



International Bancshares
Corporation

We do more





INTERNATIONAL BANCSHARES CORPORATION
ALL BANKS MEMBER FDIC
MEMBER BANKS:

International Bank Of Commerce
1200 San Bernardo Avenue
(956) 722-7611

Laredo 7002 San Bernardo Ave. (956) 728-0060 1002 Matamoros (956) 726-6622 1300 Guadalupe (956) 726-6601 2418 Jacaman Rd. (956) 764-6161 5300 San Dario Ste. 440D (956) 728-0063 5300 San Dario Ste. 202 (956) 790-6500 9710 Mines Road (956) 728-0092 4501 San Bernardo (956) 722-0485 7909 McPherson Ave. (956) 728-0064 2442 San Isidro Pkwy (956) 726-6611 2415 S. Zapata Hwy. (956) 728-0061 5610 San Bernardo (956) 726-6688 2320 Bob Bullock Lp 20 (956) 728-0062 4401 Highway 83 South (956) 794-8140 1600 Water Street, Suite B520 (956) 722-7611	11831 Bandera Rd. (210) 369-2980 3119 SE Military Drive (210) 354-6980 327 SW Loop 410 (210) 930-9825 938 SW Military Dr. (210) 930-9815 11002 Culebra (210) 930-9850 Service Center 2416 Cee Gee (210) 821-4700 8770 Tesoro (210) 821-4700 Luling 200 S. Pecan St. (830) 875-2445 Marble Falls 2401 Hwy. 281 North (830) 693-4301 San Marcos 1081 Wonder World (512) 353-1011 Shertz 3800 Hwy 3009 (210) 354-6982 McAllen One S. Broadway (956) 686-0263 7124 N. 23rd. (956) 630-9310 301 S. 10th St. (956) 688-3610 3600 N.10th. St. (956) 688-3690 2200 S. 10th St. (La Plaza East) (956) 688-3670 802 S. Jackson Road (956) 630-9360 2200 S. 10th St. (La Plaza West) (956) 688-3660 2225 Nolana (956) 688-3600 1200 E. Jackson (956) 688-3685 2800 Nolana (956) 688-3620 2900 W. Exp 83 (956) 630-9350	Edinburg 400 S. Clossner (956) 688-3640 4101 S. McColl (956) 630-9337 1724 W. University Dr. Ste. B (956) 688-3680 2205 W. University Dr. (956) 630-9340 Mission 900 N. Bryan Rd. (956) 688-3630 200 E. Griffin Pkwy (956) 632-3512 2410 E. Expressway 83 (956) 688-3625 121 S. Shary Rd. (956) 630-9365 Pharr 401 South Cage (956) 688-3635 1007 North I Rd. (956) 688-3655 Weslaco 606 S. Texas Blvd. (956) 688-3605 1310 N. Texas (956) 937-9500 Hidalgo 1023 S. Bridge (956) 688-3665 San Juan 108 E. FM 495 (956) 630-9320 Palmhurst 215 E. Mile 3 Rd. (956) 688-3675 Penitas 1705 Expressway 83 (956) 630-9347 Corpus Christi 221 S. Shoreline (361) 888-4000 6130 S. Staples (361) 991-4000 4622 Everhart (361) 903-7265 14066 Northwest Blvd. (361) 903-7285 Flour Bluff 1317 Waldron Road (361) 886-9950 Sinton 301 West Sinton (361) 364-1230 Rockport 2701 Hwy. 35 N. (361) 729-0500	Aransas Pass 2501 W. Wheeler Ave. (361) 729-0500 Portland 1800 US Hwy 181 (361) 886-9910 Port Lavaca 311 N. Virginia St. (361) 552-9771 Bay City 1916 7th Street (979) 245-5781 Victoria 6411 N. Navarro (361) 575-8394 Houston 5615 Kirby Dr. (713) 526-1211 8203 S. Kirkwood (713) 285-2165 1001 McKinney Ste. 150 (713) 285-2140 3200 Woodridge, Ste. 1350 (713) 285-2266 3939 Montrose (713) 285-2195 5085 Westheimer Ste. 4640 (713) 285-2296 1545 Eldridge Parkway (713) 285-2042 Richmond 5250 FM 1460 (832) 595-0920 Sugarland 10570 State Hwy 6 (713) 285-2199 Katy 544 West Grand Parkway (713) 285-2037 Lake Jackson 212 That Way (979) 297-2466 Angleton 130 W. Mulberry (979) 849-7711 Freeport 1208 N. Brazosport Blvd. (979) 233-2677 Dickinson 2301 West FM 646 (713) 285-2021 Eagle Pass 2395 E. Main Street (830) 773-2313 2538 E. Main Street (830) 773-2313 439 Main Street (830) 773-2313	2305 Del Rio Blvd. (830) 773-2313 455 S. Bibb Ave. Ste. 502 (830) 773-2313 2135 East Main Street (830) 773-2313 Del Rio 2410 Dodson St. (830) 775-4265 1507 Veterans Blvd (830) 775-4265 2205 Veterans Blvd, Suite E9 (830) 775-4265 Uvalde 3100 E. Hwy. 90 (830) 278-8045 2065 E. Main St. (830) 278-8045 Austin 500 West 5th St. (512) 397-4506 10405 FM 2222 (512) 397-4584 2817 E. Cesar Chavez (512) 320-9650 12625 North IH 35 Bldg. D (512) 397-4570 11400 Burnett Road Bldg. 46 (512) 397-4595 9900 South IH 35 Bldg. Y (512) 397-4530 4025 S. FM 620 (512) 320-9575 First Equity 9606 N. Mopac Expressway Ste 100 (512) 346-8892 Bastrop 701 W. Hwy 71 (512) 308-9412 Cedar Park 301 W. Whitestone Blvd (512) 397-4552 Round Rock 1850 Gattis School Rd. (512) 320-9530 Leander 1695 US Hwy 183 (512) 320-9540 Dallas 3800 Maple Ave. (469) 357-3805 Oklahoma Ardmore 2302 12th Ave. (580) 223-0345
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**International Bank Of Commerce
1200 San Bernardo Avenue
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<p>Broken Arrow 6412 S. Elm Pl. (918) 497-2492</p> <p>8112 Garnett Rd. (918) 497-2840</p> <p>Chickasha 628 Grand Ave. (405) 775-8052</p> <p>Claremore 1050 N. Lynn Riggs Blvd. (918) 497-2456</p> <p>Clinton 1002 W. Frisco Ave. (580) 323-0730</p> <p>Duncan 1006 Main (580) 255-8187</p> <p>2311 N. Hwy 81 (580) 255-9055</p> <p>Edmond 1812 SE 15th St. (405) 775-8061</p> <p>421 S. Santa Fe Ave. (405) 775-8055</p>	<p>Tulsa 2808 E. 101st St. (918) 497-2810</p> <p>1951 S. Yale Ave. (918) 497-2452</p> <p>4202 S. Garnett (918) 497-2880</p> <p>2250 E. 73rd St (918) 497-2400</p> <p>11 E. 5th St. (918) 497-2449</p> <p>8202 E. 71st St (918) 497-2454</p> <p>5302 E. Skelly Dr. (918) 497-2453</p> <p>Chandler 3108 E. First St. (405) 528-2351</p> <p>Oklahoma City 3817 NW Expressway (405) 841-2100</p> <p>100 W. Park Ave. (405) 775-8093</p> <p>5701 N. May Ave. (405) 775-8056</p>	<p>10500 S. Pennsylvania Ave (405) 775-8058</p> <p>2301 N. Portland Ave. (405) 775-8068</p> <p>12241 N. May Ave. (405) 775-8059</p> <p>4902 N. Western Ave. (405) 775-8054</p> <p>14001 N. McArthur Blvd (405) 775-1710</p> <p>Lawton 2101 W. Gore (580) 355-0253</p> <p>6425 NW Cache Rd. (580) 250-4311</p> <p>Miami 2520 N. Main (918) 542-4411</p> <p>Midwest City 2200 S. Douglas Blvd. (405) 775-8057</p> <p>Moore 513 NE 12th (405) 775-8066</p> <p>901 SW 19th (405) 775-1720</p>	<p>Pauls Valley 700 W. Grant Ave. (405) 238-7318</p> <p>Purcell 430 W. Lincoln St. (405) 775-8094</p> <p>Sand Springs 3402 State Hwy. 97 (918) 497-2459</p> <p>Sapulpa 911 E. Taft St. (918) 497-2458</p> <p>Shawnee 2512 N. Harrison Ave. (405) 775-8067</p> <p>Sulphur 2009 W. Broadway Ave. (580) 622-3118</p> <p>Weatherford 109 E. Franklin Ave. (580) 772-7441</p> <p>Stillwater 1900 N. Perkins (405) 372-0889</p> <p>Owasso 9350 N. Garnett (918) 497-2835</p>	<p>Elk City 1504 W. 3rd St. (580) 225-7200</p> <p>Norman 1461 24th Ave. (405) 841-4744</p> <p>Lindsey 209 E. Cherokee (405) 756-4494</p> <p>Muskogee 3143 Azalea Park Drive (918) 682-2300</p> <p>Bixby 11886 S. Memorial (918) 497-2855</p> <p>Bethany 7723 NW 23rd St. (405) 775-8063</p> <p>Grove 100 E. 3rd St. (918)786-4438</p> <p>Guthrie 120 N. Division St. (405) 775-8064</p>
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Laredo, Texas 78041
(956) 724-1616**

2120 Saunders
(956) 724-1616

2302 Blaine St.
(956) 724-1616

1200 Welby Court
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1600 Ruben Torres Blvd
Brownsville, TX 78522-1831
(956) 547-1000**

1623 Central Blvd.
(956) 547-1323

4520 E. 14th St.
(956) 547-1300

79 E. Alton Gloor Blvd
(956) 547-1360

2370 N. Expressway
(956) 547-1380

630 E. Elizabeth St.
(956) 547-1350

3600 W. Alton Gloor Blvd.
(956) 547-1390

South Padre Island
911 Padre Blvd.
(956) 547-1471

Port Isabel
1401 W. Hwy. 100
(956) 943-2108

Harlingen
501 S. Dixieland Rd.
(956) 428-6902

321 S. 77th Sunshine Strip
(956) 428-6454

1801 W. Lincoln
(956)428-4559

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908 N. US Highway 83
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Roma
1702 Grant St.
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Alice
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(956) 487-5531

4534 E. Hwy. 83
(956) 488-6367

4031 E. Hwy 83
(956) 487-5535

Hebronville
401 N. Smith Ave.
(361) 527-2645

Kingsville
1320 General Cavazos Blvd
(361) 516-1040

Freer
405 S. Norton
(361) 661-1211

Beeville
802 E. Houston St.
(361) 358-8700

INTERNATIONAL BANCSHARES CORPORATION AND SUBSIDIARIES
(Consolidated)

The following consolidated selected financial data is derived from the Corporation's audited financial statements as of and for the five years ended December 31, 2017. The following consolidated financial data should be read in conjunction with Management's Discussion and Analysis of Financial Condition and Results of Operations and the Consolidated Financial Statements and related notes in this report.

SELECTED FINANCIAL DATA

	AS OF OR FOR THE YEARS ENDED DECEMBER 31,				
	2017	2016	2015	2014	2013
	(Dollars in Thousands, Except Per Share Data)				
STATEMENT OF CONDITION					
Assets	\$ 12,184,698	\$ 11,804,041	\$ 11,772,869	\$ 12,196,520	\$ 12,079,477
Investment securities available-for-sale	4,154,470	4,177,349	4,199,372	4,911,963	5,304,579
Net loans	6,280,485	5,900,027	5,883,926	5,614,417	5,129,074
Deposits	8,544,892	8,610,089	8,536,253	8,438,625	8,243,425
Other borrowed funds	1,195,225	733,375	505,750	1,073,944	1,223,950
Junior subordinated deferrable interest debentures	160,416	160,416	161,416	175,416	190,726
Shareholders' equity	1,838,980	1,724,667	1,665,503	1,580,658	1,424,408
INCOME STATEMENT					
Interest income	\$ 415,136	\$ 387,914	\$ 396,754	\$ 393,599	\$ 363,217
Interest expense	38,931	43,129	44,317	46,543	54,632
Net interest income	376,205	344,785	352,437	347,056	308,585
Provision for probable loan losses ..	11,221	19,859	24,405	14,423	22,968
Non-interest income	150,406	161,702	155,734	178,348	189,605
Non-interest expense	293,748	289,625	276,924	281,043	292,632
Income before income taxes	221,642	197,003	206,842	229,938	182,590
Income taxes	64,206	63,071	70,116	76,787	56,239
Net income	157,436	133,932	136,726	153,151	126,351
Net income available to common shareholders	<u>\$ 157,436</u>	<u>\$ 133,932</u>	<u>\$ 136,726</u>	<u>\$ 153,151</u>	<u>\$ 126,351</u>
Per common share:					
Basic	\$ 2.38	\$ 2.03	\$ 2.06	\$ 2.29	\$ 1.88
Diluted	\$ 2.36	\$ 2.02	\$ 2.05	\$ 2.28	\$ 1.88

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Management's discussion and analysis represents an explanation of significant changes in the financial position and results of operations of International Bancshares Corporation and its subsidiaries (the "Company" or the "Corporation") on a consolidated basis for the three-year period ended December 31, 2017. The following discussion should be read in conjunction with the Company's Annual Report on Form 10-K for the year ended December 31, 2017, and the Selected Financial Data and Consolidated Financial Statements included elsewhere herein.

Special Cautionary Notice Regarding Forward Looking Information

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

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

- Local, regional, national and international economic business conditions and the impact they may have on the Company, the Company's customers, and such customers' ability to transact profitable business with the Company, including the ability of its borrowers to repay their loans according to their terms or a change in the value of the related collateral.
- Volatility and disruption in national and international financial markets.
- Government intervention in the U.S. financial system.
- The Company relies, in part, on external financing to fund the Company's operations from the FHLB, the Fed and other sources, and the unavailability of such funding sources in the future could adversely impact the Company's growth strategy, prospects and performance.
- Changes in consumer spending, borrowing and saving habits.
- Changes in interest rates and market prices, which could reduce the Company's net interest margins, asset valuations and expense expectations, including, without limitation, the repeal of federal prohibitions on the payment of interest on demand deposits.
- Changes in the capital markets utilized by the Company and its subsidiaries, including changes in the interest rate environment that may reduce margins.
- Changes in state and/or federal laws and regulations to which the Company and its subsidiaries, as well as their customers, competitors and potential competitors, are subject, including, without limitation, the impact of the Consumer Financial Protection Bureau ("CFPB") as a regulator of financial institutions, changes in the accounting, tax and regulatory treatment of trust preferred securities, as well as changes in banking, tax, securities, insurance, employment, environmental and immigration laws and regulations and the risk of litigation that may follow.
- Changes in our liquidity position.
- Changes in U.S.—Mexico trade, including, without limitation, reductions in border crossings and commerce resulting from the Homeland Security Programs called "US-VISIT," which is derived from Section 110 of the Illegal Immigration Reform and Immigrant Responsibility Act of 1996, renegotiation and potential

changes to the North American Free Trade Agreement (“NAFTA”), or the possible imposition of tariffs on imported goods.

- The reduction of deposits from nonresident alien individuals due to the new IRS rules requiring U.S. financial institutions to report to the IRS deposit interest payments made to nonresident alien individuals.
- The loss of senior management or operating personnel.
- Increased competition from both within and outside the banking industry.
- The timing, impact and other uncertainties of the Company’s potential future acquisitions, including the Company’s ability to identify suitable potential future acquisition candidates, the success or failure in the integration of their operations and the Company’s ability to maintain its current branch network and to enter new markets successfully and capitalize on growth opportunities.
- Changes in the Company’s ability to pay dividends on its Common Stock.
- Changes in estimates of future reserve requirements based upon periodic review thereof under relevant regulatory and accounting requirements.
- Additions to the Company’s loan loss allowance as a result of changes in local, national or international conditions which adversely affect the Company’s customers, including, without limitation, lower real estate values, lower oil prices or environmental liability risks associated with foreclosed properties.
- Greater than expected costs or difficulties related to the development and integration of new products and lines of business, including those regulated by the CFPB.
- Increased labor costs and effects related to health care reform and other laws, regulations and legal developments impacting labor costs.
- Impairment of carrying value of goodwill could negatively impact our earnings and capital.
- Changes in the soundness of other financial institutions with which the Company interacts.
- Political instability in the United States or Mexico.
- Technological changes or system failures or breaches of our network security, as well as other cyber security risks, could subject us to increased operating costs, litigation and other liabilities.
- Acts of war or terrorism.
- Natural disasters.
- Reduced earnings resulting from the write down of the carrying value of securities held in our securities available-for-sale portfolio following a determination that the securities are other-than-temporarily impaired.
- The effect of changes in accounting policies and practices as may be adopted by the regulatory agencies, as well as the Public Company Accounting Oversight Board, the Financial Accounting Standards Board and other accounting standards setters.
- The costs and effects of regulatory developments, including the resolution of legal proceedings or regulatory or other governmental inquiries and the results of regulatory examinations or reviews and the ability to obtain required regulatory approvals.
- The effect of final rules amending Regulation E that prohibit financial institutions from charging consumer fees for paying overdrafts on ATM and one-time debit card transactions, unless the consumer consents or opts-in to the overdraft service for those types of transactions, as well as the effect of any other regulatory or legal developments that limit overdraft services.
- The reduction of income and possible increase in required capital levels related to the adoption of legislation, including, without limitation, the Dodd-Frank Regulatory Reform Act (the “Dodd-Frank Act”) and the implementing rules and regulations, including the Federal Reserve’s rule that establishes debit card interchange fee standards and prohibits network exclusivity arrangements and routing restrictions that is negatively affecting interchange revenue from debit card transactions as well as revenue from consumer services.

- The increase in required capital levels related to the implementation of capital and liquidity rules of the federal banking agencies that address or are impacted by the Basel III capital and liquidity standards.
- The enhanced due diligence burden imposed on banks related to the banks' inability to rely on credit ratings under Dodd-Frank, which may result in a limitation on the types of securities certain banks will be able to purchase as a result of the due diligence burden.
- The Company's success at managing the risks involved in the foregoing items, or a failure or circumvention of the Company's internal controls and risk management, policies and procedures.

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

Overview

The Company, which is headquartered in Laredo, Texas, with 192 facilities and 294 ATMs, provides banking services for commercial, consumer and international customers of South, Central and Southeast Texas and the State of Oklahoma. The Company is one of the largest independent commercial bank holding companies headquartered in Texas. The Company, through its bank subsidiaries, is in the business of gathering funds from various sources and investing those funds in order to earn a return. The Company, either directly or through a bank subsidiary, owns one insurance agency, a liquidating subsidiary, and a fifty percent interest in an investment banking unit that owns a broker/dealer. The Company's primary earnings come from the spread between the interest earned on interest-bearing assets and the interest paid on interest-bearing liabilities. In addition, the Company generates income from fees on products offered to commercial, consumer and international customers. The sales team of each of the Company's bank subsidiaries aim to match the right mix of products and services to each customer to best serve the customer's needs. That process entails spending time with customers to assess those needs and servicing the sales arising from those discussions on a long term basis. The bank subsidiaries have various compensation plans, including incentive based compensation, for fairly compensating employees. The bank subsidiaries also have a robust process in place to review sales that support the incentive based compensation plan to monitor the quality of the sales and identify any significant irregularities, a process that has been in place for many years.

A primary goal of the Company is to grow net interest income and non-interest income while adequately managing credit risk, interest rate risk and expenses. Effective management of capital is a critical objective of the Company. A key measure of the performance of a banking institution is the return on average common equity ("ROE"). The Company's ROE for the year ended December 31, 2017 was 8.62% as compared to 7.70% for the year ended December 31, 2016.

The Company is very active in facilitating trade along the United States border with Mexico. The Company does a large amount of business with customers domiciled in Mexico. Deposits from persons and entities domiciled in Mexico comprise a large and stable portion of the deposit base of the Company's bank subsidiaries. The loan policies of the Company's bank subsidiaries generally require that loans to borrowers domiciled in foreign countries be primarily secured by assets located in the United States or have credit enhancements in the form of guarantees, from significant United States corporations. The Company also serves the growing Hispanic population through the Company's facilities located throughout South, Central and Southeast Texas and the State of Oklahoma.

Expense control is an essential element in the Company's long-term profitability. As a result, the Company monitors the efficiency ratio, which is a measure of non-interest expense to net interest income plus non-interest income closely. As the Company adjusts to regulatory changes related to the Dodd-Frank Act, including congressional efforts to revamp or reform it, the Company's efficiency ratio may suffer because the additional regulatory compliance costs are expected to increase non-interest expense. The Company monitors this ratio over time to assess the Company's efficiency relative to its peers. The Company uses this measure as one factor in determining if the Company is accomplishing its long-term goals of providing superior returns to the Company's shareholders.

Results of Operations

Summary

Consolidated Statements of Condition Information

	December 31, 2017	December 31, 2016	Percent Increase (Decrease)
	(Dollars in Thousands)		
Assets	\$ 12,184,698	\$ 11,804,041	3.2 %
Net loans	6,280,485	5,900,027	6.4
Deposits	8,544,892	8,610,089	(0.8)
Securities sold under repurchase agreements	353,805	504,985	(29.9)
Other borrowed funds	1,195,225	733,375	63.0
Junior subordinated deferrable interest debentures	160,416	160,416	—
Shareholders' equity	1,838,980	1,724,667	6.6

Consolidated Statements of Income Information

	Year Ended December 31, 2017	Year Ended December 31, 2016	Percent Increase (Decrease) 2017 vs. 2016	Year Ended December 31, 2015	Percent Increase (Decrease) 2016 vs. 2015
	(Dollars in Thousands, Except Per Share Data)				
Interest income	\$ 415,136	\$ 387,914	7.0 %	\$ 396,754	(2.2)%
Interest expense	38,931	43,129	(9.7)	44,317	(2.7)
Net interest income	376,205	344,785	9.1	352,437	(2.2)
Provision for probable loan losses	11,221	19,859	(43.5)	24,405	(18.6)
Non-interest income	150,406	161,702	(7.0)	155,734	3.8
Non-interest expense	293,748	289,625	1.4	276,924	4.6
Net income	157,436	133,932	17.5	136,726	(2.0)
Per common share:					
Basic	\$ 2.38	\$ 2.03	17.2 %	\$ 2.06	(1.5)%
Diluted	2.36	2.02	16.8	2.05	(1.5)

Net Income

Net income for the year ended December 31, 2017 increased by 17.5% compared to the same period in 2016. Net income for the year ended December 31, 2017 was positively impacted by an increase in net interest income. Net interest income increased as interest income on loans increased due to a higher volume of loans and an increase in the overall yield of the loan portfolio. Interest expense declined primarily due to the effects of the early termination of the long-term repurchase agreements by the lead bank subsidiary in prior years. Net income for the year ended December 31, 2017 was also positively impacted by a decrease in the provision for probable loan losses compared to 2016 and a tax refund received in the second quarter of 2017. The provision for probable loan losses decreased as a result of a decrease in the historical loss experience in the commercial category of the allowance for probable loan loss calculation. As discussed in prior periods, charge-offs had increased due to the deterioration of one relationship that is secured by multiple pieces of transportation equipment beginning in the fourth quarter of 2014. The Company uses a three year historical charge-off experience in the calculation, therefore, as those charge-offs begin to be eliminated from the calculation, the allowance for probable loan losses will be impacted. Net income was also positively impacted by a tax refund of \$4.9 million received in the second quarter as a result of an amended tax return for the 2012 tax year. In September 2014, the Company amended its 2012 federal income tax return as a result of a tax opinion obtained regarding a judgment against the Company paid in 2012 after litigation related to tax matters in the Company's 2004 acquisition of Local Financial Corporation ("LFIN"). Litigation against the Company was initiated by the former controlling shareholders of LFIN with respect to such tax matters. On March 5, 2010, a judgment against the Company was entered on a jury verdict in the U.S. District Court for

the Western District of Oklahoma. The Company subsequently appealed the decision and on January 5, 2012, the United States Court of Appeals Tenth Circuit affirmed the judgment and it became final and unappealable and the Company recorded the majority of the payment of the judgment as a non-deductible expense in the Company's 2012 federal income tax return. The Company engaged legal counsel to review the deductibility of the judgment and, upon receiving the tax opinion, amended the 2012 tax return to report the payment as a deductible expense. The Internal Revenue Service examined the amended return and at the conclusion of the exam, allowed a certain portion of the judgment to be deducted as a necessary and ordinary business expense. Net income for the year ended December 31, 2017 was negatively impacted by a charge of \$5.8 million, \$3.7 million after tax, taken by the lead bank subsidiary in connection with the termination of its long-term repurchase agreements outstanding in order to help manage its long-term funding costs, recorded in the first quarter of 2017. Net income for the year ended December 31, 2016 decreased by 2.0% compared to the same period in 2015 and was negatively impacted by a small decrease in the net interest margin as a result of a decrease in interest income on available-for-sale securities, and an increase in non-interest expense. The decrease in interest income on available-for-sale securities is due to a decrease in the average outstanding balance of such investments. The decrease in the balance is being driven primarily by the lack of available investments in the market that fit the Company's investment profile and investment goals. The increase in non-interest income can be attributed to an increase in income from other investments, which is being positively impacted by the sale of an investment by the merchant banking entities in which the Company holds an equity interest, the Company's share of revenue on a non-financial equity investment it holds accounted for under the equity method of accounting, and insurance proceeds from a policy the lead bank subsidiary had purchased to cover the cost of employee compensation and benefit programs, resulting in income of approximately \$5.0 million, after tax. The increase in non-interest expense can be attributed primarily to a charge of \$7.0 million, \$4.6 million after tax, to unwind a portion of a subsidiary bank's long-term repurchase agreements in order to improve the net interest margin in the long term. Also contributing to the increase is an increase of \$3.9 million, \$2.5 million after tax, in software and software maintenance costs arising from additional investments made by the Company in its network infrastructure.

Net Interest Income

Net interest income is the spread between income on interest-earning assets, such as loans and securities, and the interest expense on liabilities used to fund those assets, such as deposits, repurchase agreements and funds borrowed. Net interest income is the Company's largest source of revenue. Net interest income is affected by both changes in the level of

interest rates and changes in the amount and composition of interest-earning assets and interest-bearing liabilities. Tax-exempt yields have not been adjusted to a tax-equivalent basis.

	For the years ended December 31,		
	2017	2016	2015
	Average	Average	Average
	Rate/Cost	Rate/Cost	Rate/Cost
<i>Assets</i>			
Interest earning assets:			
Loan, net of unearned discounts:			
Domestic	5.27 %	5.06 %	5.14 %
Foreign	3.29	3.28	3.35
Investment securities:			
Taxable	2.08	1.97	2.00
Tax-exempt	4.10	4.08	4.11
Other	0.74	0.24	0.14
Total interest-earning assets	<u>3.97 %</u>	<u>3.75 %</u>	<u>3.73 %</u>
<i>Liabilities</i>			
Interest bearing liabilities:			
Savings and interest bearing demand deposits	0.19 %	0.15 %	0.12 %
Time deposits:			
Domestic	0.46	0.46	0.50
Foreign	0.44	0.41	0.42
Securities sold under repurchase agreements	1.64	2.75	2.72
Other borrowings	1.23	0.49	0.19
Junior subordinated deferrable interest debentures	3.36	2.85	2.40
Total interest bearing liabilities	<u>0.57 %</u>	<u>0.62 %</u>	<u>0.60 %</u>

The level of interest rates and the volume and mix of earning assets and interest-bearing liabilities impact net income and net interest margin. The yield on average interest-earning assets increased 5.9% from 3.75% in 2016 to 3.97% in 2017, and the rates paid on average interest-bearing liabilities decreased 8.1% from 0.62% in 2016 to 0.57% in 2017. The yield on average interest-earning assets increased 0.5% from 3.73% in 2015 to 3.75% in 2016, and the rates paid on average interest-bearing liabilities increased 3.3% from .60% in 2015 to .62% in 2016. The majority of the Company's taxable investment securities are invested in mortgage backed securities and during rapid increases or reduction in interest rates, the yield on these securities do not re-price as quickly as the loans.

