | 3.5                    |
| Total loans                  | <u>\$ 17,971,937</u> | <u>100.0 %</u>         | <u>\$ 14,750,332</u> | <u>100.0 %</u>         |

*Concentrations of Credit.* Most of our lending activity occurs within the State of Texas, including the four largest metropolitan areas of Austin, Dallas/Ft. Worth, Houston and San Antonio, as well as other markets. The majority of our loan portfolio consists of commercial and industrial and commercial real estate loans. As of June 30, 2020, there were no concentrations of loans related to any single industry in excess of 10% of total loans. The largest industry concentration was related to the energy industry, which totaled 7.9% of total loans, or 9.6% excluding PPP loans. Unfunded commitments to extend credit and standby letters of credit issued to customers in the energy industry totaled \$982.6 million and \$63.0 million, respectively, as of June 30, 2020.



**Foreign Loans.** We have U.S. dollar denominated loans and commitments to borrowers in Mexico. The outstanding balance of these loans and the unfunded amounts available under these commitments were not significant at June 30, 2020 or December 31, 2019.

**Related Party Loans.** In the ordinary course of business, we have granted loans to certain directors, executive officers and their affiliates (collectively referred to as “related parties”). Such loans totaled \$314.2 million at June 30, 2020 and \$298.5 million at December 31, 2019.

**Accrued Interest Receivable.** Accrued interest receivable on loans totaled \$39.9 million and \$45.5 million at June 30, 2020 and December 31, 2019, respectively and is included in accrued interest receivable and other assets in the accompany consolidated balance sheets.

**COVID-19 Loan Deferments.** Certain borrowers are currently unable to meet their contractual payment obligations because of the adverse effects of COVID-19. To help mitigate these effects, loan customers may apply for a deferral of payments, or portions thereof, for up to 90 days. In the absence of other intervening factors, such short-term modifications made on a good faith basis are not categorized as troubled debt restructurings, nor are loans granted payment deferrals related to COVID-19 reported as past due or placed on non-accrual status (provided the loans were not past due or on non-accrual status prior to the deferral). At June 30, 2020, there were nearly 3,100 loans in COVID-19 related deferment with an aggregate outstanding balance of approximately \$2.1 billion.

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

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

|                             | June 30, 2020     |                                           | December 31, 2019 |                                           |
|-----------------------------|-------------------|-------------------------------------------|-------------------|-------------------------------------------|
|                             | Total Non-Accrual | Non-Accrual with No Credit Loss Allowance | Total Non-Accrual | Non-Accrual with No Credit Loss Allowance |
| Commercial and industrial   | \$ 27,146         | \$ 10,623                                 | \$ 26,038         | \$ 13,266                                 |
| Energy                      | 36,239            | 30,892                                    | 65,761            | 3,281                                     |
| Paycheck Protection Program | —                 | —                                         | —                 | —                                         |
| Commercial real estate:     |                   |                                           |                   |                                           |
| Buildings, land and other   | 12,154            | 6,513                                     | 8,912             | 6,558                                     |
| Construction                | 1,869             | 677                                       | 665               | 665                                       |
| Consumer real estate        | 2,035             | 2,035                                     | 922               | 922                                       |
| Consumer and other          | 18                | —                                         | 5                 | —                                         |
| Total                       | \$ 79,461         | \$ 50,740                                 | \$ 102,303        | \$ 24,692                                 |

The following table presents non-accrual loans as of June 30, 2020 by class and year of origination.

|                             | 2020             | 2019            | 2018            | 2017            | 2016            | Prior           | Revolving<br>Loans | Revolving<br>Loans<br>Converted to<br>Term | Total            |
|-----------------------------|------------------|-----------------|-----------------|-----------------|-----------------|-----------------|--------------------|--------------------------------------------|------------------|
| Commercial and industrial   | \$ 1,439         | \$ 2,951        | \$ 8,023        | \$ 2,130        | \$ 290          | \$ 111          | \$ 8,163           | \$ 4,039                                   | \$ 27,146        |
| Energy                      | 27,628           | —               | —               | —               | —               | —               | 2,929              | 5,682                                      | 36,239           |
| Paycheck Protection Program | —                | —               | —               | —               | —               | —               | —                  | —                                          | —                |
| Commercial real estate:     |                  |                 |                 |                 |                 |                 |                    |                                            |                  |
| Buildings, land and other   | 249              | 5,763           | 33              | 1,393           | 659             | 3,700           | 357                | —                                          | 12,154           |
| Construction                | 1,192            | 677             | —               | —               | —               | —               | —                  | —                                          | 1,869            |
| Consumer real estate        | —                | —               | 418             | 211             | 350             | 663             | 336                | 57                                         | 2,035            |
| Consumer and other          | —                | —               | —               | —               | —               | —               | 18                 | —                                          | 18               |
| Total                       | <u>\$ 30,508</u> | <u>\$ 9,391</u> | <u>\$ 8,474</u> | <u>\$ 3,734</u> | <u>\$ 1,299</u> | <u>\$ 4,474</u> | <u>\$ 11,803</u>   | <u>\$ 9,778</u>                            | <u>\$ 79,461</u> |

Had non-accrual loans performed in accordance with their original contract terms, we would have recognized additional interest income, net of tax, of approximately \$570 thousand and \$1.6 million for the three and six months ended June 30, 2020, and approximately \$1.1 million and \$2.1 million for the three and six months ended June 30, 2019.

An age analysis of past due loans (including both accruing and non-accruing loans), segregated by class of loans, as of June 30, 2020 was as follows:

|                             | Loans<br>30-89 Days<br>Past Due | Loans<br>90 or More<br>Days<br>Past Due | Total<br>Past Due<br>Loans | Current<br>Loans     | Total<br>Loans       | Accruing<br>Loans 90 or<br>More Days<br>Past Due |
|-----------------------------|---------------------------------|-----------------------------------------|----------------------------|----------------------|----------------------|--------------------------------------------------|
| Commercial and industrial   | \$ 34,018                       | \$ 23,765                               | \$ 57,783                  | \$ 4,946,446         | \$ 5,004,229         | \$ 7,669                                         |
| Energy                      | 9,319                           | 7,978                                   | 17,297                     | 1,407,583            | 1,424,880            | 2,466                                            |
| Paycheck Protection Program | —                               | —                                       | —                          | 3,162,279            | 3,162,279            | —                                                |
| Commercial real estate:     |                                 |                                         |                            |                      |                      |                                                  |
| Buildings, land and other   | 10,271                          | 9,593                                   | 19,864                     | 5,339,521            | 5,359,385            | 5,225                                            |
| Construction                | 3,164                           | —                                       | 3,164                      | 1,262,386            | 1,265,550            | —                                                |
| Consumer real estate        | 10,437                          | 5,876                                   | 16,313                     | 1,233,872            | 1,250,185            | 4,661                                            |
| Consumer and other          | 7,621                           | 976                                     | 8,597                      | 496,832              | 505,429              | 976                                              |
| Total                       | <u>\$ 74,830</u>                | <u>\$ 48,188</u>                        | <u>\$ 123,018</u>          | <u>\$ 17,848,919</u> | <u>\$ 17,971,937</u> | <u>\$ 20,997</u>                                 |

*Troubled Debt Restructurings.* Troubled debt restructurings during the six months ended June 30, 2020 and June 30, 2019 are set forth in the following table.

|                           | Six Months Ended<br>June 30, 2020 |                          | Six Months Ended<br>June 30, 2019 |                          |
|---------------------------|-----------------------------------|--------------------------|-----------------------------------|--------------------------|
|                           | Balance at<br>Restructure         | Balance at<br>Period-End | Balance at<br>Restructure         | Balance at<br>Period-End |
| Commercial and industrial | \$ 3,660                          | \$ 3,652                 | \$ 677                            | \$ 555                   |
| Commercial real estate:   |                                   |                          |                                   |                          |
| Buildings, land and other | 6,606                             | 6,606                    | 7,347                             | 7,308                    |
| Construction              | 1,192                             | 1,192                    | —                                 | —                        |
| Consumer and other        | 1,104                             | 1,104                    | —                                 | —                        |
|                           | <u>\$ 12,562</u>                  | <u>\$ 12,554</u>         | <u>\$ 8,024</u>                   | <u>\$ 7,863</u>          |

Loan modifications are typically related to extending amortization periods, converting loans to interest only for a limited period of time, deferral of interest payments, waiver of certain covenants, consolidating notes and/or reducing collateral or interest rates. The modifications during the reported periods did not significantly impact our determination of the allowance for credit losses on loans.

Additional information related to restructured loans as of or for the three months ended June 30, 2020 and June 30, 2019 is set forth in the following table.

|                                                                 | June 30, 2020 | June 30, 2019 |
|-----------------------------------------------------------------|---------------|---------------|
| Restructured loans past due in excess of 90 days at period-end: |               |               |
| Number of loans                                                 | —             | —             |
| Dollar amount of loans                                          | \$ —          | \$ —          |
| Restructured loans on non-accrual status at period end          | 7,631         | 3,890         |
| Charge-offs of restructured loans:                              |               |               |
| Recognized in connection with restructuring                     | —             | —             |
| Recognized on previously restructured loans                     | —             | —             |

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

We utilize a risk grading matrix to assign a risk grade to each of our commercial loans. Loans are graded on a scale of 1 to 14. A description of the general characteristics of the 14 risk grades is set forth in our 2019 Form 10-K. We monitor portfolio credit quality by the weighted-average risk grade of each class of commercial loan. Individual relationship managers, under the oversight of credit administration, review updated financial information for all pass grade loans to reassess the risk grade on at least an annual basis. When a loan has a risk grade of 9, it is still considered a pass grade loan; however, it is considered to be on management's "watch list," where a significant risk-modifying action is anticipated in the near term. When a loan has a risk grade of 10 or higher, a special assets officer monitors the loan on an on-going basis.

The following tables present weighted-average risk grades for all commercial loans, by class and year of origination/renewal as of June 30, 2020. Paycheck Protection Program ("PPP") loans are excluded as such loans are fully guaranteed by the Small Business Administration ("SBA").

|                           | 2020                | 2019              | 2018              | 2017              | 2016              | Prior             | Revolving<br>Loans  | Revolving<br>Loans<br>Converted to<br>Term | Total               | W/A<br>Risk<br>Grade |
|---------------------------|---------------------|-------------------|-------------------|-------------------|-------------------|-------------------|---------------------|--------------------------------------------|---------------------|----------------------|
| Commercial and industrial |                     |                   |                   |                   |                   |                   |                     |                                            |                     |                      |
| Risk grades 1-8           | \$ 964,725          | \$ 717,740        | \$ 381,096        | \$ 293,462        | \$ 135,834        | \$ 131,562        | \$ 1,870,668        | \$ 43,753                                  | \$ 4,538,840        | 6.12                 |
| Risk grade 9              | 40,097              | 40,498            | 47,038            | 23,292            | 17,302            | 10,094            | 100,309             | 7,624                                      | 286,254             | 9.00                 |
| Risk grade 10             | 511                 | 6,542             | 13,823            | 6,106             | 1,106             | 914               | 55,019              | 322                                        | 84,343              | 10.00                |
| Risk grade 11             | 627                 | 11,037            | 8,118             | 3,825             | 978               | 2,258             | 32,625              | 8,178                                      | 67,646              | 11.00                |
| Risk grade 12             | —                   | 400               | 6,891             | 1,366             | 290               | 111               | 3,921               | 2,416                                      | 15,395              | 12.00                |
| Risk grade 13             | 1,439               | 2,551             | 1,132             | 764               | —                 | —                 | 4,242               | 1,623                                      | 11,751              | 13.00                |
|                           | <u>\$ 1,007,399</u> | <u>\$ 778,768</u> | <u>\$ 458,098</u> | <u>\$ 328,815</u> | <u>\$ 155,510</u> | <u>\$ 144,939</u> | <u>\$ 2,066,784</u> | <u>\$ 63,916</u>                           | <u>\$ 5,004,229</u> | 6.45                 |
| W/A Risk grade            | 5.86                | 6.75              | 7.25              | 6.26              | 6.51              | 6.08              | 6.46                | 7.90                                       | 6.45                |                      |
| Energy                    |                     |                   |                   |                   |                   |                   |                     |                                            |                     |                      |
| Risk grades 1-8           | \$ 464,306          | \$ 34,818         | \$ 15,531         | \$ 7,152          | \$ 2,177          | \$ 4,931          | \$ 458,761          | \$ 18,745                                  | \$ 1,006,421        | 6.17                 |
| Risk grade 9              | 109,731             | 14,431            | 3,754             | 18                | —                 | —                 | 97,175              | 16,594                                     | 241,703             | 9.00                 |
| Risk grade 10             | 32,588              | 228               | 1,203             | 1,032             | 930               | —                 | 10,054              | 952                                        | 46,987              | 10.00                |
| Risk grade 11             | 59,119              | 341               | 1,268             | 3,261             | —                 | 1,110             | 28,152              | 279                                        | 93,530              | 11.00                |
| Risk grade 12             | 27,628              | —                 | —                 | —                 | —                 | —                 | 2,929               | 3,432                                      | 33,989              | 12.00                |
| Risk grade 13             | —                   | —                 | —                 | —                 | —                 | —                 | —                   | 2,250                                      | 2,250               | 13.00                |
|                           | <u>\$ 693,372</u>   | <u>\$ 49,818</u>  | <u>\$ 21,756</u>  | <u>\$ 11,463</u>  | <u>\$ 3,107</u>   | <u>\$ 6,041</u>   | <u>\$ 597,071</u>   | <u>\$ 42,252</u>                           | <u>\$ 1,424,880</u> | 7.24                 |
| W/A Risk grade            | 7.42                | 7.76              | 7.73              | 8.56              | 7.50              | 7.67              | 6.82                | 8.90                                       | 7.24                |                      |

|                              | 2020              | 2019                | 2018                | 2017              | 2016              | Prior               | Revolving<br>Loans | Revolving<br>Loans<br>Converted to<br>Term | Total               | W/A<br>Risk<br>Grade |
|------------------------------|-------------------|---------------------|---------------------|-------------------|-------------------|---------------------|--------------------|--------------------------------------------|---------------------|----------------------|
| Commercial real estate:      |                   |                     |                     |                   |                   |                     |                    |                                            |                     |                      |
| Buildings, land, other       |                   |                     |                     |                   |                   |                     |                    |                                            |                     |                      |
| Risk grades 1-8              | \$ 738,500        | \$ 1,050,204        | \$ 781,460          | \$ 749,286        | \$ 471,551        | \$ 812,382          | \$ 68,195          | \$ 54,199                                  | \$ 4,725,777        | 6.97                 |
| Risk grade 9                 | 2,459             | 75,727              | 41,972              | 67,920            | 77,455            | 103,423             | 2,150              | 783                                        | 371,889             | 9.00                 |
| Risk grade 10                | 995               | 20,053              | 3,206               | 35,727            | 29,801            | 56,419              | 2,422              | 2,876                                      | 151,499             | 10.00                |
| Risk grade 11                | 3,353             | 11,407              | 3,798               | 38,848            | 14,901            | 20,944              | 3,100              | 1,715                                      | 98,066              | 11.00                |
| Risk grade 12                | 249               | 4,963               | 33                  | 1,393             | 659               | 3,450               | 294                | —                                          | 11,041              | 12.00                |
| Risk grade 13                | —                 | 800                 | —                   | —                 | —                 | 250                 | 63                 | —                                          | 1,113               | 13.00                |
|                              | <u>\$ 745,556</u> | <u>\$ 1,163,154</u> | <u>\$ 830,469</u>   | <u>\$ 893,174</u> | <u>\$ 594,367</u> | <u>\$ 996,868</u>   | <u>\$ 76,224</u>   | <u>\$ 59,573</u>                           | <u>\$ 5,359,385</u> | <u>7.28</u>          |
| W/A Risk grade               | 7.20              | 7.27                | 7.13                | 7.44              | 7.62              | 7.17                | 7.29               | 6.93                                       | 7.28                |                      |
| Construction                 |                   |                     |                     |                   |                   |                     |                    |                                            |                     |                      |
| Risk grades 1-8              | \$ 189,575        | \$ 435,960          | \$ 362,978          | \$ 764            | \$ 1,178          | \$ 16,956           | \$ 131,793         | \$ —                                       | \$ 1,139,204        | 7.15                 |
| Risk grade 9                 | 3,103             | 11,714              | 49,915              | 7,818             | 6,984             | —                   | 14,514             | —                                          | 94,048              | 9.00                 |
| Risk grade 10                | 13,124            | 12,864              | 2,589               | 891               | —                 | —                   | —                  | —                                          | 29,468              | 10.00                |
| Risk grade 11                | —                 | —                   | —                   | —                 | —                 | 961                 | —                  | —                                          | 961                 | 11.00                |
| Risk grade 12                | 992               | 677                 | —                   | —                 | —                 | —                   | —                  | —                                          | 1,669               | 12.00                |
| Risk grade 13                | 200               | —                   | —                   | —                 | —                 | —                   | —                  | —                                          | 200                 | 13.00                |
|                              | <u>\$ 206,994</u> | <u>\$ 461,215</u>   | <u>\$ 415,482</u>   | <u>\$ 9,473</u>   | <u>\$ 8,162</u>   | <u>\$ 17,917</u>    | <u>\$ 146,307</u>  | <u>\$ —</u>                                | <u>\$ 1,265,550</u> | <u>7.36</u>          |
| W/A Risk grade               | 7.30              | 7.23                | 7.64                | 9.00              | 8.75              | 6.31                | 6.97               | —                                          | 7.36                |                      |
| Total commercial real estate | <u>\$ 952,550</u> | <u>\$ 1,624,369</u> | <u>\$ 1,245,951</u> | <u>\$ 902,647</u> | <u>\$ 602,529</u> | <u>\$ 1,014,785</u> | <u>\$ 222,531</u>  | <u>\$ 59,573</u>                           | <u>\$ 6,624,935</u> | <u>7.30</u>          |
| W/A Risk grade               | 7.22              | 7.26                | 7.30                | 7.45              | 7.63              | 7.16                | 7.08               | 6.93                                       | 7.30                |                      |

In the tables above, certain loans are reported as 2020 originations and have risk grades of 11 or higher. These loans were, for the most part, first originated in various years prior to 2020 but were renewed in the current year.

The following tables present weighted average risk grades for all commercial loans by class as of December 31, 2019.

|                 | Commercial and Industrial |                     | Energy         |                     | Commercial Real Estate - Buildings, Land and Other |                     | Commercial Real Estate - Construction |                     | Total Commercial Real Estate |                     |
|-----------------|---------------------------|---------------------|----------------|---------------------|----------------------------------------------------|---------------------|---------------------------------------|---------------------|------------------------------|---------------------|
|                 | W/A Risk Grade            | Loans               | W/A Risk Grade | Loans               | W/A Risk Grade                                     | Loans               | W/A Risk Grade                        | Loans               | W/A Risk Grade               | Loans               |
| Risk grades 1-8 | 6.17                      | \$ 4,788,857        | 5.90           | \$ 1,488,301        | 6.78                                               | \$ 4,523,271        | 7.25                                  | \$ 1,274,098        | 6.88                         | \$ 5,797,369        |
| Risk grade 9    | 9.00                      | 247,212             | 9.00           | 32,163              | 9.00                                               | 163,714             | 9.00                                  | 21,509              | 9.00                         | 185,223             |
| Risk grade 10   | 10.00                     | 71,472              | 10.00          | 51,898              | 10.00                                              | 103,626             | 10.00                                 | 15,243              | 10.00                        | 118,869             |
| Risk grade 11   | 11.00                     | 53,887              | 11.00          | 14,760              | 11.00                                              | 84,057              | 11.00                                 | 1,144               | 11.00                        | 85,201              |
| Risk grade 12   | 12.00                     | 18,189              | 12.00          | 45,514              | 12.00                                              | 8,529               | 12.00                                 | 665                 | 12.00                        | 9,194               |
| Risk grade 13   | 13.00                     | 7,849               | 13.00          | 20,246              | 13.00                                              | 383                 | 13.00                                 | —                   | 13.00                        | 383                 |
| Total           | 6.44                      | <u>\$ 5,187,466</u> | 6.39           | <u>\$ 1,652,882</u> | 7.01                                               | <u>\$ 4,883,580</u> | 7.31                                  | <u>\$ 1,312,659</u> | 7.07                         | <u>\$ 6,196,239</u> |

Information about the payment status of consumer loans, segregated by portfolio segment and year of origination, as of June 30, 2020 was as follows:

|                              | 2020              | 2019              | 2018              | 2017              | 2016             | Prior             | Revolving<br>Loans | Revolving<br>Loans<br>Converted to<br>Term | Total               |
|------------------------------|-------------------|-------------------|-------------------|-------------------|------------------|-------------------|--------------------|--------------------------------------------|---------------------|
| <b>Consumer real estate:</b> |                   |                   |                   |                   |                  |                   |                    |                                            |                     |
| Past due 30-89 days          | \$ 308            | \$ 392            | \$ 744            | \$ 1,424          | \$ 951           | \$ 5,552          | \$ 594             | \$ 472                                     | \$ 10,437           |
| Past due 90 or more days     | 631               | 139               | 825               | 364               | 385              | 1,622             | 1,772              | 138                                        | 5,876               |
| Total past due               | 939               | 531               | 1,569             | 1,788             | 1,336            | 7,174             | 2,366              | 610                                        | 16,313              |
| Current loans                | 153,945           | 208,060           | 125,413           | 107,404           | 84,106           | 162,656           | 373,461            | 18,827                                     | 1,233,872           |
| Total                        | <u>\$ 154,884</u> | <u>\$ 208,591</u> | <u>\$ 126,982</u> | <u>\$ 109,192</u> | <u>\$ 85,442</u> | <u>\$ 169,830</u> | <u>\$ 375,827</u>  | <u>\$ 19,437</u>                           | <u>\$ 1,250,185</u> |
| <b>Consumer and other:</b>   |                   |                   |                   |                   |                  |                   |                    |                                            |                     |
| Past due 30-89 days          | \$ 995            | \$ 164            | \$ 88             | \$ 10             | \$ 35            | \$ 1              | \$ 6,157           | \$ 171                                     | \$ 7,621            |
| Past due 90 or more days     | 83                | 43                | 3                 | —                 | —                | —                 | 791                | 56                                         | 976                 |
| Total past due               | 1,078             | 207               | 91                | 10                | 35               | 1                 | 6,948              | 227                                        | 8,597               |
| Current loans                | 28,816            | 39,651            | 11,925            | 3,775             | 2,421            | 1,292             | 382,499            | 26,453                                     | 496,832             |
| Total                        | <u>\$ 29,894</u>  | <u>\$ 39,858</u>  | <u>\$ 12,016</u>  | <u>\$ 3,785</u>   | <u>\$ 2,456</u>  | <u>\$ 1,293</u>   | <u>\$ 389,447</u>  | <u>\$ 26,680</u>                           | <u>\$ 505,429</u>   |

Revolving loans that converted to term during the three and six months ended June 30, 2020 were as follows:

|                                | Three Months<br>Ended<br>June 30, 2020 | Six Months Ended<br>June 30, 2020 |
|--------------------------------|----------------------------------------|-----------------------------------|
| Commercial and industrial      | \$ 9,405                               | \$ 18,975                         |
| Energy                         | 26,839                                 | 42,186                            |
| <b>Commercial real estate:</b> |                                        |                                   |
| Buildings, land and other      | —                                      | 7,551                             |
| Construction                   | —                                      | —                                 |
| Consumer real estate           | 905                                    | 1,955                             |
| Consumer and other             | 10,371                                 | 10,371                            |
| Total                          | <u>\$ 47,520</u>                       | <u>\$ 81,038</u>                  |

In assessing the general economic conditions in the State of Texas, management monitors and tracks the Texas Leading Index (“TLI”), which is produced by the Federal Reserve Bank of Dallas. The TLI, the components of which are more fully described in our 2019 Form 10-K, totaled 106.7 at June 30, 2020 and 127.9 at December 31, 2019. A lower TLI value implies less favorable economic conditions.

**Allowance For Credit Losses - Loans.** The allowance for credit losses on loans is a contra-asset valuation account, calculated in accordance with ASC 326, that is deducted from the amortized cost basis of loans to present the net amount expected to be collected. The amount of the allowance represents management's best estimate of current expected credit losses on loans considering available information, from internal and external sources, relevant to assessing collectibility over the loans' contractual terms, adjusted for expected prepayments when appropriate. The contractual term excludes expected extensions, renewals and modifications unless (i) management has a reasonable expectation that a trouble debt restructuring will be executed with an individual borrower or (ii) such extension or renewal options are not unconditionally cancellable by us and, in such cases, the borrower is likely to meet applicable conditions and likely to request extension or renewal. Relevant available information includes historical credit loss experience, current conditions and reasonable and supportable forecasts. While historical credit loss experience provides the basis for the estimation of expected credit losses, adjustments to historical loss information may be made for differences in current portfolio-specific risk characteristics, environmental conditions or other relevant factors. The allowance for credit losses is measured on a collective basis for portfolios of loans when similar risk characteristics exist. Loans that do not share risk characteristics are evaluated for expected credit losses on an individual basis and excluded from the collective evaluation. Expected credit losses for collateral dependent loans, including loans where the borrower is experiencing financial difficulty but foreclosure is not probable, are based on the fair value of the collateral at the reporting date, adjusted for selling costs as appropriate.

Credit loss expense related to loans reflects the totality of actions taken on all loans for a particular period including any necessary increases or decreases in the allowance related to changes in credit loss expectations associated with specific loans or pools of loans. Portions of the allowance may be allocated for specific credits; however, the entire allowance is available for any credit that, in management's judgment, should be charged off. While management utilizes its best judgment and information available, the ultimate appropriateness of the allowance is dependent upon a variety of factors beyond our control, including the performance of our loan portfolio, the economy, changes in interest rates and the view of the regulatory authorities toward loan classifications.

In calculating the allowance for credit losses, most loans are segmented into pools based upon similar characteristics and risk profiles. Common characteristics and risk profiles include the type/purpose of loan, underlying collateral, geographical similarity and historical/expected credit loss patterns. In developing these loan pools for the purposes of modeling expected credit losses, we also analyzed the degree of correlation in how loans within each portfolio respond when subjected to varying economic conditions and scenarios as well as other portfolio stress factors. For modeling purposes, our loan pools include (i) commercial and industrial and energy - non-revolving, (ii) commercial and industrial and energy - revolving, (iii) commercial real estate - owner occupied, (iv) commercial real estate - non-owner occupied, (v) commercial real estate - construction/land development, (vi) consumer real estate and (vii) consumer and other. We periodically reassess each pool to ensure the loans within the pool continue to share similar characteristics and risk profiles and to determine whether further segmentation is necessary.

For each loan pool, we measure expected credit losses over the life of each loan utilizing a combination of models which measure (i) probability of default ("PD"), which is the likelihood that loan will stop performing/default, (ii) probability of attrition ("PA"), which is the likelihood that a loan will pay-off prior to maturity, (iii) loss given default ("LGD"), which is the expected loss rate for loans in default and (iv) exposure at default ("EAD"), which is the estimated outstanding principal balance of the loans upon default, including the expected funding of unfunded commitments outstanding as of the measurement date. For certain commercial loan portfolios, the PD is calculated using a transition matrix to determine the likelihood of a customer's risk grade migrating from one specified range of risk grades to a different specified range. Expected credit losses are calculated as the product of PD (adjusted for attrition), LGD and EAD. This methodology builds on default probabilities already incorporated into our risk grading process by utilizing pool-specific historical loss rates to calculate expected credit losses. These pool-specific historical loss rates may be adjusted for current macroeconomic assumptions, as further discussed below, and other factors such as differences in underwriting standards, portfolio mix, or when historical asset terms do not reflect the contractual terms of the financial assets being evaluated as of the measurement date. Each time we measure expected credit losses, we assess the relevancy of historical loss information and consider any necessary adjustments to address any differences in asset-specific characteristics. Due to their short-term nature, expected credit losses for overdrafts included in consumer and other loans are based solely upon a weighting of recent historical charge-offs over a period of three years.

The measurement of expected credit losses is impacted by loan/borrower attributes and certain macroeconomic variables. Significant loan/borrower attributes utilized in our modeling processes include, among other things, (i) origination date, (ii) maturity date, (iii) payment type, (iv) collateral type and amount, (v) current risk grade, (vi) current unpaid balance and commitment utilization rate, (vii) payment status/delinquency history and (viii) expected recoveries of previously charged-off amounts. Significant macroeconomic variables utilized in our modeling processes include, among other things, (i) Gross State Product for Texas and U.S. Gross Domestic Product, (ii) selected market interest rates including U.S. Treasury rates, bank prime rate, 30-year fixed mortgage rate, BBB corporate bond rate, among others, (iii) unemployment rates, (iv) commercial and residential property prices in Texas and the U.S. as a whole, (v) West Texas Intermediate crude oil price and (vi) total stock market index.

PD and PA were estimated by analyzing internally-sourced data related to historical performance of each loan pool over a complete economic cycle. PD and PA are adjusted to reflect the current impact of certain macroeconomic variables as well as their expected changes over a reasonable and supportable forecast period. We have determined that we are reasonably able to forecast the macroeconomic variables used in our modeling processes with an acceptable degree of confidence for a total of two years with the last twelve months of the forecast period encompassing a reversion process whereby the forecasted macroeconomic variables are reverted to their historical mean utilizing a rational, systematic basis. The macroeconomic variables utilized as inputs in our modeling processes were subjected to a variety of analysis procedures and were selected primarily based on statistical relevancy and correlation to our historical credit losses. By reverting these modeling inputs to their historical mean and considering loan/borrower specific attributes, our models will yield a measurement of expected credit losses that reflects our average historical loss rates for periods subsequent to the twelve-month reversion period. The LGD is based on historical recovery averages for each loan pool, adjusted to reflect the current impact of certain macroeconomic variables as well as their expected changes over a two-year forecast period, with the final twelve months of the forecast period encompassing a reversion process, which management considers to be both reasonable and supportable. This same forecast/reversion period is used for all macroeconomic variables used in all of our models. EAD is estimated using a linear regression model that estimates the average percentage of the loan balance that remains at the time of a default event.

Management qualitatively adjusts model results for risk factors that are not considered within our modeling processes but are nonetheless relevant in assessing the expected credit losses within our loan pools. These qualitative factor (“Q-Factor”) adjustments may increase or decrease management’s estimate of expected credit losses by a calculated percentage or amount based upon the estimated level of risk. The various risks that may be considered in making Q-Factor adjustments include, among other things, the impact of (i) changes in lending policies and procedures, including changes in underwriting standards and practices for collections, write-offs, and recoveries, (ii) actual and expected changes in international, national, regional, and local economic and business conditions and developments that affect the collectibility of the loan pools, (iii) changes in the nature and volume of the loan pools and in the terms of the underlying loans, (iv) changes in the experience, ability, and depth of our lending management and staff, (v) changes in volume and severity of past due financial assets, the volume of non-accrual assets, and the volume and severity of adversely classified or graded assets, (vi) changes in the quality of our credit review function, (vii) changes in the value of the underlying collateral for loans that are non-collateral dependent, (viii) the existence, growth, and effect of any concentrations of credit and (ix) other factors such as the regulatory, legal and technological environments; competition; and events such as natural disasters or health pandemics.

In some cases, management may determine that an individual loan exhibits unique risk characteristics which differentiate the loan from other loans within our loan pools. In such cases, the loans are evaluated for expected credit losses on an individual basis and excluded from the collective evaluation. Specific allocations of the allowance for credit losses are determined by analyzing the borrower’s ability to repay amounts owed, collateral deficiencies, the relative risk grade of the loan and economic conditions affecting the borrower’s industry, among other things. A loan is considered to be collateral dependent when, based upon management’s assessment, the borrower is experiencing financial difficulty and repayment is expected to be provided substantially through the operation or sale of the collateral. In such cases, expected credit losses are based on the fair value of the collateral at the measurement date, adjusted for estimated selling costs if satisfaction of the loan depends on the sale of the collateral. We reevaluate the fair value of collateral supporting collateral dependent loans on a quarterly basis. The fair value of real estate collateral supporting collateral dependent loans is evaluated by our internal appraisal services using a methodology that is consistent with the Uniform Standards of Professional Appraisal Practice. The fair value of collateral supporting collateral dependent construction loans is based on an “as is” valuation.

