



Independent Bankers Financial Corporation and Subsidiaries

Auditor's Report and Consolidated Financial Statements
December 31, 2012 and 2011



Independent Bankers Financial Corporation and Subsidiaries

Financial Report
December 31, 2012

Contents

| | |
|--|------|
| Independent Auditor's Report | 1 |
| <hr/> | |
| Financial Statements | |
| Consolidated balance sheets | 2 |
| Consolidated statements of income | 3 |
| Consolidated statements of comprehensive income | 4 |
| Consolidated statements of changes in shareholders' equity | 5 |
| Consolidated statements of cash flows | 6 |
| Notes to consolidated financial statements | 7-42 |



Independent Auditor's Report

To the Shareholders and Board of Directors
Independent Bankers Financial Corporation and Subsidiaries
Irving, Texas

Report on the Financial Statements

We have audited the accompanying consolidated financial statements of Independent Bankers Financial Corporation and Subsidiaries (the Corporation) which comprise the consolidated balance sheets as of December 31, 2012 and 2011, and the related consolidated statements of income, comprehensive income, changes in stockholders' equity and cash flows for the years then ended and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Independent Bankers Financial Corporation and Subsidiaries as of December 31, 2012 and 2011, and the results of its operations and its cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

We also have examined, in accordance with attestation standards established by the American Institute of Certified Public Accountants, the internal control over financial reporting of TIB – The Independent BankersBank (the Bank), a wholly owned subsidiary of the Corporation, as of December 31, 2012 and our report dated March 18, 2013 expressed an unqualified opinion on the effectiveness of the Bank's internal control over financial reporting.

McGladrey LLP

Dallas, Texas
March 18, 2013

Independent Bankers Financial Corporation and Subsidiaries

Consolidated Balance Sheets

December 31, 2012 and 2011

(Dollar amounts in thousands, except per share amounts)

| Assets | 2012 | 2011 |
|--|---------------------|---------------------|
| Cash due from banks | \$ 38,862 | \$ 12,334 |
| Interest-bearing deposits | 1,031,134 | 1,273,375 |
| Federal funds sold and securities purchased under agreements to resell | 74,685 | 80,715 |
| Total cash equivalents | 1,144,681 | 1,366,424 |
| Interest-bearing time deposits | - | 240 |
| Securities available for sale | 669,696 | 401,697 |
| Other investments | 7,598 | 11,842 |
| Loans held for sale | 67,532 | 49,833 |
| Loans, net | 584,440 | 588,997 |
| Premises and equipment, net | 20,407 | 3,885 |
| Other real estate owned, net | 2,735 | 4,108 |
| Mortgage servicing rights | 8,866 | 9,509 |
| Accrued interest receivable | 5,860 | 5,586 |
| Cash surrender value of life insurance | 42,296 | 26,002 |
| Deferred tax assets, net | 7,356 | 11,800 |
| Intangible assets, net | 5,084 | 6,037 |
| Other assets | 23,061 | 19,751 |
| Total assets | \$ 2,589,612 | \$ 2,505,711 |
| Liabilities and Shareholders' Equity | | |
| Deposits: | | |
| Noninterest-bearing | \$ 722,488 | \$ 727,386 |
| Interest-bearing | 1,159,877 | 994,386 |
| Total deposits | 1,882,365 | 1,721,772 |
| Federal funds purchased and securities sold under agreements to repurchase | 325,836 | 303,262 |
| Derivatives | 17,300 | 21,684 |
| Accrued interest payable and other liabilities | 24,092 | 40,441 |
| Other borrowings | 100,000 | 200,000 |
| Junior subordinated debentures | 30,928 | 30,928 |
| Total liabilities | 2,380,521 | 2,318,087 |
| Commitments and contingencies | - | - |
| Shareholders' equity: | | |
| Preferred stock, 1,000,000 shares authorized, par value \$1 per share, liquidation value \$1,000 per share: | | |
| Series A fixed rate preferred stock - issued and outstanding; 30,230 shares in 2012 and 2011 | 30 | 30 |
| Series A floating rate preferred stock - issued and outstanding; 9,775 shares in 2012 and 2011 | 10 | 10 |
| Common stock, par value \$10 per share, 5,000,000 shares authorized, 1,168,158 and 1,157,176 shares issued and outstanding in 2012 and 2011 | 11,681 | 11,572 |
| Preferred surplus | 39,965 | 39,965 |
| Capital surplus | 31,424 | 30,024 |
| Retained earnings | 127,137 | 111,588 |
| Accumulated other comprehensive loss | (1,156) | (5,565) |
| Total shareholders' equity | 209,091 | 187,624 |
| Total liabilities and shareholders' equity | \$ 2,589,612 | \$ 2,505,711 |

See Notes to Consolidated Financial Statements.