The following table analyzes the changes in net interest income during 2017, 2016 and 2015 and the relative effect of changes in interest rates and volumes for each major classification of interest-earning assets and interest-bearing

liabilities. Non-accrual loans have been included in assets for the purpose of this analysis, which reduces the resulting yields:

	2017 compared to 2016			2016 compared to 2015		
	Net increase (decrease) due to			Net increase (decrease) due to		
	Volume ⁽¹⁾	Rate ⁽¹⁾	Total	Volume ⁽¹⁾	Rate ⁽¹⁾	Total
	(Dollars in Thousands)			(Dollars in Thousands)		
Interest earned on:						
Loans, net of unearned discounts:						
Domestic	\$ 12,373	\$ 12,622	\$ 24,995	\$ 6,111	\$ (4,966)	\$ 1,145
Foreign	(325)	18	(307)	(490)	(118)	(608)
Investment securities:						
Taxable	(1,774)	4,588	2,814	(7,188)	(1,287)	(8,475)
Tax-exempt	(764)	64	(700)	(875)	(88)	(963)
Other	1	419	420	(24)	85	61
Total interest income	<u>\$ 9,511</u>	<u>\$ 17,711</u>	<u>\$ 27,222</u>	<u>\$ (2,466)</u>	<u>\$ (6,374)</u>	<u>\$ (8,840)</u>
Interest incurred on:						
Savings and interest bearing demand deposits	\$ 207	\$ 1,439	\$ 1,646	\$ 64	\$ 905	\$ 969
Time deposits:						
Domestic	(433)	61	(372)	(544)	(502)	(1,046)
Foreign	(108)	253	145	(136)	(88)	(224)
Securities sold under repurchase agreements	(9,815)	(4,444)	(14,259)	(3,083)	182	(2,901)
Other borrowings	1,275	6,575	7,850	(432)	1,945	1,513
Junior subordinated deferrable interest						
debentures	(24)	816	792	(230)	731	501
Total interest expense	<u>\$ (8,898)</u>	<u>\$ 4,700</u>	<u>\$ (4,198)</u>	<u>\$ (4,361)</u>	<u>\$ 3,173</u>	<u>\$ (1,188)</u>
Net interest income	<u>\$ 18,409</u>	<u>\$ 13,011</u>	<u>\$ 31,420</u>	<u>\$ 1,895</u>	<u>\$ (9,547)</u>	<u>\$ (7,652)</u>

(1) The change in interest due to both rate and volume has been allocated to volume and rate changes in proportion to the relationship of the absolute dollar amounts of the change in each.

As part of the strategy to manage interest rate risk, the Company strives to manage both assets and liabilities so that interest sensitivities match. One method of calculating interest rate sensitivity is through gap analysis. A gap is the difference between the amount of interest rate sensitive assets and interest rate sensitive liabilities that re-price or mature in a given time period. Positive gaps occur when interest rate sensitive assets exceed interest rate sensitive liabilities, and negative gaps occur when interest rate sensitive liabilities exceed interest rate sensitive assets. A positive gap position in a period of rising interest rates should have a positive effect on net interest income as assets will re-price faster than liabilities. Conversely, net interest income should contract somewhat in a period of falling interest rates. Management can quickly change the Company's interest rate position at any given point in time as market conditions dictate. Additionally, interest rate changes do not affect all categories of assets and liabilities equally or at the same time. Analytical techniques employed by the Company to supplement gap analysis include simulation analysis to quantify interest rate risk exposure. The gap analysis prepared by management is reviewed by the Investment Committee of the Company twice a year. The Investment Committee is comprised of certain members of the board of directors, senior managers of the various Company bank subsidiaries along with consultants. Management currently believes that the Company is properly positioned for interest rate changes; however, if management determines at any time that the Company is not properly positioned, it will strive to adjust the interest rate sensitive assets and liabilities in order to manage the effect of interest rate changes.

The Company has established guidelines for acceptable volatility of projected net interest income on the income simulation analysis and the guidelines are reviewed at least annually. As of December 31, 2017, in rising rate scenarios of +100, +200, +300 and +400 basis points, the guidelines established by management require that the net interest income not vary by more than plus or minus 15%, 15%, 15%, and 20%, respectively and in a decreasing rate scenario of -100 basis points, that the net interest income not vary by more than plus or minus 15%. At December 31, 2017, the income simulations show that a rate shift of -100, +100, +200, +300 and +400 basis points in interest rates up will vary projected net interest income for the coming 12 month period by -3.21%, +4.23%, +8.26%, +12.22% and +15.96%, respectively.

The basis point shift in interest rates is a hypothetical rate scenario used to calibrate risk, and does not necessarily represent management's current view of future market developments. The Company believes that it is properly positioned for a potential interest rate increase or decrease.

Allowance for Probable Loan Loss

The following table presents information concerning the aggregate amount of non-accrual, past due and restructured domestic loans; certain loans may be classified in one or more categories:

	December 31,				
	2017	2016	2015	2014	2013
	(Dollars in Thousands)				
Loans accounted for on a non-accrual basis	\$ 54,730	\$ 36,858	\$ 47,320	\$ 63,559	\$ 62,823
Accruing loans contractually past due ninety days or more as to interest or principal payments	6,590	5,215	11,174	9,988	7,197

The allowance for probable loan losses increased 4.7% to \$67,687,000 at December 31, 2017 from \$64,661,000 at December 31, 2016. The allowance was 1.07% of total loans, net of unearned income at December 31, 2017 and 1.08% at December 31, 2016. The provision for probable loan losses charged to expense decreased \$8,638,000 to \$11,221,000 for the year ended December 31, 2017 from \$19,859,000 for the same period in 2016. The decrease in the provision for probable loan losses charged to expense for the year ended December 31, 2017 can be attributed to a decrease in the historical charge-off experience in the commercial category of the allowance for probable loan loss calculation. As discussed in prior periods, charge-offs had increased due to the deterioration of one relationship that is secured by multiple pieces of transportation equipment beginning in the fourth quarter of 2014. The Company uses a three year historical charge-off experience in the calculation, therefore, as those charge-offs begin to be eliminated from the calculation, the allowance for probable loan losses will be impacted. The decrease in the provision for probable loan losses charged to expense for the year ended December 31, 2016 can be attributed to two large recoveries on loans that had been charged off in prior years of approximately \$10.4 million. The recoveries positively impacted the balance in the allowance for probable loan losses and resulted in a decrease to provision expense. The increase in the provision for probable loan losses charged to expense for the year ended December 31, 2015 can be attributed to an increase in the portion of the allowance for probable loan losses calculated based on actual historical loss experience in the commercial loan category of the Company's loan portfolio. The decrease in the allowance at December 31, 2014 compared to the same period in 2013 is due to a charge down in an impaired commercial relationship that is mainly secured by multiple pieces of transportation equipment, the value of which fluctuates due to market factors and the amount of use of the equipment. The provision for probable loan losses charged to expense decreased for the year ended December 31, 2014 compared to the same period in 2013 partially due to a specific reserve added in 2013 for the relationship that is mainly secured by multiple pieces of transportation equipment.

The following table details loans accounted for as “troubled debt restructuring,” segregated by loan class. Loans accounted for as troubled debt restructuring are included in impaired loans. See Note 1 to the Consolidated Financial Statements.

	<u>December 31,</u> <u>2017</u>	<u>December 31,</u> <u>2016</u>
	(Dollars in Thousands)	
Domestic		
Commercial	\$ 6,910	\$ 10,710
Commercial real estate: farmland & commercial	—	3,086
Residential: first lien	6,140	6,181
Residential: junior lien	712	812
Consumer	1,237	1,269
Foreign	347	360
Total troubled debt restructuring	<u>\$ 15,346</u>	<u>\$ 22,418</u>

The following table presents information concerning the aggregate amount of non-accrual and past due foreign loans extended to persons or entities in foreign countries. Certain loans may be classified in one or more category:

	<u>December 31,</u>				
	<u>2017</u>	<u>2016</u>	<u>2015</u>	<u>2014</u>	<u>2013</u>
	(Dollars in Thousands)				
Loans accounted for on a non-accrual basis	\$ —	\$ 387	\$ 365	\$ —	\$ —
Accruing loans contractually past due ninety days or more as to interest or principal payments	667	11	442	—	—

The gross income that would have been recorded during 2017, 2016 and 2015 on non-accrual loans in accordance with their original contract terms was approximately \$977,000, \$2,438,000 and \$3,279,000 on domestic loans and approximately \$0, \$23,800, and \$19,000 on foreign loans, respectively. The amount of interest income on such loans that was recognized in 2017, 2016 and 2015 was approximately \$4,000, \$0, and \$844,000 on domestic loans and \$0, \$0, and \$0 for foreign loans, respectively.

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 applicable regulatory guidelines. Interest income on non-accrual loans is recognized only to the extent payments are received or when, in management’s opinion, the creditor’s financial condition warrants reestablishment of interest accruals. Under special circumstances, a loan may be more than 90 days delinquent as to interest or principal and not be placed on non-accrual status. This situation generally results when a bank subsidiary has a borrower who is experiencing financial difficulties, but not to the extent that requires a restructuring of indebtedness. The majority of this category is composed of loans that are considered to be adequately secured and/or for which there has been a recent history of payments. When a loan is placed on non-accrual status, any interest accrued, not paid, is reversed and charged to operations against interest income.

Loan commitments, consisting of unused commitments to lend, letters of credit, credit card lines and other approved loans, that have not been funded, were approximately \$2,915,326,000 and \$2,262,717,000 at December 31, 2017 and 2016, respectively. See Note 19 to the Consolidated Financial Statements.

The following table summarizes loan balances at the end of each year and average loans outstanding during the year; changes in the allowance for probable loan losses arising from loans charged-off and recoveries on loans previously charged-off by loan category; and additions to the allowance which have been charged to expense:

	<u>2017</u>	<u>2016</u>	<u>2015</u>	<u>2014</u>	<u>2013</u>
	(Dollars in Thousands)				
Loans, net of unearned discounts, outstanding at December 31.	<u>\$ 6,348,172</u>	<u>\$ 5,964,688</u>	<u>\$ 5,950,914</u>	<u>\$ 5,679,245</u>	<u>\$ 5,199,235</u>
Average loans outstanding during the year ⁽¹⁾	<u>\$ 6,183,864</u>	<u>\$ 5,949,048</u>	<u>\$ 5,844,842</u>	<u>\$ 5,491,841</u>	<u>\$ 4,978,833</u>
Balance of allowance at January 1	\$ 64,661	\$ 66,988	\$ 64,828	\$ 70,161	\$ 58,193
Provision charged to expense.	11,221	19,859	24,405	14,423	22,968
Loans charged off:					
Domestic:					
Commercial, financial and agricultural.	(12,134)	(35,029)	(25,294)	(21,003)	(12,342)
Real estate—mortgage	(441)	(401)	(432)	(1,012)	(1,252)
Real estate—construction	(213)	(16)	(695)	(680)	(278)
Consumer.	(309)	(414)	(704)	(719)	(561)
Foreign.	(1)	(41)	—	(51)	(22)
Total loans charged off.	<u>(13,098)</u>	<u>(35,901)</u>	<u>(27,125)</u>	<u>(23,465)</u>	<u>(14,455)</u>
Recoveries credited to allowance:					
Domestic:					
Commercial, financial and agricultural.	4,547	7,229	4,098	3,086	2,842
Real estate—mortgage	269	299	461	291	359
Real estate—construction	21	6,099	141	72	87
Consumer.	45	69	170	210	162
Foreign.	21	19	10	50	5
Total recoveries	<u>4,903</u>	<u>13,715</u>	<u>4,880</u>	<u>3,709</u>	<u>3,455</u>
Net loans charged off.	<u>(8,195)</u>	<u>(22,186)</u>	<u>(22,245)</u>	<u>(19,756)</u>	<u>(11,000)</u>
Balance of allowance at December 31.	<u>\$ 67,687</u>	<u>\$ 64,661</u>	<u>\$ 66,988</u>	<u>\$ 64,828</u>	<u>\$ 70,161</u>
Ratio of net loans charged-off during the year to average loans outstanding during the year ⁽¹⁾	<u>0.13 %</u>	<u>0.37 %</u>	<u>0.38 %</u>	<u>0.36 %</u>	<u>0.22 %</u>
Ratio of allowance to loans, net of unearned discounts, outstanding at December 31.	<u>1.07 %</u>	<u>1.08 %</u>	<u>1.13 %</u>	<u>1.14 %</u>	<u>1.35 %</u>

(1) The average balances for purposes of the above table are calculated on the basis of daily balances.

The allowance for probable loan losses has been allocated based on the amount management has deemed to be reasonably necessary to provide for the probable losses incurred within the following categories of loans at the dates indicated and the percentage of loans to total loans in each category:

	At December 31,									
	2017		2016		2015		2014		2013	
	Allowance	Percent of total	Allowance	Percent of total	Allowance	Percent of total	Allowance	Percent of total	Allowance	Percent of total
	(Dollars in Thousands)									
Commercial, Financial and Agricultural	\$ 35,885	52.3 %	\$ 32,928	50.2 %	\$ 35,379	52.1 %	\$ 41,881	54.7 %	\$ 47,676	55.7 %
Real estate—Mortgage	12,242	17.9	11,355	17.3	10,979	16.2	8,272	16.0	8,061	16.3
Real estate—Construction	18,183	26.5	18,887	28.8	18,818	27.7	12,955	24.9	12,541	23.2
Consumer	535	0.8	607	0.9	659	1.0	660	1.1	750	1.3
Foreign	842	2.5	884	2.8	1,152	3.0	1,060	3.3	1,133	3.5
	<u>\$ 67,687</u>	<u>100.0 %</u>	<u>\$ 64,661</u>	<u>100.0 %</u>	<u>\$ 66,988</u>	<u>100.0 %</u>	<u>\$ 64,828</u>	<u>100.0 %</u>	<u>\$ 70,161</u>	<u>100.0 %</u>

The allowance for probable loan losses primarily consists of the aggregate loan loss allowances of the bank subsidiaries. The allowances are established through charges to operations in the form of provisions for probable loan losses.

The bank subsidiaries charge off that portion of any loan which management considers to represent a loss as well as that portion of any other loan which is classified as a “loss” by bank examiners. Commercial, financial and agricultural or real estate loans are generally considered by management to represent a loss, in whole or part, (i) when an exposure beyond any collateral coverage is apparent, (ii) when no further collection of the portion of the loan so exposed is anticipated based on actual results, (iii) when the credit enhancements, if any, are not adequate, and (iv) when the borrower’s financial condition would indicate so. Generally, unsecured consumer loans are charged off when 90 days past due. The decrease in charge-offs for the year ended December 31, 2017 can be attributed to the increases experienced in 2016. As discussed in prior periods, charge-offs had increased due to the deterioration of one relationship that is secured by multiple pieces of transportation equipment beginning in the fourth quarter of 2014 and increased charge-offs for the twelve months ended December 31, 2016 and December 31, 2015. In March 2016, litigation against the management of the borrower was filed in the State of Nevada, resulting in a going concern issue with the borrower’s operations and the future use of the transportation equipment pledged as collateral on the relationship. As a result, management, in accordance with its credit review procedures, re-evaluated the collateral values on the equipment in light of the new circumstances and reduced the collateral values accordingly, resulting in a further charge-down of the relationship of approximately \$19.4 million, which is included in the losses charged to the allowance in the commercial category in the table detailing the activity for the twelve months ended December 31, 2016. The same relationship had been previously charged down in the years ended December 31, 2015 and 2014. Two large recoveries on loans charged off in prior years are included in the recoveries credited to the allowance in the table detailing activity for the year ended December 31, 2016. The recoveries occurred in the first and third quarters of 2016 in the amounts of \$4.4 million and \$6 million, respectively, and are included in the Commercial and Commercial Real Estate: Other Construction and Land Development categories. The increase in charge-offs for the years ended December 31, 2015 and 2014 in the Commercial category can be attributed to a charge down of a relationship that is primarily secured by multiple pieces of transportation equipment. The relationship was charged down by \$13.5 million and \$8.5 million for the years ended December 31, 2015 and December 31, 2014, respectively.

The allowance for probable loan losses is a reserve established through a provision for probable loan losses charged to expense, which represents management’s best estimate of probable loan losses within the existing portfolio of loans. The Company’s allowance for probable loan loss methodology is based on guidance provided in Securities and Exchange Commission Staff Accounting Bulletin No. 102, “Selected Loan Loss Allowance Methodology and Documentation Issues” and includes allowance allocations calculated in accordance with ASC 310, “Receivables” and ASC 450, “Contingencies.” The reserve allocated to loans individually evaluated for impairment at December 31, 2017 can be primarily attributed to a relationship secured by a water park that is impaired at December 31, 2017. The reserve

allocated to loans individually evaluated for impairment at December 31, 2016 can be primarily attributed to the charge-down of the above discussed relationship secured by multiple pieces of transportation equipment. The reserve allocated to loans individually evaluated for impairment at December 31, 2015 decreased approximately \$10.0 million, primarily as a result of a charge down in the above described relationship secured by multiple pieces of transportation equipment. The reserve allocated to loans collectively evaluated for impairment at December 31, 2015 increased approximately \$12.0 million and can be attributed to an increase in the actual historical charge-off experience in the commercial loan category of the calculation. The reserve allocated by categories shows an overall decrease of \$5.3 million from December 31, 2013 to December 31, 2014. The decrease for the year ended December 31, 2014 compared to the year ended December 31, 2013 is partially due to a charge down in the above-described relationship secured by multiple pieces of transportation equipment. Please refer to Note 4—Allowance for Probable Loan Losses in the accompanying Notes to the consolidated Financial Statements.

While management of the Company considers that it is generally able to identify borrowers with financial problems reasonably early and to monitor credit extended to such borrowers carefully, there is no precise method of predicting loan losses. The determination that a loan is likely to be uncollectible and that it should be wholly or partially charged off as a loss is an exercise of judgment. Similarly, the determination of the adequacy of the allowance for probable loan losses can be made only on a subjective basis. It is the judgment of the Company's management that the allowance for probable loan losses at December 31, 2017 was adequate to absorb probable losses from loans in the portfolio at that date. See Critical Accounting Policies on page 25. Should any of the factors considered by management in evaluating the adequacy of the allowance for probable loan losses change, the Company's estimate of probable loan losses could also change, which could affect the level of future provisions for probable loan losses.

Non-Interest Income

	Year Ended December 31, 2017	Year Ended December 31, 2016	Percent Increase (Decrease) 2017 vs. 2016	Year Ended December 31, 2015	Percent Increase (Decrease) 2016 vs. 2015
(Dollars in Thousands)					
Service charges on deposit accounts	\$ 72,868	\$ 73,581	(1.0)%	\$ 78,825	(6.7)%
Other service charges, commissions and fees					
Banking	44,964	46,267	(2.8)	44,971	2.9
Non-banking	7,345	7,006	4.8	7,223	(3.0)
Investment securities transactions, net.	(4,774)	(2,626)	81.8	(3,682)	(28.7)
Other investments, net.	18,918	23,827	(20.6)	16,969	40.4
Other income	11,085	13,647	(18.8)	11,428	19.4
Total non-interest income	<u>\$ 150,406</u>	<u>\$ 161,702</u>	<u>(7.0)%</u>	<u>\$ 155,734</u>	<u>3.8 %</u>

Total non-interest income for the year ended December 31, 2017 decreased by 7.0% compared to the same period of 2016. The decrease in total non-interest income for the year ended December 31, 2017 can be attributed to an increase in losses recognized on the sales of certain available-for-sale investment securities in 2017 to re-position a portion of the Company's investment portfolio and to certain non-recurring items recorded in 2016. Total non-interest income for the year ended December 31, 2016 increased by 3.8% compared to the same period of 2015. The increase in non-interest income for the year ended December 31, 2016 compared to the same period of 2015 can be attributed to an increase in income from other investments, which is being positively impacted by the sale of an investment by the merchant banking entities in which the Company holds an equity interest, the Company's share of revenue on a non-financial equity investment it holds accounted for under the equity method of accounting, and insurance proceeds from a policy the lead bank subsidiary had purchased to cover the cost of employee compensation and benefit programs, resulting in income of approximately \$7.8 million. Non-interest income was negatively impacted by a decrease in service charges on deposits for the year ended December 31, 2016 compared to the same period of 2015 and can be attributed to a decrease in the volume of overdraft charges on deposit accounts.

Non-Interest Expense

	Year Ended December 31, 2017	Year Ended December 31, 2016	Percent Increase (Decrease) 2017 vs. 2016	Year Ended December 31, 2015	Percent Increase (Decrease) 2016 vs. 2015
(Dollars in Thousands)					
Employee compensation and benefits	\$ 132,750	\$ 128,661	3.2 %	\$ 125,135	2.8 %
Occupancy	28,439	26,583	7.0	28,019	(5.1)
Depreciation of bank premises and equipment . .	25,281	24,738	2.2	25,009	(1.1)
Professional fees	13,650	13,672	(0.2)	12,278	11.4
Deposit insurance assessments	3,294	5,777	(43.0)	5,938	(2.7)
Net expense, other real estate owned	965	5,688	(83.0)	5,695	(0.1)
Amortization of identified intangible assets . . .	25	128	(80.5)	644	(80.1)
Advertising	7,854	7,814	0.5	7,585	3.0
Early termination fee—securities sold under repurchase agreements	5,765	7,042	(18.1)	3,510	100.6
Software and software maintenance	19,189	15,087	27.2	11,225	34.4
Impairment charges (Total other-than- temporary impairment charges, \$0 net of \$0, \$793 net of \$1,147, and \$371, net of \$1,325, included in other comprehensive loss)	—	354	(100.0)	954	(62.9)
Other	56,536	54,081	4.5	50,932	6.2
Total non-interest expense	<u>\$ 293,748</u>	<u>\$ 289,625</u>	<u>1.4 %</u>	<u>\$ 276,924</u>	<u>4.6 %</u>

Non-interest expense for the year ended December 31, 2017 increased 1.4% compared to the same period of 2016. Non-interest expense for 2017 was positively impacted by a decrease in deposit insurance assessments arising from a decrease in the assessment rate set by the FDIC of \$2.4 million and a decrease in the net cost of operations on other real estate owned as the size of the portfolio has decreased from prior periods. Non-interest expense for the period was negatively impacted by increased technology costs related to certain network infrastructure modifications of \$4.1 million for the year ended December 31, 2017 compared to the same period of 2016. Non-interest expense increased 4.6% for the year ended December 31, 2016 compared to the same period of 2015. Non-interest expense for the twelve months ended December 31, 2017, 2016 and 2015 was negatively impacted by charges of \$5.8 million, \$7.0 million, and \$3.5 million, respectively, recorded by the Company's lead bank subsidiary related to the termination of a portion of its long-term repurchase agreements outstanding in order to help manage its long-term funding costs. Non-interest expense for the year ended December 31, 2016 was negatively impacted by an increase of \$3.9 million in software and software maintenance costs arising from additional investments made by the Company in its network infrastructure.

Effects of Inflation

The principal component of earnings is net interest income, which is affected by changes in the level of interest rates. Changes in rates of inflation affect interest rates. It is difficult to precisely measure the impact of inflation on net interest income because it is not possible to accurately differentiate between increases in net interest income resulting from inflation and increases resulting from increased business activity. Inflation also raises costs of operations, primarily those of employment and services.

Financial Condition

Investment Securities

The following table sets forth the carrying value of investment securities as of December 31, 2017, 2016 and 2015:

	December 31,		
	2017	2016	2015
	(Dollars in Thousands)		
Residential mortgage-backed securities			
Available for sale	\$ 3,891,233	\$ 3,894,470	\$ 3,893,211
Obligations of states and political subdivisions			
Available for sale	232,951	254,972	277,704
Equity securities			
Available for sale	27,886	27,907	28,457
Other securities			
Held to maturity	2,400	2,400	2,400
Total	<u>\$ 4,154,470</u>	<u>\$ 4,179,749</u>	<u>\$ 4,201,772</u>

The following tables set forth the contractual maturities of investment securities, based on amortized cost, at December 31, 2017 and the average yields of such securities, except for the totals, which reflect the weighted average yields. Actual maturities will differ from contractual maturities because borrowers may have the right to prepay obligations with or without prepayment penalties.

	Available for Sale Maturing							
	Within one year		After one but within five years		After five but within ten years		After ten years	
	Adjusted		Adjusted		Adjusted		Adjusted	
	Cost	Yield	Cost	Yield	Cost	Yield	Cost	Yield
	(Dollars in Thousands)							
Residential mortgage-backed securities	\$ 765	4.97 %	\$ 8,357	4.44 %	1,188,698	2.80 %	\$ 2,745,272	2.71 %
Obligations of states and political subdivisions	—	—	—	—	1,939	4.75 %	223,157	4.62 %
Equity securities	28,075	2.24	—	—	—	—	—	— %
Total	<u>\$ 28,840</u>	<u>2.31 %</u>	<u>\$ 8,357</u>	<u>4.44 %</u>	<u>\$ 1,190,637</u>	<u>2.80 %</u>	<u>\$ 2,968,429</u>	<u>2.86 %</u>

	Held to Maturity Maturing							
	Within one year		After one but within five years		After five but within ten years		After ten years	
	Adjusted		Adjusted		Adjusted		Adjusted	
	Cost	Yield	Cost	Yield	Cost	Yield	Cost	Yield
	(Dollars in Thousands)							
Other securities	\$ 2,275	1.79 %	\$ 125	2.59 %	\$ —	— %	\$ —	— %
Total	<u>\$ 2,275</u>	<u>1.79 %</u>	<u>\$ 125</u>	<u>2.59 %</u>	<u>\$ —</u>	<u>— %</u>	<u>\$ —</u>	<u>— %</u>

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

by the federal government in 2008 and because securities issued by others that are collateralized by residential mortgage-backed securities issued by Fannie Mae or Freddie Mac are rated consistently as AAA rated securities.

Loans

The amounts of loans outstanding, by classification, at December 31, 2017, 2016, 2015, 2014 and 2013 are shown in the following table:

	December 31,				
	2017	2016	2015	2014	2013
	(Dollars in Thousands)				
Commercial, financial and agricultural . . .	\$ 3,322,668	\$ 2,993,203	\$ 3,101,748	\$ 3,107,584	\$ 2,894,779
Real estate—mortgage	1,133,525	1,032,222	962,582	910,326	847,692
Real estate—construction	1,683,550	1,716,875	1,649,827	1,414,977	1,208,508
Consumer	49,543	55,168	57,744	61,137	66,414
Foreign	158,886	167,220	179,013	185,221	181,842
Loans, net of unearned discount	<u>\$ 6,348,172</u>	<u>\$ 5,964,688</u>	<u>\$ 5,950,914</u>	<u>\$ 5,679,245</u>	<u>\$ 5,199,235</u>

The following table shows the amounts of loans (excluding real estate mortgages and consumer loans) outstanding as of December 31, 2017, which based on remaining scheduled repayments of principal are due in the years indicated. Also, the amounts due after one year are classified according to the sensitivity to changes in interest rates:

	Maturing			
	Within one year	After one but within five years	After five years	Total
	(Dollars in Thousands)			
Commercial, financial and agricultural	\$ 1,057,717	\$ 1,906,691	\$ 358,260	\$ 3,322,668
Real estate—construction	644,902	946,370	92,278	1,683,550
Foreign	113,179	29,230	16,477	158,886
Total	<u>\$ 1,815,798</u>	<u>\$ 2,882,291</u>	<u>\$ 467,015</u>	<u>\$ 5,165,104</u>

	Interest sensitivity	
	Fixed Rate	Variable Rate
	(Dollars in Thousands)	
Due after one but within five years	\$ 176,695	\$ 2,705,596
Due after five years	88,736	378,279
Total	<u>\$ 265,431</u>	<u>\$ 3,083,875</u>

International Operations

On December 31, 2017, the Company had \$158,886,000 (1.3% of total assets) in loans outstanding to borrowers domiciled in foreign countries, which included primarily borrowers domiciled in Mexico. The loan policies of the Company's bank subsidiaries generally require that loans to borrowers domiciled in foreign countries be primarily secured by assets located in the United States or have credit enhancements in the form of guarantees, from significant United States

corporations. The composition of such loans and the related amounts of allocated allowance for probable loan losses as of December 31, 2017 and 2016 is presented below.