The following table presents details of the allowance for credit losses on loans segregated by loan portfolio segment as of June 30, 2020, calculated in accordance with the CECL methodology described above. No allowance for credit losses has been recognized for PPP loans as such loans are fully guaranteed by the SBA.

|                                            | Commercial<br>and<br>Industrial | Energy           | Commercial<br>Real Estate | Consumer<br>Real Estate | Consumer<br>and Other | Total             |
|--------------------------------------------|---------------------------------|------------------|---------------------------|-------------------------|-----------------------|-------------------|
| Modeled expected credit losses             | \$ 86,016                       | \$ 17,977        | \$ 121,978                | \$ 8,865                | \$ 8,224              | \$ 243,060        |
| Q-Factor and other qualitative adjustments | 430                             | 20,590           | (29,867)                  | 133                     | 43                    | (8,671)           |
| Specific allocations                       | 12,090                          | 2,250            | 1,314                     | —                       | 18                    | 15,672            |
| Total                                      | <u>\$ 98,536</u>                | <u>\$ 40,817</u> | <u>\$ 93,425</u>          | <u>\$ 8,998</u>         | <u>\$ 8,285</u>       | <u>\$ 250,061</u> |

The following table presents details of the allowance for credit losses on loans segregated by loan portfolio segment as of December 31, 2019, calculated in accordance with our prior incurred loss methodology described in our 2019 Form 10-K.

|                                    | Commercial<br>and<br>Industrial | Energy           | Commercial<br>Real Estate | Consumer<br>Real Estate | Consumer<br>and Other | Total             |
|------------------------------------|---------------------------------|------------------|---------------------------|-------------------------|-----------------------|-------------------|
| Historical valuation allowances    | \$ 29,015                       | \$ 7,873         | \$ 21,947                 | \$ 2,690                | \$ 7,562              | \$ 69,087         |
| Specific valuation allowances      | 7,849                           | 20,246           | 383                       | —                       | 5                     | 28,483            |
| General valuation allowances       | 9,840                           | 5,196            | 4,201                     | 904                     | (409)                 | 19,732            |
| Macroeconomic valuation allowances | 4,889                           | 4,067            | 4,506                     | 519                     | 884                   | 14,865            |
| Total                              | <u>\$ 51,593</u>                | <u>\$ 37,382</u> | <u>\$ 31,037</u>          | <u>\$ 4,113</u>         | <u>\$ 8,042</u>       | <u>\$ 132,167</u> |

The following table details activity in the allowance for credit losses on loans by portfolio segment for the three and six months ended June 30, 2020 and 2019. Allocation of a portion of the allowance to one category of loans does not preclude its availability to absorb losses in other categories. No allowance for credit losses has been recognized for PPP loans as such loans are fully guaranteed by the SBA.

|                            | Commercial<br>and<br>Industrial | Energy           | Commercial<br>Real Estate | Consumer<br>Real Estate | Consumer<br>and Other | Total             |
|----------------------------|---------------------------------|------------------|---------------------------|-------------------------|-----------------------|-------------------|
| <b>Three months ended:</b> |                                 |                  |                           |                         |                       |                   |
| <b>June 30, 2020</b>       |                                 |                  |                           |                         |                       |                   |
| Beginning balance          | \$ 92,152                       | \$ 103,201       | \$ 52,319                 | \$ 8,170                | \$ 8,039              | \$ 263,881        |
| Credit loss expense        | 7,334                           | (27,342)         | 44,587                    | 352                     | 2,297                 | 27,228            |
| Charge-offs                | (1,841)                         | (35,042)         | (3,511)                   | (135)                   | (4,178)               | (44,707)          |
| Recoveries                 | 891                             | —                | 30                        | 611                     | 2,127                 | 3,659             |
| Net charge-offs            | (950)                           | (35,042)         | (3,481)                   | 476                     | (2,051)               | (41,048)          |
| Ending balance             | <u>\$ 98,536</u>                | <u>\$ 40,817</u> | <u>\$ 93,425</u>          | <u>\$ 8,998</u>         | <u>\$ 8,285</u>       | <u>\$ 250,061</u> |
| <b>June 30, 2019</b>       |                                 |                  |                           |                         |                       |                   |
| Beginning balance          | \$ 58,571                       | \$ 25,343        | \$ 36,455                 | \$ 5,661                | \$ 10,320             | \$ 136,350        |
| Credit loss expense        | 1,597                           | 2,446            | (13)                      | 262                     | 2,108                 | 6,400             |
| Charge-offs                | (3,389)                         | (2,000)          | (557)                     | (601)                   | (5,103)               | (11,650)          |
| Recoveries                 | 935                             | 29               | 29                        | 315                     | 2,521                 | 3,829             |
| Net charge-offs            | (2,454)                         | (1,971)          | (528)                     | (286)                   | (2,582)               | (7,821)           |
| Ending balance             | <u>\$ 57,714</u>                | <u>\$ 25,818</u> | <u>\$ 35,914</u>          | <u>\$ 5,637</u>         | <u>\$ 9,846</u>       | <u>\$ 134,929</u> |
| <b>Six months ended:</b>   |                                 |                  |                           |                         |                       |                   |
| <b>June 30, 2020</b>       |                                 |                  |                           |                         |                       |                   |
| Beginning balance          | \$ 51,593                       | \$ 37,382        | \$ 31,037                 | \$ 4,113                | \$ 8,042              | \$ 132,167        |
| Impact of adopting ASC 326 | 21,263                          | (10,453)         | (13,519)                  | 2,392                   | (2,248)               | (2,565)           |
| Credit loss expense        | 29,284                          | 82,664           | 79,348                    | 1,922                   | 6,935                 | 200,153           |
| Charge-offs                | (6,210)                         | (68,842)         | (3,584)                   | (420)                   | (9,183)               | (88,239)          |
| Recoveries                 | 2,606                           | 66               | 143                       | 991                     | 4,739                 | 8,545             |
| Net charge-offs            | (3,604)                         | (68,776)         | (3,441)                   | 571                     | (4,444)               | (79,694)          |
| Ending balance             | <u>\$ 98,536</u>                | <u>\$ 40,817</u> | <u>\$ 93,425</u>          | <u>\$ 8,998</u>         | <u>\$ 8,285</u>       | <u>\$ 250,061</u> |
| <b>June 30, 2019</b>       |                                 |                  |                           |                         |                       |                   |
| Beginning balance          | \$ 48,580                       | \$ 29,052        | \$ 38,777                 | \$ 6,103                | \$ 9,620              | \$ 132,132        |
| Credit loss expense        | 13,526                          | (1,310)          | (2,365)                   | 1,509                   | 6,043                 | 17,403            |
| Charge-offs                | (6,077)                         | (2,000)          | (617)                     | (2,379)                 | (10,800)              | (21,873)          |
| Recoveries                 | 1,685                           | 76               | 119                       | 404                     | 4,983                 | 7,267             |
| Net charge-offs            | (4,392)                         | (1,924)          | (498)                     | (1,975)                 | (5,817)               | (14,606)          |
| Ending balance             | <u>\$ 57,714</u>                | <u>\$ 25,818</u> | <u>\$ 35,914</u>          | <u>\$ 5,637</u>         | <u>\$ 9,846</u>       | <u>\$ 134,929</u> |

The following table presents loans that were evaluated for expected credit losses on an individual basis and the related specific allocations, by loan portfolio segment as of June 30, 2020 and December 31, 2019.

|                             | June 30, 2020     |                      | December 31, 2019 |                      |
|-----------------------------|-------------------|----------------------|-------------------|----------------------|
|                             | Loan<br>Balance   | Specific Allocations | Loan<br>Balance   | Specific Allocations |
| Commercial and industrial   | \$ 46,087         | \$ 12,090            | \$ 24,360         | \$ 7,849             |
| Energy                      | 35,904            | 2,250                | 65,244            | 20,246               |
| Paycheck Protection Program | —                 | —                    | —                 | —                    |
| Commercial real estate:     |                   |                      |                   |                      |
| Buildings, land and other   | 28,582            | 1,114                | 8,609             | 383                  |
| Construction                | 1,869             | 200                  | 665               | —                    |
| Consumer real estate        | 1,334             | —                    | 570               | —                    |
| Consumer and other          | 18                | 18                   | 5                 | 5                    |
| Total                       | <u>\$ 113,794</u> | <u>\$ 15,672</u>     | <u>\$ 99,453</u>  | <u>\$ 28,483</u>     |



**Note 4 - Goodwill and Other Intangible Assets**

Goodwill and other intangible assets are presented in the table below. As of June 30, 2020, we evaluated recent potential triggering events that might be indicators that our goodwill was impaired. The events include the economic disruption and uncertainty surrounding the COVID-19 pandemic and the circumstances surrounding recent volatility in the market price of crude oil. Based on our evaluation, we concluded that our goodwill was not more than likely impaired as of that date.

|                          | June 30,<br>2020 | December 31,<br>2019 |
|--------------------------|------------------|----------------------|
| Goodwill                 | \$ 654,952       | \$ 654,952           |
| Other intangible assets: |                  |                      |
| Core deposits            | \$ 1,634         | \$ 2,043             |
| Customer relationships   | 349              | 438                  |
|                          | \$ 1,983         | \$ 2,481             |

The estimated aggregate future amortization expense for intangible assets remaining as of June 30, 2020 is as follows:

|                   |          |
|-------------------|----------|
| Remainder of 2020 | \$ 420   |
| 2021              | 697      |
| 2022              | 481      |
| 2023              | 282      |
| 2024              | 87       |
| Thereafter        | 16       |
|                   | \$ 1,983 |

**Note 5 - Deposits**

Deposits were as follows:

|                                            | June 30,<br>2020 | Percentage<br>of Total | December 31,<br>2019 | Percentage<br>of Total |
|--------------------------------------------|------------------|------------------------|----------------------|------------------------|
| Non-interest-bearing demand deposits:      |                  |                        |                      |                        |
| Commercial and individual                  | \$ 13,866,774    | 42.4 %                 | \$ 10,212,265        | 36.9 %                 |
| Correspondent banks                        | 283,893          | 0.9                    | 246,181              | 0.9                    |
| Public funds                               | 521,322          | 1.6                    | 415,183              | 1.5                    |
| Total non-interest-bearing demand deposits | 14,671,989       | 44.9                   | 10,873,629           | 39.3                   |
| Interest-bearing deposits:                 |                  |                        |                      |                        |
| Private accounts:                          |                  |                        |                      |                        |
| Savings and interest checking              | 7,937,394        | 24.3                   | 7,147,327            | 25.9                   |
| Money market accounts                      | 8,431,539        | 25.8                   | 7,888,433            | 28.5                   |
| Time accounts of \$100,000 or more         | 779,859          | 2.4                    | 736,481              | 2.7                    |
| Time accounts under \$100,000              | 335,131          | 1.0                    | 347,418              | 1.2                    |
| Total private accounts                     | 17,483,923       | 53.5                   | 16,119,659           | 58.3                   |
| Public funds:                              |                  |                        |                      |                        |
| Savings and interest checking              | 442,349          | 1.4                    | 548,399              | 2.0                    |
| Money market accounts                      | 76,437           | 0.2                    | 73,180               | 0.3                    |
| Time accounts of \$100,000 or more         | 4,315            | —                      | 24,672               | 0.1                    |
| Time accounts under \$100,000              | 83               | —                      | 25                   | —                      |
| Total public funds                         | 523,184          | 1.6                    | 646,276              | 2.4                    |
| Total interest-bearing deposits            | 18,007,107       | 55.1                   | 16,765,935           | 60.7                   |
| Total deposits                             | \$ 32,679,096    | 100.0 %                | \$ 27,639,564        | 100.0 %                |

The following table presents additional information about our deposits:

|                                                                                    | June 30,<br>2020 | December 31,<br>2019 |
|------------------------------------------------------------------------------------|------------------|----------------------|
| Deposits from the Certificate of Deposit Account Registry Service (CDARS) deposits | \$ 366           | \$ 361               |
| Deposits from foreign sources (primarily Mexico)                                   | 797,499          | 805,828              |
| Deposits not covered by deposit insurance                                          | 16,442,913       | 13,115,796           |



## Note 6 - Off-Balance-Sheet Arrangements, Commitments, Guarantees and Contingencies

*Financial Instruments with Off-Balance-Sheet Risk.* In the normal course of business, we enter into various transactions, which, in accordance with generally accepted accounting principles are not included in our consolidated balance sheets. We enter into these transactions to meet the financing needs of our customers. As more fully discussed in our 2019 Form 10-K, these transactions include commitments to extend credit and standby letters of credit, which involve, to varying degrees, elements of credit risk and interest rate risk in excess of the amounts recognized in the consolidated balance sheets. We minimize our exposure to loss under these commitments by subjecting them to credit approval and monitoring procedures.

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

|                                        | June 30,<br>2020 | December 31,<br>2019 |
|----------------------------------------|------------------|----------------------|
| Commitments to extend credit           | \$ 9,601,250     | \$ 9,306,043         |
| Standby letters of credit              | 254,142          | 260,587              |
| Deferred standby letter of credit fees | 1,756            | 1,276                |

*Allowance For Credit Losses - Off-Balance-Sheet Credit Exposures.* The allowance for credit losses on off-balance-sheet credit exposures is a liability account, calculated in accordance with ASC 326, representing expected credit losses over the contractual period for which we are exposed to credit risk resulting from a contractual obligation to extend credit. No allowance is recognized if we have the unconditional right to cancel the obligation. Off-balance-sheet credit exposures primarily consist of amounts available under outstanding lines of credit and letters of credit detailed in the table above. For the period of exposure, the estimate of expected credit losses considers both the likelihood that funding will occur and the amount expected to be funded over the estimated remaining life of the commitment or other off-balance-sheet exposure. The likelihood and expected amount of funding are based on historical utilization rates. The amount of the allowance represents management's best estimate of expected credit losses on commitments expected to be funded over the contractual life of the commitment. Estimating credit losses on amounts expected to be funded uses the same methodology as described for loans in Note 3 - Loans as if such commitments were funded.

The following table details activity in the allowance for credit losses on off-balance-sheet credit exposures.

|                            | Three Months Ended<br>June 30, |        | Six Months Ended<br>June 30, |        |
|----------------------------|--------------------------------|--------|------------------------------|--------|
|                            | 2020                           | 2019   | 2020                         | 2019   |
| Beginning balance          | \$ 42,164                      | \$ 500 | \$ 500                       | \$ 500 |
| Impact of adopting ASC 326 | —                              | —      | 39,377                       | —      |
| Credit loss expense        | 4,775                          | —      | 7,062                        | —      |
| Ending balance             | \$ 46,939                      | \$ 500 | \$ 46,939                    | \$ 500 |

*Lease Commitments.* We lease certain office facilities and office equipment under operating leases. The components of total lease expense were as follows:

|                                                                             | Three Months Ended<br>June 30, |          | Six Months Ended<br>June 30, |           |
|-----------------------------------------------------------------------------|--------------------------------|----------|------------------------------|-----------|
|                                                                             | 2020                           | 2019     | 2020                         | 2019      |
| Amortization of lease right-of-use assets                                   | \$ 8,150                       | \$ 6,487 | \$ 16,024                    | \$ 12,283 |
| Short-term lease expense                                                    | 610                            | 1,038    | 1,171                        | 2,117     |
| Non-lease components (including taxes, insurance, common maintenance, etc.) | 2,897                          | 2,175    | 5,824                        | 3,908     |
| Total                                                                       | \$ 11,657                      | \$ 9,700 | \$ 23,019                    | \$ 18,308 |

Right-of-use lease assets totaled \$304.9 million at June 30, 2020 and \$297.7 million at December 31, 2019 and are reported as a component of premises and equipment on our accompanying consolidated balance sheets. The related lease liabilities totaled \$334.8 million at June 30, 2020 and \$323.7 million at December 31, 2019 and are reported as a component of accrued interest payable and other liabilities in the accompanying consolidated balance sheets. Lease payments under operating leases that were applied to our operating lease liability totaled \$8.1 million and \$15.8 million during the three and six months ended June 30, 2020 and \$6.1 million and \$12.1 million during the three and six months ended June 30, 2019. There has been no significant change in our expected future minimum lease payments since December 31, 2019. See the 2019 Form 10-K for information regarding these commitments.

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

As previously disclosed, in April of 2020, purported class action lawsuits were filed against Frost Bank in each of Federal and Texas State courts alleging certain violations of law in connection with Frost Bank's participation in the PPP. Frost Bank's motion to dismiss with prejudice the Federal lawsuit was granted and as a result the Federal lawsuit is resolved. The Texas State court lawsuit has also been favorably resolved. In May of 2020, a purported class action lawsuit was filed against Frost Bank alleging, among other claims, that Frost Bank had refused to pay agent fees to purported agents of borrowers under the PPP in violation of SBA regulations. Frost Bank believes the claims in the agent fee case to be without merit.

## **Note 7 - Capital and Regulatory Matters**

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

Cullen/Frost's and Frost Bank's Common Equity Tier 1 capital includes common stock and related paid-in capital, net of treasury stock, and retained earnings. In connection with the adoption of the Basel III Capital Rules, we elected to opt-out of the requirement to include most components of accumulated other comprehensive income in Common Equity Tier 1. We also elected to exclude, for a five-year transitional period, the effects of credit loss accounting under CECL from Common Equity Tier 1, as further discussed below. Common Equity Tier 1 for both Cullen/Frost and Frost Bank is reduced by goodwill and other intangible assets, net of associated deferred tax liabilities. Frost Bank's Common Equity Tier 1 is also reduced by its equity investment in its financial subsidiary, Frost Insurance Agency ("FIA").

Tier 1 capital includes Common Equity Tier 1 capital and additional Tier 1 capital. Cullen/Frost and Frost Bank did not have any additional Tier 1 capital beyond Common Equity Tier 1 at June 30, 2020. For Cullen/Frost, additional Tier 1 capital at December 31, 2019 included \$144.5 million of 5.375% non-cumulative perpetual preferred stock. This preferred stock was redeemed during the first quarter of 2020, as further discussed below. Frost Bank did not have any additional Tier 1 capital beyond Common Equity Tier 1 at December 31, 2019.

Total capital includes Tier 1 capital and Tier 2 capital. Tier 2 capital for both Cullen/Frost and Frost Bank includes a permissible portion of the allowances for credit losses on securities, loans and off-balance-sheet credit exposures. Tier 2 capital for Cullen/Frost also includes \$100.0 million of qualified subordinated debt and \$133.0 million of trust preferred securities at both June 30, 2020 and December 31, 2019.

As discussed in Note 1 - Significant Accounting Policies, in connection with the adoption of ASC 326, we recognized an after-tax cumulative effect reduction to retained earnings totaling \$29.3 million. In February 2019, the federal bank regulatory agencies issued a final rule (the "2019 CECL Rule") that revised certain capital regulations to account for changes to credit loss accounting under U.S. GAAP. The 2019 CECL Rule included a transition option that allows banking organizations to phase in, over a three-year period, the day-one adverse effects of CECL on their regulatory capital ratios (three-year transition option). In March 2020, the federal bank regulatory agencies issued an interim final rule that maintains the three-year transition option of the 2019 CECL Rule and also provides banking organizations that were required under U.S. GAAP (as of January 2020) to implement CECL before the end of 2020 the option to delay for two years an estimate of the effect of CECL on regulatory capital, relative to the incurred loss methodology's effect on regulatory capital, followed by a three-year transition period (five-year transition option). We elected to adopt the five-year transition option. Accordingly, a CECL transitional amount totaling \$61.1 million has been added back to CET1 as of June 30, 2020. The CECL transitional amount includes \$29.3 million related to cumulative effect of adopting CECL and \$31.9 million related to the estimated incremental effect of CECL since adoption.

In April 2020, we began originating loans to qualified small businesses under the PPP administered by the SBA. Federal bank regulatory agencies have issued an interim final rule that permits banks to neutralize the regulatory capital effects of participating in the Paycheck Protection Program Lending Facility (the "PPP Facility") and clarify that PPP loans have a zero percent risk weight under applicable risk-based capital rules. Specifically, a bank may exclude all PPP loans pledged as collateral to the PPP Facility from its average total consolidated assets for the purposes of calculating its leverage ratio, while PPP loans that are not pledged as collateral to the PPP Facility will be included. The PPP loans we originated in the second quarter of 2020 are included in the calculation of our leverage ratio as of June 30, 2020 as we did not utilize the PPP Facility for funding purposes.

The following table presents actual and required capital ratios as of June 30, 2020 and December 31, 2019 for Cullen/Frost and Frost Bank under the Basel III Capital Rules. Capital levels required to be considered well capitalized are based upon prompt corrective action regulations, as amended to reflect the changes under the Basel III Capital Rules. See the 2019 Form 10-K for a more detailed discussion of the Basel III Capital Rules. After a review of risk-weight classifications during the first quarter of 2019, risk-weightings for certain loans were reclassified. Amounts reported as of December 31, 2019 have been revised to reflect these reclassifications.

|                                              | Actual            |         | Minimum Capital Required -<br>Basel III |        | Required to be<br>Considered Well<br>Capitalized |        |
|----------------------------------------------|-------------------|---------|-----------------------------------------|--------|--------------------------------------------------|--------|
|                                              | Capital<br>Amount | Ratio   | Capital<br>Amount                       | Ratio  | Capital<br>Amount                                | Ratio  |
| <b>June 30, 2020</b>                         |                   |         |                                         |        |                                                  |        |
| Common Equity Tier 1 to Risk-Weighted Assets |                   |         |                                         |        |                                                  |        |
| Cullen/Frost                                 | \$ 2,940,493      | 12.48 % | \$ 1,649,766                            | 7.00 % | \$ 1,531,926                                     | 6.50 % |
| Frost Bank                                   | 2,977,672         | 12.66   | 1,646,300                               | 7.00   | 1,528,707                                        | 6.50   |
| Tier 1 Capital to Risk-Weighted Assets       |                   |         |                                         |        |                                                  |        |
| Cullen/Frost                                 | 2,940,493         | 12.48   | 2,003,287                               | 8.50   | 1,885,447                                        | 8.00   |
| Frost Bank                                   | 2,977,672         | 12.66   | 1,999,078                               | 8.50   | 1,881,485                                        | 8.00   |
| Total Capital to Risk-Weighted Assets        |                   |         |                                         |        |                                                  |        |
| Cullen/Frost                                 | 3,401,768         | 14.43   | 2,474,649                               | 10.50  | 2,356,809                                        | 10.00  |
| Frost Bank                                   | 3,205,947         | 13.63   | 2,469,450                               | 10.50  | 2,351,857                                        | 10.00  |
| Leverage Ratio                               |                   |         |                                         |        |                                                  |        |
| Cullen/Frost                                 | 2,940,493         | 8.01    | 1,469,180                               | 4.00   | 1,836,475                                        | 5.00   |
| Frost Bank                                   | 2,977,672         | 8.11    | 1,468,312                               | 4.00   | 1,835,391                                        | 5.00   |
| <b>December 31, 2019</b>                     |                   |         |                                         |        |                                                  |        |
| Common Equity Tier 1 to Risk-Weighted Assets |                   |         |                                         |        |                                                  |        |
| Cullen/Frost                                 | \$ 2,857,250      | 12.36 % | \$ 1,617,886                            | 7.00 % | \$ 1,502,323                                     | 6.50 % |
| Frost Bank                                   | 2,958,326         | 12.82   | 1,615,206                               | 7.00   | 1,499,834                                        | 6.50   |
| Tier 1 Capital to Risk-Weighted Assets       |                   |         |                                         |        |                                                  |        |
| Cullen/Frost                                 | 3,001,736         | 12.99   | 1,964,576                               | 8.50   | 1,849,013                                        | 8.00   |
| Frost Bank                                   | 2,958,326         | 12.82   | 1,961,322                               | 8.50   | 1,845,950                                        | 8.00   |
| Total Capital to Risk-Weighted Assets        |                   |         |                                         |        |                                                  |        |
| Cullen/Frost                                 | 3,367,403         | 14.57   | 2,426,829                               | 10.50  | 2,311,266                                        | 10.00  |
| Frost Bank                                   | 3,090,993         | 13.40   | 2,422,809                               | 10.50  | 2,307,438                                        | 10.00  |
| Leverage Ratio                               |                   |         |                                         |        |                                                  |        |
| Cullen/Frost                                 | 3,001,736         | 9.28    | 1,293,188                               | 4.00   | 1,616,485                                        | 5.00   |
| Frost Bank                                   | 2,958,326         | 9.15    | 1,292,743                               | 4.00   | 1,615,929                                        | 5.00   |

As of June 30, 2020, capital levels at Cullen/Frost and Frost Bank exceed all capital adequacy requirements under the fully phased-in Basel III Capital Rules. Based on the ratios presented above, capital levels as of June 30, 2020 at Cullen/Frost and Frost Bank exceed the minimum levels necessary to be considered “well capitalized.”

Cullen/Frost and Frost Bank are subject to the regulatory capital requirements administered by the Federal Reserve Board and, for Frost Bank, the Federal Deposit Insurance Corporation (“FDIC”). Regulatory authorities can initiate certain mandatory actions if Cullen/Frost or Frost Bank fail to meet the minimum capital requirements, which could have a direct material effect on our financial statements. Management believes, as of June 30, 2020, that Cullen/Frost and Frost Bank meet all capital adequacy requirements to which they are subject.

**Preferred Stock.** On March 16, 2020, we redeemed all 6,000,000 shares of our 5.375% Non-Cumulative Perpetual Preferred Stock, Series A, (“Series A Preferred Stock”) at a redemption price of \$25 per share, or an aggregate redemption of \$150.0 million. When issued, the net proceeds of the Series A Preferred Stock totaled \$144.5 million after deducting \$5.5 million of issuance costs including the underwriting discount and professional service fees, among other things. Upon redemption, these issuance costs were reclassified to retained earnings and reported as a reduction of net income available to common shareholders.

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

awards. On July 24, 2019, our board of directors authorized a \$100.0 million stock repurchase program, allowing us to repurchase shares of our common stock over a one-year period from time to time at various prices in the open market or through private transactions. Under this plan, we repurchased 177,834 shares at a total cost of \$13.7 million during the first quarter of 2020 and 202,724 shares at a total cost of \$17.2 million during the third quarter of 2019. Under the Basel III Capital Rules, Cullen/Frost may not repurchase or redeem any of its subordinated notes and, in some cases, its common stock without the prior approval of the Federal Reserve Board.

**Dividend Restrictions.** In the ordinary course of business, Cullen/Frost is dependent upon dividends from Frost Bank to provide funds for the payment of dividends to shareholders and to provide for other cash requirements, including to repurchase its common stock. Banking regulations may limit the amount of dividends that may be paid. Approval by regulatory authorities is required if the effect of dividends declared would cause the regulatory capital of Frost Bank to fall below specified minimum levels. Approval is also required if dividends declared exceed the net profits for that year combined with the retained net profits for the preceding two years. Under the foregoing dividend restrictions and while maintaining its “well capitalized” status, at June 30, 2020, Frost Bank could pay aggregate dividends of up to \$451.7 million to Cullen/Frost without prior regulatory approval.

Under the terms of the junior subordinated deferrable interest debentures that Cullen/Frost has issued to Cullen/Frost Capital Trust II and WNB Capital Trust I, Cullen/Frost has the right at any time during the term of the debentures to defer the payment of interest at any time or from time to time for an extension period not exceeding 20 consecutive quarterly periods with respect to each extension period. In the event that we have elected to defer interest on the debentures, we may not, with certain exceptions, declare or pay any dividends or distributions on our capital stock or purchase or acquire any of our capital stock.

## Note 8 - Derivative Financial Instruments

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

**Interest Rate Derivatives.** We utilize interest rate swaps, caps and floors to mitigate exposure to interest rate risk and to facilitate the needs of our customers. Our objectives for utilizing these derivative instruments are described in our 2019 Form 10-K.

The notional amounts and estimated fair values of interest rate derivative contracts are presented in the following table. The fair values of interest rate derivative contracts are estimated utilizing internal valuation models with observable market data inputs, or as determined by the Chicago Mercantile Exchange (“CME”) for centrally cleared derivative contracts. CME rules legally characterize variation margin payments for centrally cleared derivatives as settlements of the derivatives' exposure rather than collateral. As a result, the variation margin payment and the related derivative instruments are considered a single unit of account for accounting and financial reporting purposes. Variation margin, as determined by the CME, is settled daily. As a result, derivative contracts that clear through the CME have an estimated fair value of zero as of June 30, 2020 and December 31, 2019.

|                                                 | June 30, 2020   |                      | December 31, 2019 |                      |
|-------------------------------------------------|-----------------|----------------------|-------------------|----------------------|
|                                                 | Notional Amount | Estimated Fair Value | Notional Amount   | Estimated Fair Value |
| Derivatives designated as hedges of fair value: |                 |                      |                   |                      |
| Financial institution counterparties:           |                 |                      |                   |                      |
| Loan/lease interest rate swaps – assets         | \$ —            | \$ —                 | \$ 2,545          | \$ 6                 |
| Loan/lease interest rate swaps – liabilities    | 4,378           | (202)                | 6,000             | (138)                |
| Non-hedging interest rate derivatives:          |                 |                      |                   |                      |
| Financial institution counterparties:           |                 |                      |                   |                      |
| Loan/lease interest rate swaps – assets         | —               | —                    | 122,788           | 67                   |
| Loan/lease interest rate swaps – liabilities    | 1,198,058       | (38,504)             | 1,002,860         | (19,483)             |
| Loan/lease interest rate caps – assets          | 287,544         | 1,302                | 107,835           | 266                  |
| Customer counterparties:                        |                 |                      |                   |                      |
| Loan/lease interest rate swaps – assets         | 1,198,058       | 101,801              | 1,002,860         | 43,857               |
| Loan/lease interest rate swaps – liabilities    | —               | —                    | 122,788           | (310)                |
| Loan/lease interest rate caps – liabilities     | 287,544         | (1,302)              | 107,835           | (266)                |

The weighted-average rates paid and received for interest rate swaps outstanding at June 30, 2020 were as follows:

|                                                                        | Weighted-Average   |                        |
|------------------------------------------------------------------------|--------------------|------------------------|
|                                                                        | Interest Rate Paid | Interest Rate Received |
| Interest rate swaps:                                                   |                    |                        |
| Fair value hedge loan/lease interest rate swaps                        | 3.47 %             | 0.18 %                 |
| Non-hedging interest rate swaps – financial institution counterparties | 4.03               | 2.09                   |
| Non-hedging interest rate swaps – customer counterparties              | 2.09               | 4.03                   |

The weighted-average strike rate for outstanding interest rate caps was 3.75% at June 30, 2020.

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

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

|                                       |                | June 30, 2020   |                      | December 31, 2019 |                      |
|---------------------------------------|----------------|-----------------|----------------------|-------------------|----------------------|
|                                       | Notional Units | Notional Amount | Estimated Fair Value | Notional Amount   | Estimated Fair Value |
| Financial institution counterparties: |                |                 |                      |                   |                      |
| Oil – assets                          | Barrels        | 2,512           | \$ 30,220            | 1,214             | \$ 2,796             |
| Oil – liabilities                     | Barrels        | 2,054           | (7,022)              | 2,148             | (6,916)              |
| Natural gas – assets                  | MMBTUs         | 10,414          | 2,553                | 8,295             | 2,131                |
| Natural gas – liabilities             | MMBTUs         | 10,776          | (1,205)              | 2,689             | (70)                 |
| Customer counterparties:              |                |                 |                      |                   |                      |
| Oil – assets                          | Barrels        | 2,054           | 7,193                | 2,172             | 7,208                |
| Oil – liabilities                     | Barrels        | 2,512           | (29,916)             | 1,190             | (2,652)              |
| Natural gas – assets                  | MMBTUs         | 12,298          | 1,358                | 2,689             | 83                   |
| Natural gas – liabilities             | MMBTUs         | 8,891           | (2,417)              | 8,295             | (2,039)              |

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

|                                       |                      | June 30, 2020      |                         | December 31, 2019  |                         |
|---------------------------------------|----------------------|--------------------|-------------------------|--------------------|-------------------------|
|                                       | Notional<br>Currency | Notional<br>Amount | Estimated<br>Fair Value | Notional<br>Amount | Estimated<br>Fair Value |
| Financial institution counterparties: |                      |                    |                         |                    |                         |
| Forward contracts – assets            | EUR                  | 1,130              | \$ 6                    | —                  | \$ —                    |
| Forward contracts – liabilities       | CAD                  | 1,460              | (9)                     | 4,593              | (33)                    |
| Customer counterparties:              |                      |                    |                         |                    |                         |
| Forward contracts – assets            | CAD                  | 1,454              | 16                      | 4,583              | 45                      |
| Forward contracts – liabilities       | EUR                  | 1,126              | (2)                     | —                  | —                       |

*Gains, Losses and Derivative Cash Flows.* For fair value hedges, the changes in the fair value of both the derivative hedging instrument and the hedged item are included in other non-interest income or other non-interest expense. The extent that such changes in fair value do not offset represents hedge ineffectiveness. Net cash flows from interest rate swaps on commercial loans/leases designated as hedging instruments in effective hedges of fair value are included in interest income on loans. For non-hedging derivative instruments, gains and losses due to changes in fair value and all cash flows are included in other non-interest income and other non-interest expense.

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

|                                                              | Three Months Ended<br>June 30, |       | Six Months Ended<br>June 30, |       |
|--------------------------------------------------------------|--------------------------------|-------|------------------------------|-------|
|                                                              | 2020                           | 2019  | 2020                         | 2019  |
| Commercial loan/lease interest rate swaps:                   |                                |       |                              |       |
| Amount of gain (loss) included in interest income on loans   | \$ (35)                        | \$ 28 | \$ (43)                      | \$ 54 |
| Amount of (gain) loss included in other non-interest expense | 3                              | 1     | 4                            | 1     |

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

During the first quarter of 2020, we sold certain non-hedge related, short-term put options on U.S. Treasury securities with an aggregate notional amount of \$500 million and realized gains totaling approximately \$6.0 million in connection with the sales. The put options were not exercised and expired in March 2020.