Independent Bankers Financial Corporation and Subsidiaries

Consolidated Statements of Income
Years Ended December 31, 2012 and 2011
(Dollar amounts in thousands)

| | 2012 | 2011 |
|--|------------------|------------------|
| Interest income: | | |
| Loans, including fees - taxable | \$ 23,595 | \$ 25,812 |
| Loans, including fees - tax exempt | 6,276 | 7,783 |
| Securities - taxable | 13,803 | 14,007 |
| Due from banks | 3,401 | 3,190 |
| Federal funds sold and repurchase agreements | 423 | 380 |
| Other | 197 | 201 |
| Total interest income | <u>47,695</u> | <u>51,373</u> |
| Interest expense: | | |
| Deposits | 8,464 | 8,480 |
| Federal funds purchased and repurchase agreements | 3,644 | 4,171 |
| Junior subordinated debentures and other borrowings | 6,099 | 8,498 |
| Total interest expense | <u>18,207</u> | <u>21,149</u> |
| Net interest income | 29,488 | 30,224 |
| Provision for loan losses | <u>2,962</u> | <u>2,719</u> |
| Net interest income after provision for loan losses | 26,526 | 27,505 |
| Noninterest income | 110,591 | 106,493 |
| Noninterest expense | <u>109,591</u> | <u>113,994</u> |
| Income before income taxes | 27,526 | 20,004 |
| Federal income taxes: | | |
| Current expense | 5,360 | 3,160 |
| Deferred expense | 2,070 | 982 |
| | <u>7,430</u> | <u>4,142</u> |
| Net income | \$ 20,096 | \$ 15,862 |

See Notes to Consolidated Financial Statements.

Independent Bankers Financial Corporation and Subsidiaries

Consolidated Statements of Comprehensive Income
Years Ended December 31, 2012 and 2011
(Dollar amounts in thousands)

| | 2012 | 2011 |
|--|------------------|-----------|
| Net income | \$ 20,096 | \$ 15,862 |
| Other comprehensive income: | | |
| Change in fair value of interest rate swap derivatives | 4,414 | (9,147) |
| Net tax effect | (1,545) | 3,201 |
| Fair value of interest rate swap derivatives, net | 2,869 | (5,946) |
| Change in fair value of securities available for sale | 1,333 | (385) |
| Reclassification adjustment for net gain on sale of securities | 1,036 | 1,381 |
| Net tax effect | (829) | (349) |
| Unrealized appreciation of securities available for sale | 1,540 | 647 |
| Total other comprehensive income (loss) | 4,409 | (5,299) |
| Comprehensive income | \$ 24,505 | \$ 10,563 |

See Notes to Consolidated Financial Statements.

Independent Bankers Financial Corporation and Subsidiaries

**Consolidated Statements of Changes in Shareholders' Equity
Years Ended December 31, 2012 and 2011
(Dollar amounts in thousands, except per share amounts)**

| | Preferred Stock | Common Stock | Preferred Surplus | Capital Surplus | Retained Earnings | Accumulated Other Comprehensive Loss | Total Shareholders' Equity |
|--|--------------------|------------------|----------------------|--------------------|----------------------|---|----------------------------------|
| Balance at January 1, 2011 | \$ 40 | \$ 11,491 | \$ 39,965 | \$ 29,093 | \$ 100,129 | \$ (266) | \$ 180,452 |
| Net income | - | - | - | - | 15,862 | - | 15,862 |
| Other comprehensive loss, net of tax | - | - | - | - | - | (5,299) | (5,299) |
| Sale of common stock (8,062 shares) | - | 81 | - | 931 | - | - | 1,012 |
| Preferred stock dividends | - | - | - | - | (2,205) | - | (2,205) |
| Common stock dividend declared (\$1.90 per share) | - | - | - | - | (2,198) | - | (2,198) |
| Balance at December 31, 2011 | 40 | 11,572 | 39,965 | 30,024 | 111,588 | (5,565) | 187,624 |
| Net income | - | - | - | - | 20,096 | - | 20,096 |
| Other comprehensive income, net of tax | - | - | - | - | - | 4,409 | 4,409 |
| Purchase and retirement of common stock (385 shares) | - | (4) | - | (46) | - | - | (50) |
| Sale of common stock (11,366 shares) | - | 113 | - | 1,446 | - | - | 1,559 |
| Preferred stock dividends | - | - | - | - | (2,211) | - | (2,211) |
| Common stock dividend declared (\$2.00 per share) | - | - | - | - | (2,336) | - | (2,336) |
| Balance at December 31, 2012 | \$ 40 | \$ 11,681 | \$ 39,965 | \$ 31,424 | \$ 127,137 | \$ (1,156) | \$ 209,091 |

See Notes to Consolidated Financial Statements.

Independent Bankers Financial Corporation and Subsidiaries

Consolidated Statements of Cash Flows Years Ended December 31, 2012 and 2011 (Dollar amounts in thousands)