	For the year ended December 31,			
	2017		2016	
	Amount of Loans	Related Allowance for Probable Losses	Amount of Loans	Related Allowance for Probable Losses
	(Dollars in Thousands)			
Secured by certificates of deposit in United States banks .	\$ 103,104	\$ 330	\$ 110,036	\$ 351
Secured by United States real estate	35,211	334	30,561	218
Secured by other United States collateral (securities, gold, silver, etc.)	14,414	68	16,985	103
Unsecured	1,561	32	848	19
Other (principally Mexico real estate)	4,596	78	8,790	193
	<u>\$ 158,886</u>	<u>\$ 842</u>	<u>\$ 167,220</u>	<u>\$ 884</u>

The transactions for the years ended December 31, 2017, 2016 and 2015, in that portion of the allowance for probable loan losses related to foreign debt were as follows:

	2017	2016	2015
	(Dollars in Thousands)		
Balance at January 1,	\$ 884	\$ 1,152	\$ 1,060
Charge-offs	(1)	(41)	—
Recoveries	21	19	10
Net charge-offs	20	(22)	10
Charge (credit) to expense	(62)	(246)	82
Balance at December 31	<u>\$ 842</u>	<u>\$ 884</u>	<u>\$ 1,152</u>

Deposits

	<u>2017</u>	<u>2016</u>
	<u>Average Balance</u>	<u>Average Balance</u>
	(Dollars in Thousands)	
Deposits:		
Demand—non-interest bearing		
Domestic	\$ 2,572,636	\$ 2,504,360
Foreign	658,072	644,230
Total demand non-interest bearing	<u>3,230,708</u>	<u>3,148,590</u>
Savings and interest bearing demand		
Domestic	2,612,981	2,504,369
Foreign	617,482	585,986
Total savings and interest bearing demand	<u>3,230,463</u>	<u>3,090,355</u>
Time certificates of deposit		
\$100,000 or more:		
Domestic	702,417	760,014
Foreign	833,444	843,145
Less than \$100,000:		
Domestic	371,782	409,142
Foreign	263,796	280,170
Total time, certificates of deposit	<u>2,171,439</u>	<u>2,292,471</u>
Total deposits	<u>\$ 8,632,610</u>	<u>\$ 8,531,416</u>

	<u>2017</u>	<u>2016</u>	<u>2015</u>
	(Dollars in Thousands)		
Interest expense:			
Savings and interest bearing demand			
Domestic	\$ 5,453	\$ 3,922	\$ 3,026
Foreign	755	640	567
Total savings and interest bearing demand	<u>6,208</u>	<u>4,562</u>	<u>3,593</u>
Time, certificates of deposit			
\$100,000 or more			
Domestic	3,644	3,881	4,693
Foreign	4,105	3,929	4,116
Less than \$100,000			
Domestic	1,312	1,447	1,680
Foreign	675	706	744
Total time, certificates of deposit	<u>9,736</u>	<u>9,963</u>	<u>11,233</u>
Total interest expense on deposits	<u>\$ 15,944</u>	<u>\$ 14,525</u>	<u>\$ 14,826</u>

Scheduled maturities of time deposits in amounts of \$100,000 or more at December 31, 2017, were as follows:

Due within 3 months or less	\$ 557,206
Due after 3 months and within 6 months	348,695
Due after 6 months and within 12 months	404,776
Due after 12 months	135,210
	<u>\$ 1,445,887</u>

The Company offers a variety of deposit accounts having a wide range of interest rates and terms. The Company relies primarily on its high quality customer service, sales programs, customer referrals and advertising to attract and retain these deposits. Deposits provide the primary source of funding for the Company's lending and investment activities, and the interest paid for deposits must be managed carefully to control the level of interest expense. Deposits at December 31,

2017 were \$8,544,892,000, a decrease of 0.8% from \$8,610,089,000 at December 31, 2016. Although deposits at December 31, 2017 remained relatively consistent with 2016 levels, the Company has experienced growth in deposits over the last few years. The Company is still experiencing a substantial amount of competition for deposits at higher than market rates. As a result, the Company has attempted to maintain certain deposit relationships, but has allowed certain deposits to leave as the result of aggressive pricing by competitors.

Other Borrowed Funds

Other borrowed funds include FHLB borrowings which are short-term and long-term borrowings issued by the FHLB of Dallas at the market price offered at the time of funding. These borrowings are secured by residential mortgage-backed investment securities and a portion of the Company's loan portfolio. At December 31, 2017, other borrowed funds totaled \$1,195,225,000, an increase of 63.0% from \$733,375,000 at December 31, 2016. The increase in borrowings can be attributed to cash needs to fund daily operations, purchases of available-for-sale securities and the termination of a portion of the lead bank subsidiary's long-term outstanding repurchase agreements.

Return on Equity and Assets

Certain key ratios for the Company for the years ended December 31, 2017, 2016 and 2015 follows ⁽¹⁾:

	Years ended December 31,		
	2017	2016	2015
Percentage of net income to:			
Average shareholders' equity	8.62 %	7.70 %	8.44 %
Average total assets	1.31	1.12	1.13
Percentage of average shareholders' equity to average total assets.....	15.19	14.60	13.35
Percentage of cash dividends per share to net income per share	27.70	29.56	28.12

⁽¹⁾ The average balances for purposes of the above table are calculated on the basis of daily balances.

Liquidity and Capital Resources

Liquidity

The maintenance of adequate liquidity provides the Company's bank subsidiaries with the ability to meet potential depositor withdrawals, provide for customer credit needs, maintain adequate statutory reserve levels and take full advantage of high-yield investment opportunities as they arise. Liquidity is afforded by access to financial markets and by holding appropriate amounts of liquid assets. The Company's bank subsidiaries derive their liquidity largely from deposits of individuals and business entities. Such deposits comprised approximately 27%, 28%, and 27% of the Company's bank subsidiaries' total deposits at each of the years ended December 31, 2017, 2016 and 2015, respectively. Other important funding sources for the Company's bank subsidiaries during 2017 and 2016 were borrowings from the FHLB, securities sold under repurchase agreements and large certificates of deposit, requiring management to closely monitor its asset/liability mix in terms of both rate sensitivity and maturity distribution. The Company's bank subsidiaries have had a long-standing relationship with the FHLB and keep open, unused, lines of credit in order to fund liquidity needs. In the event that the FHLB indebtedness is not renewed, the repayment of the outstanding indebtedness would more than likely be repaid through proceeds generated from the sales of unpledged available-for-sale securities. The Company maintains a sizable, high quality investment portfolio to provide significant liquidity. These securities can be sold or sold under agreements to repurchase, to provide immediate liquidity. As in the past, the Company will continue to monitor the volatility and cost of funds in an attempt to match maturities of rate-sensitive assets and liabilities and respond accordingly to anticipated fluctuations in interest rates over reasonable periods of time.

Asset/Liability Management

The Company's fund management policy has as its primary focus the measurement and management of the banks' earnings at risk in the face of rising or falling interest rate forecasts. The earliest and most simplistic concept of earnings at risk measurement is the gap report, which is used to generate a rough estimate of the vulnerability of net interest income to changes in market rates as implied by the relative re-pricings of assets and liabilities. The gap report calculates the difference between the amounts of assets and liabilities re-pricing across a series of intervals in time, with emphasis typically placed on the one-year period. This difference, or gap, is usually expressed as a percentage of total assets.

If an excess of liabilities over assets matures or re-prices within the one-year period, the statement of condition is said to be negatively gapped. This condition is sometimes interpreted to suggest that an institution is liability-sensitive, indicating that earnings would suffer from rising rates and benefit from falling rates. If a surplus of assets over liabilities occurs in the one-year time frame, the statement of condition is said to be positively gapped, suggesting a condition of asset sensitivity in which earnings would benefit from rising rates and suffer from falling rates.

The gap report thus consists of an inventory of dollar amounts of assets and liabilities that have the potential to mature or re-price within a particular period. The flaw in drawing conclusions about interest rate risk from the gap report is that it takes no account of the probability that potential maturities or re-pricings of interest-rate-sensitive accounts will occur, or at what relative magnitudes. Because simplicity, rather than utility, is the only virtue of gap analysis, financial institutions increasingly have either abandoned gap analysis or accorded it a distinctly secondary role in managing their interest-rate risk exposure.

The net interest rate sensitivity at December 31, 2017, is illustrated in the following table. This information reflects the balances of assets and liabilities whose rates are subject to change. As indicated in the table below, the Company is liability-sensitive during the early time periods and is asset-sensitive in the longer periods. The table shows the sensitivity of the statement of condition at one point in time and is not necessarily indicative of the position at future dates.

INTEREST RATE SENSITIVITY

(Dollars in Thousands)

<u>December 31, 2017</u>	Rate/Maturity				<u>Total</u>
	<u>3 Months or Less</u>	<u>Over 3 Months to 1 Year</u>	<u>Over 1 Year to 5 Years</u>	<u>Over 5 Years</u>	
	(Dollars in Thousands)				
Rate sensitive assets					
Investment securities	\$ 354,943	\$ 712,342	\$ 2,852,996	\$ 234,189	\$ 4,154,470
Loans, net of non-accruals	<u>4,816,134</u>	<u>212,144</u>	<u>263,919</u>	<u>1,001,245</u>	<u>6,293,442</u>
Total earning assets	<u>\$ 5,171,077</u>	<u>\$ 924,486</u>	<u>\$ 3,116,915</u>	<u>\$ 1,235,434</u>	<u>\$ 10,447,912</u>
Cumulative earning assets	<u>\$ 5,171,077</u>	<u>\$ 6,095,563</u>	<u>\$ 9,212,478</u>	<u>\$ 10,447,912</u>	
Rate sensitive liabilities					
Time deposits	\$ 863,461	\$ 996,047	\$ 196,910	\$ 88	\$ 2,056,506
Other interest bearing deposits	3,245,131	—	—	—	3,245,131
Securities sold under repurchase agreements	342,824	10,981	—	—	353,805
Other borrowed funds	945,225	—	—	250,000	1,195,225
Junior subordinated deferrable interest debentures	<u>160,416</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>160,416</u>
Total interest bearing liabilities	<u>\$ 5,557,057</u>	<u>\$ 1,007,028</u>	<u>\$ 196,910</u>	<u>\$ 250,088</u>	<u>\$ 7,011,083</u>
Cumulative sensitive liabilities	<u>\$ 5,557,057</u>	<u>\$ 6,564,085</u>	<u>\$ 6,760,995</u>	<u>\$ 7,011,083</u>	
Repricing gap	\$ (385,980)	\$ (82,542)	\$ 2,920,005	\$ 985,346	\$ 3,436,829
Cumulative repricing gap	(385,980)	(468,522)	2,451,483	3,436,829	
Ratio of interest-sensitive assets to liabilities	0.93	0.92	15.83	4.94	1.49
Ratio of cumulative, interest-sensitive assets to liabilities	0.93	0.93	1.36	1.49	

The detailed inventory of statement of condition items contained in gap reports is the starting point of income simulation analysis. Income simulation analysis also focuses on the variability of net interest income and net income, but without the limitations of gap analysis. In particular, the fundamental, but often unstated, assumption of the gap approach that every statement of condition item that can re-price will do so to the full extent of any movement in market interest rates is taken into consideration in income simulation analysis.

Accordingly, income simulation analysis captures not only the potential of assets and liabilities to mature or re-price, but also the probability that they will do so. Moreover, income simulation analysis focuses on the relative sensitivities of these balance sheet items and projects their behavior over an extended period of time in a motion picture rather than snapshot fashion. Finally, income simulation analysis permits management to assess the probable effects on balance sheet items not only of changes in market interest rates, but also of proposed strategies for responding to such changes. The Company and many other institutions rely primarily upon income simulation analysis in measuring and managing exposure to interest rate risk.

The Company has established guidelines for acceptable volatility of projected net interest income on the income simulation analysis and the guidelines are reviewed at least annually. As of December 31, 2017, in rising rate scenarios of +100, +200, +300 and +400 basis points, the guidelines established by management require that the net interest income

not vary by more than plus or minus 15%, 15%, 15%, and 20%, respectively and in a decreasing rate scenario of -100 basis points, that the net interest income not vary by more than plus or minus 15%. At December 31, 2017, the income simulations show that a rate shift of -100, +100, +200, +300 and +400 basis points in interest rates up will vary projected net interest income for the coming 12 month period by -3.21%, +4.23%, +8.26%, +12.22% and +15.96%, respectively. The basis point shift in interest rates is a hypothetical rate scenario used to calibrate risk, and does not necessarily represent management's current view of future market developments. The Company believes that it is properly positioned for a potential interest rate increase or decrease.

All the measurements of risk described above are made based upon the Company's business mix and interest rate exposures at the particular point in time. The exposure changes continuously as a result of the Company's ongoing business and its risk management initiatives. While management believes these measures provide a meaningful representation of the Company's interest rate sensitivity, they do not necessarily take into account all business developments that have an effect on net income, such as changes in credit quality or the size and composition of the statement of condition.

Principal sources of liquidity and funding for the Company are dividends from subsidiaries and borrowed funds, with such funds being used to finance the Company's cash flow requirements. The Company closely monitors the dividend restrictions and availability from the bank subsidiaries as disclosed in Note 20 to the Consolidated Financial Statements. At December 31, 2017, the aggregate amount legally available to be distributed to the Company from bank subsidiaries as dividends was approximately \$731,850,000, assuming that each bank subsidiary continues to be classified as "well-capitalized" under the applicable regulations in effect at December 31, 2017. The restricted capital (capital and surplus) of the bank subsidiaries was approximately \$784,357,000 as of December 31, 2017. The undivided profits of the bank subsidiaries were approximately \$1,878,736,000 as of December 31, 2017.

At December 31, 2017, the Company has outstanding \$1,195,000,000 in other borrowed funds and \$160,416,000 in junior subordinated deferrable interest debentures. In addition to borrowed funds and dividends, the Company has a number of other available alternatives to finance the growth of its existing banks as well as future growth and expansion.

Capital

The Company maintains an adequate level of capital as a margin of safety for its depositors and shareholders. At December 31, 2017, shareholders' equity was \$1,838,980,000 compared to \$1,724,667,000 at December 31, 2016, an increase of \$114,313,000, or 6.6%. Shareholders' equity increased primarily due to the retention of earnings, offset by the payment of cash dividends to shareholders and repurchases of the Company's common stock in the form of treasury stock. The accumulated other comprehensive loss is not included in the calculation of regulatory capital ratios.

During 1990, the Federal Reserve Board ("FRB") adopted a minimum leverage ratio of 3% for the most highly rated bank holding companies and at least 4% to 5% for all other bank holding companies. The Company's leverage ratio (defined as shareholders' equity plus eligible trust preferred securities issued and outstanding less goodwill and certain other intangibles divided by average quarterly assets) was 14.62% at December 31, 2017 and 13.91% at December 31, 2016. The core deposit intangibles and goodwill of \$282,532,000 as of December 31, 2017, are deducted from the sum of core capital elements when determining the capital ratios of the Company.

The FRB has adopted risk-based capital guidelines which assign risk weightings to assets and off-balance sheet items. The guidelines also define and set minimum capital requirements (risk-based capital ratios). Under the final 1992 rules, all banks are required to have Tier 1 capital of at least 4.0% of risk-weighted assets and total capital of 8.0% of risk-weighted assets. Tier 1 capital consists principally of shareholders' equity plus trust preferred securities issued and outstanding less goodwill and certain other intangibles, while total capital consists of Tier 1 capital, certain debt instruments and a portion of the reserve for loan losses. In order to be deemed well-capitalized pursuant to the regulations, an institution must have a total risk-weighted capital ratio of 10%, a Tier 1 risk-weighted ratio of 8% and a Tier 1 leverage ratio of 5%. The Company had risk-weighted Tier 1 capital ratios of 18.73% and 18.68% and risk weighted total capital ratios of 19.51% and 19.47% as of December 31, 2017 and 2016, respectively, which are well above the minimum regulatory requirements and exceed the well-capitalized ratios (see Note 20 to Notes to Consolidated Financial Statements).

In July 2013, the Federal Deposit Insurance Corporation (“FDIC”) and other regulatory bodies established a new, comprehensive capital framework for U.S. banking organizations, consisting of minimum requirements that increase both the quantity and quality of capital held by banking organizations. The final rules are a result of the implementation of the BASEL III capital reforms and various Dodd-Frank Act related capital provisions. Consistent with the Basel international framework, the rules include a new minimum ratio of Common Equity Tier 1 (“CET1”) to risk-weighted assets of 4.5% and a CET1 capital conservation buffer of 2.5% of risk-weighted assets. The capital conservation buffer began phasing-in on January 1, 2016 at .625% and increases each year until January 1, 2019, when the Company will be required to have a 2.5% capital conservation buffer, effectively resulting in a minimum ratio of CET1 capital to risk-weighted assets of at least 7% upon full implementation. The rules also raised the minimum ratio of Tier 1 capital to risk-weighted assets from 4% to 6% and include a minimum leverage ratio of 4% for all banking organizations. Regarding the quality of capital, the new rules emphasize CET1 capital and implements strict eligibility criteria for regulatory capital instruments. The new rules also improve the methodology for calculating risk-weighted assets to enhance risk sensitivity. The new rules are subject to a four year phase in period for mandatory compliance and the Company was required to begin to phase in the new rules beginning on January 1, 2015. Management believes, as of December 31, 2017, that the Company and each of the bank subsidiaries will meet all capital adequacy requirements once the capital conservation is fully phased-in.

On November 21, 2017, the Office of the Comptroller of the Currency (“OCC”), the FRB and the FDIC finalized a proposed rule that extends the current treatment under the regulatory capital rules for certain regulatory capital deductions and risk weights and certain minority interest requirements, as they apply to banking organizations that are not subject to the advanced approaches capital rules. Effective January 1, 2018, the rule also pauses the full transition to the Basel III treatment of mortgage servicing assets, certain deferred tax assets, investments in the capital of unconsolidated financial institutions and minority interests. The agencies are also considering whether to make adjustments to the capital rules in response to CECL (the FASB Standard relating to current expected credit loss) and its potential impact on regulatory capital.

On December 7, 2017, the Basel Committee on Banking Supervision unveiled the latest round of its regulatory capital framework, commonly called “Basel IV.” The framework makes changes to the capital framework first introduced as “Basel III” in 2010. The committee targeted 2022-2027 as the timeframe for implementation by regulators in individual countries, including the U.S. federal bank regulatory agencies (after notice and comment).

Junior Subordinated Deferrable Interest Debentures

The Company has formed six statutory business trusts under the laws of the State of Delaware, for the purpose of issuing trust preferred securities. The statutory business trusts formed by the Company (the “Trusts”) have each issued Capital and Common Securities and invested the proceeds thereof in an equivalent amount of junior subordinated debentures (the “Debentures”) issued by the Company. As of December 31, 2017 and December 31, 2016, the principal amount of debentures outstanding totaled \$160,416,000. On July 29, 2015, the Company bought back a portion of the Capital Securities of IB Capital Trusts X and XI from the holder of the securities for a price that reflected an approximate 24.5% discount from the redemption prices of the securities. The Company thereby retired \$13,000,000 of the total \$34,021,000 of related Junior Subordinated Deferrable Interest Debentures related to IB Capital Trust X and \$1,000,000 of the total \$27,990,000 of related Junior Subordinated Deferrable Interest Debentures related to IB Capital Trust XI. On November 1, 2016, the Company bought back a portion of the Capital Securities of IB Capital Trust XI from the holder of the securities for a price that reflected an approximate 24% discount from the redemption price of the securities. The Company thereby retired \$1,000,000 of the total \$26,990,000 of related Junior Subordinated Deferrable Interest Debentures related to IB Capital Trust XI. The discounts recorded in connection with the repurchases of the outstanding Capital Securities are included in other income on the consolidated financial statements.

The Debentures are subordinated and junior in right of payment to all present and future senior indebtedness (as defined in the respective indentures) of the Company, and are *pari passu* with one another. The interest rate payable on, and the payment terms of the Debentures are the same as the distribution rate and payment terms of the respective issues of Capital and Common Securities issued by the Trusts. The Company has fully and unconditionally guaranteed the obligations of each of the Trusts with respect to the Capital and Common Securities. The Company has the right, unless an Event of Default (as defined in the Indentures) has occurred and is continuing, to defer payment of interest on the Debentures for up to twenty consecutive quarterly periods on Trusts VI, VIII, IX, X, XI and XII. If interest payments on

any of the Debentures are deferred, distributions on both the Capital and Common Securities related to that Debenture would also be deferred. The redemption prior to maturity of any of the Debentures may require the prior approval of the Federal Reserve and/or other regulatory bodies.

For financial reporting purposes, the Trusts are treated as investments of the Company and not consolidated in the consolidated financial statements. Although the Capital Securities issued by each of the Trusts are not included as a component of shareholders' equity on the consolidated statement of condition, the Capital Securities are treated as capital for regulatory purposes. Specifically, under applicable regulatory guidelines, the Capital Securities issued by the Trusts qualify as Tier 1 capital up to a maximum of 25% of Tier 1 capital on an aggregate basis. Any amount that exceeds the 25% threshold would qualify as Tier 2 capital. At December 31, 2017 and December 31, 2016, the total \$160,416,000 of the Capital Securities outstanding qualified as Tier 1 capital.

The following table illustrates key information about each of the Debentures and their interest rates at December 31, 2017:

	Junior Subordinated Deferrable Interest Debentures	Repricing Frequency	Interest Rate	Interest Rate Index	Maturity Date	Optional Redemption Date⁽¹⁾
	(in Thousands)					
Trust VI.....	\$ 25,774	Quarterly	4.87 %	LIBOR + 3.45	November 2032	February 2008
Trust VIII.....	25,774	Quarterly	4.41 %	LIBOR + 3.05	October 2033	October 2008
Trust IX.....	41,238	Quarterly	2.96 %	LIBOR + 1.62	October 2036	October 2011
Trust X.....	21,021	Quarterly	3.03 %	LIBOR + 1.65	February 2037	February 2012
Trust XI.....	25,990	Quarterly	2.96 %	LIBOR + 1.62	July 2037	July 2012
Trust XII.....	20,619	Quarterly	2.93 %	LIBOR + 1.45	September 2037	September 2012
	<u>\$ 160,416</u>					

(1) The Capital Securities may be redeemed in whole or in part on any interest payment date after the Optional Redemption Date.

Contractual Obligations and Commercial Commitments

The following table presents contractual cash obligations of the Company (other than deposit liabilities) as of December 31, 2017:

<u>Contractual Cash Obligations</u>	<u>Total</u>	<u>Payments due by Period</u> (Dollars in Thousands)			
		<u>Less than One Year</u>	<u>One to Three Years</u>	<u>Three to Five Years</u>	<u>After Five Years</u>
Securities sold under repurchase agreements	\$ 353,805	\$ 342,824	\$ 10,981	\$ —	\$ —
Federal Home Loan Bank borrowings	1,195,225	945,225	—	—	250,000
Junior subordinated deferrable interest debentures	160,416	—	—	—	160,416
Operating leases	12,737	3,563	6,463	2,531	180
Total Contractual Cash Obligations	<u>\$ 1,722,183</u>	<u>\$ 1,291,612</u>	<u>\$ 17,444</u>	<u>\$ 2,531</u>	<u>\$ 410,596</u>

The following table presents contractual commercial commitments of the Company (other than deposit liabilities) as of December 31, 2017:

<u>Commercial Commitments</u>	<u>Total</u>	<u>Amount of Commitment Expiration Per Period</u> (Dollars in Thousands)			
		<u>Less than One Year</u>	<u>One to Three Years</u>	<u>Three to Five Years</u>	<u>After Five Years</u>
Financial and Performance Standby Letters of Credit	\$ 95,402	\$ 72,487	\$ 22,915	\$ —	\$ —
Commercial Letters of Credit	4,145	4,145	—	—	—
Credit Card Lines	20,643	20,643	—	—	—
Other Commercial Commitments	2,795,136	1,429,380	620,258	607,907	137,591
Total Commercial Commitments	<u>\$ 2,915,326</u>	<u>\$ 1,526,655</u>	<u>\$ 643,173</u>	<u>\$ 607,907</u>	<u>\$ 137,591</u>

Due to the nature of the Company's commercial commitments, including unfunded loan commitments and lines of credit, the amounts presented above do not necessarily reflect the amounts the Company anticipates funding in the periods presented above.

Critical Accounting Policies

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

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

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

The Company's internal classified report is segregated into the following categories: (i) "Special Review Credits," (ii) "Watch List—Pass Credits," or (iii) "Watch List—Substandard Credits." The loans placed in the "Special Review Credits" category reflect the Company's opinion that the loans reflect potential weakness which require monitoring on a more frequent basis. The "Special Review Credits" are reviewed and discussed on a regular basis with the credit department and the lending staff to determine if a change in category is warranted. The loans placed in the "Watch List—Pass Credits" category reflect the Company's opinion that the credit contains weaknesses which represent a greater degree of risk, which warrant "extra attention." The "Watch List—Pass Credits" are reviewed and discussed on a regular basis with the credit department and the lending staff to determine if a change in category is warranted. The loans placed in the "Watch List—Substandard Credits" classification are considered to be potentially inadequately protected by the current sound worth and debt service capacity of the borrower or of any pledged collateral. These credit obligations, even if apparently protected by collateral value, have shown defined weaknesses related to adverse financial, managerial, economic, market or political conditions which may jeopardize repayment of principal and interest. Furthermore, there is the possibility that some future loss could be sustained by the Company if such weaknesses are not corrected. For loans that are classified as impaired, management evaluates these credits ASC 310-10, "Receivables," and, if deemed necessary, a specific reserve is allocated to the credit. The specific reserve allocated under ASC 310-10, is based on (i) the present value of expected future cash flows discounted at the loan's effective interest rate; (ii) the loan's observable market price; or (iii) the fair value of the collateral if the loan is collateral dependent. Substantially all of the Company's loans evaluated as impaired under ASC 310-10 are measured using the fair value of collateral method. In limited cases, the Company may use other methods to determine the specific reserve of a loan under ASC 310-10 if such loan is not collateral dependent.

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

The Company's management continually reviews the allowance for loan losses of the bank subsidiaries using the amounts determined from the allowances established on specific loans, the allowance established on quantitative historical loss percentages, and the allowance based on qualitative data, to establish an appropriate amount to maintain in the Company's allowance for loan loss. Should any of the factors considered by management in evaluating the adequacy of the allowance for probable loan losses change, the Company's estimate of probable loan losses could also change, which could affect the level of future provisions for probable loan losses.

Recent Accounting Standards Issued

See Note 1—Summary of Significant Accounting Policies in the accompanying Notes to the Consolidated Financial Statements for details of recently issued and recently adopted accounting standards and their impact on the Company's consolidated financial statements.

Preferred Stock, Common Stock and Dividends

The Company had issued and outstanding 66,097,271 shares of \$1.00 par value Common Stock held by approximately 1,993 holders of record at February 23, 2018. The book value of the Common Stock at December 31, 2017 was \$29.28 per share compared with \$27.53 per share at December 31, 2016. In connection with the Company's participation in the Troubled Asset Relief Program Capital Purchase Program in 2008, the US Treasury received a warrant (the "Warrant") to purchase 1,326,238 shares of the Company's common stock (the "Warrant Shares") at \$24.43 per share. The term of the Warrant is ten years and was immediately exercisable. The Warrant is included as a component of Tier 1 capital. On June 12, 2013, the U. S. Treasury sold the Warrant to a third party. As of February 23, 2018, the Warrant is still outstanding, but expires on December 23, 2018. Adjustments to the \$24.43 per share Exercise Price of the Warrant will be made if the Company pays cash dividends in excess of 33 cents per semi-annual period or makes certain other shareholder distributions before the Warrant expires on December 23, 2018.

The Common Stock is traded on the NASDAQ National Market under the symbol "IBOC." The following table sets forth the approximate high and low bid prices in the Company's Common Stock during 2017 and 2016, as quoted on the NASDAQ National Market for each of the quarters in the two year period ended December 31, 2017. Some of the quotations reflect inter-dealer prices, without retail mark-up, mark-down or commission and may not necessarily represent actual transactions. The closing sales price of the Company's Common Stock was \$40.65 per share at February 23, 2018.

		<u>High</u>	<u>Low</u>
2017:	First quarter	\$ 41.83	\$ 33.40
	Second quarter	38.75	32.50
	Third quarter	41.05	33.85
	Fourth quarter	42.90	37.55
2016:	First quarter	\$ 25.79	\$ 21.05
	Second quarter	28.44	22.96
	Third quarter	30.44	24.82
	Fourth quarter	42.25	29.31

The Company paid cash dividends to the common shareholders of \$.33 per share on April 17, 2017 and October 16, 2017 to all holders of record on April 3, 2017 and September 29, 2017, respectively. The Company paid dividends to the common shareholders of \$.29 per share on April 18, 2016 to all holders of record on April 1, 2016. The Company paid cash dividends to the common shareholders of \$.31 per share on October 17, 2016 to all holders of record on September 30, 2016.

The Company's principal source of funds to pay cash dividends on its Common Stock is cash dividends from its bank subsidiaries. For a discussion of the limitations, please see Note 20 of Notes to Consolidated Financial Statements.