Amounts included in the consolidated statements of income related to non-hedge related derivative instruments are presented in the table below.

|                                           | Three Months Ended<br>June 30, |        | Six Months Ended<br>June 30, |        |
|-------------------------------------------|--------------------------------|--------|------------------------------|--------|
|                                           | 2020                           | 2019   | 2020                         | 2019   |
| Non-hedging interest rate derivatives:    |                                |        |                              |        |
| Other non-interest income                 | \$ 296                         | \$ 387 | \$ 2,335                     | \$ 973 |
| Non-hedging commodity derivatives:        |                                |        |                              |        |
| Other non-interest income                 | 539                            | 110    | 678                          | 213    |
| Non-hedging foreign currency derivatives: |                                |        |                              |        |
| Other non-interest income                 | 11                             | 12     | 18                           | 29     |
| Non-hedging put options:                  |                                |        |                              |        |
| Other non-interest income                 | —                              | —      | 5,980                        | —      |

*Counterparty Credit Risk.* Our credit exposure relating to interest rate swaps, commodity swaps/options and foreign currency forward contracts with bank customers was approximately \$103.4 million at June 30, 2020. This credit exposure is partly mitigated as transactions with customers are generally secured by the collateral, if any, securing the underlying transaction being hedged. Our credit exposure, net of collateral pledged, relating to interest rate swaps, commodity swaps/options and foreign currency forward contracts with upstream financial institution counterparties was approximately \$23.5 million at June 30, 2020. This amount was primarily related to initial margin payments to the CME and excess collateral we posted to counterparties. Collateral levels for upstream financial institution counterparties are monitored and adjusted as necessary. See Note 9 – Balance Sheet Offsetting and Repurchase Agreements for additional information regarding our credit exposure with upstream financial institution counterparties. At June 30, 2020, we had \$47.8 million in cash collateral related to derivative contracts on deposit with other financial institution counterparties.

## Note 9 - Balance Sheet Offsetting and Repurchase Agreements

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

Information about financial instruments that are eligible for offset in the consolidated balance sheet as of June 30, 2020 is presented in the following tables.

|                                         | Gross Amount<br>Recognized | Gross Amount<br>Offset   | Net Amount<br>Recognized |
|-----------------------------------------|----------------------------|--------------------------|--------------------------|
| <b>June 30, 2020</b>                    |                            |                          |                          |
| Financial assets:                       |                            |                          |                          |
| Derivatives:                            |                            |                          |                          |
| Loan/lease interest rate swaps and caps | \$ 1,302                   | \$ —                     | \$ 1,302                 |
| Commodity swaps and options             | 32,773                     | —                        | 32,773                   |
| Foreign currency forward contracts      | 6                          | —                        | 6                        |
| Total derivatives                       | 34,081                     | —                        | 34,081                   |
| Resell agreements                       | 20,000                     | —                        | 20,000                   |
| Total                                   | <u>\$ 54,081</u>           | <u>\$ —</u>              | <u>\$ 54,081</u>         |
| Financial liabilities:                  |                            |                          |                          |
| Derivatives:                            |                            |                          |                          |
| Loan/lease interest rate swaps          | \$ 38,706                  | \$ —                     | \$ 38,706                |
| Commodity swaps and options             | 8,227                      | —                        | 8,227                    |
| Foreign currency forward contracts      | 9                          | —                        | 9                        |
| Total derivatives                       | 46,942                     | —                        | 46,942                   |
| Repurchase agreements                   | 1,553,109                  | —                        | 1,553,109                |
| Total                                   | <u>\$ 1,600,051</u>        | <u>\$ —</u>              | <u>\$ 1,600,051</u>      |
|                                         |                            | Gross Amounts Not Offset |                          |
|                                         | Net Amount<br>Recognized   | Financial<br>Instruments | Collateral               |
| <b>June 30, 2020</b>                    |                            |                          |                          |
| Financial assets:                       |                            |                          |                          |
| Derivatives:                            |                            |                          |                          |
| Counterparty A                          | \$ 4                       | \$ (4)                   | \$ —                     |
| Counterparty B                          | 7,333                      | (7,333)                  | —                        |
| Other counterparties                    | 26,744                     | (13,639)                 | (11,440)                 |
| Total derivatives                       | 34,081                     | (20,976)                 | (11,440)                 |
| Resell agreements                       | 20,000                     | —                        | (20,000)                 |
| Total                                   | <u>\$ 54,081</u>           | <u>\$ (20,976)</u>       | <u>\$ (31,440)</u>       |
| Financial liabilities:                  |                            |                          |                          |
| Derivatives:                            |                            |                          |                          |
| Counterparty A                          | \$ 7,521                   | \$ (4)                   | \$ (7,517)               |
| Counterparty B                          | 13,184                     | (7,333)                  | (5,851)                  |
| Counterparty C                          | 122                        | —                        | (122)                    |
| Other counterparties                    | 26,115                     | (13,639)                 | (12,458)                 |
| Total derivatives                       | 46,942                     | (20,976)                 | (25,948)                 |
| Repurchase agreements                   | 1,553,109                  | —                        | (1,553,109)              |
| Total                                   | <u>\$ 1,600,051</u>        | <u>\$ (20,976)</u>       | <u>\$ (1,579,057)</u>    |
|                                         |                            |                          | Net<br>Amount            |

Information about financial instruments that are eligible for offset in the consolidated balance sheet as of December 31, 2019 is presented in the following tables.

|                                         | Gross Amount<br>Recognized | Gross Amount<br>Offset | Net Amount<br>Recognized |
|-----------------------------------------|----------------------------|------------------------|--------------------------|
| <b>December 31, 2019</b>                |                            |                        |                          |
| Financial assets:                       |                            |                        |                          |
| Derivatives:                            |                            |                        |                          |
| Loan/lease interest rate swaps and caps | \$ 339                     | \$ —                   | \$ 339                   |
| Commodity swaps and options             | 4,927                      | —                      | 4,927                    |
| Total derivatives                       | 5,266                      | —                      | 5,266                    |
| Resell agreements                       | 31,299                     | —                      | 31,299                   |
| Total                                   | <u>\$ 36,565</u>           | <u>\$ —</u>            | <u>\$ 36,565</u>         |
| Financial liabilities:                  |                            |                        |                          |
| Derivatives:                            |                            |                        |                          |
| Loan/lease interest rate swaps          | \$ 19,621                  | \$ —                   | \$ 19,621                |
| Commodity swaps and options             | 6,986                      | —                      | 6,986                    |
| Foreign currency forward contracts      | 33                         | —                      | 33                       |
| Total derivatives                       | 26,640                     | —                      | 26,640                   |
| Repurchase agreements                   | 1,668,142                  | —                      | 1,668,142                |
| Total                                   | <u>\$ 1,694,782</u>        | <u>\$ —</u>            | <u>\$ 1,694,782</u>      |

|                          | Net Amount<br>Recognized | Gross Amounts Not Offset |                       | Net<br>Amount |
|--------------------------|--------------------------|--------------------------|-----------------------|---------------|
|                          |                          | Financial<br>Instruments | Collateral            |               |
| <b>December 31, 2019</b> |                          |                          |                       |               |
| Financial assets:        |                          |                          |                       |               |
| Derivatives:             |                          |                          |                       |               |
| Counterparty A           | \$ 39                    | \$ (39)                  | \$ —                  | \$ —          |
| Counterparty B           | 1,650                    | (1,650)                  | —                     | —             |
| Counterparty C           | 1                        | (1)                      | —                     | —             |
| Other counterparties     | 3,576                    | (3,546)                  | —                     | 30            |
| Total derivatives        | 5,266                    | (5,236)                  | —                     | 30            |
| Resell agreements        | 31,299                   | —                        | (31,299)              | —             |
| Total                    | <u>\$ 36,565</u>         | <u>\$ (5,236)</u>        | <u>\$ (31,299)</u>    | <u>\$ 30</u>  |
| Financial liabilities:   |                          |                          |                       |               |
| Derivatives:             |                          |                          |                       |               |
| Counterparty A           | \$ 5,192                 | \$ (39)                  | \$ (5,153)            | \$ —          |
| Counterparty B           | 7,424                    | (1,650)                  | (5,774)               | —             |
| Counterparty C           | 135                      | (1)                      | (134)                 | —             |
| Other counterparties     | 13,889                   | (3,546)                  | (10,343)              | —             |
| Total derivatives        | 26,640                   | (5,236)                  | (21,404)              | —             |
| Repurchase agreements    | 1,668,142                | —                        | (1,668,142)           | —             |
| Total                    | <u>\$ 1,694,782</u>      | <u>\$ (5,236)</u>        | <u>\$ (1,689,546)</u> | <u>\$ —</u>   |

**Repurchase Agreements.** We utilize securities sold under agreements to repurchase to facilitate the needs of our customers and to facilitate secured short-term funding needs. Securities sold under agreements to repurchase are stated at the amount of cash received in connection with the transaction. We monitor collateral levels on a continuous basis. We may be required to provide additional collateral based on the fair value of the underlying securities. Securities pledged as collateral under repurchase agreements are maintained with our safekeeping agents.

The remaining contractual maturity of repurchase agreements in the consolidated balance sheets as of June 30, 2020 and December 31, 2019 is presented in the following tables.

|                                                                            | Remaining Contractual Maturity of the Agreements |                   |             |                      |                     |
|----------------------------------------------------------------------------|--------------------------------------------------|-------------------|-------------|----------------------|---------------------|
|                                                                            | Overnight and Continuous                         | Up to 30 Days     | 30-90 Days  | Greater than 90 Days | Total               |
| <b>June 30, 2020</b>                                                       |                                                  |                   |             |                      |                     |
| Repurchase agreements:                                                     |                                                  |                   |             |                      |                     |
| U.S. Treasury                                                              | \$ 49,002                                        | \$ —              | \$ —        | \$ —                 | \$ 49,002           |
| State and political subdivisions                                           | 4,000                                            | 145,000           | —           | —                    | 149,000             |
| Residential mortgage-backed securities                                     | 1,305,107                                        | 50,000            | —           | —                    | 1,355,107           |
| Total borrowings                                                           | <u>\$ 1,358,109</u>                              | <u>\$ 195,000</u> | <u>\$ —</u> | <u>\$ —</u>          | <u>\$ 1,553,109</u> |
| Gross amount of recognized liabilities for repurchase agreements           |                                                  |                   |             |                      | <u>\$ 1,553,109</u> |
| Amounts related to agreements not included in offsetting disclosures above |                                                  |                   |             |                      | <u>\$ —</u>         |
| <b>December 31, 2019</b>                                                   |                                                  |                   |             |                      |                     |
| Repurchase agreements:                                                     |                                                  |                   |             |                      |                     |
| U.S. Treasury                                                              | \$ 435,904                                       | \$ —              | \$ —        | \$ —                 | \$ 435,904          |
| State and political subdivisions                                           | —                                                | —                 | —           | —                    | —                   |
| Residential mortgage-backed securities                                     | 1,232,238                                        | —                 | —           | —                    | 1,232,238           |
| Total borrowings                                                           | <u>\$ 1,668,142</u>                              | <u>\$ —</u>       | <u>\$ —</u> | <u>\$ —</u>          | <u>\$ 1,668,142</u> |
| Gross amount of recognized liabilities for repurchase agreements           |                                                  |                   |             |                      | <u>\$ 1,668,142</u> |
| Amounts related to agreements not included in offsetting disclosures above |                                                  |                   |             |                      | <u>\$ —</u>         |

## Note 10 - Stock-Based Compensation

A combined summary of activity in our active stock plans is presented in the table. Performance stock units outstanding are presented assuming attainment of the maximum payout rate as set forth by the performance criteria. As of June 30, 2020, there were 1,108,516 shares remaining available for grant for future stock-based compensation awards.

|                          | Director Deferred Stock Units Outstanding |                                      | Non-Vested Stock Awards/Stock Units Outstanding |                                      | Performance Stock Units Outstanding |                                      | Stock Options Outstanding |                                 |
|--------------------------|-------------------------------------------|--------------------------------------|-------------------------------------------------|--------------------------------------|-------------------------------------|--------------------------------------|---------------------------|---------------------------------|
|                          | Number of Units                           | Weighted-Average Fair Value at Grant | Number of Shares/Units                          | Weighted-Average Fair Value at Grant | Number of Units                     | Weighted-Average Fair Value at Grant | Number of Shares          | Weighted-Average Exercise Price |
| Balance, January 1, 2020 | 55,370                                    | \$ 74.76                             | 440,647                                         | \$ 90.22                             | 177,288                             | \$ 83.48                             | 1,980,866                 | \$ 64.60                        |
| Authorized               | —                                         | —                                    | —                                               | —                                    | —                                   | —                                    | —                         | —                               |
| Granted                  | 10,428                                    | 73.84                                | 458                                             | 65.43                                | —                                   | —                                    | —                         | —                               |
| Exercised/vested         | (12,938)                                  | 71.09                                | —                                               | —                                    | (41,755)                            | 69.70                                | (88,830)                  | 54.56                           |
| Forfeited/expired        | —                                         | —                                    | (1,840)                                         | 89.29                                | (6,894)                             | 81.33                                | (5,052)                   | 76.19                           |
| Balance, June 30, 2020   | <u>52,860</u>                             | <u>\$ 75.47</u>                      | <u>439,265</u>                                  | <u>\$ 90.20</u>                      | <u>128,639</u>                      | <u>\$ 88.07</u>                      | <u>1,886,984</u>          | <u>\$ 65.04</u>                 |

Shares issued in connection with stock compensation awards are issued from available treasury shares. If no treasury shares are available, new shares are issued from available authorized shares. Shares issued in connection with stock compensation awards along with other related information were as follows:

|                                                    | Three Months Ended<br>June 30, |          | Six Months Ended<br>June 30, |          |
|----------------------------------------------------|--------------------------------|----------|------------------------------|----------|
|                                                    | 2020                           | 2019     | 2020                         | 2019     |
| New shares issued from available authorized shares | —                              | —        | —                            | —        |
| Issued from available treasury stock               | 77,303                         | 53,035   | 143,523                      | 153,900  |
| Total                                              | 77,303                         | 53,035   | 143,523                      | 153,900  |
| Proceeds from stock option exercises               | \$ 3,383                       | \$ 2,956 | \$ 4,846                     | \$ 7,841 |

Stock-based compensation expense is recognized ratably over the requisite service period for all awards. For most stock option awards, the service period generally matches the vesting period. For stock options granted to certain executive officers and for non-vested stock units granted to all participants, the service period does not extend past the date the participant reaches 65 years of age. Deferred stock units granted to non-employee directors generally have immediate vesting and the related expense is fully recognized on the date of grant. For performance stock units, the service period generally matches the three-year performance period specified by the award, however, the service period does not extend past the date the participant reaches 65 years of age. Expense recognized each period is dependent upon our estimate of the number of shares that will ultimately be issued.

Stock-based compensation expense and the related income tax benefit is presented in the following table.

|                                     | Three Months Ended<br>June 30, |          | Six Months Ended<br>June 30, |          |
|-------------------------------------|--------------------------------|----------|------------------------------|----------|
|                                     | 2020                           | 2019     | 2020                         | 2019     |
| Stock options                       | \$ —                           | \$ 379   | \$ —                         | \$ 761   |
| Non-vested stock awards/stock units | 2,062                          | 2,056    | 4,326                        | 4,191    |
| Director deferred stock units       | 770                            | 780      | 770                          | 780      |
| Performance stock units             | 440                            | 1,149    | 688                          | 2,286    |
| Total                               | \$ 3,272                       | \$ 4,364 | \$ 5,784                     | \$ 8,018 |
| Income tax benefit                  | \$ 624                         | \$ 732   | \$ 1,089                     | \$ 1,316 |

Unrecognized stock-based compensation expense at June 30, 2020 is presented in the table below. Unrecognized stock-based compensation expense related to performance stock units is presented assuming attainment of the maximum payout rate as set forth by the performance criteria.

|                                     |           |
|-------------------------------------|-----------|
| Non-vested stock awards/stock units | \$ 14,425 |
| Performance stock units             | 5,096     |
| Total                               | \$ 19,521 |

## Note 11 - Earnings Per Common Share

Earnings per common share is computed using the two-class method as more fully described in our 2019 Form 10-K. The following table presents a reconciliation of net income available to common shareholders, net earnings allocated to common stock and the number of shares used in the calculation of basic and diluted earnings per common share.

|                                                                           | Three Months Ended<br>June 30, |            | Six Months Ended<br>June 30, |            |
|---------------------------------------------------------------------------|--------------------------------|------------|------------------------------|------------|
|                                                                           | 2020                           | 2019       | 2020                         | 2019       |
| Net income                                                                | \$ 93,072                      | \$ 111,586 | \$ 147,825                   | \$ 228,082 |
| Less: Preferred stock dividends                                           | —                              | 2,015      | 2,016                        | 4,031      |
| Redemption of preferred stock                                             | —                              | —          | 5,514                        | —          |
| Net income available to common shareholders                               | 93,072                         | 109,571    | 140,295                      | 224,051    |
| Less: Earnings allocated to participating securities                      | 868                            | 906        | 1,335                        | 1,886      |
| Net earnings allocated to common stock                                    | \$ 92,204                      | \$ 108,665 | \$ 138,960                   | \$ 222,165 |
| Distributed earnings allocated to common stock                            | \$ 44,453                      | \$ 44,461  | \$ 88,965                    | \$ 86,699  |
| Undistributed earnings allocated to common stock                          | 47,751                         | 64,204     | 49,995                       | 135,466    |
| Net earnings allocated to common stock                                    | \$ 92,204                      | \$ 108,665 | \$ 138,960                   | \$ 222,165 |
| Weighted-average shares outstanding for basic earnings per common share   | 62,596,171                     | 62,789,182 | 62,619,427                   | 62,898,514 |
| Dilutive effect of stock compensation                                     | 204,848                        | 764,916    | 300,667                      | 791,513    |
| Weighted-average shares outstanding for diluted earnings per common share | 62,801,019                     | 63,554,098 | 62,920,094                   | 63,690,027 |

## Note 12 - Defined Benefit Plans

The components of the combined net periodic expense (benefit) for our defined benefit pension plans are presented in the table below.

|                                                 | Three Months Ended<br>June 30, |            | Six Months Ended<br>June 30, |            |
|-------------------------------------------------|--------------------------------|------------|------------------------------|------------|
|                                                 | 2020                           | 2019       | 2020                         | 2019       |
| Expected return on plan assets, net of expenses | \$ (3,072)                     | \$ (2,693) | \$ (6,144)                   | \$ (5,386) |
| Interest cost on projected benefit obligation   | 1,253                          | 1,618      | 2,505                        | 3,236      |
| Net amortization and deferral                   | 1,329                          | 1,406      | 2,659                        | 2,812      |
| Net periodic expense (benefit)                  | \$ (490)                       | \$ 331     | \$ (980)                     | \$ 662     |

Our non-qualified defined benefit pension plan is not funded. No contributions to the qualified defined benefit pension plan were made during the six months ended June 30, 2020. We do not expect to make any contributions to the qualified defined benefit plan during the remainder of 2020.

## Note 13 - Income Taxes

Income tax expense was as follows:

|                                           | Three Months Ended<br>June 30, |           | Six Months Ended<br>June 30, |           |
|-------------------------------------------|--------------------------------|-----------|------------------------------|-----------|
|                                           | 2020                           | 2019      | 2020                         | 2019      |
| Current income tax expense (benefit)      | \$ 24,530                      | \$ 14,505 | \$ 53,942                    | \$ 29,504 |
| Deferred income tax expense (benefit)     | (25,844)                       | 369       | (51,933)                     | (675)     |
| Income tax expense (benefit), as reported | \$ (1,314)                     | \$ 14,874 | \$ 2,009                     | \$ 28,829 |
| Effective tax rate                        | (1.4)%                         | 11.8 %    | 1.3 %                        | 11.2 %    |

We had a net deferred tax liability totaling \$74.8 million at June 30, 2020 and \$75.8 million at December 31, 2019. No valuation allowance for deferred tax assets was recorded at June 30, 2020 as management believes it is more likely than not that all of the deferred tax assets will be realized against deferred tax liabilities and projected future taxable income.

The effective income tax rates differed from the U.S. statutory federal income tax rates of 21% during the comparable periods primarily due to the effect of tax-exempt income from loans, securities and life insurance policies and the income tax effects associated with stock-based compensation. The effective tax rates during 2020 were also impacted by a one-time,



discrete tax benefit associated with an asset contribution to a charitable trust during the second quarter. There were no unrecognized tax benefits during any of the reported periods. Interest and/or penalties related to income taxes are reported as a component of income tax expense. Such amounts were not significant during the reported periods.

We file income tax returns in the U.S. federal jurisdiction. We are no longer subject to U.S. federal income tax examinations by tax authorities for years before 2016.

#### Note 14 - Other Comprehensive Income (Loss)

The before and after tax amounts allocated to each component of other comprehensive income (loss) are presented in the following table. Reclassification adjustments related to securities available for sale are included in net gain (loss) on securities transactions in the accompanying consolidated statements of income. Reclassification adjustments related to defined-benefit post-retirement benefit plans are included in the computation of net periodic pension expense (see Note 12 – Defined Benefit Plans).

|                                                                                                                                              | Three Months Ended<br>June 30, 2020 |                           |                      | Three Months Ended<br>June 30, 2019 |                           |                      |
|----------------------------------------------------------------------------------------------------------------------------------------------|-------------------------------------|---------------------------|----------------------|-------------------------------------|---------------------------|----------------------|
|                                                                                                                                              | Before Tax<br>Amount                | Tax Expense,<br>(Benefit) | Net of Tax<br>Amount | Before Tax<br>Amount                | Tax Expense,<br>(Benefit) | Net of Tax<br>Amount |
| Securities available for sale and transferred securities:                                                                                    |                                     |                           |                      |                                     |                           |                      |
| Change in net unrealized gain/loss during the period                                                                                         | \$ 156,509                          | \$ 32,868                 | \$ 123,641           | \$ 158,140                          | \$ 33,209                 | \$ 124,931           |
| Change in net unrealized gain on securities transferred to held to maturity                                                                  | (308)                               | (65)                      | (243)                | (308)                               | (65)                      | (243)                |
| Reclassification adjustment for net (gains) losses included in net income                                                                    | —                                   | —                         | —                    | (169)                               | (35)                      | (134)                |
| Total securities available for sale and transferred securities                                                                               | 156,201                             | 32,803                    | 123,398              | 157,663                             | 33,109                    | 124,554              |
| Defined-benefit post-retirement benefit plans:                                                                                               |                                     |                           |                      |                                     |                           |                      |
| Reclassification adjustment for net amortization of actuarial gain/loss included in net income as a component of net periodic cost (benefit) | 1,329                               | 278                       | 1,051                | 1,406                               | 296                       | 1,110                |
| Total defined-benefit post-retirement benefit plans                                                                                          | 1,329                               | 278                       | 1,051                | 1,406                               | 296                       | 1,110                |
| Total other comprehensive income (loss)                                                                                                      | \$ 157,530                          | \$ 33,081                 | \$ 124,449           | \$ 159,069                          | \$ 33,405                 | \$ 125,664           |

  

|                                                                                                                                              | Six Months Ended<br>June 30, 2020 |                           |                      | Six Months Ended<br>June 30, 2019 |                           |                      |
|----------------------------------------------------------------------------------------------------------------------------------------------|-----------------------------------|---------------------------|----------------------|-----------------------------------|---------------------------|----------------------|
|                                                                                                                                              | Before Tax<br>Amount              | Tax Expense,<br>(Benefit) | Net of Tax<br>Amount | Before Tax<br>Amount              | Tax Expense,<br>(Benefit) | Net of Tax<br>Amount |
| Securities available for sale and transferred securities:                                                                                    |                                   |                           |                      |                                   |                           |                      |
| Change in net unrealized gain/loss during the period                                                                                         | \$ 386,627                        | \$ 81,193                 | \$ 305,434           | \$ 356,286                        | \$ 74,820                 | \$ 281,466           |
| Change in net unrealized gain on securities transferred to held to maturity                                                                  | (685)                             | (144)                     | (541)                | (652)                             | (137)                     | (515)                |
| Reclassification adjustment for net (gains) losses included in net income                                                                    | (108,989)                         | (22,888)                  | (86,101)             | (169)                             | (35)                      | (134)                |
| Total securities available for sale and transferred securities                                                                               | 276,953                           | 58,161                    | 218,792              | 355,465                           | 74,648                    | 280,817              |
| Defined-benefit post-retirement benefit plans:                                                                                               |                                   |                           |                      |                                   |                           |                      |
| Reclassification adjustment for net amortization of actuarial gain/loss included in net income as a component of net periodic cost (benefit) | 2,659                             | 557                       | 2,102                | 2,812                             | 591                       | 2,221                |
| Total defined-benefit post-retirement benefit plans                                                                                          | 2,659                             | 557                       | 2,102                | 2,812                             | 591                       | 2,221                |
| Total other comprehensive income (loss)                                                                                                      | \$ 279,612                        | \$ 58,718                 | \$ 220,894           | \$ 358,277                        | \$ 75,239                 | \$ 283,038           |

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

|                                                            | Securities<br>Available<br>For Sale | Defined<br>Benefit<br>Plans | Accumulated<br>Other<br>Comprehensive<br>Income |
|------------------------------------------------------------|-------------------------------------|-----------------------------|-------------------------------------------------|
| Balance January 1, 2020                                    | \$ 313,304                          | \$ (45,934)                 | \$ 267,370                                      |
| Other comprehensive income (loss) before reclassifications | 304,893                             | —                           | 304,893                                         |
| Reclassification of amounts included in net income         | (86,101)                            | 2,102                       | (83,999)                                        |
| Net other comprehensive income (loss) during period        | 218,792                             | 2,102                       | 220,894                                         |
| Balance at June 30, 2020                                   | <u>\$ 532,096</u>                   | <u>\$ (43,832)</u>          | <u>\$ 488,264</u>                               |
| Balance January 1, 2019                                    | \$ (16,103)                         | \$ (47,497)                 | \$ (63,600)                                     |
| Other comprehensive income (loss) before reclassifications | 280,951                             | —                           | 280,951                                         |
| Reclassification of amounts included in net income         | (134)                               | 2,221                       | 2,087                                           |
| Net other comprehensive income (loss) during period        | 280,817                             | 2,221                       | 283,038                                         |
| Balance at June 30, 2019                                   | <u>\$ 264,714</u>                   | <u>\$ (45,276)</u>          | <u>\$ 219,438</u>                               |

### Note 15 – Operating Segments

We are managed under a matrix organizational structure whereby our two primary operating segments, Banking and Frost Wealth Advisors, overlap a regional reporting structure. See our 2019 Form 10-K for additional information regarding our operating segments. Summarized operating results by segment were as follows:

|                                                 | Banking    | Frost Wealth<br>Advisors | Non-Banks  | Consolidated |
|-------------------------------------------------|------------|--------------------------|------------|--------------|
| Revenues from (expenses to) external customers: |            |                          |            |              |
| Three months ended:                             |            |                          |            |              |
| June 30, 2020                                   | \$ 290,185 | \$ 35,604                | \$ (2,377) | \$ 323,412   |
| June 30, 2019                                   | 302,747    | 36,164                   | (2,842)    | 336,069      |
| Six months ended:                               |            |                          |            |              |
| June 30, 2020                                   | \$ 709,614 | \$ 76,211                | \$ (4,977) | \$ 780,848   |
| June 30, 2019                                   | 611,360    | 73,515                   | (5,552)    | 679,323      |
| Net income (loss):                              |            |                          |            |              |
| Three months ended:                             |            |                          |            |              |
| June 30, 2020                                   | \$ 92,492  | \$ 3,925                 | \$ (3,345) | \$ 93,072    |
| June 30, 2019                                   | 110,893    | 4,897                    | (4,204)    | 111,586      |
| Six months ended:                               |            |                          |            |              |
| June 30, 2020                                   | \$ 144,516 | \$ 9,512                 | \$ (6,203) | \$ 147,825   |
| June 30, 2019                                   | 223,810    | 11,297                   | (7,025)    | 228,082      |

### Note 16 – Fair Value Measurements

The fair value of an asset or liability is the price that would be received to sell that asset or paid to transfer that liability in an orderly transaction occurring in the principal market (or most advantageous market in the absence of a principal market) for such asset or liability. In estimating fair value, we utilize valuation techniques that are consistent with the market approach, the income approach and/or the cost approach. Such valuation techniques are consistently applied. Inputs to valuation techniques include the assumptions that market participants would use in pricing an asset or liability. ASC Topic 820 establishes a three-level fair value hierarchy for valuation inputs that gives the highest priority to quoted prices in active markets for identical assets or liabilities and the lowest priority to unobservable inputs. See our 2019 Form 10-K for additional information regarding the fair value hierarchy and a description of our valuation techniques.

*Financial Assets and Financial Liabilities.* The tables below summarize financial assets and financial liabilities measured at fair value on a recurring basis as of June 30, 2020 and December 31, 2019, segregated by the level of the valuation inputs within the fair value hierarchy of ASC Topic 820 utilized to measure fair value.

|                                        | Level 1 Inputs | Level 2 Inputs | Level 3 Inputs | Total Fair Value |
|----------------------------------------|----------------|----------------|----------------|------------------|
| <b>June 30, 2020</b>                   |                |                |                |                  |
| Securities available for sale:         |                |                |                |                  |
| U.S. Treasury                          | \$ 1,163,635   | \$ —           | \$ —           | \$ 1,163,635     |
| Residential mortgage-backed securities | —              | 2,131,287      | —              | 2,131,287        |
| States and political subdivisions      | —              | 7,269,495      | —              | 7,269,495        |
| Other                                  | —              | 42,279         | —              | 42,279           |
| Trading account securities:            |                |                |                |                  |
| U.S. Treasury                          | 24,495         | —              | —              | 24,495           |
| Derivative assets:                     |                |                |                |                  |
| Interest rate swaps, caps and floors   | —              | 103,103        | —              | 103,103          |
| Commodity swaps and options            | —              | 41,324         | —              | 41,324           |
| Foreign currency forward contracts     | 22             | —              | —              | 22               |
| Derivative liabilities:                |                |                |                |                  |
| Interest rate swaps, caps and floors   | —              | 40,008         | —              | 40,008           |
| Commodity swaps and options            | —              | 40,560         | —              | 40,560           |
| Foreign currency forward contracts     | 11             | —              | —              | 11               |
| <b>December 31, 2019</b>               |                |                |                |                  |
| Securities available for sale:         |                |                |                |                  |
| U.S. Treasury                          | \$ 1,948,133   | \$ —           | \$ —           | \$ 1,948,133     |
| Residential mortgage-backed securities | —              | 2,207,594      | —              | 2,207,594        |
| States and political subdivisions      | —              | 7,070,997      | —              | 7,070,997        |
| Other                                  | —              | 42,867         | —              | 42,867           |
| Trading account securities:            |                |                |                |                  |
| U.S. Treasury                          | 24,298         | —              | —              | 24,298           |
| Derivative assets:                     |                |                |                |                  |
| Interest rate swaps, caps and floors   | —              | 44,196         | —              | 44,196           |
| Commodity swaps and options            | —              | 12,218         | —              | 12,218           |
| Foreign currency forward contracts     | 45             | —              | —              | 45               |
| Derivative liabilities:                |                |                |                |                  |
| Interest rate swaps, caps and floors   | —              | 20,197         | —              | 20,197           |
| Commodity swaps and options            | —              | 11,677         | —              | 11,677           |
| Foreign currency forward contracts     | 33             | —              | —              | 33               |

Certain financial assets and financial liabilities are measured at fair value on a nonrecurring basis; that is, the instruments are not measured at fair value on an ongoing basis but are subject to fair value adjustments in certain circumstances. Financial assets measured at fair value on a non-recurring basis during the reported periods include certain collateral dependent loans reported at the fair value of the underlying collateral if repayment is expected solely from the collateral.