| | 2012 | 2011 |
|--|---------------------|---------------------|
| Cash flows from operating activities: | | |
| Net income | \$ 20,096 | \$ 15,862 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 7,731 | 4,559 |
| Provision for loan losses | 2,962 | 2,719 |
| Deferred taxes | 2,070 | 982 |
| Deferred compensation and stock based compensation expense | 1,435 | 1,299 |
| Decrease in fair value of mortgage servicing rights | 4,252 | 5,600 |
| Net gain on sale of loans | (10,522) | (3,855) |
| Net gain on derivative securities | (598) | (3,553) |
| Net gain on sale of securities | (1,036) | (1,381) |
| Other (gain) loss | (166) | 1,986 |
| Increase in cash surrender value of life insurance | (784) | (838) |
| Originations and purchases of loans held for sale | (593,199) | (375,432) |
| Proceeds from sales of loans held for sale | 586,023 | 364,487 |
| Changes in operating assets and liabilities: | | |
| Other assets | 1,443 | 3,710 |
| Accrued interest receivable | (274) | 521 |
| Accrued interest payable and other liabilities | (17,925) | 749 |
| Net cash provided by operating activities | 1,508 | 17,415 |
| Cash flows from investing activities: | | |
| Securities available for sale: | | |
| Purchases | (447,521) | (191,522) |
| Proceeds from sales | 56,281 | 27,463 |
| Proceeds from maturities, calls and principal repayments | 120,723 | 106,763 |
| Proceeds from derivative securities | 805 | 3,071 |
| Proceeds from sale of other real estate | 3,006 | 1,860 |
| Purchases of mortgage servicing rights | (3,609) | (2,231) |
| Net decrease in loans | 117 | 69,745 |
| Purchases of bank owned life insurance | (15,510) | - |
| Purchases of premises and equipment | (18,050) | (887) |
| Proceeds from sales of premises and equipment | - | 7 |
| Maturities of interest-bearing time deposits | 240 | 1,536 |
| Net cash (used in) provided by investing activities | (303,518) | 15,805 |
| Cash flows from financing activities: | | |
| Net change in deposits | 160,593 | 332,414 |
| Net change in federal funds purchased and securities sold under agreements to repurchase | 22,574 | (133,332) |
| Principal payments on other borrowings | (100,000) | - |
| Purchase and retirement of common stock | (50) | - |
| Sale of common stock | 1,559 | 1,012 |
| Dividends paid | (4,409) | (4,268) |
| Net cash provided by financing activities | 80,267 | 195,826 |
| Net (decrease) increase in cash equivalents | (221,743) | 229,046 |
| Cash equivalents at beginning of year | 1,366,424 | 1,137,378 |
| Cash equivalents at end of year | \$ 1,144,681 | \$ 1,366,424 |
| Supplemental cash flow information: | | |
| Cash paid for interest | \$ 18,547 | \$ 20,588 |
| Cash paid for taxes | \$ 8,606 | \$ 3,394 |
| Noncash transactions: | | |
| Real estate acquired in foreclosure or in settlement of loans | \$ 1,478 | \$ 7,733 |
| Dividends declared but unpaid | \$ 2,892 | \$ 2,754 |

See Notes to Consolidated Financial Statements.

Independent Bankers Financial Corporation and Subsidiaries

Notes to Consolidated Financial Statements (Dollar amounts in thousands)

Note 1. Summary of Significant Accounting Policies

The consolidated financial statements of Independent Bankers Financial Corporation and Subsidiaries (the Corporation) have been prepared in accordance with accounting principles generally accepted in the United States of America. The consolidated financial statements include the accounts of Independent Bankers Financial Corporation (IBFC), TIB-The Independent BankersBank (the Bank), and two nonbanking subsidiaries, ALX Consulting, Inc. and TIB Service Company. Effective December 31, 2012, IBFC Nevada Corporation, a non-operating holding company, was merged into IBFC. In addition, the Corporation wholly-owns IBFC Statutory Capital Trust II. See Note 12 for further discussion regarding the Trust.

The Bank is an entity which is defined by statute as a “bankers’ bank.” The statute requires all of the shareholders of the Bank to be depository institutions or holding companies for depository institutions and that the Bank provide services only for depository institutions or at the request of depository institutions. In this context, the Bank provides various banking and banking-related services to financial institutions primarily in Texas, New Mexico, Illinois, Georgia, Oklahoma, Louisiana and California, many of which are shareholders of the Corporation.

All significant intercompany transactions and balances have been eliminated in consolidation.

Use of estimates: The preparation of 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 and the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from these estimates. The allowance for loan losses, fair values of mortgage servicing rights, investment securities available for sale and financial instruments are estimates that are particularly subject to change.

Subsequent events: The Corporation has evaluated subsequent events through March 18, 2013, the date on which the financial statements were available to be issued.

Cash flow reporting: Cash equivalents include cash items, amounts due from banks, deposits with other financial institutions that have an initial maturity under 90 days when acquired by the Corporation, federal funds sold, and securities purchased under agreements to resell. Net cash flows are reported for loans and deposit transactions.

Concentrations and restrictions on cash equivalents: The Corporation maintains deposits with other financial institutions in amounts that exceed federal deposit insurance coverage. Furthermore, federal funds sold are essentially uncollateralized loans to other financial institutions. Management regularly evaluates the credit risk associated with the counterparties to these transactions and believes that the Corporation is not exposed to any significant credit risks on cash and cash equivalents.

The Corporation was required to have \$72,099 and \$73,786 of cash on deposit with the Federal Reserve Bank to meet regulatory reserve and clearing requirements at December 31, 2012 and 2011, respectively.

Securities: Securities to be held for indefinite periods of time are classified as available for sale and are carried at fair value, with unrealized holding gains and losses reported as a component of comprehensive income. Management determines the appropriate classification of securities at the time of purchase. Securities with limited marketability, such as stock in the Federal Reserve Bank and Federal Home Loan Bank, are carried at cost.