Stock Repurchase Program

In April 2009, following receipt of the Treasury Department's consent, the Board of Directors re-established a formal stock repurchase program that authorized the repurchase of up to \$40 million of common stock within the following twelve months and on April 3, 2017, the Board of Directors extended the repurchase program and again authorized the repurchase of up to \$40 million of common stock during the twelve month period commencing on April 9, 2017, which repurchase cap the Board is inclined to increase over time. Stock repurchases may be made from time to time, on the open market or through private transactions. Shares repurchased in this program will be held in treasury for reissue for various corporate purposes, including employee stock option plans. During the fourth quarter of 2017, the Company's Board of Directors adopted a Rule 10b5-1 plan and intends to adopt additional Rule 10b5-1 trading plans that will allow the Company to purchase its shares of common stock during certain trading blackout periods when the Company ordinarily would not be in the market due to trading restrictions in its internal trading policy. During the term of a 10b5-1 Plan, purchases of common stock are automatic to the extent the conditions of the 10b5-1 Plan's trading instructions are met. Shares repurchased in this program will be held in treasury for reissue for various corporate purposes, including employee

stock option plans. As of February 23, 2018, a total of 9,245,658 shares had been repurchased under all programs at a cost of \$271,289,000. The Company is not obligated to repurchase shares under its stock repurchase program or to enter into additional Rule 10b5-1 plans. The timing, actual number and value of shares purchased will depend on many factors, including the Company's cash flow and the liquidity and price performance of its shares of common stock.

Except for repurchases in connection with the administration of an employee benefit plan in the ordinary course of business and consistent with past practices, common stock repurchases are only conducted under publicly announced repurchase programs approved by the Board of Directors. The following table includes information about common stock share repurchases for the quarter ended December 31, 2017.

	Total Number of Shares Purchased	Average Price Paid Per Share	Total Number of Shares Purchased as Part of a Publicly- Announced Program	Approximate Dollar Value of Shares Available for Repurchase ⁽¹⁾
October 1 – October 31, 2017	—	\$ —	—	\$ 39,966,000
November 1 – November 30, 2017	—	—	—	39,966,000
December 1 – December 31, 2017.....	1,375	39.85	1,375	39,911,000
Total	<u>1,375</u>	<u>\$ 38.90</u>	<u>1,375</u>	

(1) The repurchase program was extended on April 3, 2017 and allows for the repurchase of up to an additional \$40,000,000 of treasury stock through April 9, 2018.

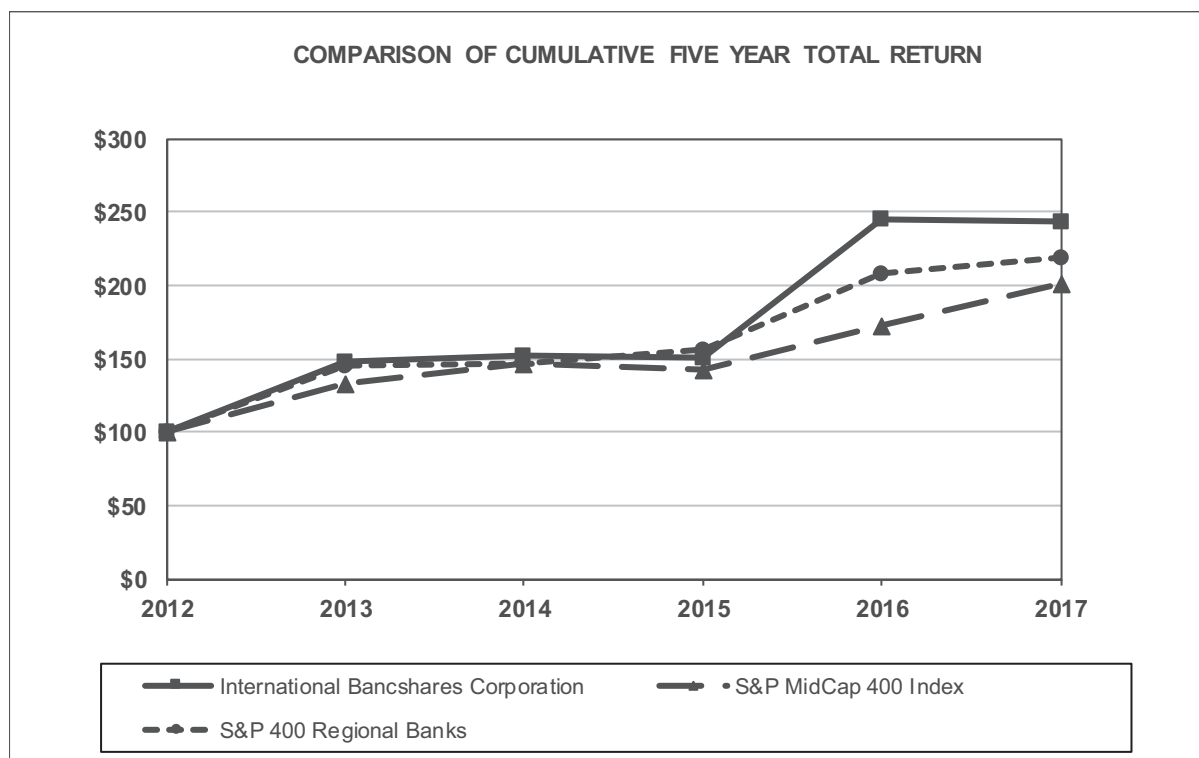
Equity Compensation Plan Information

The following table sets forth information as of December 31, 2017, with respect to the Company's equity compensation plans:

Plan Category	(A) Number of securities to be issued upon exercise of outstanding options, warrants and rights	(B) Weighted average exercise price of outstanding options, warrants and rights	(C) Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column A)
Equity Compensation plans approved by security holders	668,166	\$ 20.41	216,400
Total	<u>668,166</u>	<u>\$ 20.41</u>	<u>216,400</u>

Stock Performance

COMPARISON OF CUMULATIVE FIVE YEAR TOTAL RETURN



**Total Return To Shareholders
(Includes reinvestment of dividends)**

Company / Index	Base Period 2012	INDEXED RETURNS December 31,				
		2013	2014	2015	2016	2017
International Bancshares Corporation	100	148.68	152.84	151.39	245.70	243.29
S&P 500 Index	100	133.50	146.54	143.35	173.08	201.20
S&P 500 Banks	100	145.54	147.28	156.95	208.77	219.63

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Shareholders and the Board of Directors
of International Bancshares Corporation:

Opinion on the Financial Statements

We have audited the accompanying consolidated statements of condition of International Bancshares Corporation and its subsidiaries (the Company) as of December 31, 2017 and 2016, the related consolidated statements of income, comprehensive income, shareholders' equity and cash flows for each of the three years in the period ended December 31, 2017, and the related notes to the consolidated financial statements (collectively, the financial statements). In our opinion, the financial statements present fairly, in all material respects, the financial position of the Company as of December 31, 2017 and 2016, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2017, in conformity with accounting principles generally accepted in the United States of America.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States) (PCAOB), the Company's internal control over financial reporting as of December 31, 2017, based on criteria established in *Internal Control — Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission in 2013, and our report dated February 28, 2018 expressed an unqualified opinion on the effectiveness of the Company's internal control over financial reporting.

Basis for Opinion

These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on the Company's financial statements based on our audits. We are a public accounting firm registered with the PCAOB and are required to be independent with respect to the Company in accordance with U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud. Our audits included performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures included examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements. We believe that our audits provide a reasonable basis for our opinion.

RSM US LLP

We have served as the Company's auditor since 2007.

Dallas, Texas
February 28, 2018

INTERNATIONAL BANCSHARES CORPORATION AND SUBSIDIARIES

Consolidated Statements of Condition

December 31, 2017 and 2016

(Dollars in Thousands, Except Per Share Amounts)

	<u>December 31,</u> <u>2017</u>	<u>December 31,</u> <u>2016</u>
Assets		
Cash and cash equivalents	\$ 265,357	\$ 269,198
Investment securities:		
Held to maturity (Market value of \$2,400 on December 31, 2017 and \$2,400 on December 31, 2016)	2,400	2,400
Available for sale (Amortized cost of \$4,196,263 on December 31, 2017 and \$4,218,841 on December 31, 2016)	<u>4,152,070</u>	<u>4,177,349</u>
Total investment securities	4,154,470	4,179,749
Loans	6,348,172	5,964,688
Less allowance for probable loan losses	<u>(67,687)</u>	<u>(64,661)</u>
Net loans	6,280,485	5,900,027
Bank premises and equipment, net	514,454	527,583
Accrued interest receivable	34,456	32,172
Other investments	571,415	517,162
Identified intangible assets, net	—	25
Goodwill	282,532	282,532
Other assets	<u>81,529</u>	<u>95,593</u>
Total assets	<u>\$ 12,184,698</u>	<u>\$ 11,804,041</u>

See accompanying notes to consolidated financial statements.

INTERNATIONAL BANCSHARES CORPORATION AND SUBSIDIARIES

Consolidated Statements of Condition Continued

December 31, 2017 and 2016

(Dollars in Thousands, Except Per Share Amounts)

	<u>December 31,</u> <u>2017</u>	<u>December 31,</u> <u>2016</u>
Liabilities and Shareholders' Equity		
Liabilities:		
Deposits:		
Demand—non-interest bearing	\$ 3,243,255	\$ 3,158,051
Savings and interest bearing demand	3,245,131	3,203,728
Time	<u>2,056,506</u>	<u>2,248,310</u>
Total deposits	8,544,892	8,610,089
Securities sold under repurchase agreements	353,805	504,985
Other borrowed funds	1,195,225	733,375
Junior subordinated deferrable interest debentures	160,416	160,416
Other liabilities	<u>91,380</u>	<u>70,509</u>
Total liabilities	<u>10,345,718</u>	<u>10,079,374</u>
Shareholders' equity:		
Common shares of \$1.00 par value. Authorized 275,000,000 shares; issued 96,019,028 shares on December 31, 2017 and 95,910,143 shares on December 31, 2016	96,019	95,910
Surplus	171,816	169,567
Retained earnings	1,891,805	1,777,963
Accumulated other comprehensive loss (including \$0 on December 31, 2017 and \$(3,287) on December 31, 2016 of comprehensive loss related to other-than- temporary impairment for non-credit related issues).	<u>(28,397)</u>	<u>(26,697)</u>
Less cost of shares in treasury, 29,939,545 shares on December 31, 2017 and 29,934,675 on December 31, 2016	<u>2,131,243</u>	<u>2,016,743</u>
Total shareholders' equity	<u>1,838,980</u>	<u>1,724,667</u>
Total liabilities and shareholders' equity	<u>\$ 12,184,698</u>	<u>\$ 11,804,041</u>

See accompanying notes to consolidated financial statements.

INTERNATIONAL BANCSHARES CORPORATION AND SUBSIDIARIES

Consolidated Statements of Income

Years ended December 31, 2017, 2016 and 2015

(Dollars in Thousands, Except Per Share Amounts)

	2017	2016	2015
Interest income:			
Loans, including fees	\$ 322,508	\$ 297,820	\$ 297,283
Investment securities:			
Taxable	82,347	79,533	88,008
Tax-exempt	9,656	10,356	11,319
Other interest income	625	205	144
Total interest income	415,136	387,914	396,754
Interest expense:			
Savings deposits	6,208	4,562	3,593
Time deposits	9,736	9,963	11,233
Securities sold under repurchase agreements	6,617	20,876	23,777
Other borrowings	10,978	3,128	1,615
Junior subordinated deferrable interest debentures	5,392	4,600	4,099
Total interest expense	38,931	43,129	44,317
Net interest income	376,205	344,785	352,437
Provision for probable loan losses	11,221	19,859	24,405
Net interest income after provision for probable loan losses	364,984	324,926	328,032
Non-interest income:			
Service charges on deposit accounts	72,868	73,581	78,825
Other service charges, commissions and fees			
Banking	44,964	46,267	44,971
Non-banking.	7,345	7,006	7,223
Investment securities transactions, net	(4,774)	(2,626)	(3,682)
Other investments, net	18,918	23,827	16,969
Other income	11,085	13,647	11,428
Total non-interest income	150,406	161,702	155,734

See accompanying notes to consolidated financial statements.

INTERNATIONAL BANCSHARES CORPORATION AND SUBSIDIARIES

Consolidated Statements of Income, continued

Years ended December 31, 2017, 2016 and 2015

(Dollars in Thousands, Except Per Share Amounts)

	<u>2017</u>	<u>2016</u>	<u>2015</u>
Non-interest expense:			
Employee compensation and benefits	\$ 132,750	\$ 128,661	\$ 125,135
Occupancy	28,439	26,583	28,019
Depreciation of bank premises and equipment	25,281	24,738	25,009
Professional fees	13,650	13,672	12,278
Deposit insurance assessments	3,294	5,777	5,938
Net expense, other real estate owned	965	5,688	5,695
Amortization of identified intangible assets	25	128	644
Advertising	7,854	7,814	7,585
Early termination fee—securities sold under repurchase agreements	5,765	7,042	3,510
Software and software maintenance	19,189	15,087	11,225
Impairment charges (Total other-than-temporary impairment charges, \$0 net of \$0, \$793 net of \$1,147, and \$371 net of \$1,325 included in other comprehensive loss)	—	354	954
Other	<u>56,536</u>	<u>54,081</u>	<u>50,932</u>
Total non-interest expense	<u>293,748</u>	<u>289,625</u>	<u>276,924</u>
Income before income taxes	221,642	197,003	206,842
Provision for income taxes	<u>64,206</u>	<u>63,071</u>	<u>70,116</u>
Net income	<u>\$ 157,436</u>	<u>\$ 133,932</u>	<u>\$ 136,726</u>
Basic earnings per common share:			
Weighted average number of shares outstanding	66,046,155	65,967,989	66,411,193
Net income	<u>\$ 2.38</u>	<u>\$ 2.03</u>	<u>\$ 2.06</u>
Fully diluted earnings per common share:			
Weighted average number of shares outstanding	66,778,436	66,313,490	66,636,353
Net income	<u>\$ 2.36</u>	<u>\$ 2.02</u>	<u>\$ 2.05</u>

See accompanying notes to consolidated financial statements.

INTERNATIONAL BANCSHARES CORPORATION AND SUBSIDIARIES

Consolidated Statements of Comprehensive Income

Years ended December 31, 2017, 2016, and 2015

(Dollars in Thousands)

	2017	2016	2015
Net income	\$ 157,436	\$ 133,932	\$ 136,726
Other comprehensive income, net of tax:			
Net unrealized holding losses on securities available for sale arising during period (net of tax effects of \$(2,586), \$(16,585), and \$(6,593))	(4,803)	(30,801)	(12,243)
Reclassification adjustment for losses on securities available for sale included in net income (net of tax effects of \$1,671, \$919, and \$1,289) . . .	3,103	1,707	2,393
Reclassification adjustment for impairment charges on available for sale securities included in net income (net of tax effects of \$0, \$124, and \$334)	—	230	620
	(1,700)	(28,864)	(9,230)
Comprehensive income	\$ 155,736	\$ 105,068	\$ 127,496

See accompanying notes to consolidated financial statements.

INTERNATIONAL BANCSHARES CORPORATION AND SUBSIDIARIES

Consolidated Statements of Shareholders' Equity

Years ended December 31, 2017, 2016 and 2015

(in Thousands, except per share amounts)

	Preferred Stock	Number of Shares	Common Stock	Surplus	Retained Earnings	Other Comprehensive Income (Loss)	Treasury Stock	Total
Balance at December 31, 2014.	\$ —	95,784	95,784	165,520	1,585,389	11,397	(277,432)	\$ 1,580,658
Net Income	—	—	—	—	136,726	—	—	136,726
Dividends:								
Cash (\$.58 per share)	—	—	—	—	(38,515)	—	—	(38,515)
Purchase of treasury (261,079 shares)	—	—	—	—	—	—	(6,678)	(6,678)
Exercise of stock options	—	82	82	1,288	—	—	—	1,370
Stock compensation expense recognized in earnings	—	—	—	1,172	—	—	—	1,172
Other comprehensive (loss), net of tax:								
Net change in unrealized gains and losses on available for sale securities, net of reclassification adjustment	—	—	—	—	—	(9,230)	—	(9,230)
Balance at December 31, 2015.	—	95,866	95,866	167,980	1,683,600	2,167	(284,110)	1,665,503
Net Income	—	—	—	—	133,932	—	—	133,932
Dividends:								
Cash (\$.60 per share)	—	—	—	—	(39,569)	—	—	(39,569)
Purchase of treasury (349,029 shares)	—	—	—	—	—	—	(7,966)	(7,966)
Exercise of stock options	—	44	44	505	—	—	—	549
Stock compensation expense recognized in earnings	—	—	—	1,082	—	—	—	1,082
Other comprehensive (loss), net of tax:								
Net change in unrealized gains and losses on available for sale securities, net of reclassification adjustments.	—	—	—	—	—	(28,864)	—	(28,864)
Balance at December 31, 2016.	—	95,910	\$ 95,910	\$ 169,567	\$ 1,777,963	\$ (26,697)	\$ (292,076)	\$ 1,724,667
Net Income	—	—	—	—	157,436	—	—	157,436
Dividends:								
Cash (\$.66 per share)	—	—	—	—	(43,594)	—	—	(43,594)
Purchase of treasury (4,870 shares)	—	—	—	—	—	—	(187)	(187)
Exercise of stock options	—	109	109	1,346	—	—	—	1,455
Stock compensation expense recognized in earnings	—	—	—	903	—	—	—	903
Other comprehensive income, net of tax:								
Net change in unrealized gains and losses on available for sale securities, net of reclassification adjustments.	—	—	—	—	—	(1,700)	—	(1,700)
Balance at December 31, 2017.	—	96,019	\$ 96,019	\$ 171,816	\$ 1,891,805	\$ (28,397)	\$ (292,263)	\$ 1,838,980

See accompanying notes to consolidated financial statements.

INTERNATIONAL BANCSHARES CORPORATION AND SUBSIDIARIES

Consolidated Statements of Cash Flows

Years ended December 31, 2017, 2016 and 2015

(Dollars in Thousands)

	<u>2017</u>	<u>2016</u>	<u>2015</u>
Operating activities:			
Net income	\$ 157,436	\$ 133,932	\$ 136,726
Adjustments to reconcile net income to net cash provided by operating activities:			
Provision for probable loan losses	11,221	19,859	24,405
Specific reserve, other real estate owned	710	2,351	1,023
Depreciation of bank premises and equipment	25,281	24,738	25,009
(Gain) loss on sale of bank premises and equipment	(38)	(450)	14
(Gain) loss on sale of other real estate owned	(703)	86	(57)
Accretion of investment securities discounts	(393)	(539)	(1,704)
Amortization of investment securities premiums	24,040	26,873	28,000
Investment securities transactions, net	4,774	2,626	3,682
Impairment charges on available for sale securities	—	354	954
Amortization of identified intangible assets	25	128	644
Stock based compensation expense	903	1,082	1,172
Earnings from affiliates and other investments	(13,198)	(14,315)	(12,176)
Deferred tax expense (benefit)	4,570	7,306	(332)
Increase in accrued interest receivable	(2,284)	(600)	(111)
(Increase) decrease in other assets	(16,117)	7,494	2,967
Net increase (decrease) in other liabilities	592	(7,705)	(6,567)
Net cash provided by operating activities	<u>196,819</u>	<u>203,220</u>	<u>203,649</u>
Investing activities:			
Proceeds from maturities of securities	—	1,200	1,075
Proceeds from sales and calls of available for sale securities	396,066	352,743	164,163
Purchases of available for sale securities	(1,182,006)	(1,325,657)	(352,513)
Principal collected on mortgage backed securities	780,097	919,594	854,736
Net increase in loans	(394,267)	(38,523)	(297,689)
Purchases of other investments	(26,193)	(49,013)	(16,355)
Distributions from other investments	20,344	23,276	18,293
Purchases of bank premises and equipment	(14,315)	(38,856)	(19,831)
Proceeds from sales of bank premises and equipment	2,201	3,701	4,515
Proceeds from sales of other real estate owned	14,266	13,772	16,831
Net cash (used in) provided by investing activities	<u>(403,807)</u>	<u>(137,763)</u>	<u>373,225</u>

See accompanying notes to consolidated financial statements.

INTERNATIONAL BANCSHARES CORPORATION AND SUBSIDIARIES

Consolidated Statements of Cash Flows (Continued)

Years ended December 31, 2017, 2016 and 2015

(Dollars in Thousands)

	<u>2017</u>	<u>2016</u>	<u>2015</u>
Financing activities:			
Net increase in non-interest bearing demand deposits	\$ 85,204	\$ 8,433	\$ 219,365
Net increase (decrease) in savings and interest bearing demand deposits . .	41,403	183,506	(5,458)
Net decrease in time deposits	(191,804)	(118,103)	(116,279)
Net decrease in securities sold under repurchase agreements	(151,180)	(322,787)	(30,578)
Net increase (decrease) in other borrowed funds	461,850	227,625	(568,194)
Redemption of long-term debt.	—	(1,000)	(14,000)
Purchase of treasury stock	(187)	(7,966)	(6,678)
Proceeds from stock transactions	1,455	549	1,370
Payments of cash dividends - common.	<u>(43,594)</u>	<u>(39,569)</u>	<u>(38,515)</u>
Net cash provided by (used in) financing activities	<u>203,147</u>	<u>(69,312)</u>	<u>(558,967)</u>
(Decrease) increase in cash and cash equivalents	(3,841)	(3,855)	17,907
Cash and cash equivalents at beginning of period	<u>269,198</u>	<u>273,053</u>	<u>255,146</u>
Cash and cash equivalents at end of period.	<u>\$ 265,357</u>	<u>\$ 269,198</u>	<u>\$ 273,053</u>
Supplemental cash flow information:			
Interest paid	\$ 38,995	\$ 44,069	\$ 44,560
Income taxes paid.	66,983	49,925	65,234
Non-cash investing and financing activities:			
Net transfers from loans to other real estate owned.	2,588	2,563	3,775

See accompanying notes to consolidated financial statements.

INTERNATIONAL BANCSHARES CORPORATION AND SUBSIDIARIES

Notes to Consolidated Financial Statements

(1) Summary of Significant Accounting Policies

The accounting and reporting policies of International Bancshares Corporation (“Corporation”) and Subsidiaries (the Corporation and Subsidiaries collectively referred to herein as the “Company”) conform to U.S. generally accepted accounting principles (“GAAP”) and to general practices within the banking industry. The following is a description of the more significant of those policies.

Consolidation and Basis of Presentation

The consolidated financial statements include the accounts of the Corporation and its wholly-owned bank subsidiaries, International Bank of Commerce, Laredo (“IBC”), International Bank of Commerce, Oklahoma City, Commerce Bank, International Bank of Commerce, Zapata, International Bank of Commerce, Brownsville, and the Corporation's wholly-owned non-bank subsidiaries, IBC Subsidiary Corporation, IBC Life Insurance Company (which was terminated in September 2016), IBC Trading Company, Premier Tierra Holdings, Inc., IBC Charitable and Community Development Corporation, and IBC Capital Corporation. All significant inter-company balances and transactions have been eliminated in consolidation.

The Company, through its subsidiaries, is primarily engaged in the business of banking, including the acceptance of checking and savings deposits and the making of commercial, real estate, personal, home improvement, automobile and other installment and term loans. The primary markets of the Company are South, Central, and Southeast Texas and the state of Oklahoma. Each bank subsidiary is very active in facilitating international trade along the United States border with Mexico and elsewhere. Although the Company’s loan portfolio is diversified, the ability of the Company’s debtors to honor their contracts is primarily dependent upon the economic conditions in the Company’s trade area. In addition, the investment portfolio is directly impacted by fluctuations in market interest rates. The Company and its bank subsidiaries are subject to the regulations of certain federal agencies as well as the Texas Department of Banking and the Oklahoma Department of Banking, and undergo periodic examinations by those regulatory authorities. Such agencies may require certain standards or impose certain limitations based on their judgments or changes in law and regulations.

The Company owns one insurance-related subsidiary, IBC Insurance Agency, Inc., a wholly owned subsidiary of IBC, the bank subsidiary. The insurance-related subsidiary does not conduct underwriting activities.

The preparation of the consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities as of the dates of the statement of condition and income and expenses for the periods. Actual results could differ significantly from those estimates. Material estimates that are particularly susceptible to significant changes in the near-term relate to the determination of the allowance for probable loan losses.

Subsequent Events

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

Investment Securities

The Company classifies debt and equity securities into one of these categories: held-to-maturity, available-for-sale, or trading. Such classifications are reassessed for appropriate classification at each reporting date. Securities that are intended and expected to be held until maturity are classified as “held-to-maturity” and are carried at amortized cost for financial statement reporting. Securities that are not positively expected to be held until maturity, but are intended to be held for an indefinite period of time are classified as “available-for-sale” or “trading” and are carried at

INTERNATIONAL BANCSHARES CORPORATION AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Continued)

their fair value. Unrealized holding gains and losses are included in net income for those securities classified as “trading”, while unrealized holding gains and losses related to those securities classified as “available-for-sale” are excluded from net income and reported net of tax as other comprehensive income and in shareholders’ equity as accumulated other comprehensive income (loss) until realized. The Company did not maintain any trading securities during the three year period ended December 31, 2017.

Mortgage-backed securities held at December 31, 2017 and 2016 represent participating interests in pools of long-term first mortgage loans originated and serviced by the issuers of the securities. Mortgage-backed securities are either issued or guaranteed by the U.S. government or its agencies including the Federal Home Loan Mortgage Corporation (“Freddie Mac”), the Federal National Mortgage Association (“Fannie Mae”), the Government National Mortgage Association (“Ginnie Mae”) or other non-government entities. Investments in residential mortgage-backed securities issued by Ginnie Mae are fully guaranteed by the U. S. government. Investments in residential mortgage-backed securities issued by Freddie Mac and Fannie Mae are not fully guaranteed by the U.S. government; however, the Company believes that the quality of the bonds is similar to other AAA rated bonds with limited credit risk, particularly given the placement of Fannie Mae and Freddie Mac into conservatorship by the federal government in 2008 and because securities issued by others that are collateralized by residential mortgage-backed securities issued by Fannie Mae or Freddie Mac are rated consistently as AAA rated securities. Market interest rate fluctuations can affect the prepayment speed of principal and the yield on the security.

Premiums and discounts are amortized using the level yield or “interest method” over the terms of the securities. Declines in the fair value of held-to-maturity and available-for sale-securities below their cost that are deemed to be other than temporary are reflected in earnings as realized losses. In determining whether other-than-temporary impairment exists, management considers many factors, including (i) the length of time and the extent to which the fair value has been less than cost, (ii) the financial condition and near-term prospects of the issuer, and (iii) the intent of the Company to hold and the determination of whether the Company will more likely than not be required to sell the security prior to a recovery in fair value. If the Company determines that (i) it intends to sell the security or (ii) it is more likely than not that it will be required to sell the security before it’s anticipated recovery, the other-than-temporary impairment that is recognized in earnings is equal to the difference between the fair value of the security and the Company’s amortized cost of the security. If the Company determines that it (i) does not intend to sell the security and (ii) it will not be more likely than not required to sell the security before it’s anticipated recovery, the other-than-temporary impairment is segregated into its two components (i) the amount of impairment related to credit loss and (ii) the amount of impairment related to other factors. The difference between the present value of the cash flows expected to be collected and the amortized cost is the credit loss recognized through earnings and an adjustment to the cost basis of the security. The amount of impairment related to other factors is included in other comprehensive income (loss). Gains and losses on the sale of securities are recorded on the trade date and are determined using the specific identification method.

Provision and Allowance for Probable Loan Losses

The allowance for probable loan losses is maintained at a level considered adequate by management to provide for probable loan losses. The allowance is increased by provisions charged to operating expense and reduced by net charge-offs. The provision for probable loan losses is the amount, which, in the judgment of management, is necessary to establish the allowance for probable loan losses at a level that is adequate to absorb known and inherent risks in the loan portfolio.

Management believes that the allowance for probable loan losses is adequate. While management uses available information to recognize losses on loans, future additions to the allowance may be necessary based on changes in economic conditions. In addition, various regulatory agencies, as an integral part of their examination process, periodically review the Company’s bank subsidiaries’ allowances for probable loan losses. Such agencies may require the Company’s bank subsidiaries to make additions or reductions to their GAAP allowances based on their judgments of information available to them at the time of their examination.

INTERNATIONAL BANCSHARES CORPORATION AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Continued)

The bank subsidiaries charge off that portion of any loan which management considers to represent a loss as well as that portion of any other loan which is classified as a “loss” by bank examiners. Commercial, financial and agricultural or real estate loans are generally considered by management to represent a loss, in whole or part, (i) when an exposure beyond any collateral coverage is apparent, (ii) when no further collection of the portion of the loan so exposed is anticipated based on actual results, (iii) when the credit enhancements, if any, are not adequate, and (iv) when the borrower’s financial condition would indicate so. Generally, unsecured consumer loans are charged off when 90 days past due.

Loans

Loans are reported at the principal balance outstanding, net of unearned discounts. Interest income on loans is reported on an accrual basis. Loan fees and costs associated with originating the loans are accreted or amortized over the life of the loan using the interest method. The Company originates mortgage loans that may subsequently be sold to an unaffiliated third party. The loans are not securitized and if sold, are sold without recourse. Loans held for sale are carried at cost and the principal amount outstanding is not significant to the consolidated financial statements.