The following table presents collateral dependent loans that were remeasured and reported at fair value through a specific allocation of the allowance for credit losses on loans based upon the fair value of the underlying collateral during the reported periods.

|                                                       | Six Months Ended<br>June 30, 2020 |          | Six Months Ended<br>June 30, 2019 |           |
|-------------------------------------------------------|-----------------------------------|----------|-----------------------------------|-----------|
|                                                       | Level 2                           | Level 3  | Level 2                           | Level 3   |
| Carrying value before allocations                     | \$ 5,257                          | \$ 5,006 | \$ 2,161                          | \$ 33,839 |
| Specific (allocations) reversals of prior allocations | (731)                             | 4,209    | 1,179                             | (3,623)   |
| Fair value                                            | \$ 4,526                          | \$ 9,215 | \$ 3,340                          | \$ 30,216 |

**Non-Financial Assets and Non-Financial Liabilities.** We do not have any non-financial assets or non-financial liabilities measured at fair value on a recurring basis. Non-financial assets measured at fair value on a non-recurring basis during the reported periods may include certain foreclosed assets which, upon initial recognition, were remeasured and reported at fair value through a charge-off to the allowance for loan losses and certain foreclosed assets which, subsequent to their initial recognition, were remeasured at fair value through a write-down included in other non-interest expense. The following table presents foreclosed assets that were remeasured and reported at fair value during the reported periods:

|                                                                   | Six Months Ended<br>June 30, |               |
|-------------------------------------------------------------------|------------------------------|---------------|
|                                                                   | 2020                         | 2019          |
| Foreclosed assets remeasured at initial recognition:              |                              |               |
| Carrying value of foreclosed assets prior to remeasurement        | \$ —                         | \$ 616        |
| Charge-offs recognized in the allowance for credit losses on loan | —                            | (50)          |
| Fair value                                                        | <u>\$ —</u>                  | <u>\$ 566</u> |
| Foreclosed assets remeasured subsequent to initial recognition:   |                              |               |
| Carrying value of foreclosed assets prior to remeasurement        | \$ 328                       | \$ —          |
| Write-downs included in other non-interest expense                | (231)                        | —             |
| Fair value                                                        | <u>\$ 97</u>                 | <u>\$ —</u>   |

**Financial Instruments Reported at Amortized Cost.** The estimated fair values of financial instruments that are reported at amortized cost in our consolidated balance sheets, segregated by the level of the valuation inputs within the fair value hierarchy utilized to measure fair value, were as follows:

|                                                    | June 30, 2020   |                      | December 31, 2019 |                      |
|----------------------------------------------------|-----------------|----------------------|-------------------|----------------------|
|                                                    | Carrying Amount | Estimated Fair Value | Carrying Amount   | Estimated Fair Value |
| Financial assets:                                  |                 |                      |                   |                      |
| Level 2 inputs:                                    |                 |                      |                   |                      |
| Cash and cash equivalents                          | \$ 6,599,568    | \$ 6,599,568         | \$ 3,788,181      | \$ 3,788,181         |
| Securities held to maturity                        | 1,968,954       | 2,073,441            | 2,030,005         | 2,048,675            |
| Cash surrender value of life insurance policies    | 189,091         | 189,091              | 187,156           | 187,156              |
| Accrued interest receivable                        | 176,522         | 176,522              | 183,850           | 183,850              |
| Level 3 inputs:                                    |                 |                      |                   |                      |
| Loans, net                                         | 17,721,876      | 17,914,646           | 14,618,165        | 14,654,615           |
| Financial liabilities:                             |                 |                      |                   |                      |
| Level 2 inputs:                                    |                 |                      |                   |                      |
| Deposits                                           | 32,679,096      | 32,685,609           | 27,639,564        | 27,641,255           |
| Federal funds purchased and repurchase agreements  | 1,589,384       | 1,589,384            | 1,695,342         | 1,695,342            |
| Junior subordinated deferrable interest debentures | 136,328         | 137,115              | 136,299           | 137,115              |
| Subordinated notes                                 | 98,943          | 112,500              | 98,865            | 89,077               |
| Accrued interest payable                           | 11,323          | 11,323               | 12,393            | 12,393               |

Under ASC Topic 825, entities may choose to measure eligible financial instruments at fair value at specified election dates. The fair value measurement option (i) may be applied instrument by instrument, with certain exceptions, (ii) is generally irrevocable and (iii) is applied only to entire instruments and not to portions of instruments. Unrealized gains and losses on items for which the fair value measurement option has been elected must be reported in earnings at each subsequent reporting date. During the reported periods, we had no financial instruments measured at fair value under the fair value measurement option.

## Note 17 - Accounting Standards Updates

Information about certain recently issued accounting standards updates is presented below. Also refer to Note 20 - Accounting Standards Updates in our 2019 Form 10-K for additional information related to previously issued accounting standards updates.

*ASU 2016-13, "Financial Instruments - Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments."* ASU 2016-13 requires the measurement of all expected credit losses for financial assets held at the reporting date based on historical experience, current conditions, and reasonable and supportable forecasts and requires enhanced disclosures related to the significant estimates and judgments used in estimating credit losses, as well as the credit quality and underwriting standards of an organization's portfolio. We adopted ASU 2016-13, as subsequently updated for certain clarifications, targeted relief and codification improvements, as of January 1, 2020. See Note 1 - Significant Accounting Policies for additional information.

*ASU 2020-4, "Reference Rate Reform (Topic 848): Facilitation of the Effects of Reference Rate Reform on Financial Reporting."* ASU 2020-4 provides optional expedients and exceptions for accounting related to contracts, hedging relationships and other transactions affected by reference rate reform if certain criteria are met. ASU 2020-04 applies only to contracts, hedging relationships, and other transactions that reference LIBOR or another reference rate expected to be discontinued because of reference rate reform and do not apply to contract modifications made and hedging relationships entered into or evaluated after December 31, 2022, except for hedging relationships existing as of December 31, 2022, that an entity has elected certain optional expedients for and that are retained through the end of the hedging relationship. ASU 2020-4 was effective upon issuance and generally can be applied through December 31, 2022. The adoption of ASU 2020-4 did not significantly impact our financial statements.

## **Item 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations**

### **Financial Review**

#### **Cullen/Frost Bankers, Inc.**

The following discussion should be read in conjunction with our consolidated financial statements, and notes thereto, for the year ended December 31, 2019, and the other information included in the 2019 Form 10-K. Operating results for the three and six months ended June 30, 2020 are not necessarily indicative of the results for the year ending December 31, 2020 or any future period.

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

### **Forward-Looking Statements and Factors that Could Affect Future Results**

Certain statements contained in this Quarterly Report on Form 10-Q that are not statements of historical fact constitute forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995 (the “Act”), including statements regarding the potential effects of the ongoing COVID-19 pandemic on our business, financial condition, liquidity and results of operations, notwithstanding that such statements are not specifically identified as such. In addition, certain statements may be contained in our future filings with the SEC, in press releases, and in oral and written statements made by us or with our approval that are not statements of historical fact and constitute forward-looking statements within the meaning of the Act. Examples of forward-looking statements include, but are not limited to: (i) projections of revenues, expenses, income or loss, earnings or loss per share, the payment or nonpayment of dividends, capital structure and other financial items; (ii) statements of plans, objectives and expectations of Cullen/Frost or its management or Board of Directors, including those relating to products, services or operations; (iii) statements of future economic performance; and (iv) statements of assumptions underlying such statements. Words such as “believes”, “anticipates”, “expects”, “intends”, “targeted”, “continue”, “remain”, “will”, “should”, “may” and other similar expressions are intended to identify forward-looking statements but are not the exclusive means of identifying such statements.

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

- Local, regional, national and international economic conditions and the impact they may have on us and our customers and our assessment of that impact.
- Volatility and disruption in national and international financial and commodity markets.
- Government intervention in the U.S. financial system.
- Changes in the mix of loan geographies, sectors and types or the level of non-performing assets and charge-offs.
- Changes in estimates of future reserve requirements based upon the periodic review thereof under relevant regulatory and accounting requirements.
- The effects of and changes in trade and monetary and fiscal policies and laws, including the interest rate policies of the Federal Reserve Board.
- Inflation, interest rate, securities market and monetary fluctuations.
- The effect of changes in laws and regulations (including laws and regulations concerning taxes, banking, securities and insurance) with which we and our subsidiaries must comply.
- The soundness of other financial institutions.
- Political instability.
- Impairment of our goodwill or other intangible assets.
- Acts of God or of war or terrorism.
- The timely development and acceptance of new products and services and perceived overall value of these products and services by users.
- Changes in consumer spending, borrowings and savings habits.
- Changes in the financial performance and/or condition of our borrowers.
- Technological changes.
- The cost and effects of failure, interruption, or breach of security of our systems.
- Acquisitions and integration of acquired businesses.
- Our ability to increase market share and control expenses.
- Our ability to attract and retain qualified employees.
- Changes in the competitive environment in our markets and among banking organizations and other financial service providers.

- The effect of changes in accounting policies and practices, as may be adopted by the regulatory agencies, as well as the Public Company Accounting Oversight Board, the Financial Accounting Standards Board and other accounting standard setters.
- Changes in the reliability of our vendors, internal control systems or information systems.
- Changes in our liquidity position.
- Changes in our organization, compensation and benefit plans.
- The impact of the ongoing COVID-19 pandemic and any other pandemic, epidemic or health-related crisis.
- The costs and effects of legal and regulatory developments, the resolution of legal proceedings or regulatory or other governmental inquiries, the results of regulatory examinations or reviews and the ability to obtain required regulatory approvals.
- Greater than expected costs or difficulties related to the integration of new products and lines of business.
- Our success at managing the risks involved in the foregoing items.

Further, statements about the potential effects of the ongoing COVID-19 pandemic on our business, financial condition, liquidity and results of operations may constitute forward-looking statements and are subject to the risk that the actual effects may differ, possibly materially, from what is reflected in those forward-looking statements due to factors and future developments that are uncertain, unpredictable and in many cases beyond our control, including the scope and duration of the pandemic, actions taken by governmental authorities in response to the pandemic, and the direct and indirect impact of the pandemic on our customers, clients, third parties and us.

Forward-looking statements speak only as of the date on which such statements are made. We do not undertake any obligation to update any forward-looking statement to reflect events or circumstances after the date on which such statement is made, or to reflect the occurrence of unanticipated events.

### **Recent Developments Related to COVID-19**

*Overview.* Our business has been, and continues to be, impacted by the recent and ongoing outbreak of COVID-19. In March 2020, COVID-19 was declared a pandemic by the World Health Organization and a national emergency by the President of the United States. Efforts to limit the spread of COVID-19 have led to shelter-in-place orders, the closure of non-essential businesses, travel restrictions, supply chain disruptions and prohibitions on public gatherings, among other things, throughout many parts of the United States and, in particular, the markets in which we operate. As the current pandemic is ongoing and dynamic in nature, there are many uncertainties related to COVID-19 including, among other things, its ultimate geographic spread; its severity; the duration of the outbreak; the impact to our customers, employees and vendors; the impact to the financial services and banking industry; and the impact to the economy as a whole as well as the effect of actions taken, or that may yet be taken, or inaction by governmental authorities to contain the outbreak or to mitigate its impact (both economic and health-related). COVID-19 has negatively affected, and is expected to continue to negatively affect, our business, financial position and operating results. In light of the uncertainties and continuing developments discussed herein, the ultimate adverse impact of COVID-19 cannot be reliably estimated at this time, but it has been and is expected to continue to be material.

*Impact on our Operations.* In the State of Texas, many jurisdictions have declared health emergencies. The resulting closures and/or limited operations of non-essential businesses and related economic disruption has impacted our operations as well as the operations of our customers. Financial services have been identified as a Critical Infrastructure Sector by the Department of Homeland Security. Accordingly, our business remains open. To address the issues arising as a result of COVID-19, and in order to facilitate the continued delivery of essential services while maintaining a high level of safety for our customers as well as our employees, we have implemented our Business Continuity and Health Emergency Response plans. Among other things, significant actions taken under these plans include:

- Implemented our communications plans to ensure our employees, customers and critical vendors are kept abreast of developments affecting our operations.
- Restricted all non-essential travel and large external gatherings and have instituted a mandatory quarantine period for anyone that has traveled to an impacted area.
- Temporarily closed all of our financial center lobbies and other corporate facilities to non-employees, except for certain limited cases by appointment only. We continue to serve our consumer and business customers through our motor-banks, ATMs, internet banking, mobile app and telephone customer service capabilities.
- Expanded remote-access availability so that nearly all of our work-force has the capability to work from home or other remote locations. All activities are performed in accordance with our compliance and information security policies designed to ensure customer data and other information is properly safeguarded.
- Instituted mandatory social distancing policies for those employees not working remotely. Members of certain operations teams have been split into separate buildings or locations to create redundancy for key functions across the organization.

Notwithstanding the foregoing actions, the COVID-19 outbreak could still greatly affect our routine and essential operations due to staff absenteeism, particularly among key personnel; further limited access to or closures of our branch facilities and other physical offices; operational, technical or security-related risks arising from a remote work-force; and government or regulatory agency orders, among other things. The business and operations of our third party service providers, many of whom perform critical services for our business, could also be significantly impacted, which in turn could impact us. As a result, we are currently unable to fully assess or predict the extent of the effects of COVID-19 on our operations as the ultimate impact will depend on factors that are currently unknown and/or beyond our control.

*Impact on our Financial Position and Results of Operations.* Our financial position and results of operations are particularly susceptible to the ability of our loan customers to meet loan obligations, the availability of our workforce, the availability of our vendors and the decline in the value of assets held by us. While its effects continue to materialize, the COVID-19 pandemic has resulted in a significant decrease in commercial activity throughout the State of Texas as well as nationally. This decrease in commercial activity has caused and may continue to cause our customers (including affected businesses and individuals), vendors and counterparties to be unable to meet existing payment or other obligations to us. The national public health crisis arising from the COVID-19 pandemic (and public expectations about it), combined with certain pre-existing factors, including, but not limited to, international trade disputes, inflation risks and oil price volatility, could further destabilize the financial markets and geographies in which we operate. The resulting economic pressure on consumers and uncertainty regarding the sustainability of any economic improvements has impacted the creditworthiness of potential and current borrowers. Borrower loan defaults that adversely affect our earnings correlate with deteriorating economic conditions (such as the unemployment rate), which, in turn, are likely to impact our borrowers' creditworthiness and our ability to make loans. See further information related to the risk exposure of our loan portfolio under the sections captioned "Loans" and "Allowance for Credit Losses" elsewhere in this discussion.

In addition, the economic pressures and uncertainties arising from the COVID-19 pandemic has resulted in and may continue to result in specific changes in consumer and business spending and borrowing and saving habits, affecting the demand for loans and other products and services we offer. Consumers affected by COVID-19 may continue to demonstrate changed behavior even after the crisis is over. For example, consumers may decrease discretionary spending on a permanent or long-term basis, certain industries may take longer to recover (particularly those that rely on travel or large gatherings) as consumers may be hesitant to return to full social interaction. We lend to customers operating in such industries including energy, restaurants, hotels/lodging, aviation, entertainment, retail and commercial real estate, among others, that have been significantly impacted by COVID-19 and we are continuing to monitor these customers closely. To help mitigate the adverse effects of COVID-19, loan customers may apply for a deferral of payments, or portions thereof, for up to 90 days. After 90 days, customers may apply for an additional deferral. Additionally, the temporary closures of bank branches and the safety precautions implemented at re-opened branches could result in consumers becoming more comfortable with technology and devaluing face-to-face interaction. Our business is relationship driven and such changes could necessitate changes to our business practices to accommodate changing consumer behaviors. The potential changes in behaviors driven by COVID-19 also present heightened liquidity risks, for example, arising from increased demand for our products and services (such as unusually high draws on credit facilities) or decreased demand for our products and services (such as idiosyncratic, or broad-based, market or other developments that lead to deposit outflows).

*Legislative and Regulatory Developments.* Recent actions taken by the federal government and the Federal Reserve and other bank regulatory agencies to mitigate the economic effects of COVID-19 will also have an impact on our financial position and results of operations. These actions are further discussed below.

In an emergency measure aimed at blunting the economic impact of COVID-19, the Federal Reserve lowered the target for the federal funds rate to a range of between zero to 0.25% effective on March 16, 2020. This action by the Federal Reserve followed a prior reduction of the targeted federal funds rates to a range of 1.0% to 1.25% effective on March 4, 2020. Our earnings and cash flows are largely dependent upon our net interest income. Net interest income is the difference between interest income earned on interest-earning assets such as loans and securities and interest expense paid on interest-bearing liabilities such as deposits and borrowed funds. As our balance sheet is more asset sensitive, our earnings are more adversely affected by decreases in market interest rates as the interest rates received on loans and other investments fall more quickly and to a larger degree than the interest rates paid on deposits and other borrowings. The decline in interest rates has already led to new all-time low yields across the US Treasury maturity curve. In June 2020, the Federal Reserve indicated that it expects to maintain the targeted federal funds rate at current levels through 2022. Nonetheless, if the Federal Reserve decreases the targeted federal funds rates even further in response to the economic effects of COVID-19, overall interest rates will decline further, which will negatively impact our net interest income and further compress our net interest margin.

Other actions taken by the Federal Reserve in an effort to provide monetary stimulus to counteract the economic disruption caused by COVID-19 include:

- Expanded reverse repo operations, adding liquidity to the banking system.
- Restarted quantitative easing.
- Lowered the interest rate on the discount window by 1.5% to 0.25%.
- Reduced reserve requirement ratios to zero percent.
- Encouraged banks to use their capital and liquidity buffers to lend.
- Introduced and expanded several new programs that will operate on a temporary basis to help preserve market liquidity.

The U.S. government has also enacted certain fiscal stimulus measures in several phases to counteract the economic disruption caused by the COVID-19. The Phase 1 legislation, the Coronavirus Preparedness and Response Supplemental Appropriations Act, was enacted on March 6, 2020 and, among other things, authorized funding for research and development of vaccines and allocated money to state and local governments to aid containment and response measures. The Phase 2 legislation, the Families First Coronavirus Response Act, was enacted on March 18, 2020 and provides for paid sick/medical leave, establishes no-cost coverage for coronavirus testing, expands unemployment benefits, expands food assistance, and provides additional funding to states for the ongoing economic consequences of the pandemic, among other provisions. The Phase 3 legislation, the Coronavirus Aid, Relief, and Economic Security Act (the “CARES Act”), was enacted on March 27, 2020. Among other provisions, the CARES Act (i) authorizes the Secretary of the Treasury to make loans, loan guarantees and other investments, up to \$500 billion, for assistance to eligible businesses, States and municipalities with limited, targeted relief for passenger air carriers, cargo air carriers, and businesses critical to maintaining national security, (ii) creates a \$349 billion loan program called the Paycheck Protection Program (the “PPP”) for loans to small businesses for, among other things, payroll, group health care benefit costs and qualifying mortgage, rent and utility payments, (iii) provides certain credits against the 2020 personal income tax for eligible individuals and their dependents, (iv) expands eligibility for unemployment insurance and provides eligible recipients with an additional \$600 per week on top of the unemployment amount determined by each State and (v) expands tele-health services in Medicare. The Phase 3.5 legislation, the Paycheck Protection Program and Healthcare Enhancement Act of 2020 (the “PPPHE Act”), was enacted on April 24, 2020. Among other things, the PPPHE Act provided an additional \$310 billion of funding for the PPP of which, \$30 billion is specifically allocated for use by banks and other insured depository institutions that have assets between \$10 billion and \$50 billion.

The Paycheck Protection Program Flexibility Act of 2020” (the “PPPF Act”) was enacted in June 2020 and modifies the PPP as follows: (i) establishes a minimum maturity of five years for all loans made after the enactment of the PPPF Act and permits an extension of the maturity of existing loans to five years if the borrower and lender agree; (ii) extends the “covered period” of the CARES Act from June 30, 2020, to December 31, 2020; (iii) extends the eight-week “covered period” for expenditures that qualify for forgiveness to the earlier of 24 weeks following loan origination or December 31, 2020; (iv) extends the deferral period for payment of principal, interest and fees to the date on which the forgiveness amount is remitted to the lender by the SBA; (v) requires the borrower to use at least 60% (down from 75%) of the proceeds of the loan for payroll costs, and up to 40% (up from 25%), for other permitted purposes, as a condition to obtaining forgiveness of the loan; (vi) delays from June 30, 2020 to December 31, 2020 the date by which employees must be rehired to avoid a reduction in the amount of forgiveness of a loan, and creates a “rehiring safe harbor” that allows businesses to remain eligible for loan forgiveness if they make a good-faith attempt to rehire employees or hire similarly qualified employees, but are unable to do so, or are able to document an inability to return to pre-COVID-19 levels of business activity due to compliance with social distancing measures; and (vii) allows borrowers to receive both loan forgiveness under the PPP and the payroll tax deferral permitted under the CARES Act, rather than having to choose which of the two would be more advantageous.

In July 2020, the CARES Act was amended to extend, through August 8, 2020, the SBA’s authority to make commitments under the PPP. The SBA’s existing authority had previously expired on June 30, 2020. We are continuing to monitor the potential development of additional legislation and further actions taken by the U.S. government.

The Federal Reserve has created various additional lending facilities and expanded existing facilities to help provide financing in response to the financial disruptions caused by COVID-19. The programs include, among other things, (i) the PPP Facility, which is intended to extend loans to banks making PPP loans, (ii) the Municipal Liquidity Facility, which is intended to facilitate the purchase of eligible notes from states, and certain counties and cities around the country, and (iii) the Main Street Lending Program (“MSLP”), which is intended to facilitate credit flows to businesses affected by the COVID-19 pandemic with up to 10,000 employees or up to \$2.5 billion in 2019 annual revenues. As more fully discussed in the section captioned “Loans” elsewhere in this discussion, we are currently participating in the PPP as a lender. Additionally, we are currently evaluating participation in the MSLP.

Banks and bank holding companies have been particularly impacted by the COVID-19 pandemic as a result of disruption and volatility in the global capital markets. This disruption has impacted our cost of capital and may adversely affect our ability to access the capital markets if we need or desire to do so and, although the ultimate impact cannot be reliably estimated at this time in light of the uncertainties and ongoing developments noted herein, such impacts could be material. Furthermore, bank regulatory agencies have been (and are expected to continue to be) very proactive in responding to both market and supervisory concerns arising from the COVID-19 pandemic as well as the potential impact on customers, especially borrowers. As shown during and following the financial crisis of 2007-2008, periods of economic and financial disruption and stress have, in the past, resulted in increased scrutiny of banking organizations. We are closely monitoring the potential for new laws and regulations impacting lending and funding practices as well as capital and liquidity standards. Such changes could require us to maintain significantly more capital, with common equity as a more predominant component, or manage the composition of our assets and liabilities to comply with formulaic liquidity requirements. Furthermore, provisions of the CARES Act allow, but do not require, the FDIC to guarantee deposit obligations of banks in non-interest-bearing transaction accounts through December 31, 2020. Participation in any such guarantee program may result in fees and other assessments as the FDIC determines and may include special assessments. Other provisions of the CARES Act as well as actions taken by bank regulators, such as potential relief for working with borrowers who are distressed as a result of the effects of COVID-19, could similarly impact aggregate deposit insurance expense.

### **Application of Critical Accounting Policies and Accounting Estimates**

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

We consider accounting estimates to be critical to reported financial results if (i) the accounting estimate requires management to make assumptions about matters that are highly uncertain and (ii) different estimates that management reasonably could have used for the accounting estimate in the current period, or changes in the accounting estimate that are reasonably likely to occur from period to period, could have a material impact on our financial statements.

Accounting policies related to the allowance for credit losses on financial instruments including loans and off-balance-sheet credit exposures are considered to be critical as these policies involve considerable subjective judgment and estimation by management. As discussed in Note 1 - Summary of Significant Accounting Policies, our policies related to allowances for credit losses changed on January 1, 2020 in connection with the adoption of a new accounting standard update as codified in Accounting Standards Codification ("ASC") Topic 326 ("ASC 326") Financial Instruments - Credit Losses. In the case of loans, the allowance for credit losses is a contra-asset valuation account, calculated in accordance with ASC 326, that is deducted from the amortized cost basis of loans to present the net amount expected to be collected. In the case of off-balance-sheet credit exposures, the allowance for credit losses is a liability account, calculated in accordance with ASC 326, reported as a component of accrued interest payable and other liabilities in our consolidated balance sheets. The amount of each allowance account represents management's best estimate of current expected credit losses on these financial instruments considering available information, from internal and external sources, relevant to assessing exposure to credit loss over the contractual term of the instrument. Relevant available information includes historical credit loss experience, current conditions and reasonable and supportable forecasts. While historical credit loss experience provides the basis for the estimation of expected credit losses, adjustments to historical loss information may be made for differences in current portfolio-specific risk characteristics, environmental conditions or other relevant factors. While management utilizes its best judgment and information available, the ultimate adequacy of our allowance accounts is dependent upon a variety of factors beyond our control, including the performance of our portfolios, the economy, changes in interest rates and the view of the regulatory authorities toward classification of assets. For additional information regarding critical accounting policies, refer to Note 1 - Summary of Significant Accounting Policies and Note 3 - Loans in the notes to consolidated financial statements.

### **Overview**

A discussion of our results of operations is presented below. Certain reclassifications have been made to make prior periods comparable. Taxable-equivalent adjustments are the result of increasing income from tax-free loans and investments by an amount equal to the taxes that would be paid if the income were fully taxable based on a 21% federal tax rate, thus making tax-exempt yields comparable to taxable asset yields.

## Results of Operations

Net income available to common shareholders totaled \$93.1 million, or \$1.47 per diluted common share, and \$140.3 million, or \$2.21 per diluted common share, for the three and six months ended June 30, 2020 compared to \$109.6 million, or \$1.72 per diluted common share, and \$224.1 million, or \$3.51 per diluted common share, for the three and six months ended June 30, 2019.

Selected data for the comparable periods was as follows:

|                                                | Three Months Ended<br>June 30, |            | Six Months Ended<br>June 30, |            |
|------------------------------------------------|--------------------------------|------------|------------------------------|------------|
|                                                | 2020                           | 2019       | 2020                         | 2019       |
| Taxable-equivalent net interest income         | \$ 269,722                     | \$ 277,751 | \$ 538,174                   | \$ 548,930 |
| Taxable-equivalent adjustment                  | 23,911                         | 24,320     | 47,842                       | 49,030     |
| Net interest income                            | 245,811                        | 253,431    | 490,332                      | 499,900    |
| Credit loss expense                            | 31,975                         | 6,400      | 207,172                      | 17,403     |
| Net interest income after credit loss expense  | 213,836                        | 247,031    | 283,160                      | 482,497    |
| Non-interest income                            | 77,601                         | 82,638     | 290,516                      | 179,423    |
| Non-interest expense                           | 199,679                        | 203,209    | 423,842                      | 405,009    |
| Income before income taxes                     | 91,758                         | 126,460    | 149,834                      | 256,911    |
| Income tax expense\benefit                     | (1,314)                        | 14,874     | 2,009                        | 28,829     |
| Net income                                     | 93,072                         | 111,586    | 147,825                      | 228,082    |
| Preferred stock dividends                      | —                              | 2,015      | 2,016                        | 4,031      |
| Redemption of preferred stock                  | —                              | —          | 5,514                        | —          |
| Net income available to common shareholders    | \$ 93,072                      | \$ 109,571 | \$ 140,295                   | \$ 224,051 |
| Earnings per common share – basic              | \$ 1.47                        | \$ 1.73    | \$ 2.22                      | \$ 3.53    |
| Earnings per common share – diluted            | 1.47                           | 1.72       | 2.21                         | 3.51       |
| Dividends per common share                     | 0.71                           | 0.71       | 1.42                         | 1.38       |
| Return on average assets                       | 0.99 %                         | 1.40 %     | 0.79 %                       | 1.44 %     |
| Return on average common equity                | 9.60                           | 12.60      | 7.24                         | 13.32      |
| Average shareholders' equity to average assets | 10.30                          | 11.53      | 11.08                        | 11.27      |

Net income available to common shareholders decreased \$16.5 million, or 15.1%, for the three months ended June 30, 2020 and decreased \$83.8 million, or 37.4%, for the six months ended June 30, 2020 compared to the same periods in 2019. The decrease during the three months ended June 30, 2020 was primarily the result of a \$25.6 million increase in credit loss expense, a \$7.6 million decrease in net interest income and a \$5.0 million decrease in non-interest income partly offset by a \$16.2 million decrease in income tax expense and a \$3.5 million decrease in non-interest expense. The decrease during the six months ended June 30, 2020 was primarily the result of a \$189.8 million increase in credit loss expense, an \$18.8 million increase in non-interest expense and a \$9.6 million decrease in net interest income partly offset by a \$111.1 million increase in non-interest income and a \$26.8 million decrease in income tax expense. The increase in credit loss expense during the comparable periods resulted from both our adoption of a new credit loss accounting standard and the adverse events impacting our loan portfolio, including those arising from the COVID-19 pandemic and the significant volatility in oil prices. The increase in non-interest income during the six months ended June 30, 2020 was primarily related to a \$109.0 million net gain on securities transactions. Net income available to common shareholders for the six months ended June 30, 2020 was also impacted by the reclassification of \$5.5 million of issuance costs associated with our preferred stock to retained earnings upon redemption of the preferred stock in the first quarter.

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

## Net Interest Income

Net interest income is the difference between interest income on earning assets, such as loans and securities, and interest expense on liabilities, such as deposits and borrowings, which are used to fund those assets. Net interest income is our largest source of revenue, representing 62.8% of total revenue during the first six months of 2020. Excluding the revenue associated with the \$109.0 million net gain on securities transactions realized during the first quarter of 2020, net interest income would have represented 73.0% of total revenue during the first six months of 2020. Net interest margin is the ratio of taxable-equivalent net interest income to average earning assets for the period. The level of interest rates and the volume and mix of earning assets and interest-bearing liabilities impact net interest income and net interest margin.

The Federal Reserve influences the general market rates of interest, including the deposit and loan rates offered by many financial institutions. Our loan portfolio is significantly affected by changes in the prime interest rate. The prime rate began 2019 at 5.50% and decreased 50 basis points during the third quarter of 2019 (25 basis points in each of August and September) and 25 basis points in October 2019 to end the year at 4.75%. During 2020, the prime rate decreased 150 basis points in March to 3.25% where it remained through June 30, 2020. Our loan portfolio is also impacted by changes in the London Interbank Offered Rate (LIBOR). At June 30, 2020, the one-month and three-month U.S. dollar LIBOR interest rates were 0.16% and 0.30%, respectively, while at June 30, 2019, the one-month and three-month U.S. dollar LIBOR interest rates were 2.40% and 2.32%, respectively. The target range for the federal funds rate, which is the cost of immediately available overnight funds, began 2019 at 2.25% to 2.50% and decreased 50 basis points during the third quarter of 2019 (25 basis points in each of August and September) and 25 basis points in October 2019 to end the year at 1.50 to 1.75%. During 2020, the target range for the federal funds rate decreased 150 basis points in March to zero to 0.25% where it remained through June 30, 2020. As noted in the section captioned “Recent Developments Related to COVID-19” elsewhere in this discussion, the decrease in the target range for the federal funds rate in March 2020 was largely an emergency measure by the Federal Reserve aimed at blunting the economic impact of COVID-19.

We are primarily funded by core deposits, with non-interest-bearing demand deposits historically being a significant source of funds. This lower-cost funding base is expected to have a positive impact on our net interest income and net interest margin in a rising interest rate environment. Though federal prohibitions on the payment of interest on demand deposits were repealed in 2011, we have not experienced any significant additional interest costs as a result. See Item 3. Quantitative and Qualitative Disclosures About Market Risk elsewhere in this report for information about our sensitivity to interest rates. Further analysis of the components of our net interest margin is presented below.

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

|                                                    | Three Months Ended<br>June 30, 2020 vs. June 30, 2019 |           |                |            |
|----------------------------------------------------|-------------------------------------------------------|-----------|----------------|------------|
|                                                    | Increase (Decrease) Due to Change in                  |           |                | Total      |
|                                                    | Rate                                                  | Volume    | Number of days |            |
| Interest-bearing deposits                          | \$ (12,981)                                           | \$ 6,410  | \$ —           | \$ (6,571) |
| Federal funds sold and resell agreements           | (869)                                                 | (609)     | —              | (1,478)    |
| Securities:                                        |                                                       |           |                |            |
| Taxable                                            | —                                                     | (6,964)   | —              | (6,964)    |
| Tax-exempt                                         | 222                                                   | 60        | —              | 282        |
| Loans, net of unearned discounts                   | (56,038)                                              | 37,217    | —              | (18,821)   |
| Total earning assets                               | (69,666)                                              | 36,114    | —              | (33,552)   |
| Savings and interest checking                      | (1,199)                                               | 138       | —              | (1,061)    |
| Money market deposit accounts                      | (19,163)                                              | 1,530     | —              | (17,633)   |
| Time accounts                                      | (683)                                                 | 563       | —              | (120)      |
| Public funds                                       | (1,980)                                               | 177       | —              | (1,803)    |
| Federal funds purchased and repurchase agreements  | (4,951)                                               | 217       | —              | (4,734)    |
| Junior subordinated deferrable interest debentures | (491)                                                 | 1         | —              | (490)      |
| Subordinated notes                                 | —                                                     | —         | —              | —          |
| Federal home loan bank advances                    | —                                                     | 318       | —              | 318        |
| Total interest-bearing liabilities                 | (28,467)                                              | 2,944     | —              | (25,523)   |
| Net change                                         | \$ (41,199)                                           | \$ 33,170 | \$ —           | \$ (8,029) |

|                                                    | Six Months Ended<br>June 30, 2020 vs. June 30, 2019 |           |                |             |
|----------------------------------------------------|-----------------------------------------------------|-----------|----------------|-------------|
|                                                    | Increase (Decrease) Due to Change in                |           |                | Total       |
|                                                    | Rate                                                | Volume    | Number of days |             |
| Interest-bearing deposits                          | \$ (22,855)                                         | \$ 13,718 | \$ 52          | \$ (9,085)  |
| Federal funds sold and resell agreements           | (1,541)                                             | (728)     | 5              | (2,264)     |
| Securities:                                        |                                                     |           |                |             |
| Taxable                                            | 1,911                                               | (7,524)   | —              | (5,613)     |
| Tax-exempt                                         | 876                                                 | (1,492)   | —              | (616)       |
| Loans, net of unearned discounts                   | (82,325)                                            | 48,331    | 1,900          | (32,094)    |
| Total earning assets                               | (103,934)                                           | 52,305    | 1,957          | (49,672)    |
| Savings and interest checking                      | (2,329)                                             | 188       | 4              | (2,137)     |
| Money market deposit accounts                      | (30,722)                                            | 2,081     | 64             | (28,577)    |
| Time accounts                                      | (50)                                                | 1,339     | 47             | 1,336       |
| Public funds                                       | (2,817)                                             | 449       | 8              | (2,360)     |
| Federal funds purchased and repurchase agreements  | (7,269)                                             | 537       | 19             | (6,713)     |
| Junior subordinated deferrable interest debentures | (784)                                               | 1         | —              | (783)       |
| Subordinated notes                                 | —                                                   | —         | —              | —           |
| Federal home loan bank advances                    | —                                                   | 318       | —              | 318         |
| Total interest-bearing liabilities                 | (43,971)                                            | 4,913     | 142            | (38,916)    |
| Net change                                         | \$ (59,963)                                         | \$ 47,392 | \$ 1,815       | \$ (10,756) |

Taxable-equivalent net interest income for the three months ended June 30, 2020 decreased \$8.0 million, or 2.9%, while taxable-equivalent net interest income for six months ended June 30, 2020 decreased \$10.8 million, or 2.0%, compared to the same periods in 2019. Taxable-equivalent net interest income for the six months ended June 30, 2020 included 182 days compared to 181 days for the same period in 2019 as a result of the leap year. The additional day added approximately \$1.8 million to taxable-equivalent net interest income during the six months ended June 30, 2020. Excluding the impact of the additional day results in an effective decrease in taxable-equivalent net interest income of approximately \$12.6 million during the six months ended June 30, 2020. The taxable-equivalent net interest margin decreased 72 basis points from 3.85% during the three months ended June 30, 2019 to 3.13% during the three months ended June 30, 2020 while the taxable-equivalent net interest margin decreased 49 basis points from 3.82% during the six months ended June 30, 2019 to 3.33% during the six months ended June 30, 2020.