Independent Bankers Financial Corporation and Subsidiaries

Notes to Consolidated Financial Statements (Dollar amounts in thousands)

Interest income includes amortization of purchased premiums and discounts. Realized gains and losses on sales of securities are recorded on the trade date and are determined using the specific identification method. 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 estimating other-than-temporary impairment losses, management considers (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, and (3) the intent and ability of the Corporation to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value.

Loans held for sale: The Corporation originates mortgage loans for portfolio investment or sale in the secondary market. During the period of origination, mortgage loans are designated as held either for sale or investment purposes. Mortgage loans held for sale are carried at the lower of cost or market value, determined on a net aggregate basis. Gains or losses recognized upon the sale of loans are determined on a specific identification basis.

Loans: Loans that management has the intent and ability to hold for the foreseeable future or until maturity or pay-off are reported at their outstanding unpaid principal balances adjusted for charge offs and the allowance for loan losses. Interest income is accrued on the unpaid principal balance.

Further information regarding the Corporation's accounting policies related to past due loans, non-accrual loans, impaired loans and troubled-debt restructurings is presented in Note 3 – Loans.

Allowance for loan losses: The allowance for loan losses is a reserve established through a provision for loan losses charged to expense, which represents management's best estimate of probable losses that have been incurred within the existing portfolio of loans.

The allowance, in the judgment of management, is necessary to reserve for estimated loan losses inherent in the loan portfolio. The allowance for loan losses includes allowance allocations calculated in accordance with ASC Topic 310, "Receivables" and allowance allocations calculated in accordance with ASC Topic 450, "Contingencies." The level of the allowance reflects management's continuing evaluation of industry concentrations, specific credit risks, loan loss experience, current loan portfolio quality, present economic, political and regulatory conditions and unidentified losses inherent in the current loan portfolio, as well as trends in the foregoing. Portions of the allowance may be allocated for specific credits; however, the entire allowance is available for any credit that, in management's judgment, should be charged off. While management utilizes its best judgment and information available, the ultimate adequacy of the allowance is dependent upon a variety of factors beyond the Corporation's control, including but not limited to the performance of the loan portfolio, the economy, changes in interest rates and the view of the regulatory authorities toward loan classifications.

The Corporation's allowance for loan losses consists of three elements: (i) specific valuation allowances established for probable losses on specific loans; (ii) historical valuation allowances calculated based on historical loan loss experience for similar loans with similar characteristics and trends; and (iii) unallocated general valuation allowances determined based on general economic conditions and other qualitative risk factors both internal and external to the Corporation.

Premises and equipment: Land is carried at cost. Building and improvements, and furniture and equipment are carried at cost, less accumulated depreciation computed principally by the straight-line method based on the estimated useful lives of the related properties. Leasehold improvements are generally depreciated over the lesser of the term of the respective leases or the estimated useful lives of the improvements.

Other real estate owned: Other real estate acquired through or instead of loan foreclosure is initially recorded at fair value, less costs to sell when acquired, establishing a new cost basis. Costs after acquisition are expensed. If the fair value of the property declines, a valuation allowance is recorded through expense.

Independent Bankers Financial Corporation and Subsidiaries

Notes to Consolidated Financial Statements (Dollar amounts in thousands)

Mortgage servicing rights: Servicing assets are recognized as separate assets when rights are acquired through purchase or through sale of financial assets. Generally, purchased servicing rights are capitalized at the cost to acquire the rights. For sales of mortgage loans with servicing retained, a portion of the cost of originating the loan is allocated to the servicing right based on relative fair value. Fair value is based on market prices for comparable mortgage servicing contracts, when available, or alternatively, is based on a valuation model that calculates the present value of estimated future net servicing income. The valuation model incorporates assumptions that market participants would use in estimating future net servicing income, such as the cost to service, the discount rate, the custodial earnings rate, an inflation rate, ancillary income, prepayment speeds and default rates and losses.

Mortgage servicing rights are recorded at fair value. Any changes in fair value are included in noninterest income or expense.

Servicing fee income is recorded for fees earned for servicing loans and included in noninterest income. The fees are based on a contractual percentage of the outstanding principal or a fixed amount per loan, and are recorded as income when earned. Late fees and ancillary fees are not material.

Intangibles and other long-lived assets: The Corporation reviews long-lived assets, such as property and equipment and intangibles, subject to amortization, for impairment when events or circumstances indicate the carrying value of the assets may not be recoverable. In determining the recoverability of the asset value, an analysis is performed that primarily includes an assessment of historical cash flows and other relevant factors and circumstances. Negative cash flow is considered a potential impairment indicator. In such situations, the Corporation evaluates future cash flow projections in conjunction with qualitative factors and future operating plans. Recoverability of assets to be held and used is measured by a comparison of the asset's carrying amount to the estimated undiscounted cash flow expected to be generated by the asset. If the carrying amount of the asset exceeds the estimated future cash flow, an impairment charge is recognized by the amount by which the carrying amount exceeds the fair value.

The Corporation's impairment assessment process requires the use of estimates and assumptions regarding future cash flows and operating outcomes, which are based upon a significant degree of management judgment. Changes in economic environment, real estate markets, capital spending and overall operating performance could impact these estimates and result in future impairment charges.