Impaired Loans

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

Troubled Debt Restructured Loans

Troubled debt restructured loans (“TDR”) are those loans where, for reasons related to a borrower’s difficulty to repay a loan, the company grants a concession to the borrower that the company would not normally consider in the normal course of business. The original terms of the loan are modified or restructured. The terms that may be modified include a reduction in the original stated interest rate, an extension of the original maturity of the loan, a renewal of the loan at an interest rate below current market rates, a reduction in the principal amount of debt outstanding, a reduction in accrued interest or deferral of interest payments. A loan classified as a TDR is classified as an impaired loan and included in the impaired loan totals. A TDR loan may be returned to accrual status when the loan is brought current, has performed in accordance with the restructured terms for a reasonable period of time, is at the current market rate, and the ultimate collectability of the outstanding principal and interest is no longer questionable, however, although those loans may be placed back on accrual status, they will continue to be classified as impaired. Consistent with regulatory guidance, a TDR loan that is subsequently modified, but has shown sustained performance and classification as a TDR, will be removed from TDR status provided that the modified terms were market-based at the time of modification.

Non-Accrual Loans

The non-accrual loan policy of the Company’s bank subsidiaries is to discontinue the accrual of interest on loans when management determines that it is probable that future interest accruals will be un-collectible. As it relates to consumer loans, management charges off those loans when the loan is contractually 90 days past due. Under special circumstances, a consumer or non-consumer loan may be more than 90 days delinquent as to interest or principal and not be placed on non-accrual status. This situation generally results when a bank subsidiary has a borrower who is experiencing financial difficulties, but not to the extent that requires a restructuring of indebtedness. The majority of this category is composed of loans that are considered to be adequately secured and/or for which there are expected future payments. When a loan is placed on non-accrual status, any interest accrued, not paid is reversed and charged to operations against

INTERNATIONAL BANCSHARES CORPORATION AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Continued)

interest income. As it relates to non-consumer loans that are not 90 days past due, management will evaluate each of these loans to determine if placing the loan on non-accrual status is warranted. Interest income on non-accrual loans is recognized only to the extent payments are received or when, in management's opinion, the debtor's financial condition warrants reestablishment of interest accruals.

Other Real Estate Owned

Other real estate owned is comprised of real estate acquired by foreclosure and deeds in lieu of foreclosure. Other real estate is carried at the lower of the recorded investment in the property or its fair value less estimated costs to sell such property (as determined by independent appraisal). Prior to foreclosure, the value of the underlying loan is written down to the fair value of the real estate to be acquired by a charge to the allowance for probable loan losses, if necessary. Any subsequent write-downs are charged against other non-interest expense through a valuation allowance. Other real estate owned totaled approximately \$30,519,000 and \$42,204,000 at December 31, 2017 and 2016, respectively. Other real estate owned is included in other assets.

Bank Premises and Equipment

Bank premises and equipment are stated at cost less accumulated depreciation. Depreciation is computed on straight-line and accelerated methods over the estimated useful lives of the assets. Repairs and maintenance are charged to operations as incurred and expenditures for renewals and betterments are capitalized.

Other Investments

Other investments include equity investments in non-financial companies, bank owned life insurance, as well as equity securities with no readily determinable fair market value. Equity investments are accounted for using the equity method of accounting. Equity securities with no readily determinable fair value are accounted for using the cost method.

Income Taxes

Deferred income tax assets and liabilities are determined using the asset and liability method. Under this method, the net deferred tax asset or liability is determined based on the tax effects of the differences between the book and tax basis of the various balance sheet assets and liabilities and gives current recognition to changes in tax rates and laws. The Company files a consolidated federal income tax return with its subsidiaries.

Recognition of deferred tax assets is based on management's assessment that the benefit related to certain temporary differences, tax operating loss carry forwards, and tax credits are more likely than not to be realized. A valuation allowance is recorded for the amount of the deferred tax items for which it is more likely than not that the tax benefits will not be realized.

The Company evaluates uncertain tax positions at the end of each reporting period. The Company may recognize the tax benefit from an uncertain tax position only if it is more likely than not that the tax position will be sustained on examination by the taxing authorities, based on the technical merits of the position. The tax benefit recognized in the financial statements from any such a position is measured based on the largest benefit that has a greater than fifty percent likelihood of being realized upon ultimate settlement. As of December 31, 2017 and 2016, respectively, after evaluating all uncertain tax positions, the Company has recorded no liability for unrecognized tax benefits at the end of the reporting period. The Company would recognize any interest accrued on unrecognized tax benefits as other interest expense and penalties as other non-interest expense. During the years ended December 31, 2017, 2016 and 2015, the Company recognized no interest expense or penalties related to uncertain tax positions.

INTERNATIONAL BANCSHARES CORPORATION AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Continued)

The Company files consolidated tax returns in the U.S. Federal jurisdiction and various state jurisdictions. The Company is no longer subject to U.S. federal or state income tax examinations by tax authorities for years before 2014.

Stock Options

Compensation expense for stock awards is based on the market price of the stock on the measurement date, which is generally the date of grant, and is recognized ratably over the service period of the award. The fair value of stock options granted was estimated using the Black-Scholes-Merton option-pricing model. This model was developed for use in estimating the fair value of publicly traded options that have no vesting restrictions and are fully transferable. Additionally, the model requires the input of highly subjective assumptions. Because the Company's employee stock options have characteristics significantly different from those of publicly traded options, and because changes in the subjective input assumptions can materially affect the fair value estimate, in management's opinion, the Black-Scholes-Merton option-pricing model does not necessarily provide a reliable single measure of the fair value of the Company's stock options.

Net Income Per Share

Basic Earnings Per Share ("EPS") is calculated by dividing net income by the weighted average number of common shares outstanding. The computation of diluted EPS assumes the issuance of common shares for all dilutive potential common shares outstanding during the reporting period. The dilutive effect of stock options is considered in earnings per share calculations, if dilutive, using the treasury stock method.

Goodwill and Identified Intangible Assets

Goodwill represents the excess of costs over fair value of assets of businesses acquired. Goodwill is tested for impairment at least annually or on an interim basis if an event triggering impairment may have occurred. As of October 1, 2017, after completing goodwill testing, the Company has determined that no goodwill impairment exists.

Identified intangible assets are acquired assets that lack physical substance but can be distinguished from goodwill because of contractual or other legal rights or because the asset is capable of being sold or exchanged either on its own or in combination with a related contract, asset, or liability. The Company's identified intangible assets relate to core deposits and contract rights. As of December 31, 2017, the Company has determined that no impairment of identified intangibles exists. Identified intangible assets with definite useful lives are amortized on an accelerated basis over their estimated life. See Note 6—Goodwill and Other Intangible Assets.

Impairment of Long-Lived Assets

Long-lived assets, such as property, plant and equipment, and purchased intangibles subject to amortization, are reviewed for impairment whenever events or changes in circumstances indicate that the carrying value of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying value of the asset to the estimated undiscounted future cash flows expected to be generated by the asset. If the carrying value of an asset exceeds its estimated future cash flows, an impairment charge is recognized by the amount by which the carrying value of the asset exceeds the fair value of the asset. Assets to be disposed of would be separately presented in the statement of condition and reported at the lower of the carrying value or fair value less costs to sell, and are no longer depreciated. The assets and liabilities of a disposed group classified as held for sale would be presented separately in the appropriate asset and liability sections of the statement of condition.

INTERNATIONAL BANCSHARES CORPORATION AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Continued)

Consolidated Statements of Cash Flows

For purposes of the consolidated statements of cash flows, the Company considers all short-term investments with a maturity at date of purchase of three months or less to be cash equivalents. Also, the Company reports transactions related to deposits and loans to customers on a net basis.

Accounting for Transfers and Servicing of Financial Assets

The Company accounts for transfers and servicing of financial assets and extinguishments of liabilities based on the application of a financial-components approach that focuses on control. After a transfer of financial assets, the Company recognizes the financial and servicing assets it controls and liabilities it has incurred, derecognizes financial assets when control has been surrendered and derecognizes liabilities when extinguished. The Company has retained mortgage servicing rights in connection with the sale of mortgage loans. Because the Company may not initially identify loans as originated for resale, all loans are initially treated as held for investment. The value of the mortgage servicing rights are reviewed periodically for impairment and are amortized in proportion to, and over the period of estimated net servicing income or net servicing losses. The value of the mortgage servicing rights is not significant to the consolidated statements of condition.

Segments of an Enterprise and Related Information

The Company operates as one segment. The operating information used by the Company's chief executive officer for purposes of assessing performance and making operating decisions about the Company is the consolidated financial statements presented in this report. The Company has five active operating subsidiaries, namely, the bank subsidiaries, otherwise known as International Bank of Commerce, Laredo, International Bank of Commerce, Oklahoma City, Commerce Bank, International Bank of Commerce, Zapata and International Bank of Commerce, Brownsville. The Company applies the provisions of ASC Topic 280, "Segment Reporting," in determining its reportable segments and related disclosures.

Comprehensive Income (Loss)

Comprehensive income (loss) consists of net income and other comprehensive income (loss). Other comprehensive income (loss) includes unrealized gains and losses on securities available for sale.

Advertising

Advertising costs are expensed as incurred.

Reclassifications

Certain amounts in the prior year's presentations have been reclassified to conform to the current presentation. These reclassifications had no effect on previously reported net income or shareholders' equity.

New Accounting Standards

In May 2014, the FASB issued Accounting Standards Update No. 2014-09 to ASC 606, "Revenue from Contracts with Customers." The update sets a common standard that defines revenue and the principles for recognizing revenue. The update outlines when an entity should recognize revenue, among other matters. At its core, the update states that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled to in exchange for those goods or services. The update also

INTERNATIONAL BANCSHARES CORPORATION AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Continued)

outlines the steps that entities should take to determine and record the current revenue number including: (i) identify the contract(s) with a customer, (ii) identify the performance obligations in the contract(s), (iii) determine the transaction price, (iv) allocate the transaction price to the performance obligations in the contract(s), and (v) recognize revenue when (or as) the entity satisfies the identified performance obligations in the contract(s). The update was originally effective for annual periods beginning after December 31, 2016 and the interim periods within that reporting period. In August 2015, the FASB issued Accounting Standards Update No. 2015-14 which deferred the effective date of ASU 2014-09 by one year to annual and interim periods beginning after December 15, 2017. The Company's revenue is primarily comprised of net interest income on financial assets and financial liabilities, which is explicitly excluded from the scope of the update. The Company has evaluated the impact of the update to certain other non-interest revenue streams, including, service charges, insurance agency commissions and sales of other real estate, among others and has determined that the adoption of the update will not have a significant impact on the Company's consolidated financial statements.

In January 2016, the FASB issued Accounting Standards Update No. 2016-01 to ASC 825-10, "Financial Instruments – Overall." The update amends existing standards regarding certain aspects of recognition and measurement of financial assets and financial liabilities. The amendments in the update establish the following guidance: (i) requires equity investments, except those accounted for under the equity method of accounting or those that result in consolidation of the investee, to be measured at fair value with changes in fair value recognized in net income, (ii) simplifies the impairment assessment of equity securities without readily determinable fair values by requiring a qualitative assessment, (iii) eliminates the requirement to disclose the fair value of financial instruments measured at amortized cost for entities that are not public business entities, (iv) eliminates the requirement for public business entities to disclose the methods and significant assumptions used to estimate fair value that is required to be disclosed for financial instruments measured at amortized cost on the balance sheet, (v) requires public business entities to use the exit price notion when measuring fair value for disclosure purposes, (vi) requires an entity to present separately, in other comprehensive income, the portion of the total change in the fair value of a liability resulting from a change in the instrument-specific credit risk when the entity has elected to measure the liability at fair value in accordance with the fair value option, (vii) requires separate presentation of financial assets and liabilities by measurement category and form of financial assets on the balance sheet or in the accompanying notes to the financial statements, and (viii) clarifies that an entity should evaluate the need to a valuation allowance on a deferred tax asset related to available-for-sale securities in combination with the entity's other deferred tax assets. The update is effective for interim and annual periods beginning after December 15, 2017. The adoption of the update is will not have a significant impact to the Company's consolidated financial statements.

In February 2016, the FASB issued Accounting Standards Update No. 2016-02 to ASC 820, "Leases." The update amends existing standards for accounting for leases by lessees, with accounting for leases by lessors remaining mainly unchanged from current guidance. The update requires that lessees recognize a lease liability and a right of use asset for all leases (with the exception of short-term leases) at the commencement date of the lease and disclose key information about leasing arrangements. The update is to be applied on a modified retrospective basis for leases existing at, or entered into after, the beginning of the earliest comparative period presented in the consolidated financial statements. The update is effective for interim and annual periods beginning after December 15, 2018. In January 2018, the FASB issued a proposal that provides an additional transition method that would allow entities to not apply the guidance in the update in the comparative periods presented in the consolidated financial statements, but instead recognize a cumulative-effect adjustment to the opening balance of retained earnings in the period of adoption. The Company is evaluating the potential impact to the Company's consolidated financial statements.

In March 2016, the FASB issued Accounting Standards Update No. 2016-09 to ASC 718, "Compensation – Stock Compensation." The update amends existing standards for accounting for share-based payment transactions, including the income tax effects, the classification of awards on the balance sheet and the classification on the statement of cash flows. The update is effective for annual and interim periods after December 15, 2016. The adoption of the update did not have a significant impact to the Company's consolidated financial statements.

INTERNATIONAL BANCSHARES CORPORATION AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Continued)

In June 2016, the FASB issued Accounting Standards Update No. 2016-13 to ASC 326, “Financial Instruments – Credit Losses.” The update amends existing standards for accounting for credit losses for financial assets. The update requires that the expected credit losses on the financial instruments held as of the end of the period being reported be measured based on historical experience, current conditions, and reasonable and supportable forecasts. The update also expands the required disclosures related to significant estimates and judgements used in estimating credit losses, as well as the credit quality and underwriting standards of an organization’s financial assets. The update also amends the accounting for credit losses on available-for-sale debt securities and purchased financial assets with credit deterioration and effective for interim and annual periods beginning after December 15, 2019. The change in accounting method represents a significant difference to current accounting practice over the accounting for credit losses on financial assets. The Company has formed a task force including key members of the teams that work with the current calculation of the allowance for probable loan losses and members representing the corporate accounting and risk management areas. The task force will be working with a plan to develop and implement the changes to current practice with support from third-party vendors. The Company cannot estimate at this time the impact of ASC 326.

In January 2017, the FASB issued Accounting Standards Update No. 2017-04 to ASC 350, “Intangibles – Goodwill and Other.” The update amends existing guidance in evaluating goodwill for impairment. The update requires that an entity perform its annual or interim goodwill test by comparing the fair value of a reporting unit with its carrying amount, with any impairment charges being recognized as the difference between the fair value and carrying value. The update is intended to standardize the impairment test for all business entities and also reduce the complexity and cost of evaluating goodwill for impairment. The update is effective for any annual or interim goodwill impairment tests in fiscal years beginning after December 15, 2019. The adoption of the update is not expected to have a significant impact to the Company’s consolidated financial statements.

In March 2017, the FASB issued Accounting Standards Update No. 2017-08 to ASC 310, “Receivables – Nonrefundable Fees and Other Costs.” The update amends existing guidance on the amortization period for certain callable debt securities held at a premium. The update shortens the amortization period of the premium to the earliest call date. The update is effective for fiscal years beginning after December 15, 2018. The update is to be applied on a modified retrospective basis through a cumulative-effect adjustment to retained earnings as of the beginning of the period of adoption. The adoption of the update is not expected to have a significant impact to the Company’s consolidated financial statements.

In February 2018, the FASB issued Accounting Standards Update No. 2018-02 to ASC 220, “Income Statement – Reporting Comprehensive Income.” The update amends current guidance surrounding the reclassification of certain tax effects from accumulated other comprehensive income. The update is being issued as a result of the 2017 Tax Cuts and Jobs Act and the related impact to comprehensive income as a result of the application of current guidance with respect to changes in tax rates. Under current guidance, entities must re-evaluate the carrying value of deferred tax assets and liabilities and adjust them for the tax effect of the rate change and record that change through earnings. The result is that the tax effects for items that normally would only be recognized in comprehensive income will be recognized through earnings and results in stranded tax effects in accumulated other comprehensive income (loss) for the impact of the rate change. The update will allow a reclassification from accumulated other comprehensive income (loss) to retained earnings for the stranded tax effects resulting from the 2017 Tax Cuts and Jobs Act. The update is effective for all entities for fiscal years beginning after December 31, 2018. The adoption of the update is not expected to have a significant impact to the Company’s consolidated financial statements.

INTERNATIONAL BANCSHARES CORPORATION AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Continued)

(2) Investment Securities

The amortized cost and estimated fair value by type of investment security at December 31, 2017 are as follows:

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

	Available for Sale				Carrying value⁽¹⁾
	Amortized cost	Gross unrealized gains	Gross unrealized losses	Estimated fair value	
	(Dollars in Thousands)				
Residential mortgage-backed securities	\$ 3,943,092	\$ 14,110	\$ (65,969)	\$ 3,891,233	\$ 3,891,233
Obligations of states and political subdivisions	225,096	7,871	(16)	232,951	232,951
Equity securities	28,075	293	(482)	27,886	27,886
Total investment securities	<u>\$ 4,196,263</u>	<u>\$ 22,274</u>	<u>\$ (66,467)</u>	<u>\$ 4,152,070</u>	<u>\$ 4,152,070</u>

(1) Included in the carrying value of residential mortgage-backed securities are \$654,063 of mortgage-backed securities issued by Ginnie Mae and \$3,237,170 of mortgage-backed securities issued by Fannie Mae and Freddie Mac

The amortized cost and estimated fair value of investment securities at December 31, 2017, by contractual maturity, are shown below. Expected maturities will differ from contractual maturities because borrowers may have the right to prepay obligations with or without prepayment penalties.

	Held to Maturity		Available for Sale	
	Amortized Cost	Estimated fair value	Amortized Cost	Estimated fair value
	(Dollars in Thousands)			
Due in one year or less	\$ 2,275	\$ 2,275	\$ —	\$ —
Due after one year through five years	125	125	—	—
Due after five years through ten years	—	—	1,939	1,967
Due after ten years	—	—	223,157	230,984
Residential mortgage-backed securities	—	—	3,943,092	3,891,233
Equity securities	—	—	28,075	27,886
Total investment securities	<u>\$ 2,400</u>	<u>\$ 2,400</u>	<u>\$ 4,196,263</u>	<u>\$ 4,152,070</u>

INTERNATIONAL BANCSHARES CORPORATION AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Continued)

The amortized cost and estimated fair value by type of investment security at December 31, 2016 are as follows:

	Held to Maturity				Carrying value
	Amortized cost	Gross unrealized gains	Gross unrealized losses	Estimated fair value	
	(Dollars in Thousands)				
Other securities	\$ 2,400	\$ —	\$ —	\$ 2,400	\$ 2,400
Total investment securities	<u>\$ 2,400</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ 2,400</u>	<u>\$ 2,400</u>
	Available for Sale				Carrying value ⁽¹⁾
	Amortized cost	Gross unrealized gains	Gross unrealized losses	Estimated fair value	
	(Dollars in Thousands)				
Residential mortgage-backed securities	\$ 3,946,144	\$ 18,246	\$ (69,920)	\$ 3,894,470	\$ 3,894,470
Obligations of states and political subdivisions	244,622	10,783	(433)	254,972	254,972
Equity securities	28,075	314	(482)	27,907	27,907
Total investment securities	<u>\$ 4,218,841</u>	<u>\$ 29,343</u>	<u>\$ (70,835)</u>	<u>\$ 4,177,349</u>	<u>\$ 4,177,349</u>

(1) Included in the carrying value of residential mortgage-backed securities are \$850,033 of mortgage-backed securities issued by Ginnie Mae, \$3,026,832 of mortgage-backed securities issued by Fannie Mae and Freddie Mac and \$17,605 issued by non-government entities

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

The amortized cost and fair value of available for sale investment securities pledged to qualify for fiduciary powers, to secure public monies as required by law, repurchase agreements and short-term fixed borrowings was \$1,428,387,000 and \$1,403,084,000, respectively, at December 31, 2017.

Proceeds from the sale and call of securities available-for-sale were \$396,066,000, \$352,743,000 and \$164,163,000 during 2017, 2016 and 2015, respectively, which amounts included \$377,756,000, \$338,138,000 and \$128,444,000 of mortgage-backed securities. Gross gains of \$1,186,000, \$586,000 and \$2,450,000, and gross losses of \$5,960,000, \$3,212,000 and \$6,132,000 were realized on the sales in 2017, 2016 and 2015, respectively.

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Notes to Consolidated Financial Statements (Continued)

Gross unrealized losses on investment securities and the fair value of the related securities, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, at December 31, 2017 were as follows:

	<u>Less than 12 months</u>		<u>12 months or more</u>		<u>Total</u>	
	<u>Fair Value</u>	<u>Unrealized Losses</u>	<u>Fair Value</u>	<u>Unrealized Losses</u>	<u>Fair Value</u>	<u>Unrealized Losses</u>
	(Dollars in Thousands)					
Available for sale:						
Residential mortgage-backed securities	\$ 1,061,577	\$ (13,157)	\$ 2,029,455	\$ (52,812)	\$ 3,091,032	\$ (65,969)
Obligations of states and political subdivisions	5,534	(9)	522	(7)	6,056	(16)
Equity securities	11,499	(251)	8,019	(231)	19,518	(482)
	<u>\$ 1,078,610</u>	<u>\$ (13,417)</u>	<u>\$ 2,037,996</u>	<u>\$ (53,050)</u>	<u>\$ 3,116,606</u>	<u>\$ (66,467)</u>

Gross unrealized losses on investment securities and the fair value of the related securities, aggregated by investment category and length of time that individual securities have been in a continuous loss position, at December 31, 2016 were as follows:

	<u>Less than 12 months</u>		<u>12 months or more</u>		<u>Total</u>	
	<u>Fair Value</u>	<u>Unrealized Losses</u>	<u>Fair Value</u>	<u>Unrealized Losses</u>	<u>Fair Value</u>	<u>Unrealized Losses</u>
	(Dollars in Thousands)					
Available for sale:						
Residential mortgage-backed securities	\$ 2,513,872	\$ (52,245)	\$ 396,695	\$ (17,675)	\$ 2,910,567	\$ (69,920)
Obligations of states and political subdivisions	31,104	(433)	—	—	31,104	(433)
Equity securities	14,066	(184)	5,452	(298)	19,518	(482)
	<u>\$ 2,559,042</u>	<u>\$ (52,862)</u>	<u>\$ 402,147</u>	<u>\$ (17,973)</u>	<u>\$ 2,961,189</u>	<u>\$ (70,835)</u>

The unrealized losses on investments in residential mortgage-backed securities are primarily caused by changes in market interest rates. Residential mortgage-backed securities are primarily securities issued by Freddie Mac, Fannie Mae and Ginnie Mae. The contractual cash obligations of the securities issued by Ginnie Mae are fully guaranteed by the U.S. government. The contractual cash obligations of the securities issued by Freddie Mac and Fannie Mae are not fully guaranteed by the U.S. government; however, the Company believes that the quality of the bonds is similar to other AAA rated bonds with limited credit risk, particularly given the placement of Fannie Mae and Freddie Mac into conservatorship by the federal government in early September 2008 and because securities issued by others that are collateralized by residential mortgage-backed securities issued by Fannie Mae and Freddie Mac are rated consistently as AAA rated securities. The decrease in fair value on residential mortgage-backed securities issued by Freddie Mac, Fannie Mae and Ginnie Mae is due to market interest rates. The Company has no intent to sell and more likely than not be required to sell before a market price recovery or maturity of the securities; therefore, it is the conclusion of the Company that the investments in residential mortgage-backed securities issued by Freddie Mac, Fannie Mae and Ginnie Mae are not considered other-than-temporarily impaired. In addition, the Company had a small investment in non-agency residential mortgage-backed securities that had additional market volatility beyond economically induced interest rate events, which were sold in the first quarter of 2017. The Company concluded that the investments in non-agency residential mortgage-backed securities were other-than-temporarily impaired due to both credit and other than credit issues. No impairment charges were recorded in 2017. Impairment charges of \$354,000 (\$230,100, after tax) and \$954,000 (\$620,1000, after tax) were recorded in 2016 and 2015, respectively on the non-agency residential mortgage backed securities. The impairment charges represent the credit related impairment on the securities.

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

INTERNATIONAL BANCSHARES CORPORATION AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Continued)

required to sell before a market price recovery or maturity of the securities, it is the conclusion of the Company that the investments are not considered other-than-temporarily impaired.

The following table presents a reconciliation of credit-related impairment charges on available-for-sale investments recognized in earnings for the twelve months ended December 31, 2017 (in Thousands):

Balance at December 31, 2016.....	\$ 13,931
Sale of other-than-temporarily impaired available-for-sale securities during period	<u>(13,931)</u>
Balance at December 31, 2017.....	<u>\$ —</u>

The following table presents a reconciliation of credit-related impairment charges on available-for-sale investments recognized in earnings for the twelve months ended December 31, 2016 (in Thousands):

Balance at December 31, 2015.....	\$ 13,577
Impairment charges recognized during period.....	<u>354</u>
Balance at December 31, 2016.....	<u>\$ 13,931</u>

The following table presents a reconciliation of credit-related impairment charges on available-for-sale investments recognized in earnings for the twelve months ended December 31, 2015 (in Thousands):

Balance at December 31, 2014.....	\$ 12,623
Impairment charges recognized during period.....	<u>954</u>
Balance at December 31, 2015.....	<u>\$ 13,577</u>

(3) Loans

A summary of loans, by loan type at December 31, 2017 and 2016 is as follows:

	<u>December 31, 2017</u>	<u>December 31, 2016</u>
	(Dollars in Thousands)	
Commercial, financial and agricultural	\$ 3,322,668	\$ 2,993,203
Real estate - mortgage.....	1,133,525	1,032,222
Real estate - construction	1,683,550	1,716,875
Consumer.....	49,543	55,168
Foreign.....	158,886	167,220
Total loans	<u>\$ 6,348,172</u>	<u>\$ 5,964,688</u>

(4) Allowance for Probable Loan Losses

The allowance for probable loan losses primarily consists of the aggregate loan loss allowances of the bank subsidiaries. The allowances are established through charges to operations in the form of provisions for probable loan losses. Loan losses or recoveries are charged or credited directly to the allowances. The allowance for probable loan losses of each bank subsidiary is maintained at a level considered appropriate by management, based on estimated probable losses in the loan portfolio. The allowance for probable loan losses is derived from the following elements: (i) allowances established on specific impaired loans, which are based on a review of the individual characteristics of each loan, including the customer's ability to repay the loan, the underlying collateral values, and the industry in which the customer operates, (ii) allowances based on actual historical loss experience for similar types of loans in the Company's loan portfolio, and

INTERNATIONAL BANCSHARES CORPORATION AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Continued)

(iii) allowances based on general economic conditions, changes in the mix of loans, company resources, border risk and credit quality indicators, among other things.

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

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

World and U.S. economic conditions have continued to improve; however, there remains some uncertainty created by continued issues with negative demographic trends, weak labor participation rates, enormous government debt, excessive regulations, and unfunded entitlement programs that could create a financial crisis. The impact to the world and U.S. economy from these issues is being magnified by a lack of appropriate government action to find solutions to the problems. In the Company's market area, the challenges are further magnified by the uncertainty around the renegotiation of the North American Free Trade Agreement ("NAFTA"), and whether such negotiations will advance NAFTA or repeal it. Economic risk factors are minimized by the underwriting standards of the bank subsidiaries. The general underwriting standards encompass the following principles: (i) the financial strength of the borrower including strong earnings, a high net worth, significant liquidity and an acceptable debt to worth ratio, (ii) managerial and business competence, (iii) the ability to repay, (iv) for a new business, projected cash flows, (v) loan to value, (vi) in the case of a secondary guarantor, a guarantor financial statement, and (vii) financial and/or other character references. Although the underwriting standards reduce the risk of loss, unique risk factors exist in each type of loan in which the bank subsidiaries invest.

Commercial and industrial loans are mostly secured by the collateral pledged by the borrower that is directly related to the business activities of the company such as accounts receivable and inventory. The ability of the borrower to collect accounts receivable, and to turn inventory into sales are risk factors in the repayment of the loan.

Construction and land development loans can carry risk of repayment when projects incur cost overruns, have an increase in the price of building materials, encounter zoning and environmental issues, or encounter other factors that may affect the completion of a project on time and on budget. Additionally, repayment risk may be negatively impacted when the market experiences a deterioration in the value of real estate. Risks specifically related to 1-4 family development loans also include the practice by the mortgage industry of more restrictive underwriting standards, which inhibits the buyer from obtaining long term financing and excessive housing and lot inventory in the market.