The decreases in taxable-equivalent net interest income and taxable-equivalent net interest margin during the three and six months ended June 30, 2020 were primarily related to decreases in the average yields on loans, interest-bearing deposits and federal funds sold and resell agreements combined with decreases in the average volume of taxable securities (based on amortized cost) and increases in the average volume of interest bearing liabilities, and for the three months ended June 30, 2020, a decrease in the average volumes of tax-exempt securities. The impact of these items was partly offset by decreases in the average cost of interest-bearing deposits and other borrowed funds combined with increases in the average volumes of loans and interest-bearing deposits (primarily amounts held in an interest-bearing account at the Federal Reserve), and for the six months ended June 30, 2020, increases in the average yields on taxable and tax-exempt securities.

The average volume of interest-earning assets for the three months ended June 30, 2020 increased \$6.0 billion, while the average volume of interest-earning assets for the six months ended June 30, 2020 increased \$3.9 billion compared to the same periods in 2019, respectively. The increase in the average volume of interest-earning assets for the three months ended June 30, 2020 included a \$3.7 billion increase in average interest-bearing deposits, federal funds sold and resell agreements, a \$3.2 billion increase in average loans (of which approximately \$2.5 billion related to PPP loans, as further discussed below) and a \$218.6 million increase in average tax-exempt securities partly offset by a \$1.0 billion decrease in average taxable securities. The increase in the average volume of interest-earning assets for the six months ended June 30, 2020 included a \$2.3 billion increase in average interest-bearing deposits, federal funds sold and resell agreements, a \$2.0 billion increase in average loans (of which \$1.2 billion related to PPP loans, as further discussed below) and a \$228.6 million increase in average tax-exempt securities partly offset by a \$544.3 million decrease in average taxable securities.

The average taxable-equivalent yield on interest-earning assets decreased 109 basis points from 4.33% during the three months ended June 30, 2019 to 3.24% during the three months ended June 30, 2020 while the average taxable-equivalent yield on interest-earning assets decreased 78 basis points from 4.30% during the six months ended June 30, 2019 to 3.52% during the six months ended June 30, 2020. The average taxable-equivalent yield on interest-earning assets was primarily impacted by the aforementioned changes in market interest rates and changes in the volume and relative mix of interest-earning assets.

The average taxable-equivalent yield on loans decreased 139 basis points from 5.34% during the three months ended June 30, 2019 to 3.95% during the three months ended June 30, 2020 while the average taxable-equivalent yield on loans decreased 106 basis points from 5.33% during the six months ended June 30, 2019 to 4.27% during the six months ended June 30, 2020. The average taxable-equivalent yield on loans was negatively impacted by lower average market interest rates during the three and six months ended June 30, 2020 compared to the same periods in 2019. The average volume of loans for the three and six months ended June 30, 2020 increased \$3.2 billion, or 22.1%, and \$2.0 billion, or 13.9%, compared to the same periods in 2019. Loans made up approximately 50.0% and 49.4% of average interest-earning assets during the three and six months ended June 30, 2020, respectively, compared to 49.4% and 49.2% during the same periods in 2019 respectively. As discussed in the section captioned “Loans” elsewhere in this discussion, in April 2020, we began originating loans to qualified small businesses under the PPP administered by the SBA under the provisions of the CARES Act. Through June 30, 2020, we have funded approximately \$3.2 billion of SBA-approved PPP loans. During the second quarter of 2020, we recognized approximately \$19.3 million in PPP loan related deferred processing fees (net of amortization of related deferred origination costs) as a yield adjustment and this amount is included in interest income on loans. As a result of the inclusion of these net fees in interest income, the average yield on PPP loans was approximately 4.13% during the second quarter of 2020 compared to the stated interest rate of 1.0% on these loans. As of June 30, 2020, we expect to recognize additional PPP loan related deferred processing fees (net of deferred origination costs) totaling approximately \$77.4 million as a yield adjustment over the remaining terms of these loans.

The average taxable-equivalent yield on securities was 3.53% during the three months ended June 30, 2020, increasing 11 basis points from 3.42% during the same period in 2019 while the average taxable-equivalent yield on securities was 3.49% during the six months ended June 30, 2020, increasing 9 basis points from 3.40% during the same period in 2019. The average taxable-equivalent yield on securities during the three and six months ended June 30, 2020 was positively impacted by increases in the average yields on tax-exempt securities, and for the six months taxable securities, as a result of investments in higher-yielding, longer-duration securities and an increase in the relative proportion tax-exempt securities to total securities.

The average yield on taxable securities remained unchanged at 2.40% during the three months ended June 30, 2020 and 2019 while the average yield on taxable securities increased 8 basis points from 2.30% during the six months ended June 30, 2019 to 2.38% during the six months ended June 30, 2020. This increase during the six months ended June 30, 2020 resulted as the proceeds from the maturity of a significant volume of U.S. Treasury securities during the second half of 2019 were reinvested in higher-yielding residential mortgage-backed securities. The average taxable-equivalent yield on tax-exempt securities increased 1 basis point from 4.06% during the three months ended June 30, 2019 to 4.07% during the three months ended June 30, 2020 while the average taxable-equivalent yield on tax-exempt securities increased 2 basis points from 4.05% during the six months ended June 30, 2019 to 4.07% during the six months ended June 30, 2020. Tax exempt securities made up approximately 67.7% and 66.5% of total average securities during the three and six months ended June 30, 2020, respectively, compared to 61.8% and 63.1% during the same respective periods in 2019. The average volume of total securities (based on carrying amount) during the three months ended June 30, 2020 decreased \$821.5 million, or 6.2%, compared to the same period in 2019 while the average volume of total securities (based on carrying amount) during the six months ended June 30, 2020 decreased \$315.7 million, or 2.4%, compared to the same period in 2019. Securities made up approximately 35.6% of average interest-earning assets during the three months ended June 30, 2020 compared to 45.8% during the same period in 2019 while securities made up approximately 38.6% of average interest-earning assets during the six months ended June 30, 2020 compared to 44.9% during the same period in 2019. The decreases were partly related to the impact of PPP loans and increased interest-bearing deposits on total average interest-earning assets.

Average interest-bearing deposits, federal funds sold and resell agreements for the three months ended June 30, 2020 increased \$3.7 billion, or 258.5%, compared to the same period in 2019 while average interest-bearing deposits, federal funds sold and resell agreements for the six months ended June 30, 2020 increased \$2.3 billion, or 133.6%, compared to the same period in 2019. Interest-bearing deposits, federal funds sold and resell agreements made up approximately 14.5% and 12.0% of average interest-earning assets during the three and six months ended June 30, 2020, respectively, compared to 4.9% and 5.8% during the three and six months ended June 30, 2019, respectively. The increases in the average volume of interest-bearing deposits, federal funds sold and resell agreements was primarily due to an increase in the average volume of amounts held in an interest-bearing account at the Federal Reserve during the three and six months ended June 30, 2020 compared to the same periods in 2019 primarily due to an increase in the average volume of deposits and other borrowed funds and the proceeds from the sale of securities. The combined average yield on interest-bearing deposits, federal funds sold and resell agreements was 0.10% and 0.51% during the three and six months ended June 30, 2020, respectively, compared to 2.62% and 2.53% during the same periods in 2019, respectively. The average yield on interest-bearing deposits, federal funds sold and resell agreements was negatively impacted by lower average market interest rates for the three and six months ended June 30, 2020 compared to the same periods in 2019.

The average rate paid on interest-bearing liabilities was 0.19% during the three months ended June 30, 2020 decreasing 61 basis points from 0.80% during the same period in 2019 while the average rate paid on interest-bearing liabilities was 0.33%

during the six months ended June 30, 2020 decreasing 48 basis points from 0.81% during the same period in 2019. Average deposits increased \$5.3 billion, or 20.5%, during the three months ended June 30, 2020 compared to the same period in 2019 and included a \$1.7 billion increase in average interest-bearing deposits and a \$3.6 billion increase in average non-interest bearing deposits. Average deposits increased \$3.3 billion, or 12.7%, during the six months ended June 30, 2020 compared to the same period in 2019 and included a \$1.2 billion increase in average interest-bearing deposits and a \$2.1 billion increase in average non-interest bearing deposits. The ratio of average interest-bearing deposits to total average deposits was 56.0% and 58.2% during the three and six months ended June 30, 2020, respectively, compared to 61.0% during the same periods in 2019. The average cost of deposits is primarily impacted by changes in market interest rates as well as changes in the volume and relative mix of interest-bearing deposits. The average cost of interest-bearing deposits and total deposits was 0.14% and 0.08%, respectively, during the three months ended June 30, 2020 compared to 0.68% and 0.41%, respectively, during the same period in 2019. The average cost of interest-bearing deposits and total deposits was 0.26% and 0.15%, respectively, during the six months ended June 30, 2020 compared to 0.69% and 0.42%, respectively, during the same period in 2019. The average cost of deposits during the first six months of 2020 was impacted by decreases in the interest rates we pay on most of our interest-bearing deposit products as a result of the aforementioned decreases in market interest rates.

In April 2020, we borrowed an aggregate \$1.3 billion from the Federal Home Loan Bank (“FHLB”) to provide additional liquidity in light of our significant PPP lending volume. These advances were subsequently paid-off in May 2020 as we determined additional liquidity resources were not necessary. Average FHLB advances totaled \$439.6 million during the second quarter of 2020 while the average cost of these advances was 0.29%. The cost of the advances was partly offset by dividends received on the FHLB stock we were required to purchase in connection with the advances. The FHLB stock was redeemed in connection with the repayment of the advances.

Our net interest spread, which represents the difference between the average rate earned on earning assets and the average rate paid on interest-bearing liabilities, was 3.19% during the six months ended June 30, 2020 compared to 3.49% during same period in 2019. The net interest spread, as well as the net interest margin, will be impacted by future changes in short-term and long-term interest rate levels, as well as the impact from the competitive environment. A discussion of the effects of changing interest rates on net interest income is set forth in Item 3. Quantitative and Qualitative Disclosures About Market Risk included elsewhere in this report.

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

Our net interest income and net interest margin have been, and we currently expect them to continue to be, impacted by the aforementioned decreases in market interest rates and the expectation that interest rates will remain at these low levels for some period of time in light of the ongoing economic disruption arising from the COVID-19 pandemic. Notwithstanding the foregoing, our participation in the PPP, as discussed above, is expected to continue to positively impact net interest income and net interest margin in the near term.

## Credit Loss Expense

Credit loss expense is determined by management as the amount to be added to the allowance for credit loss accounts for various types of financial instruments including loans, securities and off-balance-sheet credit exposures after net charge-offs have been deducted to bring the allowances to a level which, in management’s best estimate, is necessary to absorb expected credit losses over the lives of the respective financial instruments. The components of credit loss expense were as follows:

|                                    | Three Months Ended<br>June 30, |                 | Six Months Ended<br>June 30, |                  |
|------------------------------------|--------------------------------|-----------------|------------------------------|------------------|
|                                    | 2020                           | 2019            | 2020                         | 2019             |
| Credit loss expense related to:    |                                |                 |                              |                  |
| Loans                              | \$ 27,228                      | \$ 6,400        | \$ 200,153                   | \$ 17,403        |
| Off-balance-sheet credit exposures | 4,775                          | —               | 7,062                        | —                |
| Securities held to maturity        | (28)                           | —               | (43)                         | —                |
| Total                              | <u>\$ 31,975</u>               | <u>\$ 6,400</u> | <u>\$ 207,172</u>            | <u>\$ 17,403</u> |

Credit loss expense for the three and six months ended June 30, 2019 was calculated under the prior incurred loss accounting methodology. See the section captioned “Allowance for Credit Losses” elsewhere in this discussion for further analysis of credit loss expense related to loans and off-balance-sheet credit exposures.

## Non-Interest Income

The components of non-interest income were as follows:

|                                             | Three Months Ended<br>June 30, |           | Six Months Ended<br>June 30, |            |
|---------------------------------------------|--------------------------------|-----------|------------------------------|------------|
|                                             | 2020                           | 2019      | 2020                         | 2019       |
| Trust and investment management fees        | \$ 31,060                      | \$ 30,448 | \$ 65,533                    | \$ 62,145  |
| Service charges on deposit accounts         | 17,580                         | 21,798    | 40,231                       | 42,588     |
| Insurance commissions and fees              | 10,668                         | 10,118    | 27,153                       | 28,524     |
| Interchange and debit card transaction fees | 2,966                          | 3,868     | 6,221                        | 7,148      |
| Other charges, commissions and fees         | 7,663                          | 8,933     | 17,028                       | 17,995     |
| Net gain (loss) on securities transactions  | —                              | 169       | 108,989                      | 169        |
| Other                                       | 7,664                          | 7,304     | 25,361                       | 20,854     |
| Total                                       | \$ 77,601                      | \$ 82,638 | \$ 290,516                   | \$ 179,423 |

Total non-interest income for the three and six months ended June 30, 2020 decreased \$5.0 million, or 6.1%, and increased \$111.1 million, or 61.9%, respectively compared to the same periods in 2019. Excluding \$109.0 million and \$169 thousand in net gains on securities transaction during the six months ended June 30, 2020 and 2019, respectively, total non-interest income increased \$2.3 million, or 1.3%, during the six months ended June 30, 2020. Changes in the various components of non-interest income are discussed in more detail below.

**Trust and Investment Management Fees.** Trust and investment management fees for the three and six months ended June 30, 2020 increased \$612 thousand, or 2.0%, and \$3.4 million, or 5.5%, respectively compared to the same periods in 2019. Investment fees are the most significant component of trust and investment management fees, making up approximately 80.2% and 82.2% of total trust and investment management fees for the first six months of 2020 and 2019, respectively. The increase in trust and investment management fees during the three months ended June 30, 2020 was primarily due to increases in trust investment fees (up \$699 thousand) and custody fees (up \$389 thousand) partly offset by decreases in real estate fees (down \$257 thousand) and oil and gas fees (down \$102 thousand). The increase in trust and investment management fees during the six months ended June 30, 2020 was primarily due to increases in trust investment fees (up \$1.4 million), estate fees (up \$1.1 million), real estate fees (up \$384 thousand) and oil and gas fees (up \$373 thousand). Investment and other custodial account fees are generally based on the market value of assets within a trust account. The increase in trust investment fees was primarily related to an increase in the number of accounts. The fluctuations in estate fees and real estate fees were primarily related to variation in transaction volume. Oil and gas fees during the second quarter of 2020 were impacted by the sharp decline in oil prices in March 2020. Volatility in the equity and bond markets impacts the market value of trust assets and the related investment fees. Investor concerns related to the uncertain economic outlook arising from the COVID-19 pandemic have caused significant market volatility resulting in significant declines in market valuations, particularly among equity securities, during the latter part of the first quarter of 2020 and the early part of the second quarter of 2020. While as of June 30, 2020, market valuations have rebounded somewhat from recent declines, the volatility and on-going uncertainty related to the economic effects of COVID-19 impacted trust and investment management fees during the second quarter of 2020. Furthermore, trust and investment management fees may be similarly impacted in future periods as a result of decreased demand and overall transaction volume for our other trust services.

At June 30, 2020, trust assets, including both managed assets and custody assets, were primarily composed of equity securities (49.3% of assets), fixed income securities (34.7% of assets) and cash equivalents (9.7% of assets). The estimated fair value of these assets was \$35.7 billion (including managed assets of \$15.8 billion and custody assets of \$19.9 billion) at June 30, 2020, compared to \$37.8 billion (including managed assets of \$16.4 billion and custody assets of \$21.4 billion) at December 31, 2019 and \$36.2 billion (including managed assets of \$15.6 billion and custody assets of \$20.5 billion) at June 30, 2019.

**Service Charges on Deposit Accounts.** Service charges on deposit accounts for the three and six months ended June 30, 2020 decreased \$4.2 million, or 19.4%, and \$2.4 million, or 5.5%, compared to the same periods in 2019. The decreases were primarily related to decreases in overdraft/insufficient funds charges on consumer and commercial accounts. Overdraft/insufficient funds charges totaled \$5.6 million (\$4.5 million consumer and \$1.2 million commercial) during the three months ended June 30, 2020 compared to \$10.3 million (\$8.1 million consumer and \$2.2 million commercial) during the same period in 2019. Overdraft/insufficient funds charges totaled \$16.1 million (\$12.6 million consumer and \$3.6 million commercial) during the six months ended June 30, 2020 compared to \$19.9 million (\$15.5 million consumer and \$4.4 million commercial) during the same period in 2019. Consumer overdraft/insufficient funds charges decreased \$3.6 million and \$3.0 million during the three months and six months ended June 30, 2020, respectively, while commercial overdrafts/insufficient funds charges decreased \$1.0 million and \$812 thousand during the same respective periods. The decreases in overdraft/insufficient funds

charges during the three and six months ended June 30, 2020 were primarily related to a decrease in the volume of overdrafts relative to the same periods in 2019.

Commercial service charges increased \$722 thousand and \$2.0 million during the three and six months ended June 30, 2020, respectively. The increases in commercial service charges were impacted by a lower earnings credit rate partly offset by decreases in the volume of billable services. The earnings credit rate is the value given to deposits maintained by treasury management customers. Earnings credits applied to customer deposit balances offset service fees that would otherwise be charged. Because average market interest rates in 2020 were lower compared to 2019, deposit balances have become less valuable and are yielding a lower earnings credit rate.

*Insurance Commissions and Fees.* Insurance commissions and fees for the three months ended June 30, 2020 increased \$550 thousand, or 5.4%, while insurance commissions and fees for the six months ended June 30, 2020 decreased \$1.4 million, or 4.8%, compared to the same periods in 2019. The increase in insurance commissions and fees during the three months ended June 30, 2020 was the result of increases in commission income (up \$495 thousand) and contingent income (up \$55 thousand). The increase in commission income during the three months ended June 30, 2020 was primarily related to increases in commercial lines and, to a lesser extent, personal lines property and casualty commissions resulting from increased rates combined with increased coverage levels. The decrease in insurance commissions and fees during the six months ended June 30, 2020 was the result of decreases in commission income (down \$835 thousand) and contingent income (down \$535 thousand). The decrease in commission income was primarily related to decreases in benefit plan commissions and life insurance commissions partly offset by increases in both commercial lines and personal lines property and casualty commissions. The decrease in benefit plan commissions was related to decreased business volumes, premium reductions and flat to lower market rates. The decrease in life insurance commissions was related to a decrease business volumes. The increases in commercial lines and personal lines property and casualty commissions were related to increased rates, partly offset by decreased business volumes.

Contingent income totaled \$414 thousand and \$3.0 million during the three and six months ended June 30, 2020, respectively, compared to \$359 thousand and \$3.6 million during the same periods in 2019. Contingent income primarily consists of amounts received from various property and casualty insurance carriers related to the loss performance of insurance policies previously placed. These performance related contingent payments are seasonal in nature and are mostly received during the first quarter of each year. This performance related contingent income totaled \$2.1 million and \$2.7 million during the six months ended June 30, 2020 and 2019, respectively. The decrease in performance related contingent income during 2020 was related to lower growth within the portfolio combined with a deterioration in the loss performance of insurance policies previously placed. Contingent income also includes amounts received from various benefit plan insurance companies related to the volume of business generated and/or the subsequent retention of such business. This benefit plan related contingent income totaled \$378 thousand and \$986 thousand during the three and six months ended June 30, 2020, respectively, compared to \$262 thousand and \$865 thousand during the same periods in 2019.

Notwithstanding normal seasonal variation, commission income during the second quarter of 2020 was partly impacted by reduced business volumes resulting from the COVID-19 pandemic, relative to the first quarter of 2020. Commission income in future periods may be similarly impacted. Benefit plan commissions may be particularly impacted by the effects of temporary furloughs and permanent layoffs. The COVID-19 pandemic has also given rise to a hard insurance market characterized by decreased capacity for most types of insurance coupled with more stringent underwriting standards among insurers. This may cause clients to drop or adjust coverage choices as part of expense control measures. Reduced business volumes may also adversely impact the level of contingent commissions we receive in 2021.

**Interchange and Debit Card Transaction Fees.** Interchange fees, or “swipe” fees, are charges that merchants pay to us and other card-issuing banks for processing electronic payment transactions. Interchange and debit card transaction fees consist of income from debit card usage, point of sale income from PIN-based debit card transactions and ATM service fees. Interchange and debit card transaction fees are reported net of related network costs.

A comparison of gross and net interchange and debit card transaction fees for the reported periods is presented in the table below. Revenue from interchange and debit card transactions was impacted by reduced transaction volumes and fee waivers resulting from the COVID-19 pandemic. We currently expect that revenue from interchange and debit card transactions will be similarly impacted in future periods.

|                                                   | Three Months Ended<br>June 30, |          | Six Months Ended<br>June 30, |           |
|---------------------------------------------------|--------------------------------|----------|------------------------------|-----------|
|                                                   | 2020                           | 2019     | 2020                         | 2019      |
| Income from debit card transactions               | \$ 5,527                       | \$ 5,974 | \$ 11,332                    | \$ 11,379 |
| ATM service fees                                  | 753                            | 1,086    | 1,680                        | 2,067     |
| Gross interchange and debit card transaction fees | 6,280                          | 7,060    | 13,012                       | 13,446    |
| Network costs                                     | 3,314                          | 3,192    | 6,791                        | 6,298     |
| Net interchange and debit card transaction fees   | \$ 2,966                       | \$ 3,868 | \$ 6,221                     | \$ 7,148  |

Federal Reserve rules applicable to financial institutions that have assets of \$10 billion or more provide that the maximum permissible interchange fee for an electronic debit transaction is the sum of 21 cents per transaction and 5 basis points multiplied by the value of the transaction. An upward adjustment of no more than 1 cent to an issuer's debit card interchange fee is allowed if the card issuer develops and implements policies and procedures reasonably designed to achieve certain fraud-prevention standards. The Federal Reserve also has rules governing routing and exclusivity that require issuers to offer two unaffiliated networks for routing transactions on each debit or prepaid product.

**Other Charges, Commissions and Fees.** Other charges, commissions and fees for the three months ended June 30, 2020 decreased \$1.3 million, or 14.2%, compared to the same period in 2019. The decrease included decreases in income from the sale of money market accounts (down \$551 thousand) and mutual funds (down \$134 thousand); funds transfer service charges (down \$157 thousand); and merchant services rebates (down \$134 thousand); among other things. Other charges, commissions and fees for the six months ended June 30, 2020 decreased \$967 thousand, or 5.4%, compared to the same period in 2019. The decrease included decreases in letter of credit fees (down \$403 thousand); income from the sale of life insurance (down \$384 thousand) and money market accounts (down \$298 thousand); income from capital markets advisory services (down \$223 thousand); funds transfer service charges (down \$140 thousand); and merchant service rebates (down \$115 thousand); among other things. The decreases in these items were partly offset by increases in income from the sale of mutual funds (up \$278 thousand) and annuities (up \$166 thousand) and an increase in brokerage commissions (up \$115 thousand). The aforementioned revenue streams were adversely impacted by reduced transaction volumes during the second quarter of 2020 resulting from the COVID-19 pandemic. We currently expect that these revenue streams will be similarly impacted in future periods.

**Net Gain/Loss on Securities Transactions.** During the six months ended June 30, 2020 and 2019, we sold certain available-for-sale securities with amortized costs totaling \$1.1 billion and \$3.3 billion, respectively. We realized a net gain of \$109.0 million on the 2020 sales and a net gain of \$169 thousand on the 2019 sales. During the first quarter of 2020, we sold \$483.1 million of residential mortgage-backed securities and realized a net gain of \$1.9 million on those sales. The proceeds from these sales were reinvested into other residential mortgage-backed securities that had lower pre-payment rates. We also sold \$519.1 million of 30-year U.S Treasury securities during the first quarter of 2020 and realized a net gain of \$107.1 million on those sales. These U.S. Treasury securities were purchased during the fourth quarter of 2019 to hedge, in effect, against falling interest rates. Prior to their sale, these securities had significant unrealized holding gains as a result of decreases in market interest rates during the first quarter of 2020. We elected to sell these securities to provide liquidity and realize the gains.

During the first six months of 2019, we purchased and subsequently sold \$2.4 billion of U.S. Treasury securities in connection with our tax planning strategies related to the Texas franchise tax. The gross proceeds from the sales of these securities outside of Texas are included in total revenues/receipts from all sources reported for Texas franchise tax purposes, which results in a reduction in the overall percentage of revenues/receipts apportioned to Texas and subjected to taxation under the Texas franchise tax. We realized a net gain of \$3 thousand on those sales. We also sold certain available-for-sale U.S. Treasury securities with an amortized cost totaling \$548.9 million and certain available-for-sale municipal securities with an amortized cost totaling \$310.7 million. We realized a net gain of \$166 thousand on those sales. The proceeds from the sales provided short-term liquidity and were subsequently reinvested in other higher yielding securities.

**Other Non-Interest Income.** Other non-interest income for the three months ended June 30, 2020 increased \$360 thousand, or 4.9%, compared to the same period in 2019. The increase was primarily related to an increase in public finance underwriting fees (up \$759 thousand) partly offset by a decrease in income from customer foreign exchange transactions (down \$362 thousand). Changes in these items were primarily due to an fluctuations in business volumes. Other non-interest income for the six months ended June 30, 2020 increased \$4.5 million, or 21.6%, compared to the same period in 2019. Other non-interest income during the six months ended June 30, 2020 included approximately \$6.0 million in gains realized on the sale of certain non-hedge related, short-term put options on U.S. Treasury securities with an aggregate notional amount of \$500 million. The put options were not exercised and expired in March 2020. The increase in other non-interest income during the six months ended June 30, 2020 was also partly related to an increase in income from customer derivative and trading activities (up \$1.6 million), primarily due to an increase in business volume, an increase in sundry and other miscellaneous income (up \$1.2 million) and an increase in public finance underwriting fees (up \$677 thousand). Sundry and other miscellaneous income included \$2.6 million and \$931 thousand related to the recovery of prior write-offs in 2020 and 2019, respectively, among other things. The aforementioned items were partly offset by a decrease in gains on the sale of foreclosed and other assets (down \$4.6 million). Other non-interest income for the six months ended June 30, 2020 and 2019 included gains on the sale of various branch and operational facilities totaling \$758 thousand and \$5.4 million, respectively, among other things.

## Non-Interest Expense

The components of non-interest expense were as follows:

|                                     | Three Months Ended<br>June 30, |            | Six Months Ended<br>June 30, |            |
|-------------------------------------|--------------------------------|------------|------------------------------|------------|
|                                     | 2020                           | 2019       | 2020                         | 2019       |
| Salaries and wages                  | \$ 90,350                      | \$ 90,790  | \$ 189,162                   | \$ 183,266 |
| Employee benefits                   | 18,861                         | 20,051     | 43,750                       | 43,577     |
| Net occupancy                       | 25,266                         | 21,133     | 50,650                       | 40,400     |
| Technology, furniture and equipment | 26,046                         | 22,157     | 51,286                       | 43,821     |
| Deposit insurance                   | 2,800                          | 2,453      | 5,424                        | 5,261      |
| Intangible amortization             | 241                            | 305        | 498                          | 630        |
| Other                               | 36,115                         | 46,320     | 83,072                       | 88,054     |
| Total                               | \$ 199,679                     | \$ 203,209 | \$ 423,842                   | \$ 405,009 |

Total non-interest expense for the three and six months ended June 30, 2020 decreased \$3.5 million, or 1.7%, and \$18.8 million, or 4.7%, respectively, compared to the same periods in 2019. Changes in the various components of non-interest expense are discussed below.

**Salaries and Wages.** Salaries and wages for the three and six months ended June 30, 2020 decreased \$440 thousand, or 0.5%, and increased \$5.9 million, or 3.2%, compared to the same periods in 2019. The decrease during the three months ended June 30, 2020 was primarily related to an increase in salary costs deferred as loan origination costs in connection with the high volume of PPP loan originations during the second quarter of 2020. These deferred salary costs, which totaled \$5.5 million, will be recognized as a yield adjustment component of interest income over the remaining terms of these loans. The decrease was also partly related to a decrease in stock-based compensation expense. The impact of these items was mostly offset by an increase in salaries due to an increase in the number of employees and normal, annual merit and market increases. The increase in salaries and wages during the six months ended June 30, 2020 was primarily related to an increase in salaries, due to an increase in the number of employees and normal, annual merit and market increases, partly offset the aforementioned increase in salary costs deferred as loan origination costs and a decrease in stock-based compensation expense.

**Employee Benefits.** Employee benefits expense for the three and six months ended June 30, 2020 decreased \$1.2 million, or 5.9%, and increased \$173 thousand, or 0.4%, compared to the same periods in 2019. The decrease in employee benefits expense during the three months ended June 30, 2020 was primarily related to decreases in certain discretionary benefit plan expenses partly offset by an increase in medical benefits expense and payroll taxes, among other things. The increase in employee benefits expense during the six months ended June 30, 2020 was primarily due to increases in medical benefits expense and payroll taxes mostly offset by a decreases in certain discretionary benefit plan expenses.

Our defined benefit retirement and restoration plans were frozen effective as of December 31, 2001 and were replaced by a profit sharing plan (which was merged with and into our 401(k) plan during 2019). Management believes these actions helped to reduce the volatility in retirement plan expense. However, we still have funding obligations related to the defined benefit and restoration plans and could recognize retirement expense related to these plans in future years, which would be dependent on the return earned on plan assets, the level of interest rates and employee turnover. A prolonged negative impact on the value of stocks and other asset classes due to the COVID-19 pandemic could result in a significant reduction to pension plan asset values

and expected returns, which could impact the level of future funding and expense. See Note 12 - Defined Benefit Plans for additional information related to our net periodic pension benefit/cost.

*Net Occupancy.* Net occupancy expense for the three and six months ended June 30, 2020 increased \$4.1 million, or 19.6%, and increased \$10.3 million, or 25.4%, respectively, compared to the same periods in 2019. The increases were primarily related to increases in lease expense (up \$2.1 million and \$4.9 million, respectively), depreciation on leasehold improvements (up \$1.3 million and \$2.3 million respectively), property taxes (up \$809 thousand and \$1.6 million, respectively) and building depreciation (up \$466 thousand and \$964 thousand, respectively), among other things. The increases from these items were partly offset by decreases in repairs and maintenance/service contracts expense (down \$1.1 million and \$600 thousand, respectively). Net occupancy expense was impacted by the commencement of the lease of our new corporate headquarters building in San Antonio in June 2019, as well as renewals of other leases related to existing facilities and new locations, in part related to our expansion within the Houston market area.

*Technology, Furniture and Equipment.* Technology, furniture and equipment expense for the three and six months ended June 30, 2020 increased \$3.9 million, or 17.6%, and increased \$7.5 million, or 17.0%, respectively, compared to the same periods in 2019. The increases were primarily related to increases in cloud services expense (up \$2.4 million and \$3.9 million, respectively), depreciation of furniture and equipment (up \$961 thousand and \$2.0 million, respectively) and software maintenance (up \$523 thousand and \$1.8 million respectively).

*Deposit Insurance.* Deposit insurance expense totaled \$2.8 million and \$5.4 million for the three and six months ended June 30, 2020 compared to \$2.5 million and \$5.3 million for the three and six months ended June 30, 2019. Provisions of the CARES Act allow, but do not require, the FDIC to expand deposit insurance coverage for non-interest-bearing transaction accounts through December 31, 2020. Such action could result in additional deposit insurance expense. Other provisions of the CARES Act as well as actions taken by bank regulators, such as potential relief for working with borrowers who are distressed as a result of the effects of COVID-19, could similarly impact aggregate deposit insurance expense.