Income taxes: Income tax expense is the total of the current year income tax due or refundable and the change in deferred tax assets and liabilities (excluding deferred tax assets and liabilities related to components of other comprehensive income). Deferred tax assets and liabilities are the expected future tax amounts for the temporary differences between carrying amounts and the tax bases of assets and liabilities, computed using enacted tax rates. A valuation allowance, if needed, reduces deferred tax assets to the expected amount most likely to be realized. Realization of deferred tax assets is dependent upon the generation of a sufficient level of future taxable income and recoverable taxes paid in prior years. Although realization is not assured, management believes it is more likely than not that all of the deferred tax assets will be realized.

The Corporation evaluates tax positions taken or expected to be taken in the course of preparing the Corporation's federal and state tax returns to determine whether the tax positions are "more-likely-than-not" of being sustained "when challenged" or "when examined" by the applicable tax authority. Tax positions deemed to meet the more-likely-than-not threshold would be recorded as a tax benefit or expense in the current year. The Corporation files income tax returns in U.S. federal jurisdictions and various states. With few exceptions, the Corporation is no longer subject to U.S. federal and state income tax examinations by tax authorities for years ended on or before December 31, 2006. For the years ended December 31, 2012 and 2011, management has determined there are no material uncertain tax positions. The Corporation classifies interest and, if applicable, penalties related to income tax liabilities as a component of income tax expense.

Independent Bankers Financial Corporation and Subsidiaries

Notes to Consolidated Financial Statements (Dollar amounts in thousands)

Transactions as agent: The Corporation acts as an agent for customer banks to purchase and sell federal funds. Revenue is recorded based on maturity.

The Corporation also acts as agent in facilitating overnight investment transaction between participating respondent banks and the Federal Reserve System. Transactions with the Federal Reserve System are facilitated via the Excess Balance Account (EBA) pursuant to Regulation D as applicable for correspondent banks and similarly purposed institutions while federal funds transactions are facilitated via federal funds market brokers and direct contact. The Corporation acts as intermediary for these transactions but is not otherwise obligated by the transaction. The Corporation's financial statements do not reflect these transactions except for the fees earned. At December 31, 2012 and 2011, the Corporation was agent for participating respondent banks on EBA funds totaling \$3,528,202 and \$3,260,223, respectively. There were no agent federal funds for 2012 and 2011.

Accounting for transfers and servicing of financial assets: The Corporation 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 Corporation 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.

Derivative financial instruments: The Corporation's hedging policies permit the use of various derivative financial instruments to manage interest rate risk or to hedge specified assets and liabilities. All derivatives are recorded at fair value on the Corporation's balance sheets. To qualify for hedge accounting, derivatives must be highly effective at reducing the risk associated with the exposure being hedged and must be designated as a hedge at the inception of the derivative contract. The Corporation considers a hedge to be highly effective if the change in fair value of the derivative hedging instrument is within 80% to 120% of the opposite change in the fair value of the hedged item attributable to the hedged risk. If derivative instruments are designated as hedges of fair values, both the change in the fair value of the hedge and the hedged item are included in current earnings. Fair value adjustments related to cash flow hedges are recorded in other comprehensive income. Ineffective portions of hedges are reflected in earnings as they occur. During the life of the hedge, the Corporation formally assesses whether derivatives designated as hedging instruments continue to be highly effective in offsetting changes in the fair value or cash flows of hedged items. If it is determined that a hedge has ceased to be highly effective, the Corporation will discontinue hedge accounting prospectively and the derivative instrument is reclassified to a trading position recorded at fair value.

Fair value measurements: ASC Topic 820, "Fair Value Measurements and Disclosures," defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and requires certain disclosures about fair value measurements (see Note 18 — Fair Value of Financial Instruments). In general, fair values of financial instruments are based upon quoted market prices, where available. If such quoted market prices are not available, fair value is based upon models that primarily use, as inputs, observable market-based parameters. Valuation adjustments may be made to ensure that financial instruments are recorded at fair value. These adjustments may include amounts to reflect counterparty credit quality and the Corporation's creditworthiness, among other things, as well as unobservable parameters. Any such valuation adjustments are applied consistently over time.

Loss contingencies: Loss contingencies, including claims and legal actions arising in the ordinary course of business, are recorded as liabilities when the likelihood of loss is probable and an amount or range of loss can be reasonably estimated.

Dividend restriction: Banking regulations require the maintenance of certain capital and net income levels that may limit the amount of dividends that may be paid. Approval by regulatory authorities is required if the effect of dividends declared would cause the regulatory capital of the Bank to fall below specified minimum levels. Regulatory capital requirements are more fully disclosed in Note 21 – Regulatory Matters.

Independent Bankers Financial Corporation and Subsidiaries

Notes to Consolidated Financial Statements (Dollar amounts in thousands)

Comprehensive income: Comprehensive income includes all changes in shareholders' equity during a period, except those resulting from transactions with shareholders. Besides net income, other components of the Corporation's comprehensive income include the after tax effect of changes in the net unrealized gain/loss in securities available for sale and changes in the accumulated gain/loss on effective cash flow hedging instruments.