Commercial real estate loans demonstrate a risk of repayment when market values deteriorate, the business experiences turnover in key management, the business has an inability to attract or keep occupancy levels stable, or when

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Notes to Consolidated Financial Statements (Continued)

the market experiences an exit of a specific business industry that is significant to the local economy, such as a manufacturing plant.

First and second lien residential 1-4 family mortgage and consumer loan repayments may be affected by unemployment or underemployment and deteriorating market values of real estate.

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

	December 31, 2017								
	Domestic						Foreign		
	Commercial	Commercial real estate: other construction & land development	Commercial real estate: farmland & commercial	Commercial real estate: multifamily	Residential: first lien	Residential: junior lien	Consumer	Foreign	Total
	(Dollars in Thousands)								
Balance at December 31,	\$ 25,649	\$ 13,889	\$ 16,731	\$ 806	\$ 2,455	\$ 3,716	\$ 531	\$ 884	\$ 64,661
Losses charge to allowance.	(12,094)	(213)	(40)	—	(101)	(340)	(309)	(1)	(13,098)
Recoveries credited to allowance.	4,020	21	527	—	11	258	45	21	4,903
Net losses charged to allowance	(8,074)	(192)	487	—	(90)	(82)	(264)	20	(8,195)
Provision (credit) charged to operations	10,330	(2,022)	(555)	303	585	2,469	173	(62)	11,221
Balance at December 31,	<u>\$ 27,905</u>	<u>\$ 11,675</u>	<u>\$ 16,663</u>	<u>\$ 1,109</u>	<u>\$ 2,950</u>	<u>\$ 6,103</u>	<u>\$ 440</u>	<u>\$ 842</u>	<u>\$ 67,687</u>
	December 31, 2016								
	Domestic						Foreign		
	Commercial	Commercial real estate: other construction & land development	Commercial real estate: farmland & commercial	Commercial real estate: multifamily	Residential: first lien	Residential: junior lien	Consumer	Foreign	Total
	(Dollars in Thousands)								
Balance at December 31,	\$ 21,431	\$ 13,920	\$ 19,769	\$ 1,248	\$ 3,509	\$ 5,321	\$ 638	\$ 1,152	\$ 66,988
Losses charge to allowance.	(32,959)	(16)	(1,890)	(180)	(70)	(331)	(414)	(41)	(35,901)
Recoveries credited to allowance.	7,110	6,099	119	—	21	278	69	19	13,715
Net losses charged to allowance	(25,849)	6,083	(1,771)	(180)	(49)	(53)	(345)	(22)	(22,186)
Provision (credit) charged to operations	30,067	(6,114)	(1,267)	(262)	(1,005)	(1,552)	238	(246)	19,859
Balance at December 31,	<u>\$ 25,649</u>	<u>\$ 13,889</u>	<u>\$ 16,731</u>	<u>\$ 806</u>	<u>\$ 2,455</u>	<u>\$ 3,716</u>	<u>\$ 531</u>	<u>\$ 884</u>	<u>\$ 64,661</u>
	December 31, 2015								
	Domestic						Foreign		
	Commercial	Commercial real estate: other construction & land development	Commercial real estate: farmland & commercial	Commercial real estate: multifamily	Residential: first lien	Residential: junior lien	Consumer	Foreign	Total
	(Dollars in Thousands)								
Balance at December 31,	\$ 22,352	\$ 12,955	\$ 18,683	\$ 846	\$ 3,589	\$ 4,683	\$ 660	\$ 1,060	\$ 64,828
Losses charge to allowance.	(24,802)	(695)	(492)	—	(157)	(275)	(704)	—	(27,125)
Recoveries credited to allowance.	3,135	141	963	—	30	431	170	10	4,880
Net losses charged to allowance	(21,667)	(554)	471	—	(127)	156	(534)	10	(22,245)
Provision (credit) charged to operations	20,746	1,519	615	402	47	482	512	82	24,405
Balance at December 31,	<u>\$ 21,431</u>	<u>\$ 13,920</u>	<u>\$ 19,769</u>	<u>\$ 1,248</u>	<u>\$ 3,509</u>	<u>\$ 5,321</u>	<u>\$ 638</u>	<u>\$ 1,152</u>	<u>\$ 66,988</u>

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Notes to Consolidated Financial Statements (Continued)

The allowance for probable loan losses is a reserve established through a provision for probable loan losses charged to expense, which represents management's best estimate of probable loan losses when evaluating loans (i) individually or (ii) collectively. The decrease in the provision for probable loan losses charged to expense for the year ended December 31, 2017 can be attributed to a decrease in the historical loss experience in the commercial category of the calculation. As discussed in prior periods, charge-offs increased from historical levels due to the deterioration of one relationship that is secured by multiple pieces of transportation equipment beginning in the fourth quarter of 2014. The Company uses a three year historical charge-off experience in the calculation, therefore, as those charge-offs are eliminated from the calculation, the allowance for probable loan losses is impacted. On August 26, 2017, Hurricane Harvey made landfall in Rockport, Texas, as a category four storm and followed the Gulf Coast of Texas north to the Houston metro area and finally the State of Louisiana. The Texas Gulf Coast is an area where the Company serves many consumer and commercial customers. The Company has reviewed the exposure to losses of property arising from the impact of Hurricane Harvey and has determined that the impact is not significant to warrant a specific reserve; however, it is still evaluating the impact, therefore the Company's allowance for probable loan losses at December 31, 2017 includes factors in the qualitative ratios used in the calculation to incorporate the potential impact of losses arising from the impact of Hurricane Harvey on certain portions of the loan portfolio. The increase in losses charged to the allowance for probable loan losses for the year ended December 31, 2016 can be attributed to further deterioration in the previously identified and charged down relationship primarily secured by multiple pieces of transportation equipment. In March 2016, litigation against the management of the borrower was filed in the State of Nevada, resulting in a going concern issue with the borrower's operations and the future use of the transportation equipment pledged as collateral on the relationship. As a result, management, in accordance with its credit review procedures, re-evaluated the collateral values on the equipment in light of the new circumstances and reduced the collateral values accordingly, resulting in a further charge-down of the relationship of approximately \$19.4 million, which is included in the losses charged to the allowance in the commercial category in the table detailing the year ended December 31, 2016 activity. The impact of the charge-down is also reflected in the various tables in this Note including impaired loans, non-accrual loans and the credit quality indicator summary. Two large recoveries on loans charged off in prior years are included in the recoveries credited to the allowance in the table detailing activity for the year ended December 31, 2016. The recoveries occurred in the first and third quarters of 2016 in the amounts of \$4.4 million and \$6 million, respectively and are included in the Commercial and Commercial Real Estate: Other Construction and Land Development categories. The increase in charge-offs for the years ended December 31, 2015 in the Commercial category can be attributed to a charge down of the previously discussed relationship that is primarily secured by multiple pieces of transportation equipment. The relationship was charged down by \$13.5 million for the year ended December 31, 2015.

INTERNATIONAL BANCSHARES CORPORATION AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Continued)

The table below provides additional information on the balance of loans individually or collectively evaluated for impairment and their related allowance, by loan class:

	December 31, 2017			
	Loans Individually Evaluated For Impairment		Loans Collectively Evaluated For Impairment	
	Recorded Investment	Allowance	Recorded Investment	Allowance
	(Dollars in Thousands)			
Domestic				
Commercial	\$ 17,947	\$ 300	\$ 1,068,520	\$ 27,605
Commercial real estate: other construction & land development	2,455	116	1,681,095	11,559
Commercial real estate: farmland & commercial	33,123	18	2,010,162	16,645
Commercial real estate: multifamily	476	—	192,440	1,109
Residential: first lien	6,852	—	425,925	2,950
Residential: junior lien	723	—	700,025	6,103
Consumer	1,281	—	48,262	440
Foreign	347	—	158,539	842
Total	\$ 63,204	\$ 434	\$ 6,284,968	\$ 67,253

	December 31, 2016			
	Loans Individually Evaluated For Impairment		Loans Collectively Evaluated For Impairment	
	Recorded Investment	Allowance	Recorded Investment	Allowance
	(Dollars in Thousands)			
Domestic				
Commercial	\$ 22,412	\$ —	\$ 887,255	\$ 25,649
Commercial real estate: other construction & land development	4,776	371	1,712,099	13,518
Commercial real estate: farmland & commercial	10,810	546	1,932,260	16,185
Commercial real estate: multifamily	552	—	139,914	806
Residential: first lien	6,836	44	415,068	2,411
Residential: junior lien	978	—	609,340	3,716
Consumer	1,295	—	53,873	531
Foreign	746	—	166,474	884
Total	\$ 48,405	\$ 961	\$ 5,916,283	\$ 63,700

Loans accounted for on a non-accrual basis at December 31, 2017, 2016 and 2015 amounted to \$54,730,000, \$37,245,000 and \$47,685,000, respectively. The effect of such non-accrual loans reduced interest income by approximately \$977,000, \$2,461,000 and \$3,298,000 for the years ended December 31, 2017, 2016 and 2015, respectively. Amounts received on non-accruals are applied, for financial accounting purposes, first to principal and then to interest after all principal has been collected. Accruing loans contractually past due 90 days or more as to principal or interest payments at December 31, 2017, 2016 and 2015 amounted to approximately \$7,257,000, \$5,226,000 and \$11,616,000, respectively.

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Notes to Consolidated Financial Statements (Continued)

The table below provides additional information on loans accounted for on a non-accrual basis by loan class:

	<u>December 31, 2017</u>	<u>December 31, 2016</u>
	<u>(Dollars in Thousands)</u>	
Domestic		
Commercial	\$ 17,909	\$ 22,369
Commercial real estate: other construction & land development	2,455	4,776
Commercial real estate: farmland & commercial	33,123	8,314
Commercial real estate: multifamily	476	552
Residential: first lien	712	655
Residential: junior lien	11	166
Consumer	44	26
Foreign	—	387
Total non-accrual loans	<u>\$ 54,730</u>	<u>\$ 37,245</u>

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

The following tables detail key information regarding the Company's impaired loans by loan class for the year ended December 31, 2017:

	<u>December 31, 2017</u>				
	<u>Recorded</u>	<u>Unpaid</u>	<u>Related</u>	<u>Average</u>	<u>Interest</u>
	<u>Investment</u>	<u>Principal</u>	<u>Allowance</u>	<u>Recorded</u>	<u>Recognized</u>
	<u>(Dollars in Thousands)</u>				
Loans with Related Allowance					
Domestic					
Commercial	\$ 1,300	\$ 1,577	\$ 300	\$ 1,346	\$ —
Commercial real estate: other construction & land development	145	169	116	150	—
Commercial real estate: farmland & commercial	449	590	18	489	—
Total impaired loans with related allowance	<u>\$ 1,894</u>	<u>\$ 2,336</u>	<u>\$ 434</u>	<u>\$ 1,985</u>	<u>\$ —</u>

	<u>December 31, 2017</u>				
	<u>Recorded</u>	<u>Unpaid</u>	<u>Average</u>	<u>Recorded</u>	<u>Interest</u>
	<u>Investment</u>	<u>Principal</u>	<u>Recorded</u>	<u>Investment</u>	<u>Recognized</u>
	<u>(Dollars in Thousands)</u>				
Loans with No Related Allowance					
Domestic					
Commercial	\$ 16,646	\$ 44,095	\$ 19,615	\$ 3	\$ —
Commercial real estate: other construction & land development	2,310	2,455	3,493	—	—
Commercial real estate: farmland & commercial	32,675	33,275	38,536	—	—
Commercial real estate: multifamily	476	505	511	—	—
Residential: first lien	6,852	6,968	7,249	324	—
Residential: junior lien	723	736	970	45	—
Consumer	1,281	1,283	1,293	3	—
Foreign	347	347	750	16	—
Total impaired loans with no related allowance	<u>\$ 61,310</u>	<u>\$ 89,664</u>	<u>\$ 72,417</u>	<u>\$ 391</u>	<u>\$ —</u>

INTERNATIONAL BANCSHARES CORPORATION AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Continued)

The following tables detail key information regarding the Company's impaired loans by loan class for the year ended December 31, 2016:

	December 31, 2016				
	<u>Recorded Investment</u>	<u>Unpaid Principal Balance</u>	<u>Related Allowance</u>	<u>Average Recorded Investment</u>	<u>Interest Recognized</u>
	(Dollars in Thousands)				
Loans with Related Allowance					
Domestic					
Commercial real estate: other construction & land development	\$ 1,958	\$ 1,971	\$ 371	2,512	—
Commercial real estate: farmland & commercial	2,808	3,948	546	3,247	—
Commercial real estate: multifamily	62	62	44	62	—
Total impaired loans with related allowance	<u>\$ 4,828</u>	<u>\$ 5,981</u>	<u>\$ 961</u>	<u>\$ 9,579</u>	<u>\$ —</u>

	December 31, 2016				
	<u>Recorded Investment</u>	<u>Unpaid Principal Balance</u>	<u>Average Recorded Investment</u>	<u>Interest Recognized</u>	
	(Dollars in Thousands)				
Loans with No Related Allowance					
Domestic					
Commercial	\$ 21,412	\$ 50,737	\$ 19,354	\$ 3	
Commercial real estate: other construction & land development	2,818	4,419	2,336	67	
Commercial real estate: farmland & commercial	8,002	9,054	8,523	110	
Commercial real estate: multifamily	552	562	401	—	
Residential: first lien	6,774	6,847	6,860	298	
Residential: junior lien	978	1,017	1,011	52	
Consumer	1,295	1,295	1,214	1	
Foreign	746	746	751	16	
Total impaired loans with no related allowance	<u>\$ 42,577</u>	<u>\$ 74,677</u>	<u>\$ 40,450</u>	<u>\$ 547</u>	

A portion of the impaired loans have adequate collateral and credit enhancements not requiring a related allowance for loan loss. Management is confident the Company's loss exposure regarding these credits will be significantly reduced due to the Company's long-standing practices that emphasize secured lending with strong collateral positions and guarantor support. Management is likewise confident the reserve for probable loan losses is adequate.

Management of the Company recognizes the risks associated with these impaired loans. However, management's decision to place loans in this category does not necessarily mean that losses will occur. In the current environment, troubled loan management can be protracted because of the legal and process problems that delay the collection of an otherwise collectible loan. Additionally, management believes that the collateral related to these impaired loans and/or the secondary support from guarantors mitigates the potential for losses from impaired loans.

INTERNATIONAL BANCSHARES CORPORATION AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Continued)

The following table details loans accounted for as “troubled debt restructuring,” segregated by loan class. Loans accounted for as troubled debt restructuring are included in impaired loans.

	<u>December 31, 2017</u>	<u>December 31, 2016</u>
	<u>(Dollars in Thousands)</u>	
Domestic		
Commercial	\$ 6,910	\$ 10,710
Commercial real estate: farmland & commercial	—	3,086
Residential: first lien	6,140	6,181
Residential: junior lien	712	812
Consumer	1,237	1,269
Foreign	<u>347</u>	<u>360</u>
 Total troubled debt restructuring	 <u>\$ 15,346</u>	 <u>\$ 22,418</u>

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

While management of the Company considers that it is generally able to identify borrowers with financial problems reasonably early and to monitor credit extended to such borrowers carefully, there is no precise method of predicting loan losses. The determination that a loan is likely to be uncollectible and that it should be wholly or partially charged-off as a loss is an exercise of judgment. Similarly, the determination of the adequacy of the allowance for probable loan losses can be made only on a subjective basis. It is the judgment of the Company’s management that the allowance for probable loan losses at December 31, 2017 and December 31, 2016, was adequate to absorb probable losses from loans in the portfolio at that date.

The following table presents information regarding the aging of past due loans by loan class:

	<u>December 31, 2017</u>					<u>Current</u>	<u>Total Portfolio</u>
	<u>30 - 59 Days</u>	<u>60 - 89 Days</u>	<u>90 Days or Greater</u>	<u>90 Days or greater & still accruing</u>	<u>Total Past Due</u>		
	<u>(Dollars in Thousands)</u>						
Domestic							
Commercial	\$ 3,790	\$ 398	\$ 18,308	\$ 537	\$ 22,496	\$ 1,063,971	\$ 1,086,467
Commercial real estate: other construction & land development	354	308	820	6	1,482	1,682,068	1,683,550
Commercial real estate: farmland & commercial	3,925	518	31,133	954	35,576	2,007,709	2,043,285
Commercial real estate: multifamily	84	—	476	—	560	192,356	192,916
Residential: first lien	4,295	2,458	4,095	3,861	10,848	421,929	432,777
Residential: junior lien	1,310	580	1,110	1,099	3,000	697,748	700,748
Consumer	868	98	160	133	1,126	48,417	49,543
Foreign	<u>1,229</u>	<u>69</u>	<u>667</u>	<u>667</u>	<u>1,965</u>	<u>156,921</u>	<u>158,886</u>
Total past due loans	<u>\$ 15,855</u>	<u>\$ 4,429</u>	<u>\$ 56,769</u>	<u>\$ 7,257</u>	<u>\$ 77,053</u>	<u>\$ 6,271,119</u>	<u>\$ 6,348,172</u>

INTERNATIONAL BANCSHARES CORPORATION AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Continued)

	December 31, 2016						
	30 - 59 Days	60 - 89 Days	90 Days or Greater	90 Days or greater & still accruing (Dollars in Thousands)	Total Past Due	Current	Total Portfolio
Domestic							
Commercial	\$ 4,081	\$ 829	\$ 21,123	\$ 392	\$ 26,033	\$ 883,634	\$ 909,667
Commercial real estate: other construction & land development	1,502	396	4,456	9	6,354	1,710,521	1,716,875
Commercial real estate: farmland & commercial	3,454	3,054	6,150	289	12,658	1,930,412	1,943,070
Commercial real estate: multifamily	44	—	552	—	596	139,870	140,466
Residential: first lien	5,615	1,350	4,143	3,756	11,108	410,796	421,904
Residential: junior lien	762	178	540	382	1,480	608,838	610,318
Consumer	910	95	413	387	1,418	53,750	55,168
Foreign	931	425	397	11	1,753	165,467	167,220
Total past due loans	<u>\$ 17,299</u>	<u>\$ 6,327</u>	<u>\$ 37,774</u>	<u>\$ 5,226</u>	<u>\$ 61,400</u>	<u>\$ 5,903,288</u>	<u>\$ 5,964,688</u>

The increase in the commercial real estate: farmland and commercial in the 90 days and greater category at December 31, 2017 compared to December 31, 2016 can be attributed to a relationship that is secured by a water park that is currently classified as Impaired. The Company's internal classified report is segregated into the following categories: (i) "Special Review Credits," (ii) "Watch List—Pass Credits," or (iii) "Watch List—Substandard Credits." The loans placed in the "Special Review Credits" category reflect the Company's opinion that the loans reflect potential weakness which require monitoring on a more frequent basis. The "Special Review Credits" are reviewed and discussed on a regular basis with the credit department and the lending staff to determine if a change in category is warranted. The loans placed in the "Watch List—Pass Credits" category reflect the Company's opinion that the credit contains weaknesses which represent a greater degree of risk, which warrant "extra attention." The "Watch List—Pass Credits" are reviewed and discussed on a regular basis with the credit department and the lending staff to determine if a change in category is warranted. The loans placed in the "Watch List—Substandard Credits" classification are considered to be potentially inadequately protected by the current sound worth and debt service capacity of the borrower or of any pledged collateral. These credit obligations, even if apparently protected by collateral value, have shown defined weaknesses related to adverse financial, managerial, economic, market or political conditions which may jeopardize repayment of principal and interest. Furthermore, there is the possibility that some future loss could be sustained by the Company if such weaknesses are not corrected. For loans that are classified as impaired, management evaluates these credits in accordance with the provision of ASC 310-10, "Receivables," and, if deemed necessary, a specific reserve is allocated to the credit. The specific reserve allocated under ASC 310-10, is based on (i) the present value of expected future cash flows discounted at the loan's effective interest rate; (ii) the loan's observable market price; or (iii) the fair value of the collateral if the loan is collateral dependent. Substantially all of the Company's loans evaluated as impaired under ASC 310-10 are measured using the fair value of collateral method. In limited cases, the Company may use other methods to determine the specific reserve of a loan under ASC 310-10 if such loan is not collateral dependent.

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

INTERNATIONAL BANCSHARES CORPORATION AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Continued)

A summary of the loan portfolio by credit quality indicator by loan class is as follows:

	December 31, 2017				
	Pass	Special Review	Watch List—Pass	Watch List— Substandard	Watch List— Impaired
	(Dollars in Thousands)				
Domestic					
Commercial	\$ 905,707	\$ —	\$ 3,170	\$ 159,643	\$ 17,947
Commercial real estate: other construction & land development	1,616,604	1,288	672	62,531	2,455
Commercial real estate: farmland & commercial	1,863,763	5,134	41,820	99,445	33,123
Commercial real estate: multifamily	192,440	—	—	—	476
Residential: first lien	425,811	40	—	74	6,852
Residential: junior lien	699,875	150	—	—	723
Consumer	48,262	—	—	—	1,281
Foreign	158,539	—	—	—	347
Total	<u>\$ 5,911,001</u>	<u>\$ 6,612</u>	<u>\$ 45,662</u>	<u>\$ 321,693</u>	<u>\$ 63,204</u>
	December 31, 2016				
	Pass	Special Review	Watch List—Pass	Watch List— Substandard	Watch List— Impaired
	(Dollars in Thousands)				
Domestic					
Commercial	\$ 720,350	\$ 90,746	\$ 1,121	\$ 75,038	\$ 22,412
Commercial real estate: other construction & land development	1,648,633	1,986	—	61,480	4,776
Commercial real estate: farmland & commercial	1,792,542	7,983	59,872	71,863	10,810
Commercial real estate: multifamily	139,914	—	—	—	552
Residential: first lien	413,638	814	—	616	6,836
Residential: junior lien	609,190	150	—	—	978
Consumer	53,873	—	—	—	1,295
Foreign	166,474	—	—	—	746
Total	<u>\$ 5,544,614</u>	<u>\$ 101,679</u>	<u>\$ 60,993</u>	<u>\$ 208,997</u>	<u>\$ 48,405</u>

The decrease in Special review credits for December 31, 2017 compared to December 31, 2016 can be attributed to the reclassification of a relationship secured by barges used in the transportation of petroleum products from Special Review to Watch List - Substandard and by the reclassification of a relationship secured by equipment used in oil and gas production from Special Review to the Pass category. The decrease in the Watch List - Pass credits for December 31, 2017 compared to December 31, 2016 can be attributed to a relationship secured by real estate from Watch List - Pass to the Pass category. The increase in Watch List - Substandard credits at December 31, 2017 compared to December 31, 2016 can be primarily attributed to the relationship mentioned above, in addition to the reclassification of three additional relationships from Pass to Watch List - Substandard. One such relationship is in the oil and gas production business, one is in the water park business and is secured by a water park, and one is secured by construction equipment. Additionally, there was an increase in the outstanding balance on a relationship primarily secured by transportation equipment, which was already classified as Watch List-Substandard at December 31, 2016.

INTERNATIONAL BANCSHARES CORPORATION AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Continued)

(5) Bank Premises and Equipment

A summary of bank premises and equipment, by asset classification, at December 31, 2017 and 2016 were as follows:

	<u>Estimated useful lives</u>	<u>2017</u>	<u>2016</u>
(Dollars in Thousands)			
Bank buildings and improvements	5 - 40 years	\$ 550,094	\$ 542,063
Furniture, equipment and vehicles	1 - 20 years	289,743	280,586
Land		123,087	125,213
Real estate held for future expansion:			
Land, building, furniture, fixture and equipment	7 - 27 years	—	—
Less: accumulated depreciation		<u>(448,470)</u>	<u>(420,279)</u>
Bank premises and equipment, net		<u>\$ 514,454</u>	<u>\$ 527,583</u>

(6) Goodwill and Other Intangible Assets

The majority of the Company's identified intangibles are in the form of amortizable core deposit premium. A small portion of the fully amortized identified intangibles represent identified intangibles in the acquisition of the rights to the insurance agency contracts of InsCorp, Inc., acquired in 2008. Information on the Company's identified intangible assets follows:

	<u>Carrying Amount</u>	<u>Accumulated Amortization</u>	<u>Net</u>
(Dollars in Thousands)			
December 31, 2017:			
Core deposit premium	\$ 58,675	\$ 58,675	\$ —
Identified intangible (contract rights)	<u>2,022</u>	<u>2,022</u>	<u>—</u>
Total identified intangibles	<u>\$ 60,697</u>	<u>\$ 60,697</u>	<u>\$ —</u>
December 31, 2016:			
Core deposit premium	\$ 58,675	\$ 58,650	\$ 25
Identified intangible (contract rights)	<u>2,022</u>	<u>2,022</u>	<u>—</u>
Total identified intangibles	<u>\$ 60,697</u>	<u>\$ 60,672</u>	<u>\$ 25</u>

Amortization expense of intangible assets for the years ended December 31, 2017, 2016 and 2015, was \$25,000, \$128,000 and \$644,000, respectively.

There were no changes in the carrying amount of goodwill for the years ended December 31, 2017 and 2016.

INTERNATIONAL BANCSHARES CORPORATION AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Continued)

(7) Deposits

Deposits as of December 31, 2017 and 2016 and related interest expense for the years ended December 31, 2017, 2016 and 2015 were as follows:

	<u>2017</u>	<u>2016</u>
	<u>(Dollars in Thousands)</u>	
Deposits:		
Demand - non-interest bearing		
Domestic	\$ 2,609,932	\$ 2,509,544
Foreign	633,323	648,507
Total demand non-interest bearing	<u>3,243,255</u>	<u>3,158,051</u>
Savings and interest bearing demand		
Domestic	2,615,143	2,589,675
Foreign	629,988	614,053
Total savings and interest bearing demand	<u>3,245,131</u>	<u>3,203,728</u>
Time, certificates of deposit \$100,000 or more		
Domestic	637,006	748,104
Foreign	808,881	838,161
Less than \$100,000		
Domestic	354,998	389,682
Foreign	255,621	272,363
Total time, certificates of deposit	<u>2,056,506</u>	<u>2,248,310</u>
Total deposits	<u>\$ 8,544,892</u>	<u>\$ 8,610,089</u>

	<u>2017</u>	<u>2016</u>	<u>2015</u>
	<u>(Dollars in Thousands)</u>		
Interest expense:			
Savings and interest bearing demand			
Domestic	\$ 5,453	\$ 3,922	\$ 3,026
Foreign	755	640	567
Total savings and interest bearing demand	<u>6,208</u>	<u>4,562</u>	<u>3,593</u>
Time, certificates of deposit \$100,000 or more			
Domestic	3,644	3,881	4,693
Foreign	4,105	3,929	4,116
Less than \$100,000			
Domestic	1,312	1,447	1,680
Foreign	675	706	744
Total time, certificates of deposit	<u>9,736</u>	<u>9,963</u>	<u>11,233</u>
Total interest expense on deposits	<u>\$ 15,944</u>	<u>\$ 14,525</u>	<u>\$ 14,826</u>

INTERNATIONAL BANCSHARES CORPORATION AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Continued)

Scheduled maturities of time deposits as of December 31, 2017 were as follows:

	Total
	(in Thousands)
2018	\$ 1,859,507
2019	139,276
2020	41,572
2021	13,303
2022	2,760
Thereafter	88
Total	\$ 2,056,506

Scheduled maturities of time deposits in amounts of \$100,000 or more at December 31, 2017, were as follows:

	Total
	(in Thousands)
Due within 3 months or less	\$ 557,206
Due after 3 months and within 6 months	348,695
Due after 6 months and within 12 months	404,776
Due after 12 months	135,210
	\$ 1,445,887

Time deposits that meet or exceed the FDIC insurance limit of \$250,000 at December 31, 2017 and December 31, 2016 were \$894,000 and \$1,005,000, in thousands, respectively.

(8) Securities Sold Under Repurchase Agreements

The Company's bank subsidiaries have entered into repurchase agreements with an investment banking firm and individual customers of the bank subsidiaries. The purchasers have agreed to resell to the bank subsidiaries identical securities upon the maturities of the agreements. Securities sold under repurchase agreements were mortgage-backed securities and averaged \$402,396,000 and \$759,458,000 during 2017 and 2016, respectively, and the maximum amount outstanding at any month end during 2017 and 2016 was \$514,616,000 and \$819,155,000 respectively.