*Other Non-Interest Expense.* Other non-interest expense for the three and six months ended June 30, 2020 decreased \$10.2 million, or 22.0%, and decreased \$5.0 million, or 5.7%, respectively, compared to the same periods in 2019. The decrease in other non-interest expense during the three months ended June 30, 2020 included decreases in advertising/promotions expense (down \$3.1 million); travel, meals and entertainment expense (down \$3.0 million); and business development expense (down \$806 thousand), among other things. The decrease in other non-interest expense during the three months ended June 30, 2020 was also partly due to an increase in costs deferred as loan origination costs in connection with the high volume of PPP loan originations during the second quarter of 2020. These deferred costs, which totaled \$1.8 million, will be recognized as a yield adjustment component of interest income over the remaining terms of these loans. The decrease in other non-interest expense during the six months ended June 30, 2020 included decreases in travel, meals and entertainment expense (down \$3.0 million); advertising/promotions expense (down \$2.5 million); and business development expense (down \$435 thousand), among other things. The decrease in other non-interest expense during the six months ended June 30, 2020 was also partly due to the aforementioned increase in costs deferred as loan origination costs in connection with the high volume of PPP loan originations during the second quarter of 2020. The decreases in these items were partly offset by increases in donations expense (up \$859 thousand); telephone/data communications expense (up \$777 thousand); platform fees related to investment services (up \$777 thousand); professional services expense (up \$511 thousand); and sundry and other miscellaneous expenses (up \$465 thousand).

## Results of Segment Operations

Our operations are managed along two primary operating segments: Banking and Frost Wealth Advisors. A description of each business and the methodologies used to measure financial performance is described in Note 15 - Operating Segments in the accompanying notes to consolidated financial statements included elsewhere in this report. Net income (loss) by operating segment is presented below:

|                         | Three Months Ended<br>June 30, |                   | Six Months Ended<br>June 30, |                   |
|-------------------------|--------------------------------|-------------------|------------------------------|-------------------|
|                         | 2020                           | 2019              | 2020                         | 2019              |
| Banking                 | \$ 92,492                      | \$ 110,893        | \$ 144,516                   | \$ 223,810        |
| Frost Wealth Advisors   | 3,925                          | 4,897             | 9,512                        | 11,297            |
| Non-Banks               | (3,345)                        | (4,204)           | (6,203)                      | (7,025)           |
| Consolidated net income | <u>\$ 93,072</u>               | <u>\$ 111,586</u> | <u>\$ 147,825</u>            | <u>\$ 228,082</u> |

## Banking

Net income for the three and six months ended June 30, 2020 decreased \$18.4 million, or 16.6%, and decreased \$79.3 million, or 35.4%, respectively, compared to the same periods in 2019. The decrease during the three months ended June 30, 2020 was primarily the result of a \$25.6 million increase in credit loss expense, a \$7.7 million decrease in net interest income and a \$4.9 million decrease in non-interest income partly offset by a \$15.9 million decrease in income tax expense and a \$3.9 million decrease in non-interest expense. The decrease during the six months ended June 30, 2020 was primarily the result of a \$189.8 million increase in credit loss expense, a \$13.8 million increase in non-interest expense and a \$9.9 million decrease in net interest income partly offset by a \$108.1 million increase in non-interest income and a \$26.0 million decrease in income tax expense.

Net interest income for the three and six months ended June 30, 2020 decreased \$7.7 million, or 3.0%, and decreased \$9.9 million, or 2.0%, compared to the same periods in 2019. The decreases were primarily related to decreases in the average yields on loans, interest-bearing deposits and federal funds sold and resell agreements combined with decreases in the average volumes of taxable securities (based on amortized cost) and increases in the average volume of interest bearing liabilities, and for the three months ended June 30, 2020, a decrease in the average volume of tax-exempt securities. The impact of these items was partly offset by decreases in the average cost of interest-bearing deposits and other borrowed funds combined with increases in the average volumes of loans and interest-bearing deposits (primarily amounts held in an interest-bearing account at the Federal Reserve), and for the six months ended June 30, 2020, increases in the average yields on taxable and tax-exempt securities. Net interest income for the first six months of 2020 was also positively impacted by the additional day as a result of leap year. See the analysis of net interest income included in the section captioned “Net Interest Income” included elsewhere in this discussion.

Credit loss expense for the three and six months ended June 30, 2020 totaled \$32.0 million and \$207.2 million compared to \$6.4 million and \$17.4 million for the same periods in 2019. The increases resulted from both our adoption of a new credit loss accounting standard and the adverse events impacting our loan portfolio, including those arising from the COVID-19 pandemic and the significant decline in oil prices. See the sections captioned “Credit Loss Expense” and “Allowance for Credit Losses” elsewhere in this discussion for further analysis of credit loss expense related to loans and off-balance-sheet commitments.

Non-interest income for the three and six months ended June 30, 2020 decreased \$4.9 million, or 10.2% and increased \$108.1 million, or 99.9%, respectively, compared to the same periods in 2019. The decrease during the three months ended June 30, 2020 was primarily due to decreases in services charges on deposit accounts, interchange and debit card transaction fees, and other charges, commissions partly offset by increases in insurance commissions and fees and other non-interest income. The increase during the six months ended June 30, 2020 was primarily due to a \$109.0 million net gain on securities transactions. Excluding the net gain on securities transactions during the six months ended June 30, 2020, total non-interest income for the Banking segment decreased \$702 thousand, or 0.6%, compared to the same period in 2019. This decrease was primarily due to decreases in services charges on deposit accounts, insurance commissions and fees, interchange and debit card transaction fees, and other charges, commissions and fees partly offset by an increase in other non-interest income. The decreases in services charges on deposit accounts during the three and six months ended June 30, 2020 were primarily related to decreases in overdraft/insufficient funds charges on consumer and commercial accounts due to decreases in transaction volumes. The decreases in interchange and debit card transactions fees during the three and six months ended June 30, 2020 were impacted by reduced transaction volumes and fee waivers resulting from the COVID-19 pandemic. The decrease in other charges, commissions and fees during the three and six months ended June 30, 2020 included decreases in funds transfer service charges; merchant services rebates; income from capital markets advisory services; and letter of credit fees; among other things. The increase in other non-interest income during the three months ended June 30, 2020 was primarily related to increases in public finance underwriting fees and income from customer derivative and trading activities partly offset by a decrease in income from customer foreign exchange transactions. Changes in these items were primarily due to fluctuations in business volumes. The increase in other non-interest income during the six months ended June 30, 2020 included approximately \$6.0 million in gains realized on the sale of certain non-hedge related, short-term put options on U.S. Treasury securities with an aggregate notional amount of \$500 million. The put options were not exercised and expired in March 2020. The increase in other non-interest income during the six months ended June 30, 2020 was also partly related to an increase in income from customer derivative and trading activities, primarily due to an increase in business volume, an increase in sundry and other miscellaneous income and an increase in public finance underwriting fees. The fluctuations in insurance commissions and fees during the three and six months ended June 30, 2020 are further discussed below in relation to Frost Insurance Agency. See the analysis of these categories of non-interest income included in the section captioned “Non-Interest Income” included elsewhere in this discussion.

Non-interest expense decreased \$3.9 million, or 2.3%, for the three months ended June 30, 2020 and increased \$13.8 million, or 4.0%, for the six months ended June 30, 2020, compared to the same periods in 2019. The decrease during the three months ended was primarily due to decreases in other non-interest expense, employee benefits and salaries and wages partly

offset by increases in technology, furniture and equipment expense and net occupancy expense. The increase during the six months ended was primarily related to increases in technology, furniture and equipment expense, net occupancy expense and salaries and wages partly offset by a decrease in other non-interest expense. The decrease in other non-interest expense during the three months ended June 30, 2020 included decreases in advertising/promotions expense; travel, meals and entertainment expense; business development expense, and professional service expense, among other things. The decrease in other non-interest expense during the six months ended June 30, 2020 included decreases in travel, meals and entertainment expense; advertising/promotions expense; and business development expense, among other things. The decreases in these items were partly offset by increases in donations expense; telephone/data communications expense; professional services expense; and sundry and other miscellaneous expenses. The decreases in other non-interest expense during the three and six months ended June 30, 2020 were also partly due to an increase in costs deferred as loan origination costs in connection with the high volume of PPP loan originations during the second quarter of 2020. The decrease in employee benefits expense during the three months ended June 30, 2020 was primarily related to decreases in certain benefit plan expenses partly offset by an increase in medical benefits expense and payroll taxes, among other things. The decrease in salaries and wages during the three months ended June 30, 2020 was primarily related to an increase in salary costs deferred as loan origination costs in connection with the high volume of PPP loan originations during the second quarter of 2020. The increase in salaries and wages during the six months ended June 30, 2020 was primarily related to an increase in salaries, due to an increase in the number of employees and normal annual merit and market increases, partly offset the aforementioned increase in salary costs deferred as loan origination costs and a decrease in stock-based compensation expense. The increases in technology, furniture and equipment expense during the three and six months ended June 30, 2020 were primarily related to increases in cloud services expense, depreciation of furniture and equipment and software maintenance. The increases in net occupancy expense during the three and six months ended June 30, 2020 were primarily related to increases in lease expense, depreciation on leasehold improvements, property taxes and building depreciation, among other things. The increases from these items were partly offset by decreases in repairs and maintenance/service contracts expense. See the analysis of these categories of non-interest expense included in the section captioned “Non-Interest Expense” included elsewhere in this discussion.

Frost Insurance Agency, which is included in the Banking operating segment, had gross commission revenues of \$10.7 million and \$27.2 million during the three and six months ended June 30, 2020 compared to \$10.1 million and \$28.7 million during the three and six months ended June 30, 2019. The increase in insurance commissions and fees during the three months ended June 30, 2020 was primarily the result of increases in commission income, primarily related to increases in commercial lines and, to a lesser extent, personal lines property and casualty commissions resulting from increased rates combined with increased in coverage levels. The decrease in insurance commissions and fees during the six months ended June 30, 2020 was the result of decreases in commission income and contingent income. The decrease in commission income was primarily related to decreases in benefit plan commissions (related to decreased business volumes, premium reductions and flat to lower market rates) and life insurance commissions (related to decreased business volumes) partly offset by increases in both commercial lines and personal lines property and casualty commissions (related to increased rates, partly offset by decreased business volumes). Business volumes during the second quarter of 2020 were adversely impacted the COVID-19 pandemic. The decrease in contingent income during the six months ended June 30, 2020 was partly due to lower growth and a deterioration in the loss performance of insurance policies previously placed. See the analysis of insurance commissions and fees included in the section captioned “Non-Interest Income” included elsewhere in this discussion.

#### *Frost Wealth Advisors*

Net income for the three and six months ended June 30, 2020 decreased \$972 thousand, or 19.8%, and decreased \$1.8 million, or 15.8%, respectively, compared to the same periods in 2019. The decrease during three months ended was primarily related to a \$672 thousand increase in non-interest expense, a \$412 thousand decrease in net interest income and a \$148 thousand decrease in non-interest income partly offset by a \$258 thousand decrease in income tax expense. The decrease during the six months ended June 30, 2020 was primarily related to a \$5.0 million increase in non-interest expense and a \$488 thousand decrease in net interest income partly offset by a \$3.2 million increase in non-interest income and \$474 thousand decrease in income tax expense.

Net interest income for the three and six months ended June 30, 2020 decreased \$412 thousand, or 37.6%, and \$488 thousand, or 23.8%, respectively, compared to the same periods in 2019. These decreases were primarily due to decreases in the average funds transfer prices allocated to the funds provided by Frost Wealth Advisors. The decreases in the average funds transfer prices were primarily due to decreases in market interest rates. See the analysis of net interest income included in the section captioned “Net Interest Income” included elsewhere in this discussion.

Non-interest income for the three and six months ended June 30, 2020 decreased \$148 thousand, or 0.4%, and increased \$3.2 million, or 4.5%, respectively, compared to the same periods in 2019. The decrease during the three months ended June 30, 2020 was primarily related to a decrease in other charges, commissions and fees mostly offset by an increase in trust and investment management fees. The increase during the six months end June 30, 2020 was primarily related to an increase in trust and investment management fees. Trust and investment management fee income is the most significant income component

for Frost Wealth Advisors. Investment fees are the most significant component of trust and investment management fees, making up approximately 80.2% of total trust and investment management fees for the first six months of 2020.

The decrease in other charges, commissions and fees during the three months ended included decreases in income from the sale of money market accounts and mutual funds, among other things. The increase in trust and investment management fees during the three months ended June 30, 2020 was primarily due to increases in trust investment fees and custody fees partly offset by decreases in real estate fees and oil and gas fees. The increase in trust and investment management fees during the six months ended June 30, 2020 was primarily due to increases in trust investment fees, estate fees, real estate fees and oil and gas fees. See the analysis of trust and investment management fees, particularly as it relates to the effects of the COVID-19 pandemic, and other charges, commissions and fees included in the section captioned “Non-Interest Income” included elsewhere in this discussion.

Non-interest expense for the three and six months ended June 30, 2020 increased \$672 thousand, or 2.2%, and \$5.0 million, or 8.4%, respectively, compared to the same periods in 2019. The increase during the three months ended June 30, 2020 was primarily due to an increase in net occupancy expense partly offset by a decrease in other non-interest expense. The increase during the six months ended June 30, 2020 was primarily due to increases in net occupancy expense and salaries and wages. The increases in net occupancy expense during the three and six months end June 30, 2020 were primarily related to increases in lease expense. The decrease in other non-interest expense during the three months ended June 30, 2020 was primarily related to decreases in travel, meals and entertainment expense, professional service expense and management fee expense, among other things. The increase in salaries and wages during the six months ended June 30, 2020 was primarily due to an increase in the number of employees and normal, annual merit and market increases.

### *Non-Banks*

The Non-Banks operating segment had net losses of \$3.3 million and \$6.2 million during the three and six months ended June 30, 2020, respectively, compared to a net losses of \$4.2 million and \$7.0 million during the same respective periods in 2019. The decreases in the net losses for the three and six months ended June 30, 2020 were primarily due to decreases in net interest expense, primarily related to decreases in the average rates paid on our long term borrowings, and increases in income tax benefit. The net loss during the three months ended June 30, 2020 was also partly reduced by a decrease in other non-interest expense. This decrease was primarily related to a decrease in travel, meals and entertainment expense.

### **Income Taxes**

During the three months ended June 30, 2020, we recognized an income tax benefit of \$1.3 million, for an effective tax rate of negative 1.4%, compared to income tax expense of \$14.9 million, for an effective tax rate of 11.8%, during the same period in 2019. During the six months ended June 30, 2020, we recognized income tax expense of \$2.0 million, for an effective tax rate of 1.3%, compared to income tax expense of \$28.8 million, for an effective tax rate of 11.2%, for the same period in 2019.

The effective income tax rates differed from the U.S. statutory federal income tax rate of 21% during 2020 and 2019 primarily due to the effect of tax-exempt income from loans, securities and life insurance policies and the income tax effects associated with stock-based compensation, among other things, and their relative proportion to total pre-tax net income. The decreases in the effective tax rates during 2020 were primarily related to a decrease in pre-tax net income. The effective tax rates during 2020 were also impacted by a one-time, discrete tax benefit associated with an asset contribution to a charitable trust during the second quarter.

### **Average Balance Sheet**

Average assets totaled \$35.7 billion for the six months ended June 30, 2020 representing an increase of \$4.3 billion, or 13.7%, compared to average assets for the same period in 2019. Earning assets increased \$3.9 billion, or 13.5%, during the first six months of 2020 compared to the same period in 2019. The increase in earning assets was primarily related to a \$2.3 billion increase in average interest-bearing deposits, federal funds sold and resell agreements; a \$2.0 billion increase in average loans; and a \$228.6 million increase in average tax-exempt securities partly offset by a \$544.3 million decrease in average taxable securities. Average premises and equipment increased \$261.4 million, or 33.9%, in part due to the commencement of the lease on our new downtown San Antonio headquarters in the second quarter of 2019 as well as the commencement of other new leases associated with various new branch locations. Average deposits increased \$3.3 billion, or 12.7%, during the first six months of 2020 compared to the same period in 2019. The increase included a \$2.1 billion increase in non-interest bearing deposits and a \$1.2 billion increase in interest-bearing deposit accounts. Average non-interest bearing deposits made up 41.8% and 39.0% of average total deposits during the first six months of 2020 and 2019, respectively.

## Loans

Loans were as follows as of the dates indicated:

|                              | June 30,<br>2020 | Percentage<br>of Total | December 31,<br>2019 | Percentage<br>of Total |
|------------------------------|------------------|------------------------|----------------------|------------------------|
| Commercial and industrial    | \$ 5,004,229     | 27.9 %                 | \$ 5,187,466         | 35.2 %                 |
| Energy:                      |                  |                        |                      |                        |
| Production                   | 1,162,673        | 6.5                    | 1,348,900            | 9.2                    |
| Service                      | 164,597          | 0.9                    | 192,996              | 1.3                    |
| Other                        | 97,610           | 0.5                    | 110,986              | 0.8                    |
| Total energy                 | 1,424,880        | 7.9                    | 1,652,882            | 11.2                   |
| Paycheck Protection Program  | 3,162,279        | 17.6                   | —                    | —                      |
| Commercial real estate:      |                  |                        |                      |                        |
| Commercial mortgages         | 5,042,546        | 28.1                   | 4,594,113            | 31.1                   |
| Construction                 | 1,265,550        | 7.0                    | 1,312,659            | 8.9                    |
| Land                         | 316,839          | 1.8                    | 289,467              | 2.0                    |
| Total commercial real estate | 6,624,935        | 36.9                   | 6,196,239            | 42.0                   |
| Consumer real estate:        |                  |                        |                      |                        |
| Home equity loans            | 346,210          | 1.9                    | 375,596              | 2.6                    |
| Home equity lines of credit  | 395,099          | 2.2                    | 354,671              | 2.4                    |
| Other                        | 508,876          | 2.8                    | 464,146              | 3.1                    |
| Total consumer real estate   | 1,250,185        | 6.9                    | 1,194,413            | 8.1                    |
| Total real estate            | 7,875,120        | 43.8                   | 7,390,652            | 50.1                   |
| Consumer and other           | 505,429          | 2.8                    | 519,332              | 3.5                    |
| Total loans                  | \$ 17,971,937    | 100.0 %                | \$ 14,750,332        | 100.0 %                |

Loans increased \$3.2 billion, or 21.8%, compared to December 31, 2019. As further discussed below, during the second quarter of 2020, we began originating loans to qualified small businesses under the PPP administered by the SBA under the provisions of the CARES Act. Excluding PPP loans, total loans would have otherwise increased \$59.3 million, or 0.4%, from December 31, 2019, and decreased \$528.6 million, or 3.4%, from total loans of \$15.3 billion at March 31, 2020. The majority of our loan portfolio is comprised of commercial and industrial loans, energy loans, and real estate loans. Real estate loans include both commercial and consumer balances. Selected details related to our loan portfolio segments are presented below. Refer to our 2019 Form 10-K for a more detailed discussion of our loan origination and risk management processes. Other than in connection with our making PPP loans as described below, it is possible that the effects of COVID-19 could continue to result in less demand for our loan products.

*Commercial and industrial.* Commercial and industrial loans decreased \$183.2 million, or 3.5%, during the first six months of 2020. Our commercial and industrial loans are a diverse group of loans to small, medium and large businesses. The purpose of these loans varies from supporting seasonal working capital needs to term financing of equipment. While some short-term loans may be made on an unsecured basis, most are secured by the assets being financed with collateral margins that are consistent with our loan policy guidelines. The commercial and industrial loan portfolio also includes commercial leases and purchased shared national credits ("SNC"s).

*Energy.* Energy loans include loans to entities and individuals that are engaged in various energy-related activities including (i) the development and production of oil or natural gas, (ii) providing oil and gas field servicing, (iii) providing energy-related transportation services, (iv) providing equipment to support oil and gas drilling, (v) refining petrochemicals, or (vi) trading oil, gas and related commodities. Energy loans decreased \$228.0 million, or 13.8%, during the first six months of 2020 compared to December 31, 2019. The average loan size, the significance of the portfolio and the specialized nature of the energy industry requires a highly prescriptive underwriting policy. Exceptions to this policy are rarely granted. Due to the large borrowing requirements of this customer base, the energy loan portfolio includes participations and SNCs.

*Purchased Shared National Credits.* Purchased shared national credits are participations purchased from upstream financial organizations and tend to be larger in size than our originated portfolio. Our purchased SNC portfolio totaled \$935.5 million at June 30, 2020, decreasing \$13.3 million, or 1.4%, from \$948.8 million at December 31, 2019. At June 30, 2020, 40.4% of outstanding purchased SNCs were related to the energy industry while 17.7% were related to the construction industry, 10.4% were related to the real estate management industry and 10.1% were related to the financial services industry. The remaining purchased SNCs were diversified throughout various other industries, with no other single industry exceeding 10% of the total purchased SNC portfolio. Additionally, almost all of the outstanding balance of purchased SNCs was included in the energy and commercial and industrial portfolio, with the remainder included in the real estate categories. SNC participations are

originated in the normal course of business to meet the needs of our customers. As a matter of policy, we generally only participate in SNCs for companies headquartered in or which have significant operations within our market areas. In addition, we must have direct access to the company's management, an existing banking relationship or the expectation of broadening the relationship with other banking products and services within the following 12 to 24 months. SNCs are reviewed at least quarterly for credit quality and business development successes.

*Commercial Real Estate.* Commercial real estate loans totaled \$6.6 billion at June 30, 2020, increasing \$428.7 million, or 6.9%, compared to \$6.2 billion at December 31, 2019. At such dates, commercial real estate loans represented 84.1% and 83.8% of total real estate loans, respectively. The majority of this portfolio consists of commercial real estate mortgages, which includes both permanent and intermediate term loans. These loans are viewed primarily as cash flow loans and secondarily as loans secured by real estate. Consequently, these loans must undergo the analysis and underwriting process of a commercial and industrial loan, as well as that of a real estate loan. At June 30, 2020, approximately 46% of the outstanding principal balance of our commercial real estate loans were secured by owner-occupied properties.

*Consumer Real Estate and Other Consumer Loans.* The consumer loan portfolio, including all consumer real estate and consumer installment loans, totaled \$1.8 billion at June 30, 2020 and \$1.7 billion at December 31, 2019. Consumer real estate loans increased \$55.8 million, or 4.7%, from December 31, 2019. Combined, home equity loans and lines of credit made up 59.3% and 61.1% of the consumer real estate loan total at June 30, 2020 and December 31, 2019, respectively. We offer home equity loans up to 80% of the estimated value of the personal residence of the borrower, less the value of existing mortgages and home improvement loans. In general, we do not originate 1-4 family mortgage loans; however, from time to time, we may invest in such loans to meet the needs of our customers or for other regulatory compliance purposes. Consumer and other loans decreased \$13.9 million, or 2.7%, from December 31, 2019. The consumer and other loan portfolio primarily consists of automobile loans, overdrafts, unsecured revolving credit products, personal loans secured by cash and cash equivalents and other similar types of credit facilities.

*Paycheck Protection Program.* In April 2020, we began originating loans to qualified small businesses under the PPP administered by the SBA under the provisions of the CARES Act. Loans covered by the PPP may be eligible for loan forgiveness for certain costs incurred related to payroll, group health care benefit costs and qualifying mortgage, rent and utility payments. The remaining loan balance after forgiveness of any amounts is still fully guaranteed by the SBA. Terms of the PPP loans include the following (i) maximum amount limited to the lesser of \$10 million or an amount calculated using a payroll-based formula, (ii) maximum loan term of five years, (iii) interest rate of 1.00%, (iv) no collateral or personal guarantees are required, (v) no payments are required until the date on which the forgiveness amount relating to the loan is remitted to the lender and (vi) loan forgiveness up to the full principal amount of the loan and any accrued interest, subject to certain requirements including that no more than 40% of the loan forgiveness amount may be attributable to non-payroll costs. In return for processing and booking the loan, the SBA will pay the lender a processing fee tiered by the size of the loan (5% for loans of not more than \$350 thousand; 3% for loans of more than \$350 thousand and less than \$2 million; and 1% for loans of at least \$2 million).

Through June 30, 2020, we have funded approximately \$3.2 billion of SBA-approved PPP loans. During the second quarter of 2020, we recognized approximately \$19.3 million in PPP loan related deferred processing fees (net of amortization of related deferred origination costs) as a yield adjustment and this amount is included in interest income on loans. As a result of the inclusion of these net fees in interest income, the average yield on PPP loans was approximately 4.13% during the second quarter of 2020 compared to the stated interest rate of 1.0% on these loans. As of June 30, 2020, we expect to recognize additional PPP loan related deferred processing fees (net of deferred origination costs) totaling approximately \$77.4 million as a yield adjustment over the remaining terms of these loans.

## Non-Performing Assets

Non-performing assets and accruing past due loans are presented in the table below. Troubled debt restructurings on non-accrual status are reported as non-accrual loans. Troubled debt restructurings on accrual status are reported separately.

|                                                                       | June 30,<br>2020 | December 31,<br>2019 |
|-----------------------------------------------------------------------|------------------|----------------------|
| Non-accrual loans:                                                    |                  |                      |
| Commercial and industrial                                             | \$ 27,146        | \$ 26,038            |
| Energy                                                                | 36,239           | 65,761               |
| Paycheck Protection Program                                           | —                | —                    |
| Commercial real estate:                                               |                  |                      |
| Buildings, land and other                                             | 12,154           | 8,912                |
| Construction                                                          | 1,869            | 665                  |
| Consumer real estate                                                  | 2,035            | 922                  |
| Consumer and other                                                    | 18               | 5                    |
| Total non-accrual loans                                               | 79,461           | 102,303              |
| Restructured loans                                                    | 4,932            | 6,098                |
| Foreclosed assets:                                                    |                  |                      |
| Real estate                                                           | 806              | 1,084                |
| Other                                                                 | —                | —                    |
| Total foreclosed assets                                               | 806              | 1,084                |
| Total non-performing assets                                           | \$ 85,199        | \$ 109,485           |
| Ratio of non-performing assets to:                                    |                  |                      |
| Total loans and foreclosed assets                                     | 0.47 %           | 0.74 %               |
| Total loans, excluding PPP loans, and foreclosed assets               | 0.58             | 0.74                 |
| Total assets                                                          | 0.22             | 0.32                 |
| Accruing past due loans:                                              |                  |                      |
| 30 to 89 days past due                                                | \$ 69,999        | \$ 50,784            |
| 90 or more days past due                                              | 20,997           | 7,421                |
| Total accruing past due loans                                         | \$ 90,996        | \$ 58,205            |
| Ratio of accruing past due loans to total loans:                      |                  |                      |
| 30 to 89 days past due                                                | 0.39 %           | 0.34 %               |
| 90 or more days past due                                              | 0.12             | 0.05                 |
| Total accruing past due loans                                         | 0.51 %           | 0.39 %               |
| Ratio of accruing past due loans to total loans, excluding PPP loans: |                  |                      |
| 30 to 89 days past due                                                | 0.47 %           | 0.34 %               |
| 90 or more days past due                                              | 0.14             | 0.05                 |
| Total accruing past due loans                                         | 0.61 %           | 0.39 %               |

Non-performing assets include non-accrual loans, troubled debt restructurings and foreclosed assets. Non-performing assets at June 30, 2020 decreased \$24.3 million from December 31, 2019 primarily due to a decrease in non-accrual energy loans, which, for the most part, was related to the recognition of charge-offs as further discussed below.

Generally, loans are placed on non-accrual status if principal or interest payments become 90 days past due and/or management deems the collectibility of the principal and/or interest to be in question, as well as when required by regulatory requirements. Once interest accruals are discontinued, accrued but uncollected interest is charged to current year operations. Subsequent receipts on non-accrual loans are recorded as a reduction of principal, and interest income is recorded only after principal recovery is reasonably assured. Classification of a loan as non-accrual does not preclude the ultimate collection of loan principal or interest. Non-accrual commercial and industrial loans included one credit relationship in excess of \$5.0 million totaling \$8.4 million at June 30, 2020. This credit relationship was previously reported as non-accrual with an aggregate balance of \$8.4 million at December 31, 2019. Non-accrual energy loans included two credit relationships in excess of \$5 million totaling \$35.9 million at June 30, 2020 and two credit relationships in excess of \$5 million totaling \$61.7 million at December 31, 2019. During the six months ended June 30, 2020, we charged off \$68.8 million related to energy loans. Of that amount, \$48.8 million related to credit relationships previously reported as non-accrual as of December 31, 2019. Non-accrual real estate loans primarily consist of land development, 1-4 family residential construction credit relationships and loans secured by office buildings and religious facilities. There were no non-accrual commercial real estate loans in excess of \$5.0 million at June 30, 2020 or December 31, 2019.



Restructured loans totaled \$4.9 million at June 30, 2020 and consisted of a single credit relationship including commercial and industrial loans, a commercial real estate loan and a consumer loan. Restructured loans at December 31, 2019 totaled \$6.1 million and consisted of three credit relationships primarily related to commercial real estate.

Foreclosed assets represent property acquired as the result of borrower defaults on loans. Foreclosed assets are recorded at estimated fair value, less estimated selling costs, at the time of foreclosure. Write-downs occurring at foreclosure are charged against the allowance for loan losses. Regulatory guidelines require us to reevaluate the fair value of foreclosed assets on at least an annual basis. Our policy is to comply with the regulatory guidelines. Write-downs are provided for subsequent declines in value and are included in other non-interest expense along with other expenses related to maintaining the properties. Write-downs of foreclosed assets totaled \$231 thousand during the six months ended June 30, 2020, while there were no write-downs of foreclosed assets during the six months ended June 30, 2019.

Accruing past due loans at June 30, 2020 increased \$32.8 million compared to December 31, 2019. The increase was primarily related to increases in all loan portfolio segments with the largest increases in past due commercial and industrial loans (up \$16.8 million), consumer real estate (up \$5.8 million) and commercial real estate loans (up \$4.2 million).

Potential problem loans consist of loans that are performing in accordance with contractual terms but for which management has concerns about the ability of an obligor to continue to comply with repayment terms because of the obligor's potential operating or financial difficulties. Management monitors these loans closely and reviews their performance on a regular basis. At June 30, 2020 and December 31, 2019, we had \$105.0 million and \$63.4 million in loans of this type which are not included in any one of the non-performing non-accrual, restructured or 90 days past due loan categories. At June 30, 2020, potential problem loans consisted of 12 credit relationships. Of the total outstanding balance at June 30, 2020, 54.3% was related to the energy industry, 24.2% was related to the manufacturing industry and 13.9% was related to the restaurant industry. Weakness in these organizations' operating performance and financial condition, among other factors, have caused us to heighten the attention given to these credits.

Certain borrowers are currently unable to meet their contractual payment obligations because of the adverse effects of COVID-19. In an effort to mitigate these effects, loan customers may apply for a deferral of payments, or portions thereof, for up to 90 days. After 90 days, customers may apply for an additional deferral. In the absence of other intervening factors, such short-term modifications made on a good faith basis are not categorized as troubled debt restructurings, nor are loans granted payment deferrals related to COVID-19 reported as past due or placed on non-accrual status (provided the loans were not past due or on non-accrual status prior to the deferral). The COVID-19 pandemic has contributed to an increased risk of delinquencies, defaults and foreclosures. As a result of the COVID-19 pandemic, a significant number and amount of our loans have experienced ratings downgrades, credit deterioration and defaults. We have a significant amount of loans in certain industries that have been particularly impacted. These include energy, aviation, restaurants, hotels/lodging, entertainment, retail and commercial real estate, among others. See additional information about the effects of and risks associated with the COVID-19 pandemic in the section captioned "Recent Developments Related to COVID-19" elsewhere in this discussion and Part II. Other Information, Item 1A. Risk Factors elsewhere in this report.

### **Allowance for Credit Losses**

As discussed in Note 1 - Summary of Significant Accounting Policies in the accompanying notes to consolidated financial statements, our policies and procedures related to accounting for credit losses changed on January 1, 2020 in connection with the adoption of a new accounting standard update as codified in Accounting Standards Codification ("ASC") Topic 326 ("ASC 326") Financial Instruments - Credit Losses. In the case of loans and securities, allowances for credit losses are contra-asset valuation accounts, calculated in accordance with ASC 326, that are deducted from the amortized cost basis of these assets to present the net amount expected to be collected. In the case of off-balance-sheet credit exposures, the allowance for credit losses is a liability account, calculated in accordance with ASC 326, reported as a component of accrued interest payable and other liabilities in our consolidated balance sheets. The amount of each allowance account represents management's best estimate of current expected credit losses ("CECL") on these financial instruments considering available information, from internal and external sources, relevant to assessing exposure to credit loss over the contractual term of the instrument. Relevant available information includes historical credit loss experience, current conditions and reasonable and supportable forecasts. While historical credit loss experience provides the basis for the estimation of expected credit losses, adjustments to historical loss information may be made for differences in current portfolio-specific risk characteristics, environmental conditions or other relevant factors. While management utilizes its best judgment and information available, the ultimate adequacy of our allowance accounts is dependent upon a variety of factors beyond our control, including the performance of our portfolios, the economy, changes in interest rates and the view of the regulatory authorities toward classification of assets. For additional information regarding critical accounting policies, refer to Note 1 - Summary of Significant Accounting Policies and Note 3 - Loans in the accompanying notes to consolidated financial statements.