Noninterest income: The Corporation generates significant revenues attributable to the services that it provides to its correspondent banks. The majority of these fees are related to interchange and merchant fees derived from the Corporation's credit card portfolio. Fees related to these transactions are recognized as revenue when the transaction is processed and the fee is earned.

Reclassifications: Certain reclassifications have been made to the prior year financial statements to conform to the current year presentation. Such reclassifications had no effect on net income or shareholders' equity.

New authoritative accounting guidance: *ASU No. 2011-02, "A Creditor's Determination of Whether a Restructuring is a Troubled Debt Restructuring."* The provisions of ASU No. 2011-02 provide a creditor additional guidance in determining whether a restructuring constitutes a troubled debt restructuring by concluding that both the following conditions exist: (1) a creditor has granted a concession, and (2) the borrower is experiencing financial difficulties. A provision in ASU No. 2011-02 also ends the FASB's deferral of the additional disclosures about troubled debt restructurings as required by ASU No. 2010-20. The provisions of ASU No. 2011-02 became effective for the Corporation's reporting period ending December 31, 2011 and required retrospective application to all restructurings occurring during 2011 along with additional required disclosures. The adoption of ASU No. 2011-02 did not have a material impact on the Corporation's financial statements.

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

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

Independent Bankers Financial Corporation and Subsidiaries

Notes to Consolidated Financial Statements (Dollar amounts in thousands)

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

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

Note 2. Securities Available for Sale

Securities available for sale consisted of the following:

| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Estimated Fair Value |
|-----------------------------------|-------------------|------------------------------|-------------------------------|----------------------------|
| December 31, 2012: | | | | |
| Mortgage-backed securities | \$ 654,282 | \$ 15,746 | \$ 332 | \$ 669,696 |
| December 31, 2011: | | | | |
| Mortgage-backed securities | \$ 388,652 | \$ 13,209 | \$ 164 | \$ 401,697 |

Mortgage-backed securities are backed by pools of mortgages that are insured or guaranteed by the Federal Home Loan Mortgage Corporation ("FHLMC"), the Government National Mortgage Corporation ("GNMA") or the Federal National Mortgage Corporation ("FNMA").

At December 31, 2012, there were no holdings of securities of any one issuer, other than the U.S. government and its agencies, in an amount greater than 10% of shareholders' equity.

Independent Bankers Financial Corporation and Subsidiaries

Notes to Consolidated Financial Statements (Dollar amounts in thousands)

Unrealized losses, fair value and length of time that individual securities have been in a continuous unrealized loss position as of December 31, 2012 and 2011 are summarized as follows:

| | Continuous Unrealized Losses Existing for Less than 12 Months | | Continuous Unrealized Losses Existing for Greater than 12 Months | | Total | |
|-----------------------------------|---|----------------------|--|----------------------|-------------------|----------------------|
| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| December 31, 2012: | | | | | | |
| Mortgage-backed securities | \$ 105,165 | \$ 332 | \$ - | \$ - | \$ 105,165 | \$ 332 |
| December 31, 2011: | | | | | | |
| Mortgage-backed securities | \$ 40,254 | \$ 164 | \$ - | \$ - | \$ 40,254 | \$ 164 |

For those securities with unrealized losses at December 31, 2012 and 2011, the losses are generally due to changes in interest rates and, as such, are considered by management to be temporary. Management has the ability and intent to hold these securities for a period of time sufficient for a recovery of cost.

Securities with estimated fair values of \$511,458 and \$265,924 at December 31, 2012 and 2011, respectively, were pledged to secure securities sold under agreements to repurchase or lines of credit as permitted by law.

Mortgage-backed securities are not due at a single due date.

Sales of securities available for sale were as follows:

| | <u>2012</u> | <u>2011</u> |
|----------------------|------------------|------------------|
| Proceeds from sales | <u>\$ 56,281</u> | <u>\$ 27,463</u> |
| Gross realized gains | <u>\$ 1,036</u> | <u>\$ 1,381</u> |

Independent Bankers Financial Corporation and Subsidiaries

Notes to Consolidated Financial Statements (Dollar amounts in thousands)

Note 3. Loans

Loans consisted of the following at year-end:

| | <u>2012</u> | <u>2011</u> |
|---------------------------|-------------------|-------------------|
| Correspondent loans: | | |
| Bank stock | \$ 95,800 | \$ 98,317 |
| Real estate | 159,025 | 149,361 |
| Agriculture | 3,065 | 646 |
| Commercial and industrial | 13,661 | 16,764 |
| Consumer | 1,542 | 1,159 |
| Other | 4,402 | 4,633 |
| | <u>277,495</u> | 270,880 |
| Municipal | 172,169 | 187,505 |
| Mortgage | 8,996 | 10,555 |
| Credit card | 142,738 | 137,547 |
| Gross loans | <u>601,398</u> | 606,487 |
| Allowance for loan losses | <u>(16,958)</u> | (17,490) |
| Loans, net | <u>\$ 584,440</u> | <u>\$ 588,997</u> |

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

Loans are generally in three primary categories: correspondent lending, credit cards and municipal lending. Correspondent lending may further include bank stock, real estate, commercial and industrial, and other correspondent loans.