INTERNATIONAL BANCSHARES CORPORATION AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Continued)

Further information related to repurchase agreements at December 31, 2017 and 2016 is set forth in the following table:

	Collateral Securities		Repurchase Borrowing	
	Book Value of Securities Sold	Fair Value of Securities Sold	Balance of Liability	Weighted Average Interest Rate
	(Dollars in Thousands)			
December 31, 2017 term:				
Overnight agreements	\$ 340,054	\$ 334,506	\$ 242,824	0.25 %
1 to 29 days.....	—	—	—	—
30 to 90 days.....	109,300	107,238	100,000	3.99
Over 90 days.....	11,327	11,168	10,981	0.74
Total	\$ 460,681	\$ 452,912	\$ 353,805	1.32 %
December 31, 2016 term:				
Overnight agreements	\$ 295,282	\$ 292,286	\$ 190,915	0.15 %
1 to 29 days.....	10,250	10,148	9,863	0.50
30 to 90 days.....	2,315	2,317	2,300	0.33
Over 90 days.....	382,304	375,060	301,907	4.01
Total	\$ 690,151	\$ 679,811	\$ 504,985	2.46 %

The book value and fair value of securities sold includes the entire book value and fair value of securities partially or fully pledged under repurchase agreements.

(9) Other Borrowed Funds

Other borrowed funds include Federal Home Loan Bank borrowings, which are short and long-term fixed borrowings issued by the Federal Home Loan Bank of Dallas at the market price offered at the time of funding. These borrowings are secured by mortgage-backed investment securities and a portion of the Company's loan portfolio. The increase in other borrowed funds is a result of purchases of available-for-sale securities.

Further information regarding the Company's other borrowed funds at December 31, 2017 and 2016 is set forth in the following table:

	December 31,	
	2017	2016
	(Dollars in Thousands)	
Federal Home Loan Bank advances—short-term		
Balance at year end	\$ 945,225	\$ 583,375
Rate on balance outstanding at year end	1.44 %	0.66 %
Average daily balance	\$ 839,858	\$ 483,379
Average rate	1.23 %	0.47 %
Maximum amount outstanding at any month end	\$ 1,043,250	\$ 600,875
Federal Home Loan Bank advances—long-term ⁽¹⁾		
Balance at year end	\$ 250,000	\$ 150,000
Rate on balance outstanding at year end	1.26 %	0.58 %
Average daily balance	\$ 51,644	\$ 150,000
Average rate	1.26 %	0.58 %
Maximum amount outstanding at any month end	\$ 250,000	\$ 150,000

(1) Long-term advances outstanding at December 31, 2017 mature in the following increments: \$100,000,000 in November 2027 and \$150,000,000 in December 2027 and are callable by the FHLB on a quarterly basis. Long-Term advances outstanding at December 31, 2016 matured in January 2017.

INTERNATIONAL BANCSHARES CORPORATION AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Continued)

(10) Junior Subordinated Deferrable Interest Debentures

The Company has formed six statutory business trusts under the laws of the State of Delaware, for the purpose of issuing trust preferred securities. The statutory business trusts formed by the Company (the “Trusts”) have each issued Capital and Common Securities and invested the proceeds thereof in an equivalent amount of junior subordinated debentures (the “Debentures”) issued by the Company. As of December 31, 2017 and December 31, 2016, the principal amount of debentures outstanding totaled \$160,416,000. On July 29, 2015, the Company bought back a portion of the Capital Securities of IB Capital Trusts X and XI from the holder of the securities for a price that reflected an approximate 24.5% discount from the redemption prices of the securities. The Company thereby retired \$13,000,000 of the total \$34,021,000 of related Junior Subordinated Deferrable Interest Debentures related to IB Capital Trust X and \$1,000,000 of the total \$27,990,000 of related Junior Subordinated Deferrable Interest Debentures related to IB Capital Trust XI. On November 1, 2016, the Company bought back a portion of the Capital Securities of IB Capital Trust XI from the holder of the securities for a price that reflected an approximate 24% discount from the redemption price of the securities. The Company thereby retired \$1,000,000 of the total \$26,990,000 of related Junior Subordinated Deferrable Interest Debentures related to IB Capital Trust XI. The discounts recorded in connection with the repurchases of the outstanding Capital Securities are included in other income on the consolidated financial statements.

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

For financial reporting purposes, the Trusts are treated as investments of the Company and not consolidated in the consolidated financial statements. Although the Capital Securities issued by each of the Trusts are not included as a component of shareholders’ equity on the consolidated statement of condition, the Capital Securities are treated as capital for regulatory purposes. Specifically, under applicable regulatory guidelines, the Capital Securities issued by the Trusts qualify as Tier 1 capital up to a maximum of 25% of Tier 1 capital on an aggregate basis. Any amount that exceeds the 25% threshold would qualify as Tier 2 capital. At December 31, 2017 and December 31, 2016, the total \$160,416,000 of the Capital Securities outstanding qualified as Tier 1 capital.

The following table illustrates key information about each of the Debentures and their interest rates at December 31, 2017:

	Junior Subordinated Deferrable Interest Debentures	Repricing Frequency	Interest Rate	Interest Rate Index(1)	Maturity Date	Optional Redemption Date⁽¹⁾
	(Dollars in Thousands)					
Trust VI	\$ 25,774	Quarterly	4.87 %	LIBOR + 3.45	November 2032	February 2008
Trust VIII	25,774	Quarterly	4.41 %	LIBOR + 3.05	October 2033	October 2008
Trust IX	41,238	Quarterly	2.96 %	LIBOR + 1.62	October 2036	October 2011
Trust X	21,021	Quarterly	3.03 %	LIBOR + 1.65	February 2037	February 2012
Trust XI	25,990	Quarterly	2.96 %	LIBOR + 1.62	July 2037	July 2012
Trust XII	20,619	Quarterly	2.93 %	LIBOR + 1.45	September 2037	September 2012
	<u>\$ 160,416</u>					

(1) The Capital Securities may be redeemed in whole or in part on any interest payment date after the Optional Redemption Date.

(11) Earnings per Share (“EPS”)

Basic EPS is calculated by dividing net income by the weighted average number of common shares outstanding. The computation of diluted EPS assumes the issuance of common shares for all dilutive potential common shares

INTERNATIONAL BANCSHARES CORPORATION AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Continued)

outstanding during the reporting period. The calculation of the basic EPS and the diluted EPS for the years ended December 31, 2017, 2016, and 2015 is set forth in the following table:

	Net Income (Numerator)	Shares (Denominator)	Per Share Amount
(Dollars in Thousands, Except Per Share Amounts)			
December 31, 2017:			
Basic EPS			
Net income available to common shareholders	\$ 157,436	66,046,155	\$ 2.38
Potential dilutive common shares and warrants	—	732,281	
Diluted EPS	\$ 157,436	66,778,436	\$ 2.36
December 31, 2016:			
Basic EPS			
Net income available to common shareholders	\$ 133,932	65,967,989	\$ 2.03
Potential dilutive common shares and warrants	—	345,501	
Diluted EPS	\$ 133,932	66,313,490	\$ 2.02
December 31, 2015:			
Basic EPS			
Net income available to common shareholders	\$ 136,726	66,411,193	\$ 2.06
Potential dilutive common shares	—	225,160	
Diluted EPS	\$ 136,726	66,636,353	\$ 2.05

(12) Employees' Profit Sharing Plan

The Company has a deferred profit sharing plan for full-time employees with a minimum of one year of continuous employment. The Company's annual contribution to the plan is based on a percentage, as determined by the Board of Directors, of income before income taxes, as defined, for the year. Allocation of the contribution among officers and employees' accounts is based on length of service and amount of salary earned. Profit sharing costs of \$3,750,000, \$3,650,000 and \$3,525,000 were charged to income for the years ended December 31, 2017, 2016, and 2015, respectively.

(13) International Operations

The Company provides international banking services for its customers through its bank subsidiaries. Neither the Company nor its bank subsidiaries have facilities located outside the United States. International operations are distinguished from domestic operations based upon the domicile of the customer.

Because the resources employed by the Company are common to both international and domestic operations, it is not practical to determine net income generated exclusively from international activities.

INTERNATIONAL BANCSHARES CORPORATION AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Continued)

A summary of assets attributable to international operations at December 31, 2017 and 2016 are as follows:

	2017	2016
	(Dollars in Thousands)	
Loans:		
Commercial	\$ 113,019	\$ 124,079
Others	45,867	43,141
	158,886	167,220
Less allowance for probable loan losses	(842)	(884)
Net loans	\$ 158,044	\$ 166,336
Accrued interest receivable	\$ 671	\$ 603

At December 31, 2017, the Company had \$99,547,000 in outstanding standby and commercial letters of credit to facilitate trade activities.

Revenues directly attributable to international operations were approximately \$5,248,000, \$5,495,000 and \$6,113,000 for the years ended December 31, 2017, 2016 and 2015, respectively.

(14) Income Taxes

The Company files a consolidated U.S. Federal and State income tax return. The current and deferred portions of net income tax expense included in the consolidated statements of income are presented below for the years ended December 31:

	2017	2016	2015
	(Dollars in Thousands)		
Current			
U.S.	\$ 56,974	\$ 52,403	\$ 65,196
State	2,662	3,362	5,258
Foreign	—	—	(6)
Total current taxes	59,636	55,765	70,448
Deferred			
U.S.	4,620	7,279	(261)
State	(50)	27	(71)
Total deferred taxes	4,570	7,306	(332)
Total income taxes	\$ 64,206	\$ 63,071	\$ 70,116

INTERNATIONAL BANCSHARES CORPORATION AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Continued)

Total income tax expense differs from the amount computed by applying the U.S. Federal income tax rate of 35% for 2017, 2016 and 2015 to income before income taxes. The reasons for the differences for the years ended December 31 are as follows:

	<u>2017</u>	<u>2016</u>	<u>2015</u>
	(Dollars in Thousands)		
Computed expected tax expense	\$ 77,643	\$ 69,253	\$ 72,389
Change in taxes resulting from:			
Tax-exempt interest income	(4,701)	(3,940)	(3,910)
State tax, net of federal income taxes, tax credit and refunds	1,697	3,287	3,371
Resolution of IRS exam	(4,985)	—	—
Other investment income	(3,198)	(3,694)	(3,540)
Deferred tax adjustment due to federal tax rate change	(3,168)	—	—
Other	918	(1,835)	1,806
Actual tax expense	<u>\$ 64,206</u>	<u>\$ 63,071</u>	<u>\$ 70,116</u>

The tax effects of temporary differences that give rise to significant portions of the deferred tax assets and deferred tax liabilities at December 31, 2017 and 2016 are reflected below:

	<u>2017</u>	<u>2016</u>
	(Dollars in Thousands)	
Deferred tax assets:		
Loans receivable, principally due to the allowance for probable loan losses	\$ 14,546	\$ 24,315
Other real estate owned	2,053	3,652
Impairment charges on available-for-sale securities	844	6,086
Accrued expenses	81	137
Net unrealized losses on available for sale investment securities	9,680	14,791
Other	4,434	6,917
Total deferred tax assets	<u>31,638</u>	<u>55,898</u>
Deferred tax liabilities:		
Bank premises and equipment, principally due to differences on depreciation	(10,940)	(19,837)
Identified intangible assets and goodwill	(13,417)	(21,386)
Other	(12,474)	(16,300)
Total deferred tax liabilities	<u>(36,831)</u>	<u>(57,523)</u>
Net deferred tax liability	<u>\$ (5,193)</u>	<u>\$ (1,625)</u>

The net deferred tax liability of \$5,193,000 at December 31, 2017 and \$1,625,000 at December 31, 2016 is included in other liabilities in the consolidated statements of condition.

In September 2014, the Company amended its 2012 federal income tax return as a result of a tax opinion obtained regarding a judgment against the Company paid in 2012 after litigation related to tax matters in the Company's 2004 acquisition of Local Financial Corporation ("LFIN"). Litigation against the Company was initiated by the former controlling shareholders of LFIN with respect to such tax matters. On March 5, 2010, a judgment against the Company was entered on a jury verdict in the U.S. District Court for the Western District of Oklahoma. The Company subsequently appealed the decision and on January 5, 2012, the United States Court of Appeals Tenth Circuit affirmed the judgment and it became final and unappealable and the Company recorded the majority of the payment of the judgment as a non-deductible expense in the Company's 2012 federal income tax return. The Company engaged legal counsel to review the

INTERNATIONAL BANCSHARES CORPORATION AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Continued)

deductibility of the judgment and, upon receiving the tax opinion, amended the 2012 tax return to report the payment as a deductible expense. The Internal Revenue Service examined the amended return and at the conclusion of the exam, allowed a certain portion of the judgment to be deducted as a necessary and ordinary business expense, resulting in a tax refund of \$4.9 million.

On December 22, 2017, the Tax Cuts and Jobs Act (“Tax Act”) was signed into law. The Tax Act materially changes U.S. corporate income tax rates, among other things. The Company was in a net deferred tax liability position at the time the Tax Act was enacted and subsequently revalued the carrying value of the net deferred liability and its components to the new 21% effective tax rate. The change in the tax rate resulted in a net benefit to the Company of \$3,168,000 and is included as a reduction to income tax expense in the consolidated income statement.

(15) Stock Options

On April 5, 2012, the Board of Directors adopted the 2012 International Bancshares Corporation Stock Option Plan (the “2012 Plan”). There are 800,000 shares available for stock option grants under the 2012 Plan. Under the 2012 Plan, both qualified incentive stock options (“ISOs”) and non-qualified stock options (“NQSOS”) may be granted. Options granted may be exercisable for a period of up to 10 years from the date of grant, excluding ISOs granted to 10% shareholders, which may be exercisable for a period of up to only five years. As of December 31, 2017, 216,400 shares were available for future grants under the 2012 Plan.

The fair value of each option award granted under the plan is estimated on the date of grant using a Black-Scholes-Merton option valuation model that uses the assumptions noted in the following table. Expected volatility is based on the historical volatility of the price of the Company’s stock. The Company uses historical data to estimate the expected dividend yield and employee termination rates within the valuation model. The expected term of options is derived from historical exercise behavior. The risk-free rate for periods within the contractual life of the option is based on the U.S. Treasury yield curve in effect at the time of grant.

	2017 ⁽¹⁾	2016
Expected Life (Years).....	—	7.61
Dividend yield.....	— %	2.50 %
Interest rate.....	— %	1.50 %
Volatility.....	— %	41.32 %

(1) No stock options were granted during the twelve months ended December 31, 2017.

INTERNATIONAL BANCSHARES CORPORATION AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Continued)

A summary of option activity under the stock option plans for the twelve months ended December 31, 2017 is as follows:

	<u>Number of options</u>	<u>Weighted average exercise price</u>	<u>Weighted average remaining contractual term (years)</u>	<u>Aggregate intrinsic value (\$)</u> <small>(in Thousands)</small>
Options outstanding at December 31, 2016	800,502	\$ 19.43		
Plus: Options granted	—	—		
Less:				
Options exercised	108,885	13.34		
Options expired	2,188	10.40		
Options forfeited	<u>21,263</u>	20.62		
Options outstanding at December 31, 2017	<u>668,166</u>	20.41	5.54	\$ 12,887
Options fully vested and exercisable at December 31, 2017	283,472	\$ 18.62	4.46	\$ 5,975

Stock-based compensation expense included in the consolidated statements of income for the years ended December 31, 2017, 2016 and 2015 was approximately \$903,000, \$1,082,000 and \$1,172,000, respectively. As of December 31, 2017, there was approximately \$1,418,000 of total unrecognized stock-based compensation cost related to non-vested options granted under the Company plans that will be recognized over a weighted average period of 1.4 years.

Other information pertaining to option activity during the twelve month period ending December 31, 2017, 2016 and 2015 is as follows:

	<u>Twelve Months Ended December 31,</u>		
	<u>2017⁽¹⁾</u>	<u>2016</u>	<u>2015</u>
Weighted average grant date fair value of stock options granted	\$ —	\$ 8.74	\$ 9.42
Total fair value of stock options vested	\$ 1,182,000	\$ 1,015,000	\$ 872,000
Total intrinsic value of stock options exercised	\$ 2,595,000	\$ 792,000	\$ 781,000

(1) No stock options were granted during the twelve months ended December 31, 2017.

(16) Long Term Restricted Stock Units

As a participant in the Troubled Asset Relief Program Capital Purchase Program (the “CPP”) until November 28, 2012, the Company was subject to certain compensation restrictions, which included a prohibition on the payment or accrual of any bonuses (including equity-based incentive compensation) to certain officers and employees except for awards of CPP-compliant long- term restricted stock and stock units.

On December 18, 2009, the Company’s board of directors (the “Board”) adopted the 2009 International Bancshares Corporation Long-Term Restricted Stock Unit Plan (the “Plan”) to give the Company additional flexibility in the compensation of its officers, employees, consultants and advisors in compliance with all applicable laws and restrictions.

The Plan authorizes the Company to issue Restricted Stock Units (“RSUs”) to officers, employees, consultants and advisors of the Company and its subsidiaries. The Plan provides that RSUs shall be issued by a committee of the Board

INTERNATIONAL BANCSHARES CORPORATION AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Continued)

appointed by the Board from time to time consisting of at least two (2) members of the Board, each of whom is both a non-employee director and an outside director. On December 18, 2009, the Board adopted resolutions creating the Long-Term Restricted Stock Unit Plan Committee to administer the Plan. RSUs issued under the Plan are not equity and are payable only in cash. The Plan provides for both the issuance of CPP-compliant long-term RSUs as well as RSUs that are not CPP-compliant. No grants have been made under the Plan since December 2012 and there are currently no outstanding grants under the Plan.

(17) Commitments, Contingent Liabilities and Other Matters

The Company leases portions of its banking premises and equipment under operating leases. Total rental expense for the years ended December 31, 2017, 2016 and 2015 were approximately \$5,258,000, \$5,870,000 and \$6,200,000, respectively. Future minimum lease payments due under non-cancellable operating leases at December 31, 2017 were as follows:

Fiscal year ending:

	<u>Total</u>
	<u>(in thousands)</u>
2018	\$ 3,563
2019	3,376
2020	3,087
2021	2,037
2022	494
Thereafter	180
Total	<u>\$ 12,737</u>

It is expected that certain leases will be renewed, as these leases expire. Aggregate future minimum rentals to be received under non-cancellable sub-leases greater than one year at December 31, 2017 were \$92,416,000.

Cash of approximately \$116,129,000 and \$111,353,000 at December 31, 2017 and 2016, respectively, was maintained to satisfy regulatory reserve requirements.

The Company is involved in various legal proceedings that are in various stages of litigation. The Company has determined, based on discussions with its counsel that any material loss in such actions, individually or in the aggregate, is remote or the damages sought, even if fully recovered, would not be considered material to the consolidated statements of condition and related statements of income, comprehensive income, shareholders' equity and cash flows of the Company. However, many of these matters are in various stages of proceedings and further developments could cause management to revise its assessment of these matters.

(18) Transactions with Related Parties

In the ordinary course of business, the subsidiaries of the Company make loans to directors and executive officers of the Corporation, including their affiliates, families and companies in which they are principal owners. In the opinion of management, these loans are made on substantially the same terms, including interest rates and collateral, as those prevailing at the time for comparable transactions with other persons and do not involve more than normal risk of collectability or present other unfavorable features. The aggregate amounts receivable from such related parties amounted to approximately \$27,626,000 and \$26,547,000 at December 31, 2017 and 2016, respectively.

INTERNATIONAL BANCSHARES CORPORATION AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Continued)

(19) Financial Instruments with Off-Statement of Condition Risk and Concentrations of Credit Risk

In the normal course of business, the bank subsidiaries are party to financial instruments with off-statement of condition risk to meet the financing needs of their customers. These financial instruments include commitments to their customers. These financial instruments involve, to varying degrees, elements of credit risk in excess of the amounts recognized in the consolidated statement of condition. The contract amounts of these instruments reflect the extent of involvement the bank subsidiaries have in particular classes of financial instruments. At December 31, 2017, the following financial amounts of instruments, whose contract amounts represent credit risks, were outstanding:

Commitments to extend credit	\$ 2,795,137,000
Credit card lines.	20,643,000
Standby letters of credit	95,402,000
Commercial letters of credit	4,145,000

The Company enters into a standby letter of credit to guarantee performance of a customer to a third party. These guarantees are primarily issued to support public and private borrowing arrangements. The credit risk involved is represented by the contractual amounts of those instruments. Under the standby letters of credit, the Company is required to make payments to the beneficiary of the letters of credit upon request by the beneficiary so long as all performance criteria have been met. At December 31, 2017, the maximum potential amount of future payments is approximately \$95,402,000. At December 31, 2017, the fair value of these guarantees is not significant. Unsecured letters of credit totaled approximately \$35,409,000 and \$40,738,000 at December 31, 2017 and 2016, respectively.

The Company enters into commercial letters of credit on behalf of its customers which authorize a third party to draw drafts on the Company up to a stipulated amount and with specific terms and conditions. A commercial letter of credit is a conditional commitment on the part of the Company to provide payment on drafts drawn in accordance with the terms of the commercial letter of credit.

The bank subsidiaries' exposure to credit loss in the event of nonperformance by the other party to the above financial instruments is represented by the contractual amounts of the instruments. The bank subsidiaries use the same credit policies in making commitments and conditional obligations as they do for on-statement of condition instruments. The bank subsidiaries control the credit risk of these transactions through credit approvals, limits and monitoring procedures. Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates normally less than one year or other termination clauses and may require the payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The bank subsidiaries evaluate each customer's credit-worthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the subsidiary banks upon extension of credit, is based on management's credit evaluation of the customer. Collateral held varies, but may include residential and commercial real estate, bank certificates of deposit, accounts receivable and inventory.

The bank subsidiaries make commercial, real estate and consumer loans to customers principally located in South, Central and Southeast Texas and the State of Oklahoma. Although the loan portfolio is diversified, a substantial portion of its debtors' ability to honor their contracts is dependent upon the economic conditions in these areas, especially in the real estate and commercial business sectors.

(20) Capital Requirements

On December 23, 2008, as part of the Troubled Asset Relief Program Capital Purchase Program of the United States Department of the Treasury ("Treasury"), the Company issued to the Treasury a warrant to purchase 1,326,238 shares of the Company's common stock at a price per share of \$24.43 and with a term of ten years (the "Warrant").

INTERNATIONAL BANCSHARES CORPORATION AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Continued)

On June 12, 2013, the U.S. Treasury sold the Warrant to a third party. As of February 20, 2016, the Warrant is still outstanding. Adjustments to the \$24.43 per share Exercise Price of the Warrant will be made if the Company pays cash dividends in excess of 33 cents per semi-annual period or makes certain other shareholder distributions before the Warrants expires on December 23, 2018.

Bank regulatory agencies limit the amount of dividends, which the bank subsidiaries can pay the Corporation, through IBC Subsidiary Corporation, without obtaining prior approval from such agencies. At December 31, 2017, the subsidiary banks could pay dividends of up to \$731,850,000 to the Corporation without prior regulatory approval and without adversely affecting their “well-capitalized” status under regulatory capital rules in effect at December 31, 2017. In addition to legal requirements, regulatory authorities also consider the adequacy of the bank subsidiaries’ total capital in relation to their deposits and other factors. These capital adequacy considerations also limit amounts available for payment of dividends. The Company historically has not allowed any subsidiary bank to pay dividends in such a manner as to impair its capital adequacy.

The Company and the bank subsidiaries are subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory and possibly additional discretionary actions by regulators that, if undertaken, could have a direct material effect on the Company’s consolidated financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Company must meet specific capital guidelines that involve quantitative measures of the Company’s assets, liabilities, and certain off-statement of condition items as calculated under regulatory accounting practices. The Company’s capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.

Current quantitative measures established by regulation to ensure capital adequacy require the Company to maintain minimum amounts and ratios (set forth in the table on the following page) of Total and Tier 1 capital to risk-weighted assets and of Tier 1 capital to average assets. Management believes, as of December 31, 2017, that the Company and each of the bank subsidiaries met all capital adequacy requirements to which they are subject.

In July 2013, the Federal Deposit Insurance Corporation (“FDIC”) and other regulatory bodies established a new, comprehensive capital framework for U.S. banking organizations, consisting of minimum requirements that increase both the quantity and quality of capital held by banking organizations. The final rules are a result of the implementation of the BASEL III capital reforms and various Dodd-Frank Act related capital provisions. Consistent with the Basel international framework, the rules include a new minimum ratio of Common Equity Tier 1 (“CET1”) to risk-weighted assets of 4.5% and a CET1 capital conservation buffer of 2.5% of risk-weighted assets. The capital conservation buffer began phasing-in on January 1, 2016 at .625% and increases each year until January 1, 2019, when the Company will be required to have a 2.5% capital conservation buffer, effectively resulting in a minimum ratio of CET1 capital to risk-weighted assets of at least 7% upon full implementation. The rules also raised the minimum ratio of Tier 1 capital to risk-weighted assets from 4% to 6% and include a minimum leverage ratio of 4% for all banking organizations. Regarding the quality of capital, the new rules emphasize CET1 capital and implements strict eligibility criteria for regulatory capital instruments. The new rules also improve the methodology for calculating risk-weighted assets to enhance risk sensitivity. The new rules are subject to a four year phase in period for mandatory compliance and the Company was required to begin to phase in the new rules beginning on January 1, 2015. Management believes, as of December 31, 2017, that the Company and each of the bank subsidiaries will meet all capital adequacy requirements once the capital conservation is fully phased-in.

On November 21, 2017, the OCC, the Federal Reserve and the FDIC finalized a proposed rule that extends the current treatment under the regulatory capital rules for certain regulatory capital deductions and risk weights and certain minority interest requirements, as they apply to banking organizations that are not subject to the advanced approaches capital rules. Effective January 1, 2018, the rule also pauses the full transition to the Basel III treatment of mortgage servicing assets, certain deferred tax assets, investments in the capital of unconsolidated financial institutions and minority

INTERNATIONAL BANCSHARES CORPORATION AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Continued)

interests. The agencies are also considering whether to make adjustments to the capital rules in response to CECL (the FASB Standard relating to current expected credit loss) and its potential impact on regulatory capital.

On December 7, 2017, the Basel Committee on Banking Supervision unveiled the latest round of its regulatory capital framework, commonly called “Basel IV.” The framework makes changes to the capital framework first introduced as “Basel III” in 2010. The committee targeted 2022-2027 as the timeframe for implementation by regulators in individual countries, including the U.S. federal bank regulatory agencies (after notice and comment).

The aforementioned capital conservation buffer is designed to absorb losses during periods of economic stress. Banking institutions with a ratio of CET1 capital to risk-weighted assets above the minimum but below the conservation buffer will face constraints on dividends, equity repurchases and compensation based on the amount of the shortfall.

As of December 31, 2017, capital levels at the Company exceed all capital adequacy requirements under the Basel III Capital Rules as currently applicable to the Company. Based on the ratios presented below, capital levels as of December 31, 2017 at the Company exceed the minimum levels necessary to be considered “well capitalized.”

As of December 31, 2017, the most recent notification from the Federal Deposit Insurance Corporation categorized all the bank subsidiaries as well-capitalized under the regulatory framework for prompt corrective action. To be categorized as “well-capitalized,” the Company and the bank subsidiaries must maintain minimum Total risk-based, Tier 1 risk based, and Tier 1 leverage ratios as set forth in the table. There are no conditions or events since that notification that management believes have changed the categorization of the Company or any of the bank subsidiaries as well-capitalized.