*Allowance for Credit Losses - Loans.* The table below provides, as of the dates indicated, an allocation of the allowance for loan losses by loan portfolio segment; however, allocation of a portion of the allowance to one segment does not preclude its availability to absorb losses in other segments:

|                           | June 30,<br>2020  | March 31,<br>2020 | Post ASC 326<br>Adoption on<br>January 1,<br>2020 | December 31,<br>2019 |
|---------------------------|-------------------|-------------------|---------------------------------------------------|----------------------|
| Commercial and industrial | \$ 98,536         | \$ 92,152         | \$ 72,856                                         | \$ 51,593            |
| Energy                    | 40,817            | 103,201           | 26,929                                            | 37,382               |
| Commercial real estate    | 93,425            | 52,319            | 17,518                                            | 31,037               |
| Consumer real estate      | 8,998             | 8,170             | 6,505                                             | 4,113                |
| Consumer and other        | 8,285             | 8,039             | 5,794                                             | 8,042                |
| Total                     | <u>\$ 250,061</u> | <u>\$ 263,881</u> | <u>\$ 129,602</u>                                 | <u>\$ 132,167</u>    |

Upon the adoption of ASC 326 on January 1, 2020, the total amount of the allowance for credit losses on loans estimated using the CECL methodology decreased \$2.6 million compared to the total amount of the allowance for credit losses on loans estimated as of December 31, 2019 using the prior incurred loss model. Fluctuations in the estimated allowances by portfolio segment offset one another, for the most part, and, as a result, the overall estimated amount of allowance for credit losses did not significantly change as a result of the change in methodology. The manner in which credit loss allowances are allocated to the individual portfolio segments was partly impacted by a change in the way the underlying loans within each segment are pooled for modeling purposes. The impact of varying economic conditions and portfolio stress factors are now a component of the credit loss models applied to each modeling pool. In that regard, the amounts allocated to the underlying pools of loans within each portfolio segment more directly reflect the economic variables and portfolio stress factors that correlate with credit losses within each portfolio. Under the prior methodology, allocations in excess of those derived from historical loss rates were recognized as an overlay on each of the various portfolios based upon management judgment. Nonetheless, despite fluctuations in the allocation of portions of the overall allowance to the various portfolio segments, the entire allowance is available to absorb any credit losses within the entire loan portfolio. The remainder of this discussion focuses on expected credit losses estimated as of June 30, 2020 compared to the post ASC 326 estimate of expected credit losses as of January 1, 2020 and, in some cases, March 31, 2020.

The allowance allocated to commercial and industrial loans totaled \$98.5 million, or 1.97% of total commercial and industrial loans, at June 30, 2020 increasing \$25.7 million, or 35.2%, compared to \$72.9 million, or 1.40% of total commercial and industrial loans, post ASC 326 adoption on January 1, 2020. Modeled expected credit losses increased \$28.8 million while Q-Factor adjustments related to commercial and industrial loans decreased \$7.3 million. Specific allocations for commercial and industrial loans that were evaluated for expected credit losses on an individual basis increased from \$7.9 million post ASC 326 adoption on January 1, 2020 to \$12.1 million at June 30, 2020. The allowance allocated to energy loans totaled \$40.8 million, or 2.86% of total energy loans, at June 30, 2020 increasing \$13.9 million, or 51.6%, compared to \$26.9 million, or 1.63% of total energy loans, post ASC 326 adoption on January 1, 2020. Modeled expected credit losses related to energy loans increased \$12.1 million while Q-Factor adjustments related to energy loans increased \$19.8 million. Specific allocations for energy loans that were evaluated for expected credit losses on an individual basis totaled \$20.2 million post ASC 326 adoption on January 1, 2020. The loans to which these specific allocations were related were subsequently charged off and there were \$2.3 million of specific allocations related to energy loans at June 30, 2020. The allowance allocated to commercial real estate loans totaled \$93.4 million, or 1.41% of total commercial real estate loans, at June 30, 2020 increasing \$75.9 million, or 433.3%, compared to \$17.5 million, or 0.28% of total commercial real estate loans, post ASC 326 adoption on January 1, 2020. Modeled expected credit losses related to commercial real estate loans increased \$106.6 million while Q-Factor adjustments related to commercial real estate loans decreased \$31.7 million. Specific allocations for commercial real estate loans that were evaluated for expected credit losses on an individual basis increased from \$383 thousand post ASC 326 adoption on January 1, 2020 to \$1.3 million at June 30, 2020. The allowance allocated to consumer real estate loans totaled \$9.0 million, or 0.72% of total consumer real estate loans, at June 30, 2020 increasing \$2.5 million, or 38.3%, compared to \$6.5 million, or 0.54% of total consumer real estate loans, post ASC 326 adoption on January 1, 2020. Modeled expected credit losses related to consumer real estate loans increased \$3.0 million while Q-Factor adjustments related to consumer real estate loans decreased \$458 thousand. The allowance allocated to consumer loans totaled \$8.3 million, or 1.64% of total consumer loans, at June 30, 2020 increasing \$2.5 million, or 43.0%, compared to \$5.8 million, or 1.12% of total consumer loans, post ASC 326 adoption on January 1, 2020. Modeled expected credit losses related to consumer loans increased \$2.6 million while Q-Factor adjustments related to consumer loans decreased \$111 thousand.

As more fully described in Note 3 - Loans in the accompanying consolidated financial statements, we measure expected credit losses over the life of each loan utilizing a combination of models which measure probability of default and loss given default, among other things. The measurement of expected credit losses is impacted by loan/borrower attributes and certain

macroeconomic variables. Models are adjusted to reflect current impact of certain macroeconomic variables as well as their expected changes over a reasonable and supportable forecast period.

In estimating expected credit losses as of June 30, 2020, we utilized the Moody's Analytics June 2020 CF Consensus Scenario (the "CF Scenario") to forecast the macroeconomic variables used in our models. The CF Scenario is based on the review of a variety of surveys of baseline forecasts of the U.S. economy. The CF Scenario projections include, among other things, (i) a 36.9% decline in the U.S. Gross Domestic Product ("GDP") in the second quarter of 2020 followed by a 23.5% rebound in the third quarter of 2020; (ii) a U.S. unemployment rate of 15.8% for in the second quarter of 2020 improving to 9.6% by the fourth quarter of 2020 and 6.5% by the end of the forecast period in the second quarter of 2022 with Texas unemployment rates slightly less at those dates; and (iii) an average 10 year Treasury rate of 0.67% in the second quarter of 2020, dropping to a low of 0.34% in the second quarter of 2021 and increasing to 0.91% by the end of the forecast period in the second quarter of 2022. The CF Scenario also projects average oil prices of \$26 per barrel in the second quarter of 2020, \$32 per barrel in the fourth quarter of 2020, \$42 per barrel on average for the year in 2021 and \$50 in the second quarter of 2022. For our March 31, 2020 estimate of expected credit losses, our outlook for oil prices was significantly more negative as a result of the assumed persistence of the oil price war between Saudi Arabia and Russia and increasing oil supplies in the face of decreasing global demand resulting from the COVID-19 pandemic. As a result, we used significant qualitative adjustments in the determination of the allowance for credit losses on energy loans. Though less as of June 30, 2020, we continue to make qualitative adjustments related to the impact of oil price volatility in the determination of the allowance for credit losses on energy loans, as further discussed below.

In estimating expected credit losses as of March 31, 2020, we utilized the Moody's Analytics March 2020 S8 Low Oil Price Scenario (the "S8 Scenario") to forecast the macroeconomic variables used in our models. The S8 scenario used the Moody's Baseline forecast, updated during the week of March 16, 2020, adjusted to assume that the price per barrel of West Texas Intermediate ("WTI") crude oil will remain at \$35 flat for two years. The S8 Scenario also assumed the persistence of the oil price war between Saudi Arabia and Russia and increasing oil supplies in the face of decreasing global demand. At that time, the S8 Scenario forecasted declines in the U.S. Gross Domestic Product and the Texas Gross State Product in the second quarter of 2020, a flat U.S. unemployment rate for the remainder of 2020 and the 10-yr Treasury rate dropping to 0.49% in second quarter of 2020 and remaining below 1.0% until the second quarter of 2021. The low oil prices incorporated in the S8 Scenario also resulted in a forecasted gradual increase in the Texas unemployment rate, from 3.6% in the first quarter of 2020 to 6.2% by the first quarter of 2022, exceeding the forecasted U.S. unemployment rate of 4.1% for the first quarter of 2022 and reflecting the impact of oil prices on the overall Texas economy. In late March and early April 2020, Moody's updated various macroeconomic variables in Moody's Baseline forecast subsequent to our modeling processes in order to incorporate the expected economic impact of recent developments related to the COVID-19 pandemic. Given the level of economic disruption and uncertainty within the State of Texas and the nation as a whole, arising from the COVID-19 pandemic and volatility and declines in oil and gas prices driven by decreased demand and increased supply, we qualitatively adjusted the model results for these and other risk factors that are not considered within our modeling processes but are nonetheless relevant in assessing the expected credit losses within our loan pools as further discussed below.

The economic forecast used in our initial estimate of expected credit losses under ASC 326 on January 1, 2020 projected that the Texas unemployment rate would remain below 4.0% through 2021. The increases in modeled expected credit losses across all of our loan portfolios as of June 30, 2020 compared to the modeled expected credit losses as of our initial adoption of ASC 326 on January 1, 2020 were primarily the result of changes in our economic forecast, particularly forecasts related to unemployment and the gross domestic product, as well as changes in portfolio volumes and risk attributes, as discussed below.

The overall loan portfolio, excluding PPP loans which are fully guaranteed by the SBA, increased \$59.3 million, or 0.4%, which included a \$428.7 million, or 6.9%, increase in commercial real estate loans and a \$55.8 million, or 4.7%, increase in consumer real estate loans mostly offset by a \$183.2 million, or 3.5%, decrease in commercial and industrial loans, a \$228.0 million, or 13.8%, decrease in energy loans and a \$13.9 million, or 2.7% decrease in consumer and other loans. The weighted average risk grade for commercial and industrial loans did not significantly change totaling 6.45 at June 30, 2020 compared to 6.44 at December 31, 2019. Commercial and industrial loans graded "watch" and "special mention" (risk grades 9 and 10) increased \$51.9 million during the first six months of 2020 while classified commercial and industrial loans increased \$14.9 million. Classified loans consist of loans having a risk grade of 11, 12 or 13. The weighted-average risk grade for energy loans increased to 7.24 at June 30, 2020 from 6.39 at December 31, 2019. The increase in the weighted average risk grade was primarily related to a \$49.2 million increase in classified energy loans and a \$204.6 million increase in energy loans graded "watch" and "special mention," while pass grade energy loans decreased \$481.9 million. The weighted average risk grade for commercial real estate loans increased to 7.30 at June 30, 2020 from 7.07 at December 31, 2019. Commercial real estate loans graded as "watch" and "special mention" increased \$342.8 million while classified commercial real estate loans increased \$18.3 million.

As noted above our credit loss models utilized the economic forecasts in the Moody's CF Consensus Scenario for June 2020 in the second quarter of 2020 and the Moody's S8 Low Oil Scenario for March 2020 in the first quarter of 2020. We qualitatively adjust the model results based on this scenario for various risk factors that are not considered within our modeling processes but are nonetheless relevant in assessing the expected credit losses within our loan pools. These Q-Factor adjustments are discussed below.

Q-Factor adjustments are based upon management judgment and current assessment as to the impact of risks related to changes in lending policies and procedures; economic and business conditions; loan portfolio attributes and credit concentrations; and external factors, among other things, that are not already captured within the modeling inputs, assumptions and other processes. Management assesses the potential impact of such items within a range of severely negative impact to positive impact and adjusts the modeled expected credit loss by an aggregate adjustment percentage based upon the assessment. As a result of this assessment as of June 30, 2020, modeled expected credit losses were adjusted upwards by a weighted-average Q-Factor adjustment of approximately 0.7%. This weighted-average Q-Factor adjustment was based on a positive expected impact related to changes in lending policies, procedures and underwriting standards; a limited negative expected impact associated with changes in loan portfolio attributes and concentrations, changes in risk grades, changes in the volumes and severity of loan delinquencies and adverse classifications and potential deterioration of collateral values; and a severely negative impact from other risk factors associated with our commercial real estate construction and land portfolios, particularly the risks related to expected extensions.

In connection with our assessment of Q-Factor adjustments for our initial estimate of expected credit losses upon the adoption of ASC 326 on January 1, 2020, modeled expected credit losses were adjusted upwards by a weighted-average Q-Factor adjustment of approximately 12.9%, which included a 10% upward adjustment to modeled expected credit losses related to risks associated with model uncertainty and under-prediction. This adjustment was based upon the results of certain back testing procedures performed on our credit loss models. The Q-Factor adjustment as of June 30, 2020 did not include this additional 10% upward adjustment related to risks associated with model uncertainty and under-prediction. While management believes this adjustment is appropriate in a relatively benign or moderately stressful economic environment, management nonetheless believes this adjustment is not currently appropriate given the extreme levels and volatility in macroeconomic indicators under the current economic conditions and the fact that such conditions are expected to persist for the foreseeable future. The weighted-average Q-Factor adjustment totaled approximately 17.9% as of March 31, 2020 and included the 10% adjustment related to risks associated with model uncertainty and under-prediction. The decrease in the Q-Factor adjustment since March 31, 2020 reflects the fact that much of these expected credit losses are now captured in our credit loss models as a result of updates in policies and procedures related to managing the effects of COVID-19 on our loan customers, risk-grade migrations and updated macroeconomic forecasts.

Management also made certain other qualitative adjustments for loans within certain industries that are expected to be more significantly impacted by the COVID-19 pandemic and oil price volatility and declines as described below.

In early March 2020, Saudi Arabia announced significant price discounts on oil which resulted in a sharp decrease in global oil prices including the benchmark WTI. Saudi Arabia further announced that it would significantly increase its production leading Russia to respond in kind. These actions arose in the face of increasing global supplies and decreasing global demand. The subsequent worsening global economic outlook and decreased demand resulting from the COVID-19 pandemic resulted in further decreases in energy prices. The WTI price per barrel of crude oil was approximately \$39 as of June 30, 2020 up from \$20 per barrel as of March 31, 2020 but still down from approximately \$61 per barrel as of December 31, 2019. In late March 2020, we established a special Energy Oversight Council to oversee and assess the credit quality of our energy loan portfolio.

As of June 30, 2020, we provided an additional \$20.5 million of qualitative adjustments for our energy loan portfolio. This amount is down from \$85.0 million as of March 31, 2020. In assessing the energy portfolio for the additional qualitative adjustments during the second quarter, we updated our borrowing base determinations for nearly all of our energy production loans using current engineering valuations and an oil price deck of \$30 in 2020. Through this process, we estimated an aggregate borrowing base deficiency on energy production loans totaling approximately \$36 million at June 30, 2020 compared to an aggregate borrowing base deficiency of approximately \$106 million at March 31, 2020. The March 31, 2020 estimated aggregate borrowing base deficiency was based on a stress testing exercise using an oil price deck of \$9 for 2020 and included an analysis of our customers' secondary sources of capital. Management believes that the aggregate borrowing base deficiency amount should serve as the appropriate level of expected credit losses for energy production loans. Accordingly, we provided an additional qualitative adjustment of \$15.5 million at June 30, 2020 for energy production loans. This amount is down from \$84.0 million at March 31, 2020 in part due to the rebound in oil prices and the recognition of \$35.0 million of charge-offs related to three large energy production credit relationships during the second quarter of 2020.

We performed a separate assessment of other energy loans which are primarily made up of borrowers associated with oilfield services such as transportation and logistics; equipment manufacturing and other services, among other things. Business activity among oilfield service firms has experienced significant contraction since March 2020 and there are indications of further worsening of conditions due to significant declines in equipment utilization and operating margins. Furthermore, there has been a significant decrease in the number of active oil rigs in Texas since March 2020, while the aforementioned rebound in oil prices during the second quarter has not had any apparent impact on stemming the decline. As a result, we expect that the revenues and operating margins of our oilfield services customers will be significantly impacted. Accordingly, we provided an additional qualitative adjustment of \$5.0 million for our other, non-production energy loans portfolio at June 30, 2020. This amount is up from \$1.0 million at March 31, 2020.

In late June 2020, we established a special Commercial Real Estate Oversight Council to oversee and assess the credit quality of our non-owner occupied and construction commercial real estate portfolios. Due to the adverse economic effects of the COVID-19 pandemic, management believes these portfolios have an elevated level of risk that requires a higher level of oversight, particularly as it relates to monitoring risk grades, payment deferrals, covenant modifications and structuring issues, among other things.

In estimating current expected credit losses as of June 30, 2020, we determined that our credit loss models for our owner occupied commercial real estate portfolio were overly sensitive to the volatility of the forecasted Texas unemployment rate and the forecasted U.S. GDP. The modeled loss rate for this portfolio was nearly 170% higher than the modeled loss rate for our commercial and industrial loan portfolio. Management believes that the loss rates for our owner occupied commercial real estate loan portfolio and our commercial and industrial loan portfolio should be similar due to the fact that the loans within both portfolios are underwritten with the assumption that the primary repayment source is the cash flow from the operations of the borrower. This differs from non-owner occupied real estate where the primary repayment source is the cash flow generated by the underlying real estate being financed. Furthermore, our owner occupied commercial real estate loan portfolio and our commercial and industrial loan portfolio have a similar customer base. The loans within our owner occupied commercial real estate portfolio generally have a longer term than the loans within our commercial and industrial loan portfolio, which increases the modeled loss rate of the portfolio, despite the fact that this portfolio generally experiences lower losses in the case of default due to higher collateral valuations relative to the amount of the underlying loans. In light of the foregoing, management reduced the modeled loss allocation for owner occupied commercial real estate by \$53.1 million as of June 30, 2020. Of this amount, \$8.6 million was reallocated to the non-owner occupied commercial real estate portfolio and \$2.8 million was reallocated to the commercial real estate construction portfolio. Additional qualitative adjustments were made for these portfolios as we believe our borrowers' ability to access the capital markets for the sale or refinancing of assets, including those under construction, may be impaired for a significant amount of time. This would require secondary sources of capital and liquidity to support completed projects, access to which may take considerably longer to stabilize than was expected at the time the loans to these borrowers were originally underwritten. Additionally, management reallocated an additional \$10.9 million for specific industries within the commercial real estate portfolio that have been particularly impacted by the economic effects of the COVID-19 pandemic, as further discussed below. The net effect of these additional qualitative adjustments, when combined with the aforementioned 0.7% Q-Factor adjustment, was an overall negative qualitative adjustment to the allowance for credit losses on commercial real estate loans totaling \$29.9 million.

The COVID-19 pandemic has resulted in a significant decrease in commercial activity throughout the State of Texas as well as nationally. Efforts to limit the spread of COVID-19 have led to the closure of non-essential businesses, travel restrictions, supply chain disruptions and prohibitions on public gatherings, among other things, throughout many parts of the United States and, in particular, the markets in which we operate. Aside from the energy industry, which is discussed above, we lend to customers operating in certain other industries that have been, and are expected to be, more significantly impacted by the effects of the COVID-19 pandemic. These industries are presented in the following table and include amounts reported as both commercial and industrial loans and commercial real estate loans while PPP loans are excluded.

|                | Outstanding<br>Balance at June 30,<br>2020 | Percentage of Total<br>Loans, Excluding<br>PPP Loans | Allocated Allowance | Allocated Allowance<br>as a Percentage of<br>Outstanding Balance |
|----------------|--------------------------------------------|------------------------------------------------------|---------------------|------------------------------------------------------------------|
| Retail         | \$ 783,229                                 | 5.29 %                                               | \$ 16,101           | 2.06 %                                                           |
| Hotels/lodging | 261,343                                    | 1.76                                                 | 3,171               | 1.21                                                             |
| Restaurants    | 224,492                                    | 1.52                                                 | 9,744               | 4.34                                                             |
| Aviation       | 193,801                                    | 1.31                                                 | 5,408               | 2.79                                                             |
| Entertainment  | 120,327                                    | 0.81                                                 | 5,511               | 4.58                                                             |
| Total          | <u>\$ 1,583,192</u>                        | 10.69 %                                              | <u>\$ 39,935</u>    | 2.52 %                                                           |

We are continuing to monitor customers in these industries closely. In assessing these portfolios for an additional qualitative adjustment as of June 30, 2020, we performed a comprehensive review of the financial condition and overall outlook of the borrowers within these portfolios. Based on this analysis, we determined that there continues to be an elevated level of risk due to state and nationwide restrictions impacting each of these industries. As a result, we provided an additional qualitative adjustment of \$10.9 million, all of which was allocated to commercial real estate loans. This amount is up from \$8.8 million at March 31, 2020, of which \$7.8 million was allocated to commercial real estate loans and \$1.0 million was allocated to commercial and industrial loans.

Activity in the allowance for credit losses on loans is presented in the following table.

|                                                   | Three Months Ended<br>June 30, |            | Six Months Ended<br>June 30, |            |
|---------------------------------------------------|--------------------------------|------------|------------------------------|------------|
|                                                   | 2020                           | 2019       | 2020                         | 2019       |
| Balance at beginning of period                    | \$ 263,881                     | \$ 136,350 | \$ 132,167                   | \$ 132,132 |
| Impact of adopting ASC 326                        | —                              | —          | (2,565)                      | —          |
| Credit loss expense                               | 27,228                         | 6,400      | 200,153                      | 17,403     |
| Charge-offs:                                      |                                |            |                              |            |
| Commercial and industrial                         | (1,841)                        | (3,389)    | (6,210)                      | (6,077)    |
| Energy                                            | (35,042)                       | (2,000)    | (68,842)                     | (2,000)    |
| Commercial real estate                            | (3,511)                        | (557)      | (3,584)                      | (617)      |
| Consumer real estate                              | (135)                          | (601)      | (420)                        | (2,379)    |
| Consumer and other                                | (4,178)                        | (5,103)    | (9,183)                      | (10,800)   |
| Total charge-offs                                 | (44,707)                       | (11,650)   | (88,239)                     | (21,873)   |
| Recoveries:                                       |                                |            |                              |            |
| Commercial and industrial                         | 891                            | 935        | 2,606                        | 1,685      |
| Energy                                            | —                              | 29         | 66                           | 76         |
| Commercial real estate                            | 30                             | 29         | 143                          | 119        |
| Consumer real estate                              | 611                            | 315        | 991                          | 404        |
| Consumer and other                                | 2,127                          | 2,521      | 4,739                        | 4,983      |
| Total recoveries                                  | 3,659                          | 3,829      | 8,545                        | 7,267      |
| Net charge-offs                                   | (41,048)                       | (7,821)    | (79,694)                     | (14,606)   |
| Balance at end of period                          | \$ 250,061                     | \$ 134,929 | \$ 250,061                   | \$ 134,929 |
| Ratio of allowance for credit losses on loans to: |                                |            |                              |            |
| Total loans                                       | 1.39 %                         | 0.93 %     | 1.39 %                       | 0.93 %     |
| Total loans - excluding PPP loans                 | 1.69                           | 0.93       | 1.69                         | 0.93       |
| Non-accrual loans                                 | 314.70                         | 188.66     | 314.70                       | 188.66     |
| Ratio of annualized net charge-offs to:           |                                |            |                              |            |
| Average total loans                               | 0.94                           | 0.22       | 0.98                         | 0.21       |
| Average total loans - excluding PPP loans         | 1.10                           | 0.22       | 1.07                         | 0.21       |

Credit loss expense related to loans increased \$182.8 million during the six months ended June 30, 2020 compared to the same period in 2019. Credit loss expense related to loans during the six months ended June 30, 2020 primarily reflects the increase in expected credit losses resulting from a deterioration in forecasted economic conditions and the current and uncertain future impacts associated with the COVID-19 pandemic and recent volatility in oil prices. Credit loss expense also reflects the level of net charge-offs, the deterioration of credit quality and other changes within the loan portfolio during the first quarter of 2020. The ratio of the allowance for credit losses on loans to total loans was 1.39% (1.69% excluding PPP loans) at June 30, 2020 compared to 0.90% at December 31, 2019. Management believes the recorded amount of the allowance for credit losses on loans is appropriate based upon management's best estimate of current expected credit losses within the existing portfolio of loans. Should any of the factors considered by management in making this estimate change, our estimate of current expected credit losses could also change, which could affect the level of future credit loss expense related to loans.

*Allowance for Credit Losses - Off-Balance-Sheet Credit Exposures.* Upon the adoption of ASC 326 on January 1, 2020, the total amount of the allowance for credit losses on off-balance-sheet credit exposures estimated using the CECL methodology increased \$39.4 million compared to the total amount of the allowance for credit losses on off-balance-sheet credit exposures estimated as of December 31, 2019 using the prior incurred loss model. The increase reflects the impact of assuming portions of all of these commitments will fund in the future and applying our credit loss modeling processes to such amounts as if such amounts were funded loans. Previously, we only recognized a liability for estimated incurred credit losses on off-balance-sheet

credit exposures when the borrowers to which such commitments were extended exceeded certain risk grades and had not violated any underlying covenants that would relieve us of any obligation to fund additional amounts under the commitment. Subsequent to the adoption of ASC 326 on January 1, 2020, we recognized credit loss expense related to off-balance-sheet credit exposures totaling \$7.1 million during the first six months of 2020 to increase the amount of the related allowance for credit losses on off-balance-sheet credit exposures to \$46.9 million as of June 30, 2020. The increase primarily reflects changes in underlying risk grades and expected utilization of available funds, an increase in overall off-balance-sheet credit exposures and a deterioration in forecasted economic conditions and the current and uncertain future impacts associated with COVID-19. Further information regarding our policies and methodology used to estimate the allowance for credit losses on off-balance-sheet credit exposures is presented in Note 6 - Off-Balance-Sheet Arrangements, Commitments, Guarantees and Contingencies in the accompanying notes to consolidated financial statements.

## Capital and Liquidity

*Capital.* Shareholders' equity totaled \$4.0 billion at June 30, 2020 and \$3.9 billion December 31, 2019. In addition to net income of \$147.8 million, other sources of capital during the six months ended June 30, 2020 included other comprehensive income, net of tax, of \$220.9 million; \$5.8 million related to stock-based compensation and \$4.8 million in proceeds from stock option exercises. Additionally, we issued \$2.8 million of common stock held in treasury to our 401(k) plan. During the second quarter of 2020, we began to issue shares of our common stock directly to our 401(k) plan in connection with matching contributions. Previously, we contributed the matching contributions in cash which were then utilized to purchase shares of our common stock on the open market. Uses of capital during the six months ended June 30, 2020 included a \$150.0 million redemption of preferred stock, \$91.8 million of dividends paid on preferred and common stock, \$29.3 million related to the cumulative effect of adopting a new accounting principle and \$14.0 million of treasury stock purchases. See Note 1 - Significant Accounting Policies.

The accumulated other comprehensive income/loss component of shareholders' equity totaled a net, after-tax, unrealized gain of \$488.3 million at June 30, 2020 compared to \$267.4 million at December 31, 2019. The change was primarily due to a \$219.3 million net, after-tax, increase in the net unrealized gain on securities available for sale.

Under the Basel III Capital Rules, we have elected to opt-out of the requirement to include most components of accumulated other comprehensive income in regulatory capital. Accordingly, amounts reported as accumulated other comprehensive income/loss do not increase or reduce regulatory capital and are not included in the calculation of our regulatory capital ratios. In connection with the adoption of ASC 326 on January 1, 2020, we also elected to exclude, for a transitional period, the effects of credit loss accounting under CECL in the calculation of our regulatory capital and regulatory capital ratios. Regulatory agencies for banks and bank holding companies utilize capital guidelines designed to measure capital and take into consideration the risk inherent in both on-balance-sheet and off-balance-sheet items. See Note 7 - Capital and Regulatory Matters in the accompanying notes to consolidated financial statements included elsewhere in this report.

We paid a quarterly dividend of \$0.71 per common share during the first and second quarters of both 2020 and 2019. This equates to a common stock dividend payout ratio of 64.0% and 39.0% during the first six months of 2020 and 2019, respectively. Our ability to declare or pay dividends on, or purchase, redeem or otherwise acquire, shares of our capital stock may be impacted by certain restrictions described in Note 7 - Capital and Regulatory Matters in the accompanying notes to consolidated financial statements included elsewhere in this report.

*Preferred Stock.* On March 16, 2020, we redeemed all 6,000,000 shares of our 5.375% Non-Cumulative Perpetual Preferred Stock, Series A, ("Series A Preferred Stock") at a redemption price of \$25 per share, or an aggregate redemption of \$150.0 million. When issued, the net proceeds of the Series A Preferred Stock totaled \$144.5 million after deducting \$5.5 million of issuance costs including the underwriting discount and professional service fees, among other things. Upon redemption, these issuance costs were reclassified to retained earnings and reported as a reduction of net income available to common shareholders.

*Stock Repurchase Plans.* From time to time, our board of directors has authorized stock repurchase plans. In general, stock repurchase plans allow us to proactively manage our capital position and return excess capital to shareholders. Shares purchased under such plans also provide us with shares of common stock necessary to satisfy obligations related to stock compensation awards. On July 24, 2019, our board of directors authorized a \$100.0 million stock repurchase program, allowing us to repurchase shares of our common stock over a one-year period from time to time at various prices in the open market or through private transactions. We repurchased 177,834 shares at a total cost of \$13.7 million during the first quarter of 2020 and 202,724 shares at a total cost of \$17.2 million during the third quarter of 2019. No further repurchases were made under this plan prior to its expiration on July 24, 2020. See Note 7 - Capital and Regulatory Matters in the accompanying notes to consolidated financial statements and Part II, Item 2 - Unregistered Sales of Equity Securities and Use of Proceeds, each included elsewhere in this report.

*Liquidity.* As more fully discussed in our 2019 Form 10-K, our liquidity position is continuously monitored and adjustments are made to the balance between sources and uses of funds as deemed appropriate. Liquidity risk management is an important element in our asset/liability management process. We regularly model liquidity stress scenarios to assess potential liquidity outflows or funding problems resulting from economic disruptions, volatility in the financial markets, unexpected credit events or other significant occurrences deemed problematic by management. These scenarios are incorporated into our contingency funding plan, which provides the basis for the identification of our liquidity needs. Our principal source of funding has been our customer deposits, supplemented by our short-term and long-term borrowings as well as maturities of securities and loan amortization. As of June 30, 2020, we had approximately \$5.0 billion held in an interest-bearing account at the Federal Reserve. We also have the ability to borrow funds as a member of the Federal Home Loan Bank (“FHLB”). As of June 30, 2020, based upon available, pledgeable collateral, our total borrowing capacity with the FHLB was approximately \$2.7 billion. Furthermore, at June 30, 2020, we had approximately \$8.8 billion in securities that were unencumbered by a pledge and could be used to support additional borrowings through repurchase agreements or the Federal Reserve discount window, as needed.

Since Cullen/Frost is a holding company and does not conduct operations, its primary sources of liquidity are dividends upstreamed from Frost Bank and borrowings from outside sources. Banking regulations may limit the amount of dividends that may be paid by Frost Bank. See Note 7 - Capital and Regulatory Matters in the accompanying notes to consolidated financial statements included elsewhere in this report regarding such dividends. At June 30, 2020, Cullen/Frost had liquid assets, including cash and resell agreements, totaling \$184.8 million.

#### **Accounting Standards Updates**

See Note 17 - Accounting Standards Updates in the accompanying notes to consolidated financial statements included elsewhere in this report for details of recently issued accounting pronouncements and their expected impact on our financial statements.