Correspondent bank loans are underwritten after evaluating and understanding the borrower's ability to operate profitably and manage its business. Underwriting standards are designed to determine that the borrower's management possesses sound ethics and solid business acumen. The Corporation's management examines past, current, and projected cash flows to determine the ability of the borrower to repay their obligations as agreed. Correspondent loans are primarily made based on the identified cash flows of the borrower and secondarily on the underlying collateral provided by the borrower. The cash flows of borrowers, however, may not be as expected and the collateral securing these loans may fluctuate in value. Most correspondent loans are generally secured by the assets being financed or other business assets. However, some short-term loans may be made on an unsecured basis.

Bank stock loans are those generally made to holding companies, control groups, or individuals. Those loans to holding companies and control groups are generally for the purpose of bank capitalization, bank/branch purchases, or liquidity. These loans are generally secured by a majority of the outstanding stock of the bank unless through the underwriting process, it is determined the borrower warrants either unsecured debt or a minority position in collateral. Loans are also offered for minority interest bank stock or holding company loans. There is value in this underlying collateral but emphasis is given to the overall creditworthiness of the borrower. Specific minimum guidelines are considered for both secured and unsecured debts.

Independent Bankers Financial Corporation and Subsidiaries

Notes to Consolidated Financial Statements (Dollar amounts in thousands)

Real estate loans noted above exclude “held-for-sale” loans. Commercial real estate loans are viewed primarily as cash flow loans and secondarily as loans secured by real estate. Commercial real estate is generally largely dependent on the successful operation of the property securing the loan or the business conducted on the property securing the loan. Commercial real estate loans may be more adversely affected by conditions in the real estate markets or in the general economy. The properties securing the Corporation’s commercial real estate portfolio are diverse in terms of type and geographic location. This diversity can help reduce the Corporation’s exposure to adverse economic events that affect any single market or industry. Management monitors and evaluates commercial real estate loans based on collateral, geography and risk grade criteria. Within the category of commercial real estate, the volume of construction and development loans is considered insignificant. As a general rule, the Corporation avoids financing single-purpose projects unless other underwriting factors are present to help mitigate risk. The level of commercial real estate is monitored consistent with regulatory guidelines with levels substantially below those guidelines. Changes in real property values and the employment status of borrowers are key risk factors that may impact the collectability of these loans, along with the condition of the collateral if foreclosed.

The Corporation will make loans to tax-exempt municipal entities. These entities will primarily be governmental entities such as cities, counties, school districts and economic development authorities but may also include hospital districts, utility districts, universities, colleges and private schools. These entities are often very well known to local bankers who desire to maintain or expand their relationship with the entity. In the risk assessment, municipal loans are categorized as General Obligations, Revenue Bonds, and Permanent School Fund (PSF) guaranteed loans. Changes in real property values is a key risk factor that may impact the collectability of these receivables along with the nature, value, and condition of the collateral if repossessed.

The credit card portfolio consists of consumer and business loans extended through credit card accounts to individuals and entities. These loans are generally unsecured. The Corporation has a marketing relationship and provides an agent bank credit card program to correspondent banks across the country which results in a geographically diverse portfolio. The portfolio is composed of stable, relationship based applicants referred to the Corporation by these correspondent banks. The credit card program originated in the 1980s therefore the portfolio is generally seasoned and mature. The employment status of borrowers is a key risk factor that may impact the collectability of these receivables.

The Corporation engages TIB Service Company, a loan review group wholly owned by the Corporation, to review and validate the credit risk program on an annual basis. Results of these reviews are presented to management. The loan review process complements and reinforces the risk identification and assessment decisions made by lenders and credit personnel, as well as the Corporation’s policies and procedures.

Concentrations of credit: Most of the Corporation’s lending activity occurs within the State of Texas and in other markets to a much lesser degree. The majority of the Corporation’s loan portfolio consists of correspondent loans, including bank stock loans, real estate, and commercial loans, and municipal and credit card loans.

Independent Bankers Financial Corporation and Subsidiaries

Notes to Consolidated Financial Statements (Dollar amounts in thousands)

Related party loans: In the ordinary course of business, the Corporation has granted loans to certain directors, executive officers and their affiliates (collectively referred to as “related parties”). These loans were made on substantially the same terms, including interest rates and collateral, as those prevailing at the time for comparable transactions with other unaffiliated persons and do not involve more than normal risk of collectability. Activity in related party loans is presented in the following table.

| | <u>2012</u> | <u>2011</u> |
|--|-----------------|-----------------|
| Balance outstanding, beginning of year | \$ 4,118 | \$ 2,077 |
| Principal additions | 17 | 3,302 |
| Principal reductions | <u>(1,680)</u> | <u>(1,261)</u> |
| Balance outstanding, end of year | <u>\$ 2,455</u> | <u>\$ 4,118</u> |

Nonaccrual and past due loans: Loans are considered past due if the required principal and interest payments have not been received as of the date such payments were due. Loans are placed on nonaccrual status when, in management’s opinion, the borrower may be unable to meet payment obligations as they become due, as well as when required by regulatory provisions. Loans may be placed on nonaccrual status regardless of whether or not such loans are considered past due. When interest accrual is discontinued, all unpaid accrued interest is reversed. Interest income is subsequently recognized only to the extent cash payments are received in excess of principal due. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured.