INTERNATIONAL BANCSHARES CORPORATION AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Continued)

The Company's and the bank subsidiaries' actual capital amounts and ratios for 2017 under current guidelines are presented in the following table:

	<u>Actual</u>		<u>For Capital Adequacy Purposes</u>		<u>To Be Well-Capitalized Under Prompt Corrective Action Provisions</u>	
	<u>Amount</u>	<u>Ratio</u>	<u>Phase In Schedule</u>		<u>Amount</u>	<u>Ratio</u>
			<u>(greater than or equal to)</u>	<u>(greater than or equal to)</u>		
(Dollars in Thousands)						
As of December 31, 2017:						
Common Equity Tier 1 (to Risk Weighted Assets):						
Consolidated	\$ 1,584,665	17.11 %	\$ 532,579	5.750 %	N/A	N/A
International Bank of Commerce, Laredo	1,119,173	17.10	376,245	5.750	\$ 425,320	6.50 %
International Bank of Commerce, Oklahoma	169,279	13.41	72,586	5.750	82,054	6.50
International Bank of Commerce, Brownsville	165,034	25.94	36,583	5.750	41,355	6.50
International Bank of Commerce, Zapata	66,406	30.58	12,487	5.750	14,116	6.50
Commerce Bank	79,330	33.22	13,733	5.750	15,524	6.50
Total Capital (to Risk Weighted Assets):						
Consolidated	\$ 1,807,107	19.51 %	\$ 856,757	9.250 %	N/A	N/A
International Bank of Commerce, Laredo	1,173,068	17.93	605,263	9.250	\$ 654,339	10.00 %
International Bank of Commerce, Oklahoma	178,057	14.11	116,769	9.250	126,237	10.00
International Bank of Commerce, Brownsville	170,613	26.82	58,851	9.250	63,623	10.00
International Bank of Commerce, Zapata	68,718	31.64	20,088	9.250	21,717	10.00
Commerce Bank	81,278	34.03	22,092	9.250	23,884	10.00
Tier 1 Capital (to Risk Weighted Assets):						
Consolidated	\$ 1,734,595	18.73 %	\$ 671,512	7.250 %	N/A	N/A
International Bank of Commerce, Laredo	1,119,173	17.10	474,395	7.250	\$ 523,471	8.00 %
International Bank of Commerce, Oklahoma	169,279	13.41	91,521	7.250	100,989	8.00
International Bank of Commerce, Brownsville	165,034	25.94	46,127	7.250	50,899	8.00
International Bank of Commerce, Zapata	66,406	30.58	15,745	7.250	17,374	8.00
Commerce Bank	79,330	33.22	17,316	7.250	19,107	8.00
Tier 1 Capital (to Average Assets):						
Consolidated	\$ 1,734,595	14.62 %	\$ 474,675	4.00 %	\$ N/A	N/A
International Bank of Commerce, Laredo	1,119,173	13.44	333,166	4.00	416,458	5.00 %
International Bank of Commerce, Oklahoma	169,279	11.31	59,854	4.00	74,818	5.00
International Bank of Commerce, Brownsville	165,034	17.17	38,440	4.00	48,050	5.00
International Bank of Commerce, Zapata	66,406	14.20	18,701	4.00	23,376	5.00
Commerce Bank	79,330	14.56	21,789	4.00	27,236	5.00

INTERNATIONAL BANCSHARES CORPORATION AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Continued)

The Company's and the bank subsidiaries' actual capital amounts and ratios for 2016 are also presented in the following table:

	Actual		For Capital Adequacy Purposes		To Be Well-Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount (greater than or equal to)	Ratio (greater than or equal to)	Amount (greater than or equal to)	Ratio (greater than or equal to)
As of December 31, 2016:						
Common Equity Tier 1 (to Risk Weighted Assets):						
Consolidated	\$ 1,468,662	16.95 %	\$ 444,190	5.125 %	N/A	N/A
International Bank of Commerce, Laredo	1,201,527	16.63	370,342	5.125	\$ 469,701	6.50 %
International Bank of Commerce, Brownsville	158,533	25.61	31,720	5.125	40,230	6.50
International Bank of Commerce, Zapata	65,989	34.09	9,922	5.125	12,584	6.50
Commerce Bank	73,765	31.84	11,872	5.125	15,058	6.50
Total Capital (to Risk Weighted Assets):						
Consolidated	\$ 1,687,501	19.47 %	\$ 747,540	8.625 %	N/A	N/A
International Bank of Commerce, Laredo	1,260,886	17.45	623,258	8.625	\$ 722,618	10.00 %
International Bank of Commerce, Brownsville	163,937	26.49	53,382	8.625	61,892	10.00
International Bank of Commerce, Zapata	67,464	34.85	16,698	8.625	19,360	10.00
Commerce Bank	76,093	32.85	19,980	8.625	23,166	10.00
Tier 1 Capital (to Risk Weighted Assets):						
Consolidated	\$ 1,618,935	18.68 %	\$ 574,197	6.625 %	N/A	N/A
International Bank of Commerce, Laredo	1,201,527	16.63	478,734	6.625	\$ 578,094	8.00 %
International Bank of Commerce, Brownsville	158,533	25.61	41,004	6.625	49,514	8.00
International Bank of Commerce, Zapata	65,989	34.09	12,826	6.625	15,488	8.00
Commerce Bank	73,765	31.84	15,347	6.625	18,532	8.00
Tier 1 Capital (to Average Assets):						
Consolidated	\$ 1,618,935	13.91 %	\$ 465,438	4.00 %	N/A	N/A
International Bank of Commerce, Laredo	1,201,527	12.50	384,342	4.00	480,427	5.00 %
International Bank of Commerce, Brownsville	158,533	16.91	37,509	4.00	46,886	5.00
International Bank of Commerce, Zapata	65,989	13.87	19,029	4.00	23,786	5.00
Commerce Bank	73,765	13.05	22,607	4.00	28,259	5.00

(21) Fair Value

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

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

INTERNATIONAL BANCSHARES CORPORATION AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Continued)

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

The following table represents financial instruments reported on the consolidated statements of condition at their fair value as of December 31, 2017 by level within the fair value measurement hierarchy.

	Assets/Liabilities Measured at Fair Value December 31, 2017	Fair Value Measurements at Reporting Date Using (in Thousands)		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
<i>Measured on a recurring basis:</i>				
Assets:				
Available for sale securities				
Residential mortgage-backed securities	\$ 3,891,233	\$ —	\$ 3,891,233	\$ —
States and political subdivisions	232,951	—	232,951	—
Equity Securities	27,886	27,886	—	—
	<u>\$ 4,152,070</u>	<u>\$ 27,886</u>	<u>\$ 4,124,184</u>	<u>\$ —</u>

The following table represents financial instruments reported on the consolidated balance sheets at their fair value as of December 31, 2016 by level within the fair value measurement hierarchy.

	Assets/Liabilities Measured at Fair Value December 31, 2016	Fair Value Measurements at Reporting Date Using (in Thousands)		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
<i>Measured on a recurring basis:</i>				
Assets:				
Available for sale securities				
Residential mortgage - backed securities	\$ 3,894,470	\$ —	\$ 3,876,865	\$ 17,605
States and political subdivisions	254,972	—	254,972	—
Equity Securities	27,907	27,907	—	—
	<u>\$ 4,177,349</u>	<u>\$ 27,907</u>	<u>\$ 4,131,837</u>	<u>\$ 17,605</u>

For the year ended December 31, 2017, investment securities available-for-sale are classified within level 2 of the valuation hierarchy, with the exception of certain equity investments that are classified within level 1. For the year ended December 31, 2016, the Company had certain securities classified within level 3 of the fair value hierarchy. Those investments were sold in the first quarter of 2017. For investments classified as level 2 in the fair value hierarchy, the Company obtains fair value measurements for investment securities from an independent pricing service. The fair value measurements consider observable data that may include dealer quotes, market spreads, cash flows, the U.S. Treasury yield curve, live trading levels, trade execution data, market consensus prepayment speeds, credit information and the bond's terms and conditions, among other things. Investment securities classified as level 3 are non-agency

INTERNATIONAL BANCSHARES CORPORATION AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Continued)

mortgage-backed securities. The non-agency mortgage-backed securities held by the Company are traded in inactive markets and markets that have experienced significant decreases in volume and level of activity, as evidenced by few recent transactions, a significant decline or absence of new issuances, price quotations that are not based on comparable securities transactions and wide bid-ask spreads among other factors. As a result of the inability to use quoted market prices to determine fair value for these securities, the Company determined that fair value, as determined by level 3 inputs in the fair value hierarchy, is more appropriate for financial reporting and more consistent with the expected performance of the investments. For the investments classified within level 3 of the fair value hierarchy, the Company used a discounted cash flow model to determine fair value. Inputs in the model included both historical performance and expected future performance based on information currently available.

Assumptions used in the discounted cash flow model as of December 31, 2016 for investment securities classified within level 3 of the fair value hierarchy, were applied separately to those portions of the bond where the underlying residential mortgage loans had been performing under original contract terms for at least the prior 24 months and those where the underlying residential mortgages had not been meeting the original contractual obligation for the same period. Unobservable inputs included in the model are estimates on future principal prepayment rates, and default and loss severity rates. For that portion of the bond where the underlying residential mortgage had been meeting the original contract terms for at least 24 months, the Company used the following estimates in the model: (i) a voluntary prepayment rate of 7%, (ii) a 1% default rate, (iii) a loss severity rate of 25%, and (iv) a discount rate of 13%. The assumptions used in the model for the rest of the bond included the following estimates: (i) a voluntary prepayment rate of 2%, (ii) a default rate of 4.5%, (iii) a loss severity rate that started at 60% for the first year (2012) then declines by 5% for the following four years (2013, 2014, 2015, and 2016), and (iv) a discount rate of 13%. The estimates used in the model to determine fair value were based on observable historical data of the underlying collateral.

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

Balance at December 31, 2016.....	\$ 17,605
Principal paydowns	(798)
Sales of available for sale securities	(21,904)
Reclassification of unrealized gains (losses) included in other comprehensive loss due to sale	<u>5,097</u>
Balance at December 31, 2017.....	<u>\$ —</u>

Certain financial instruments are measured at fair value on a nonrecurring basis. They are not measured at fair value on an ongoing basis but are subject to fair value adjustments in certain circumstances (for example, when there is evidence of impairment).

INTERNATIONAL BANCSHARES CORPORATION AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Continued)

The following table represents financial instruments measured at fair value on a non-recurring basis as of and for the period ended December 31, 2017 by level within the fair value measurement hierarchy:

	Assets/Liabilities Measured at Fair Value Year ended December 31, 2017	Fair Value Measurements at Reporting Date Using			Net Provision (Credit) During Period
		(in thousands)			
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	
<i>Measured on a non-recurring basis:</i>					
Assets:					
Impaired loans	\$ 11,210	\$ —	\$ —	\$ 11,210	\$ 2,138
Other real estate owned	2,000	—	—	2,000	710

The following table represents financial instruments measured at fair value on a non-recurring basis as of and for the year ended December 31, 2016 by level within the fair value measurement hierarchy:

	Assets/Liabilities Measured at Fair Value Year ended December 31, 2016	Fair Value Measurements at Reporting Date Using			Net (Credit) Provision During Period
		(in thousands)			
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	
<i>Measured on a non-recurring basis:</i>					
Assets:					
Impaired loans	\$ 38,794	\$ —	\$ —	\$ 38,794	\$ 19,699
Other real estate owned	9,445	—	—	9,445	2,351

The Company's assets measured at fair value on a non-recurring basis are limited to impaired loans and other real estate owned. Impaired loans are classified within level 3 of the valuation hierarchy. The fair value of impaired loans is derived in accordance with FASB ASC 310, "Receivables". Impaired loans are primarily comprised of collateral-dependent commercial loans. Understanding that as the primary sources of loan repayments decline, the secondary repayment source comes into play and correctly evaluating the fair value of that secondary source, the collateral, becomes even more important. Re-measurement of the impaired loan to fair value is done through a specific valuation allowance included in the allowance for probable loan losses. The fair value of impaired loans is based on the fair value of the collateral, as determined through either an appraisal or evaluation process. The basis for the Company's appraisal and appraisal review process is based on regulatory guidelines and strives to comply with all regulatory appraisal laws, regulations and the Uniform Standards of Professional Appraisal Practice. All appraisals and evaluations are "as is" (the property's highest and best use) valuations based on the current conditions of the property/project at that point in time. The determination of the fair value of the collateral is based on the net realizable value, which is the appraised value less any closing costs, when applicable. As of December 31, 2017, the Company had approximately \$53,267,000 of impaired commercial collateral dependent loans, of which approximately \$18,585,000 had an appraisal performed within the immediately preceding twelve months and of which approximately \$0 had an evaluation performed within the immediately preceding twelve months. As of December 31, 2016, the Company had approximately \$38,108,000 of impaired commercial collateral dependent loans, of which approximately \$26,162,000 had an appraisal performed within the

INTERNATIONAL BANCSHARES CORPORATION AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Continued)

immediately preceding twelve months and of which approximately \$6,836,000 had an evaluation performed within the immediately preceding twelve months.

The determination to either seek an appraisal or to perform an evaluation begins in weekly credit quality meetings, where the committee analyzes the existing collateral values of the impaired loans and where obsolete appraisals are identified. In order to determine whether the Company would obtain a new appraisal or perform an internal evaluation to determine the fair value of the collateral, the credit committee reviews the existing appraisal to determine if the collateral value is reasonable in view of the current use of the collateral and the economic environment related to the collateral. If the analysis of the existing appraisal does not find that the collateral value is reasonable under the current circumstances, the Company would obtain a new appraisal on the collateral or perform an internal evaluation of the collateral. The ultimate decision to get a new appraisal rests with the independent credit administration group. A new appraisal is not required if an internal evaluation, as performed by in-house experts, is able to appropriately update the original appraisal assumptions to reflect current market conditions and provide an estimate of the collateral's market value for impairment analysis. The internal evaluations must be in writing and contain sufficient information detailing the analysis, assumptions and conclusions and they must support performing an evaluation in lieu of ordering a new appraisal.

Other real estate owned is comprised of real estate acquired by foreclosure and deeds in lieu of foreclosure. Other real estate owned is carried at the lower of the recorded investment in the property or its fair value less estimated costs to sell such property (as determined by independent appraisal) within level 3 of the fair value hierarchy. Prior to foreclosure, the value of the underlying loan is written down to the fair value of the real estate to be acquired by a charge to the allowance for probable loan losses, if necessary. The fair value is reviewed periodically and subsequent write downs are made accordingly through a charge to operations. Other real estate owned is included in other assets on the consolidated financial statements. For the twelve months ended December 31, 2017, December 31, 2016 and December 31, 2015, respectively the Company recorded approximately \$30,000, \$381,000 and \$696,000 in charges to the allowance for probable loan losses in connection with loans transferred to other real estate owned. For the twelve months ended December 31, 2017, December 31, 2016 and December 31, 2015, respectively, the Company recorded approximately \$710,000, \$2,351,000 and \$1,023,000 in adjustments to fair value in connection with other real estate owned.

The fair value estimates, methods, and assumptions for the Company's financial instruments at December 31, 2017 and December 31, 2016 are outlined below.

Cash and Cash Equivalents

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

Investment securities held-to-maturity

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

Investment Securities

For investment securities, which include U.S. Treasury securities, obligations of other U.S. government agencies, obligations of states and political subdivisions and mortgage pass through and related securities, fair values are from an independent pricing service. The fair value measurements consider observable data that may include dealer quotes, market spreads, cash flows, the U.S. Treasury yield curve, live trading levels, trade execution data, market consensus prepayment speeds, credit information and the bond's terms and conditions, among other things. See disclosures of fair value of investment securities in Note 2.

INTERNATIONAL BANCSHARES CORPORATION AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Continued)

Loans

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

For variable rate performing loans, the carrying amount approximates the fair value. For fixed rate performing loans, except residential mortgage loans, the fair value is calculated by discounting scheduled cash flows through the estimated maturity using estimated market discount rates that reflect the credit and interest rate risk inherent in the loan. For performing residential mortgage loans, fair value is estimated by discounting contractual cash flows adjusted for prepayment estimates using discount rates based on secondary market sources or the primary origination market. Fixed rate performing loans are within Level 3 of the fair value hierarchy. At December 31, 2017, and December 31, 2016, the carrying amount of fixed rate performing loans was \$1,505,531,000 and \$1,411,272,000, respectively, and the estimated fair value was \$1,454,434,000 and \$1,375,807,000, respectively.

Accrued Interest

The carrying amounts of accrued interest approximate fair value.

Deposits

The fair value of deposits with no stated maturity, such as non-interest bearing demand deposit accounts, savings accounts and interest bearing demand deposit accounts, was equal to the amount payable on demand as of December 31, 2017 and December 31, 2016. The fair value of time deposits is based on the discounted value of contractual cash flows. The discount rate is based on currently offered rates. Time deposits are within Level 3 of the fair value hierarchy. At December 31, 2017 and December 31, 2016, the carrying amount of time deposits was \$2,056,506,000 and \$2,248,310,000, respectively, and the estimated fair value was \$2,058,621,000 and \$2,247,648,000, respectively.

Securities Sold Under Repurchase Agreements

Securities sold under repurchase agreements include both short and long-term maturities. Due to the contractual terms of the short-term instruments, the carrying amounts approximated fair value at December 31, 2017 and December 31, 2016. The fair value of the long-term instruments is based on established market spread using option adjusted spreads methodology. Long-term repurchase agreements are within level 3 of the fair value hierarchy. At December 31, 2017 and December 31, 2016, respectively, the carrying amount of long-term repurchase agreements was \$100,000,000 and \$300,000,000 and the estimated fair value was \$99,504,000 and \$289,324,000, respectively.

Junior Subordinated Deferrable Interest Debentures

The company currently has floating rate junior subordinated deferrable interest debentures outstanding. Due to the contractual terms of the floating rate junior subordinated deferrable interest debentures, the carrying amounts approximated fair value at December 31, 2017 and December 31, 2016.

Other Borrowed Funds

The company currently has short and long-term borrowings issued from the Federal Home Loan Bank (“FHLB”). Due to the contractual terms of the short-term borrowings, the carrying amounts approximated fair value at December 31, 2017 and December 31, 2016. The long-term borrowings outstanding at December 31, 2017 are fixed-rate borrowings and the fair value is based on established market spreads for similar types of borrowings. The fixed-rate long-term borrowings

INTERNATIONAL BANCSHARES CORPORATION AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Continued)

are included in Level 2 of the fair value hierarchy. At December 31, 2017, the carrying amount of the fixed-rate long-term FHLB borrowings was \$250,000,000 and the estimated fair value was \$249,728,000.

Commitments to Extend Credit and Letters of Credit

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

Limitations

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

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

INTERNATIONAL BANCSHARES CORPORATION AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Continued)

(22) International Bancshares Corporation (Parent Company Only) Financial Information

Statements of Condition

(Parent Company Only)

December 31, 2017 and 2016

(Dollars in Thousands)

	<u>2017</u>	<u>2016</u>
ASSETS		
Cash	\$ 18,398	\$ 18,555
Other investments	92,620	94,908
Investment in subsidiaries	1,878,521	1,787,120
Other assets	23,120	1,098
Total assets	<u>\$ 2,012,659</u>	<u>\$ 1,901,681</u>
LIABILITIES AND SHAREHOLDERS' EQUITY		
Liabilities:		
Junior subordinated deferrable interest debentures	\$ 160,416	\$ 160,416
Due to IBC Trading	21	21
Other liabilities	13,242	16,577
Total liabilities	<u>173,679</u>	<u>177,014</u>
Shareholders' equity:		
Common shares	96,019	95,910
Surplus	171,816	169,567
Retained earnings	1,891,805	1,777,963
Accumulated other comprehensive (loss) income	(28,397)	(26,697)
	<u>2,131,243</u>	<u>2,016,743</u>
Less cost of shares in treasury	(292,263)	(292,076)
Total shareholders' equity	<u>1,838,980</u>	<u>1,724,667</u>
Total liabilities and shareholders' equity	<u>\$ 2,012,659</u>	<u>\$ 1,901,681</u>

INTERNATIONAL BANCSHARES CORPORATION AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Continued)

(23) International Bancshares Corporation (Parent Company Only) Financial Information

Statements of Income

(Parent Company Only)

Years ended December 31, 2017, 2016 and 2015

(Dollars in Thousands)

	<u>2017</u>	<u>2016</u>	<u>2015</u>
Income:			
Dividends from subsidiaries	\$ 64,600	\$ 84,432	\$ 51,575
Interest income on notes receivable	—	2	7
Interest income on other investments	8,100	8,958	5,738
Other	<u>26</u>	<u>255</u>	<u>3,442</u>
Total income	72,726	93,647	60,762
Expenses:			
Interest expense (Debentures)	5,392	4,600	4,099
Other	<u>5,648</u>	<u>3,637</u>	<u>3,037</u>
Total expenses	<u>11,040</u>	<u>8,237</u>	<u>7,136</u>
Income before federal income taxes and equity in undistributed net income of subsidiaries	61,686	85,410	53,626
Income tax expense	<u>(2,076)</u>	311	386
Income before equity in undistributed net income of subsidiaries	63,762	85,099	53,240
Equity in undistributed net income of subsidiaries	<u>93,674</u>	<u>48,833</u>	<u>83,486</u>
Net income	<u>\$ 157,436</u>	<u>\$ 133,932</u>	<u>\$ 136,726</u>

INTERNATIONAL BANCSHARES CORPORATION AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Continued)

(24) International Bancshares Corporation (Parent Company Only) Financial Information

**Statements of Cash Flows
(Parent Company Only)**

**Years ended December 31, 2017, 2016 and 2015
(Dollars in Thousands)**

	<u>2017</u>	<u>2016</u>	<u>2015</u>
Operating activities:			
Net income	\$ 157,436	\$ 133,932	\$ 136,726
Adjustments to reconcile net income to net cash provided by operating activities:			
Investment securities transactions, net	(23)	—	—
Impairment charges on available for sale securities	—	112	385
Stock compensation expense	903	1,082	1,172
(Decrease) increase in other liabilities	(3,453)	3,901	(1,998)
Equity in undistributed net income of subsidiaries	(93,674)	(48,833)	(83,486)
Net cash provided by operating activities	<u>61,189</u>	<u>90,194</u>	<u>52,799</u>
Investing activities:			
Principal collected on mortgage-backed securities	6,328	1,105	474
Net decrease in notes receivable	—	99	105
Increase in other assets and other investments	(25,348)	(27,834)	(1,830)
Net cash used in investing activities	<u>(19,020)</u>	<u>(26,630)</u>	<u>(1,251)</u>
Financing activities:			
Redemption of long-term debt	—	(1,000)	(14,000)
Proceeds from stock transactions	1,455	549	1,370
Payments of cash dividends - common	(43,594)	(39,569)	(38,515)
Purchase of treasury stock	(187)	(7,966)	(6,678)
Net cash used in financing activities	<u>(42,326)</u>	<u>(47,986)</u>	<u>(57,823)</u>
(Decrease) increase in cash	(157)	15,578	(6,275)
Cash at beginning of year	18,555	2,977	9,252
Cash at end of year	<u>\$ 18,398</u>	<u>\$ 18,555</u>	<u>\$ 2,977</u>

INTERNATIONAL BANCSHARES CORPORATION AND SUBSIDIARIES
Condensed Quarterly Income Statements
(Dollars in Thousands, Except Per Share Amounts)

	<u>Fourth Quarter</u>	<u>Third Quarter</u>	<u>Second Quarter</u>	<u>First Quarter</u>
2017				
Interest income	\$ 108,036	\$ 106,945	\$ 103,174	\$ 96,981
Interest expense	<u>10,895</u>	<u>9,993</u>	<u>8,797</u>	<u>9,246</u>
Net interest income	97,141	96,952	94,377	87,735
Provision for probable loan losses	2,125	6,591	805	1,700
Non-interest income	37,362	41,366	33,963	37,715
Non-interest expense	<u>72,698</u>	<u>71,711</u>	<u>73,713</u>	<u>75,626</u>
Income before income taxes	59,680	60,016	53,822	48,124
Income taxes	<u>14,445</u>	<u>20,388</u>	<u>13,253</u>	<u>16,120</u>
Net income	<u>\$ 45,235</u>	<u>\$ 39,628</u>	<u>\$ 40,569</u>	<u>\$ 32,004</u>
Per common share:				
Basic				
Net income	<u>\$ 0.69</u>	<u>\$ 0.60</u>	<u>\$ 0.61</u>	<u>\$ 0.48</u>
Diluted				
Net income	<u>\$ 0.68</u>	<u>\$ 0.59</u>	<u>\$ 0.61</u>	<u>\$ 0.48</u>

INTERNATIONAL BANCSHARES CORPORATION AND SUBSIDIARIES
Condensed Quarterly Income Statements
(Dollars in Thousands, Except Per Share Amounts)

	<u>Fourth Quarter</u>	<u>Third Quarter</u>	<u>Second Quarter</u>	<u>First Quarter</u>
2016				
Interest income	\$ 96,337	\$ 96,624	\$ 97,896	\$ 97,057
Interest expense	<u>10,113</u>	<u>11,175</u>	<u>11,024</u>	<u>10,817</u>
Net interest income	86,224	85,449	86,872	86,240
Provision for probable loan losses	4,975	(1,347)	7,097	9,134
Non-interest income	43,630	40,530	36,611	40,931
Non-interest expense	<u>73,056</u>	<u>76,667</u>	<u>71,984</u>	<u>67,918</u>
Income before income taxes	51,823	50,659	44,402	50,119
Income taxes	<u>16,350</u>	<u>14,872</u>	<u>14,714</u>	<u>17,135</u>
Net income	<u>\$ 35,473</u>	<u>\$ 35,787</u>	<u>\$ 29,688</u>	<u>\$ 32,984</u>
Per common share:				
Basic				
Net income	<u>\$ 0.54</u>	<u>\$ 0.54</u>	<u>\$ 0.45</u>	<u>\$ 0.50</u>
Diluted				
Net income	<u>\$ 0.53</u>	<u>\$ 0.54</u>	<u>\$ 0.45</u>	<u>\$ 0.50</u>

INTERNATIONAL BANCSHARES CORPORATION AND SUBSIDIARIES
Condensed Average Statements of Condition
(Dollars in Thousands)
(Unaudited)

Distribution of Assets, Liabilities and Shareholders' Equity

The following table sets forth a comparative summary of average interest earning assets and average interest bearing liabilities and related interest yields for the years ended December 31, 2017, 2016, and 2015. Tax-exempt income has not been adjusted to a tax-equivalent basis:

	2017			2016			2015		
	Average Balance	Interest	Average Rate/Cost	Average Balance	Interest	Average Rate/Cost	Average Balance	Interest	Average Rate/Cost
(Dollars in Thousands)									
<i>Assets</i>									
Interest earning assets:									
Loan, net of unearned discounts:									
Domestic	\$ 6,026,180	\$ 317,320	5.27 %	\$ 5,781,466	\$ 292,325	5.06 %	\$ 5,662,616	\$ 291,180	5.14 %
Foreign	157,684	5,188	3.29	167,582	5,495	3.28	182,226	6,103	3.35
Investment securities:									
Taxable	3,954,632	82,347	2.08	4,044,843	79,533	1.97	4,404,569	88,008	2.00
Tax-exempt	235,253	9,656	4.10	253,990	10,356	4.08	275,267	11,319	4.11
Other	84,752	625	0.74	84,275	205	0.24	100,816	144	0.14
Total interest-earning assets	10,458,501	415,136	3.97 %	10,332,156	387,914	3.75 %	10,625,494	396,754	3.73 %
Non-interest earning assets:									
Cash and cash equivalents	179,134			154,334			166,460		
Bank premises and equipment, net	494,327			488,110			499,233		
Other assets	957,270			1,006,286			951,728		
Less allowance for probable loan losses	(68,312)			(66,021)			(65,857)		
Total	\$ 12,020,920			\$ 11,914,865			\$ 12,177,058		
<i>Liabilities and Shareholders' Equity</i>									
Interest bearing liabilities:									
Savings and interest bearing demand deposits	\$ 3,230,463	\$ 6,208	0.19 %	\$ 3,090,355	\$ 4,562	0.15 %	\$ 3,036,542	\$ 3,593	0.12 %
Time deposits:									
Domestic	1,074,199	4,956	0.46	1,169,156	5,328	0.46	1,278,148	6,374	0.50
Foreign	1,097,240	4,780	0.44	1,123,315	4,635	0.41	1,155,698	4,859	0.42
Securities sold under repurchase agreements	402,396	6,617	1.64	759,458	20,876	2.75	872,611	23,777	2.72
Other borrowings	891,611	10,978	1.23	633,380	3,128	0.49	864,535	1,615	0.19
Junior subordinated interest deferrable debentures	160,416	5,392	3.36	161,249	4,600	2.85	170,843	4,099	2.40
Total interest bearing liabilities	6,856,325	38,931	0.57 %	6,936,913	43,129	0.62 %	7,378,377	44,317	0.60 %
Non-interest bearing liabilities:									
Demand Deposits	3,230,708			3,148,590			3,059,527		
Other liabilities	107,952			90,308			82,571		
Shareholders' equity	1,825,935			1,739,054			1,620,583		
Total	\$ 12,020,920			\$ 11,914,865			\$ 12,141,058		
Net interest income		\$ 376,205			\$ 344,785			\$ 352,437	
Net yield on interest earning assets			3.34 %			3.34 %			3.32 %

**INTERNATIONAL BANCSHARES CORPORATION
OFFICERS AND DIRECTORS**

OFFICERS

DENNIS E. NIXON
Chairman of the Board and President

JULIE L. TARVIN
Vice President

JUDITH I. WAWROSKI
Treasurer

WILLIAM J. CUELLAR
Auditor

MARISA V. SANTOS
Secretary

HILDA V. TORRES
Assistant Secretary

DIRECTORS

DENNIS E. NIXON
Chairman of the Board
International Bank of Commerce

JAVIER DE ANDA
Senior Vice President
B.P. Newman Investment Company

IRVING GREENBLUM
International Investments/Real Estate

DOUG HOWLAND
Investments

PEGGY NEWMAN
Investments

LARRY NORTON
President
Norton Stores, Inc.

ROBERTO R. RESENDEZ
Owner
Cattle Ranching and Real Estate Investment Company

ANTONIO R. SANCHEZ, JR.
Chairman of the Board
Sanchez Oil & Gas Corporation
Investments

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