**Consolidated Average Balance Sheets and Interest Income Analysis - Quarter To Date**  
(Dollars in thousands - taxable-equivalent basis)

|                                                           | June 30, 2020        |                         |            | June 30, 2019        |                         |            |
|-----------------------------------------------------------|----------------------|-------------------------|------------|----------------------|-------------------------|------------|
|                                                           | Average Balance      | Interest Income/Expense | Yield/Cost | Average Balance      | Interest Income/Expense | Yield/Cost |
| <b>Assets:</b>                                            |                      |                         |            |                      |                         |            |
| Interest-bearing deposits                                 | \$ 4,986,273         | \$ 1,257                | 0.10 %     | \$ 1,171,139         | \$ 7,828                | 2.64 %     |
| Federal funds sold and resell agreements                  | 91,987               | 63                      | 0.27       | 245,554              | 1,541                   | 2.48       |
| Securities:                                               |                      |                         |            |                      |                         |            |
| Taxable                                                   | 4,042,418            | 23,360                  | 2.40       | 5,082,573            | 30,324                  | 2.40       |
| Tax-exempt                                                | 8,458,214            | 81,818                  | 4.07       | 8,239,595            | 81,536                  | 4.06       |
| Total securities                                          | 12,500,632           | 105,178                 | 3.53       | 13,322,168           | 111,860                 | 3.42       |
| Loans, net of unearned discounts                          | 17,549,539           | 172,407                 | 3.95       | 14,375,154           | 191,228                 | 5.34       |
| <b>Total Earning Assets and Average Rate Earned</b>       | 35,128,431           | 278,905                 | 3.24       | 29,114,015           | 312,457                 | 4.33       |
| Cash and due from banks                                   | 521,578              |                         |            | 484,085              |                         |            |
| Allowance for credit losses on loans and securities       | (266,201)            |                         |            | (138,349)            |                         |            |
| Premises and equipment, net                               | 1,045,069            |                         |            | 809,088              |                         |            |
| Accrued interest and other assets                         | 1,409,470            |                         |            | 1,222,246            |                         |            |
| <b>Total Assets</b>                                       | <u>\$ 37,838,347</u> |                         |            | <u>\$ 31,491,085</u> |                         |            |
| <b>Liabilities:</b>                                       |                      |                         |            |                      |                         |            |
| Non-interest-bearing demand deposits:                     |                      |                         |            |                      |                         |            |
| Commercial and individual                                 | \$ 13,072,768        |                         |            | \$ 9,640,935         |                         |            |
| Correspondent banks                                       | 236,856              |                         |            | 201,779              |                         |            |
| Public funds                                              | 475,147              |                         |            | 304,897              |                         |            |
| Total non-interest-bearing demand deposits                | 13,784,771           |                         |            | 10,147,611           |                         |            |
| Interest-bearing deposits:                                |                      |                         |            |                      |                         |            |
| Private accounts                                          |                      |                         |            |                      |                         |            |
| Savings and interest checking                             | 7,615,390            | 303                     | 0.02       | 6,774,143            | 1,364                   | 0.08       |
| Money market deposit accounts                             | 8,230,050            | 1,896                   | 0.09       | 7,588,056            | 19,529                  | 1.03       |
| Time accounts                                             | 1,117,852            | 3,901                   | 1.40       | 969,668              | 4,021                   | 1.66       |
| Public funds                                              | 564,663              | 127                     | 0.09       | 513,272              | 1,930                   | 1.51       |
| Total interest-bearing deposits                           | 17,527,955           | 6,227                   | 0.14       | 15,845,139           | 26,844                  | 0.68       |
| Total deposits                                            | 31,312,726           |                         |            | 25,992,750           |                         |            |
| Federal funds purchased and repurchase agreements         | 1,295,425            | 486                     | 0.15       | 1,242,246            | 5,220                   | 1.69       |
| Junior subordinated deferrable interest debentures        | 136,323              | 988                     | 2.90       | 136,265              | 1,478                   | 4.34       |
| Subordinated notes                                        | 98,929               | 1,164                   | 4.71       | 98,772               | 1,164                   | 4.71       |
| Federal Home Loan Bank advances                           | 439,560              | 318                     | 0.29       | —                    | —                       | —          |
| <b>Total Interest-Bearing Funds and Average Rate Paid</b> | 19,498,192           | 9,183                   | 0.19       | 17,322,422           | 34,706                  | 0.80       |
| Accrued interest and other liabilities                    | 656,738              |                         |            | 388,680              |                         |            |
| <b>Total Liabilities</b>                                  | 33,939,701           |                         |            | 27,858,713           |                         |            |
| <b>Shareholders' Equity</b>                               | 3,898,646            |                         |            | 3,632,372            |                         |            |
| <b>Total Liabilities and Shareholders' Equity</b>         | <u>\$ 37,838,347</u> |                         |            | <u>\$ 31,491,085</u> |                         |            |
| Net interest income                                       |                      | <u>\$ 269,722</u>       |            |                      | <u>\$ 277,751</u>       |            |
| Net interest spread                                       |                      |                         | 3.05 %     |                      |                         | 3.53 %     |
| Net interest income to total average earning assets       |                      |                         | 3.13 %     |                      |                         | 3.85 %     |

For these computations: (i) average balances are presented on a daily average basis, (ii) information is shown on a taxable-equivalent basis assuming a 21% tax rate, (iii) average loans include loans on non-accrual status, and (iv) average securities include unrealized gains and losses on securities available for sale while yields are based on average amortized cost.



# Consolidated Average Balance Sheets and Interest Income Analysis - Year To Date

(Dollars in thousands - taxable-equivalent basis)

|                                                           | June 30, 2020        |                         |               | June 30, 2019        |                         |               |
|-----------------------------------------------------------|----------------------|-------------------------|---------------|----------------------|-------------------------|---------------|
|                                                           | Average Balance      | Interest Income/Expense | Yield/Cost    | Average Balance      | Interest Income/Expense | Yield/Cost    |
| <b>Assets:</b>                                            |                      |                         |               |                      |                         |               |
| Interest-bearing deposits                                 | \$ 3,785,983         | \$ 9,382                | 0.49 %        | \$ 1,448,520         | \$ 18,467               | 2.54 %        |
| Federal funds sold and resell agreements                  | 176,061              | 865                     | 0.97          | 247,738              | 3,129                   | 2.51          |
| Securities:                                               |                      |                         |               |                      |                         |               |
| Taxable                                                   | 4,268,913            | 49,390                  | 2.38          | 4,813,190            | 55,003                  | 2.30          |
| Tax-exempt                                                | 8,463,098            | 163,395                 | 4.07          | 8,234,541            | 164,011                 | 4.05          |
| Total securities                                          | 12,732,011           | 212,785                 | 3.49          | 13,047,731           | 219,014                 | 3.40          |
| Loans, net of unearned discounts                          | 16,272,357           | 345,784                 | 4.27          | 14,290,642           | 377,878                 | 5.33          |
| <b>Total Earning Assets and Average Rate Earned</b>       | <b>32,966,412</b>    | <b>568,816</b>          | <b>3.52</b>   | <b>29,034,631</b>    | <b>618,488</b>          | <b>4.30</b>   |
| Cash and due from banks                                   | 532,234              |                         |               | 503,286              |                         |               |
| Allowance for credit losses on loans and securities       | (198,759)            |                         |               | (136,011)            |                         |               |
| Premises and equipment, net                               | 1,033,741            |                         |               | 772,293              |                         |               |
| Accrued interest and other assets                         | 1,359,453            |                         |               | 1,216,706            |                         |               |
| <b>Total Assets</b>                                       | <b>\$ 35,693,081</b> |                         |               | <b>\$ 31,390,905</b> |                         |               |
| <b>Liabilities:</b>                                       |                      |                         |               |                      |                         |               |
| Non-interest-bearing demand deposits:                     |                      |                         |               |                      |                         |               |
| Commercial and individual                                 | \$ 11,595,976        |                         |               | \$ 9,637,530         |                         |               |
| Correspondent banks                                       | 237,872              |                         |               | 203,746              |                         |               |
| Public funds                                              | 427,149              |                         |               | 328,551              |                         |               |
| Total non-interest-bearing demand deposits                | 12,260,997           |                         |               | 10,169,827           |                         |               |
| Interest-bearing deposits:                                |                      |                         |               |                      |                         |               |
| Private accounts                                          |                      |                         |               |                      |                         |               |
| Savings and interest checking                             | 7,322,838            | 699                     | 0.02          | 6,774,003            | 2,836                   | 0.08          |
| Money market deposit accounts                             | 8,052,248            | 11,592                  | 0.29          | 7,641,488            | 40,169                  | 1.06          |
| Time accounts                                             | 1,113,464            | 8,513                   | 1.54          | 932,771              | 7,177                   | 1.55          |
| Public funds                                              | 602,436              | 1,476                   | 0.49          | 533,730              | 3,836                   | 1.45          |
| Total interest-bearing deposits                           | 17,090,986           | 22,280                  | 0.26          | 15,881,992           | 54,018                  | 0.69          |
| Total deposits                                            | 29,351,983           |                         |               | 26,051,819           |                         |               |
| Federal funds purchased and repurchase agreements         | 1,277,365            | 3,523                   | 0.55          | 1,211,376            | 10,236                  | 1.70          |
| Junior subordinated deferrable interest debentures        | 136,316              | 2,193                   | 3.22          | 136,258              | 2,976                   | 4.37          |
| Subordinated notes                                        | 98,909               | 2,328                   | 4.71          | 98,752               | 2,328                   | 4.71          |
| Federal Home Loan Bank advances                           | 219,780              | 318                     | 0.29          | —                    | —                       | —             |
| <b>Total Interest-Bearing Funds and Average Rate Paid</b> | <b>18,823,356</b>    | <b>30,642</b>           | <b>0.33</b>   | <b>17,328,378</b>    | <b>69,558</b>           | <b>0.81</b>   |
| Accrued interest and other liabilities                    | 655,133              |                         |               | 355,551              |                         |               |
| <b>Total Liabilities</b>                                  | <b>31,739,486</b>    |                         |               | <b>27,853,756</b>    |                         |               |
| <b>Shareholders' Equity</b>                               | <b>3,953,595</b>     |                         |               | <b>3,537,149</b>     |                         |               |
| <b>Total Liabilities and Shareholders' Equity</b>         | <b>\$ 35,693,081</b> |                         |               | <b>\$ 31,390,905</b> |                         |               |
| Net interest income                                       |                      | <u>\$ 538,174</u>       |               |                      | <u>\$ 548,930</u>       |               |
| Net interest spread                                       |                      |                         | <u>3.19 %</u> |                      |                         | <u>3.49 %</u> |
| Net interest income to total average earning assets       |                      |                         | <u>3.33 %</u> |                      |                         | <u>3.82 %</u> |

For these computations: (i) average balances are presented on a daily average basis, (ii) information is shown on a taxable-equivalent basis assuming a 21% tax rate, (iii) average loans include loans on non-accrual status, and (iv) average securities include unrealized gains and losses on securities available for sale while yields are based on average amortized cost.



### Item 3. Quantitative and Qualitative Disclosures About Market Risk

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

Refer to the discussion of market risks included in Item 7A. Quantitative and Qualitative Disclosures About Market Risk in the 2019 Form 10-K. There has been no significant change in the types of market risks we face since December 31, 2019.

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

For modeling purposes, as of June 30, 2020, the model simulations projected that 100 and 200 basis point ratable increases in interest rates would result in positive variances in net interest income of 1.4% and 4.0%, respectively, relative to the flat-rate case over the next 12 months, while a 25 basis point ratable decrease in interest rates would result in a negative variance in net interest income of 1.8% relative to the flat-rate case over the next 12 months. The June 30, 2020 model simulations for increased interest rates were impacted by the assumption, for modeling purposes, that we will begin to pay interest on commercial demand deposits (those not already receiving an earnings credit rate) in the third quarter of 2020, as further discussed below. For modeling purposes, as of June 30, 2019, the model simulations projected that 100 and 200 basis point ratable increases in interest rates would result in positive variances in net interest income of 0.4% and 1.7%, respectively, relative to the flat-rate case over the next 12 months, while 100 and 200 basis point ratable decreases in interest rates would result in negative variances in net interest income of 3.0% and 8.2%, respectively, relative to the flat-rate case over the next 12 months. The June 30, 2019 model simulations for increased interest rates were impacted by the assumption, for modeling purposes, that we would begin to pay interest on commercial demand deposits (those not already receiving an earnings credit rate) in the third quarter of 2019, as further discussed below. The likelihood of a decrease in interest rates beyond 25 basis points as of June 30, 2020 was considered remote given prevailing interest rate levels.

The model simulations as of June 30, 2020 indicate that our projected balance sheet is more asset sensitive in comparison to our balance sheet as of June 30, 2019. The shift to a more asset sensitive position was primarily due to an increase in the relative proportion of interest-bearing deposits and federal funds sold to projected average interest-earning assets. Interest-bearing deposits and federal funds sold are more immediately impacted by changes in interest rates in comparison to our other categories of earning assets. The shift to a more asset sensitive position was also partly due to a decrease in the assumed interest rate paid on projected commercial demand deposits (those not already receiving an earnings credit rate), as further discussed below.

We do not currently pay interest on a significant portion of our commercial demand deposits. Any interest rate that would ultimately be paid on these commercial demand deposits would likely depend upon a variety of factors, some of which are beyond our control. Our modeling simulation as of June 30, 2020 assumed a moderate pricing structure with regards to interest payments on commercial demand deposits (those not already receiving an earnings credit) with interest payments assumed to begin in the third quarter of 2020. This moderate pricing structure on commercial demand deposits assumes a deposit pricing beta of 25%. The pricing beta is a measure of how much deposit rates reprice, up or down, given a defined change in market rates. Our modeling simulation as of June 30, 2019 assumed a much more aggressive pricing structure with regards to interest payments for commercial demand deposits (those not already receiving an earnings credit) with interest payments assumed to begin in the third quarter of 2019. We modified our assumed pricing structure during 2020 compared to 2019 based upon our market observations during the most recent interest rate cycle.

As of June 30, 2020, the effects of a 200 basis point increase and a 25 basis point decrease in interest rates on our derivative holdings would not result in a significant variance in our net interest income.

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

#### **Item 4. Controls and Procedures**

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

## Part II. Other Information

### Item 1. Legal Proceedings

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

### Item 1A. Risk Factors

Refer to the risk factors disclosed under Item 1A. of our 2019 Form 10-K for a discussion of certain material risks and uncertainties that management believed affect our business. The following risk factors are provided to supplement that discussion.

*Our business, financial condition, liquidity and results of operations have been, and will likely continue to be, adversely affected by the COVID-19 pandemic.*

The COVID-19 pandemic has created economic and financial disruptions that have adversely affected, and are likely to continue to adversely affect, our business, financial condition, liquidity and results of operations. The extent to which the COVID-19 pandemic will continue to negatively affect our business, financial condition, liquidity and results of operations will depend on future developments, which are highly uncertain and cannot be predicted, including the scope and duration of the pandemic (including the possibility of resurgence of COVID-19 after initial abatement), the effectiveness of our Business Continuity and Health Emergency Response plans, the direct and indirect impact of the pandemic on our employees, customers, clients, counterparties and service providers, as well as other market participants, and actions taken, or that may yet be taken, or inaction by governmental authorities and other third parties in response to the pandemic.

The COVID-19 pandemic has contributed to:

- Increased unemployment and business disruption and decreased consumer and business confidence and consumer and commercial activity generally, leading to an increased risk of delinquencies, defaults and foreclosures.
- Higher and more volatile credit loss expense and potential for increased charge-offs, particularly as customers may need to draw on their committed credit lines to help finance their businesses and activities.
- Ratings downgrades, credit deterioration and defaults in many industries, particularly energy and natural resources, restaurants, hospitality, entertainment, transportation and commercial real estate.
- A sudden and significant reduction in the valuation of the equity, fixed-income and commodity markets and the significant increase in the volatility of those markets.
- A decrease in the rates and yields on U.S. Treasury securities, which may lead to decreased net interest income.
- Increased demands on capital and liquidity, leading us to cease repurchases of our common stock in order to preserve capital and provide added liquidity.
- A reduction in the value of the assets that we manage or otherwise administer or service for others, affecting related fee income and demand for our services.
- Heightened cybersecurity, information security and operational risks as a result of work-from-home arrangements and impacts on our service providers.

Any disruption to our ability to deliver financial products or services to, or interact with, our clients and customers could result in losses or increased operational costs, regulatory fines, penalties and other sanctions, or harm our reputation.

As noted in the section captioned “Recent Developments Related to COVID-19” in Part I. Financial Information, Item 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations elsewhere in this report, the Federal Reserve has taken various actions and the U.S. government has enacted several fiscal stimulus measures to counteract the economic disruption caused by the COVID-19 pandemic and provide economic assistance to individual households and businesses, stabilize the markets and support economic growth. The success of these measures is unknown and they may not be sufficient to fully mitigate the negative impact of the COVID-19 pandemic. We face an increased risk of litigation and governmental, regulatory and third-party scrutiny as a result of the effects of COVID-19 on market and economic conditions and actions governmental authorities take in response to those conditions. Furthermore, various governmental programs such as the PPP are complex and our participation may lead to additional litigation and governmental, regulatory and third-party scrutiny, negative publicity and damage to our reputation. For example, our participation in the PPP as a lender may adversely affect our revenue and results of operations depending on the timing and amount of forgiveness, if any, to which our borrowers will be entitled.

The length of the pandemic and the efficacy of the extraordinary measures being put in place to address it are unknown. Until the pandemic subsides, we expect continued draws on lines of credit, reduced fee income and revenues related to investment management, insurance and brokerage operations and increased customer and client defaults, including defaults of

unsecured loans. Even after the pandemic subsidies, the U.S. economy may continue to experience a recession, and we anticipate our businesses would be materially and adversely affected by a prolonged recession. To the extent the pandemic adversely affects our business, financial condition, liquidity or results of operations, it may also have the effect of heightening many of the other risks described in the section entitled “Risk Factors” in our 2019 Form 10-K and subsequent Quarterly Reports on Form 10-Q. See the section captioned “Recent Developments Related to COVID-19” in Part I. Financial Information, Item 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations elsewhere in this report for further discussion.

### *We Are Subject To Volatility Risk In Crude Oil Prices*

As of June 30, 2020, we had \$1.4 billion of energy loans which comprised approximately 7.9% of our loan portfolio at that date. Furthermore, energy production and related industries represent a large part of the economies in some of our primary markets. In recent years, actions by certain members of the Organization of Petroleum Exporting Countries (“OPEC”) impacting crude oil production levels have led to increased global oil supplies, which has resulted in significant declines in market oil prices. Decreased market oil prices compressed margins for many U.S. and Texas-based oil producers, particularly those that utilize higher-cost production technologies such as hydraulic fracking and horizontal drilling, as well as oilfield service providers, energy equipment manufacturers and transportation suppliers, among others. In March of 2020, disagreements between members of OPEC signaled that production levels would rise and led to a significant decline in market oil prices. While oil prices have recovered from recent lows, on-going oil price volatility and depressed market oil prices, are expected to continue due to the uncertainties and economic impacts of COVID-19. See the section captioned “Recent Developments Related to COVID-19” in Part I. Financial Information, Item 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations elsewhere in this report for further discussion. The price per barrel of crude oil was approximately \$39 as of June 30, 2020 down from \$61 as of December 31, 2019. We have experienced increased losses within our energy portfolio recently as a result of depressed oil prices and increased oil price volatility, relative to our historical experience. Continued and further depressed oil prices and increased oil price volatility could have further negative impacts on the U.S. economy, in particular, the economies of energy-dominant states such as Texas, and our borrowers and customers.

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

The following table provides information with respect to purchases we made or were made on our behalf or any “affiliated purchaser” (as defined in Rule 10b-18(a)(3) under the Securities Exchange Act of 1934), of our common stock during the three months ended June 30, 2020. Dollar amounts in thousands.

| Period                          | Total Number of<br>Shares Purchased | Average Price<br>Paid Per Share | Total Number of<br>Shares Purchased<br>as Part of Publicly<br>Announced Plan | Maximum<br>Number of Shares<br>(or Approximate<br>Dollar Value)<br>That May Yet Be<br>Purchased Under<br>the Plan at the<br>End of the Period |
|---------------------------------|-------------------------------------|---------------------------------|------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------|
| April 1, 2020 to April 30, 2020 | —                                   | \$ —                            | —                                                                            | \$ 69,153                                                                                                                                     |
| May 1, 2020 to May 31, 2020     | —                                   | —                               | —                                                                            | 69,153                                                                                                                                        |
| June 1, 2020 to June 30, 2020   | —                                   | —                               | —                                                                            | 69,153                                                                                                                                        |
| Total                           | —                                   |                                 | —                                                                            |                                                                                                                                               |

### **Item 3. Defaults Upon Senior Securities**

None.

### **Item 4. Mine Safety Disclosures**

None.

### **Item 5. Other Information**

None.

**Item 6. Exhibits**

## (a) Exhibits

| <b>Exhibit Number</b>  | <b>Description</b>                                                                        |
|------------------------|-------------------------------------------------------------------------------------------|
| 10.1 <sup>(1)</sup>    | <a href="#">Deferred Stock Unit Award Agreement with 11 directors</a>                     |
| 31.1                   | <a href="#">Rule 13a-14(a) Certification of the Corporation's Chief Executive Officer</a> |
| 31.2                   | <a href="#">Rule 13a-14(a) Certification of the Corporation's Chief Financial Officer</a> |
| 32.1 <sup>(2)</sup>    | <a href="#">Section 1350 Certification of the Corporation's Chief Executive Officer</a>   |
| 32.2 <sup>(2)</sup>    | <a href="#">Section 1350 Certification of the Corporation's Chief Financial Officer</a>   |
| 101.INS <sup>(3)</sup> | Inline XBRL Instance Document                                                             |
| 101.SCH                | Inline XBRL Taxonomy Extension Schema Document                                            |
| 101.CAL                | Inline XBRL Taxonomy Extension Calculation Linkbase Document                              |
| 101.DEF                | Inline XBRL Taxonomy Extension Definition Linkbase Document                               |
| 101.LAB                | InlineXBRL Taxonomy Extension Label Linkbase Document                                     |
| 101.PRE                | Inline XBRL Taxonomy Extension Presentation Linkbase Document                             |
| 104 <sup>(4)</sup>     | Cover Page Interactive Data File                                                          |

---

(1) Management contract or compensatory plan or arrangement

(2) This exhibit shall not be deemed “filed” for purposes of Section 18 of the Securities Exchange Act of 1934, or otherwise subject to the liability of that section, and shall not be deemed to be incorporated by reference into any filing under the Securities Act of 1933 or the Securities Exchange Act of 1934.

(3) The instance document does not appear in the interactive data file because its XBRL tags are embedded within the Inline XBRL document.

(4) Formatted as Inline XBRL and contained within the Inline XBRL Instance Document in Exhibit 101.

## Signatures

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

Cullen/Frost Bankers, Inc.

(Registrant)

Date: July 30, 2020

By: /s/ Jerry Salinas

**Jerry Salinas**

**Group Executive Vice President**

**and Chief Financial Officer**

**(Duly Authorized Officer, Principal Financial**

**Officer and Principal Accounting Officer)**

77

[\(Back To Top\)](#)

## Section 2: EX-10.1 (EX-10.1 DEFERRED STOCK UNIT AWARD AGREEMENT)

### Exhibit 10.1

#### Deferred Stock Unit Award Agreement with 11 Directors

Form of Deferred Stock Unit Award Agreements made with the following directors of Cullen/Frost Bankers, Inc.

1. Carlos Alvarez
2. Chris M. Avery
3. Anthony R. Chase
4. Cynthia J. Comparin
5. Samuel G. Dawson
6. Crawford H. Edwards
7. David J. Haemisegger
8. Karen E. Jennings
9. Charles W. Matthews
10. Ida Clement Steen
11. Graham Weston

All of the above agreements are substantially identical in all material respects, except as to the dates of the agreements and the parties thereto.



**Cullen/Frost Bankers, Inc.**  
**2015 OMNIBUS INCENTIVE PLAN (the "Plan")**  
**Deferred Stock Unit Award Agreement**

This Award Agreement sets forth the terms and conditions of an Award of Deferred Stock Units ("DSUs") granted to you under the 2015 OMNIBUS INCENTIVE PLAN (the "Plan") as of [•].

1. The Plan. This Award is made pursuant to the Plan, the terms of which are incorporated in this Award Agreement. Capitalized terms used in this Award Agreement that are not defined in this Award Agreement have the meanings as used or defined in the Plan. References in this Award Agreement to any specific Plan provision shall not be construed as limiting the applicability of any other Plan provision. The Award is subject to all terms and provisions of the Plan as well as the terms and provisions of this Award Agreement.

2. Award. Subject to the terms and provisions of this Agreement and the Plan, Cullen/Frost Bankers, Inc. ("Cullen/Frost") hereby awards you as of the date hereof [•]([•]) Deferred Stock Units. A DSU is an unfunded and unsecured promise of Cullen/Frost to deliver (or cause to be delivered) to you on the Delivery Date (as defined below), one Share for each DSU. Until such delivery, you have only the rights of a general unsecured creditor and no rights as a shareholder of Cullen/Frost.

3. Delivery.

(a) In General. Except as provided below in this Paragraph 3 and under Paragraph 9 hereof, the "Delivery Date" shall be the date when you experience a separation from service with Cullen/Frost. For purposes of this Award Agreement, a "separation from service" shall have the same meaning as ascribed to such term under Section 409A and the applicable regulations thereunder, applying all default provisions thereunder.

(b) Death. If you die before the Delivery Date, the Shares underlying your then-outstanding DSUs shall be delivered to the representative of your estate as soon as practicable after the date of death and after such documentation as may be requested by the Committee is provided to the Committee.

4. Dividend Equivalent Rights. Before the delivery of Shares pursuant to this Award Agreement, at or as soon as practicable after the time of distribution of any regular cash dividend paid by Cullen/Frost in respect of the Common Stock, you shall be entitled to receive an amount in cash or other property equal to such regular cash dividend payment as would have been made in respect of the Shares underlying this Award that have not yet been delivered, as if such Shares had been actually delivered. Each Dividend Equivalent Right shall be subject to the provisions of Article 18 of the Plan.

5. Non-transferability. Except as may otherwise be provided in this paragraph or as otherwise may be provided by the Committee, the limitations set forth in Section 14.1 of the Plan shall apply to this Award. Any purported transfer or assignment in violation of the provisions of this Paragraph or of Section 14.1 of the Plan shall be void. The Committee may adopt procedures pursuant to which you may transfer some or all of your DSUs for no consideration to a person described in Section 14.2 of the Plan.

6. Successors and Assigns of Cullen/Frost. The terms and conditions of this Award Agreement shall be binding upon and shall inure to the benefit of Cullen/Frost and its successors and assigns.

7. Amendment. The Committee reserves the right at any time to amend the terms and conditions set forth in this Award Agreement in any respect in accordance with Article 3 of the Plan, and the Board may amend the Plan in any respect in accordance with Article 21 of the Plan. Notwithstanding the foregoing and Sections 21.2 and 21.4 of the Plan, no such amendment shall materially adversely affect your rights and obligations under this Award Agreement without your consent (or the consent of your estate, if such consent is obtained after your death), except that the Committee reserves the right to accelerate the delivery of the Shares, provided such acceleration would not subject you to additional tax under Section 409A. Any amendment of this Award Agreement shall be in writing signed by an authorized member of the Board or any other person or persons authorized by the Board.

8. Governing Law. **THIS AWARD SHALL BE GOVERNED BY AND CONSTRUED IN ACCORDANCE WITH THE LAWS OF THE STATE OF TEXAS, WITHOUT REGARD TO PRINCIPLES OF CONFLICT OF LAWS.**

9. Compliance of Award Agreement and Plan With Section 409A.

(a) References in this Award Agreement to “Section 409A” refer to Section 409A of the Code, including any amendments or successor provisions to that Section and any regulations and other administrative guidance thereunder, in each case as they may be from time to time amended or interpreted through further administrative guidance. This Award Agreement and the Plan provisions that apply to this Award are intended and shall be construed to comply with Section 409A (including, where applicable, the requirements applicable to and the conditions for exemption from treatment as a “deferral of compensation” or “deferred compensation” as those terms are defined in the regulations under Section 409A (“409A deferred compensation”), whether by reason of short-term deferral treatment or other exceptions or provisions). The Committee shall have full authority to give effect to this intent. To the extent necessary to give effect to this intent, in the case of any conflict or potential inconsistency between the provisions of the Plan and this Award Agreement, the provisions of this Award Agreement shall govern, and in the case of any conflict or potential inconsistency between this Paragraph 9 and the other provisions of this Award Agreement, this Paragraph 9 shall govern.

(b) Except as provided below, delivery of Shares shall be made within 90 days after the Delivery Date.

Notwithstanding the foregoing, if you are determined to be a “specified employee” upon the Delivery Date, delivery of the Shares underlying your Award shall be made on the first day of the seventh month following the Delivery Date.

(c) Notwithstanding any provisions of this Award Agreement or the Plan to the contrary, to the extent necessary to comply with Section 409A, any securities, other Awards or other property that Cullen/Frost may deliver in respect of your DSUs shall not have the effect of deferring delivery or payment, income inclusion, or a substantial risk of forfeiture, beyond the date on which such delivery, payment or inclusion would occur or such risk of forfeiture would lapse, with respect to the Shares that would otherwise have been deliverable (unless the Committee elects a later date for this purpose in a manner otherwise consistent with Section 409A, including, to the extent applicable, the subsequent election provisions of Section 409A(a)(4)(C) of the Code and Treasury Regulations section 1.409A-2(b)).

(d) Notwithstanding the timing provisions of Paragraph 3(b), the delivery of Shares referred to therein shall be made within 90 days after the date of death.

(e) Notwithstanding any provision of Paragraph 4 or Article 18 of the Plan to the contrary, the Dividend Equivalent Rights with respect to each of your outstanding DSUs shall be paid to you within the calendar year in which occurs the date of distribution of any regular cash dividends paid by Cullen/Frost in respect of a Share the record date for which occurs on or after the date of grant. The payment shall be in an amount (less applicable withholding) equal to such regular dividend payment as would have been made in respect of the Shares underlying such outstanding DSUs.

(f) Delivery of Shares in respect of this Award may be made, if and to the extent elected by the Committee, later than the Delivery Date or other date or period specified hereinabove (but, in the case of any Award that constitutes 409A deferred compensation, only to the extent that the later date is permitted under Section 409A).

10. Headings. The headings in this Award Agreement are for the purpose of convenience only and are not intended to define or limit the construction of the provisions hereof.

**IN WITNESS WHEREOF**, Cullen/Frost and you have caused this Award Agreement to be duly executed and delivered.

Date:

CULLEN/FROST BANKERS, INC.

\_\_\_\_\_  
[•], Chairman

Accepted and Agreed:

\_\_\_\_\_  
[•], Director

## Exhibit 31.1

### Rule 13a-14(a) Certification of the Corporation's Chief Executive Officer

**I, Phillip D. Green, certify that:**

1. I have reviewed this Quarterly Report on Form 10-Q of Cullen/Frost Bankers, Inc.;
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.

July 30, 2020

/s/ Phillip D. Green

---

Phillip D. Green  
Chief Executive Officer

[\(Back To Top\)](#)

## Section 4: EX-31.2 (EX-31.2 CHIEF FINANCIAL OFFICER CERTIFICATION)

## Exhibit 31.2

### Rule 13a-14(a) Certification of the Corporation's Chief Financial Officer

**I, Jerry Salinas, certify that:**

1. I have reviewed this Quarterly Report on Form 10-Q of Cullen/Frost Bankers, Inc.;
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.

July 30, 2020

/s/ Jerry Salinas

---

Jerry Salinas  
Group Executive Vice President and Chief Financial Officer

[\(Back To Top\)](#)

## Section 5: EX-32.1 (EX-32.1 CHIEF EXECUTIVE OFFICER SECTION 1350 CERTIFICATION)

### Exhibit 32.1

#### Section 1350 Certification of the Corporation's Chief Executive Officer

Pursuant to Subsections (a) and (b) of Section 1350 of Chapter 63 of Title 18 of the United States Code in accordance with Section 906 of the Sarbanes-Oxley Act of 2002, the undersigned, Phillip D. Green, Chief Executive Officer, of Cullen/Frost Bankers, Inc. (the "Corporation"), hereby certifies, to his knowledge, that the Corporation's Quarterly Report on Form 10-Q for the quarter ended June 30, 2020 (the "Report") fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934, and that the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Corporation.

/s/ Phillip D. Green

---

Phillip D. Green

July 30, 2020

---

*The forgoing certification is being furnished solely pursuant to Subsections (a) and (b) of Section 1350 of Chapter 63 of Title 18 of the United States Code in accordance with Section 906 of the Sarbanes-Oxley Act of 2002 and shall not be deemed "filed" for purposes of Section 18 of the Securities Exchange Act of 1934, or otherwise subject to the liability of that section, and shall not be deemed to be incorporated by reference into any filing under the Securities Act of 1933 or the Securities Exchange Act of 1934.*

[\(Back To Top\)](#)

# Section 6: EX-32.2 (EX-32.2 CHIEF FINANCIAL OFFICER SECTION 1350 CERTIFICATION)

## Exhibit 32.2

### Section 1350 Certification of the Corporation’s Chief Financial Officer

Pursuant to Subsections (a) and (b) of Section 1350 of Chapter 63 of Title 18 of the United States Code in accordance with Section 906 of the Sarbanes-Oxley Act of 2002, the undersigned, Jerry Salinas, Chief Financial Officer, of Cullen/Frost Bankers, Inc. (the “Corporation”), hereby certifies, to his knowledge, that the Corporation’s Quarterly Report on Form 10-Q for the quarter ended June 30, 2020 (the “Report”) fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934, and that the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Corporation.

/s/ Jerry Salinas  
\_\_\_\_\_  
Jerry Salinas

\_\_\_\_\_  
July 30, 2020

*The forgoing certification is being furnished solely pursuant to Subsections (a) and (b) of Section 1350 of Chapter 63 of Title 18 of the United States Code in accordance with Section 906 of the Sarbanes-Oxley Act of 2002 and shall not be deemed “filed” for purposes of Section 18 of the Securities Exchange Act of 1934, or otherwise subject to the liability of that section, and shall not be deemed to be incorporated by reference into any filing under the Securities Act of 1933 or the Securities Exchange Act of 1934.*

([Back To Top](#))