Year-end nonaccrual loans, segregated by class of loans, were as follows:

| | <u>2012</u> | <u>2011</u> |
|---------------------------|-----------------|------------------|
| Correspondent loans: | | |
| Bank stock | \$ 198 | \$ - |
| Real estate | 4,699 | 11,145 |
| Agriculture | - | - |
| Commercial and industrial | - | - |
| Consumer | - | - |
| Other | - | - |
| | <u>4,897</u> | <u>11,145</u> |
| Municipal | - | - |
| Mortgage | 528 | 691 |
| Credit card | - | - |
| | <u>\$ 5,425</u> | <u>\$ 11,836</u> |

Had nonaccrual loans performed in accordance with their original contract terms, the Corporation would have recognized additional interest income, net of tax, of approximately \$230 and \$708 in 2012 and 2011, respectively.

Independent Bankers Financial Corporation and Subsidiaries

Notes to Consolidated Financial Statements (Dollar amounts in thousands)

The following table presents an age analysis of past due loans, segregated by class of loans, as of December 31, 2012 and 2011.

| | Loans 30-89 Days Past Due | Loans 90 or More Days Past Due | Total Past Due Loans | Nonaccrual |
|-----------------------------|---------------------------------|--------------------------------------|-------------------------|------------------|
| 2012: | | | | |
| Correspondent loans: | | | | |
| Bank stock | \$ 288 | \$ - | \$ 288 | \$ 198 |
| Real estate | 882 | - | 882 | 4,699 |
| Agriculture | - | - | - | - |
| Commercial and industrial | - | - | - | - |
| Consumer | - | - | - | - |
| Other | - | - | - | - |
| | <u>1,170</u> | <u>-</u> | <u>1,170</u> | <u>4,897</u> |
| Municipal | - | - | - | - |
| Mortgage | 165 | - | 165 | 528 |
| Credit card | 741 | 271 | 1,012 | - |
| | <u>\$ 2,076</u> | <u>\$ 271</u> | <u>\$ 2,347</u> | <u>\$ 5,425</u> |
| 2011: | | | | |
| Correspondent loans: | | | | |
| Bank stock | \$ - | \$ - | \$ - | \$ - |
| Real estate | - | - | - | 11,145 |
| Agriculture | - | - | - | - |
| Commercial and industrial | - | - | - | - |
| Consumer | - | - | - | - |
| Other | - | - | - | - |
| | <u>-</u> | <u>-</u> | <u>-</u> | <u>11,145</u> |
| Municipal | - | - | - | - |
| Mortgage | 1,155 | - | 1,155 | 691 |
| Credit card | 1,029 | 582 | 1,611 | - |
| | <u>\$ 2,184</u> | <u>\$ 582</u> | <u>\$ 2,766</u> | <u>\$ 11,836</u> |

Loans contractually past due over ninety days which continued to accrue interest amounted to approximately \$271 and \$582 at December 31, 2012 and 2011, respectively.

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

Independent Bankers Financial Corporation and Subsidiaries

Notes to Consolidated Financial Statements (Dollar amounts in thousands)

Troubled debt restructurings: A restructuring of a debt constitutes a Troubled Debt Restructuring (TDR) if (i) a borrower is experiencing financial difficulties and (ii) the creditor has granted a concession that it would not otherwise consider. A debt restructuring is not necessarily a troubled debt restructuring if, in general, a borrower can obtain funds from sources other than the existing financial institution, at market interest rates and terms offered for new debt with similar risk. No single item is necessarily meant to be determinative; mitigating circumstances may be considered. Indicators of financial difficulty may include but are not necessarily limited to default on any debt, bankruptcy, inability to obtain funds outside of existing creditors at an effective interest rate equal to the current market interest rate for similar debt for a non-troubled debtor, inability to service debt (principal and/or interest) in accordance with the existing loan contract terms, refusal to grant concessions likely would result in delinquency, or known debt restructuring of debts with other creditors.

All requests for renewals and/or modifications are evaluated to determine if characteristics exist that would warrant identification as a TDR. All TDR's are placed on nonaccrual for a period of time but may be reevaluated after a period of performance for possible return to accrual status. These assets are also evaluated for impairment.

| | Bank Stock | Real Estate | Other Correspondent | Municipal | Mortgage | Credit Card | Total |
|---|---------------|----------------|------------------------|-----------|----------|----------------|----------|
| Troubled debt restructurings during the year ended December 31, 2012 | | | | | | | |
| Number of contracts | - | 5 | - | - | 1 | - | 6 |
| Pre-restructuring outstanding recorded investment | \$ - | \$ 7,901 | \$ - | \$ - | \$ 174 | \$ - | \$ 8,075 |
| Post-restructuring outstanding recorded investment | \$ - | \$ 7,901 | \$ - | \$ - | \$ 174 | \$ - | \$ 8,075 |
| Troubled debt restructurings during the year ended December 31, 2011 | | | | | | | |
| Number of contracts | - | 3 | - | - | - | - | 3 |
| Pre-restructuring outstanding recorded investment | \$ - | \$ 3,797 | \$ - | \$ - | \$ - | \$ - | \$ 3,797 |
| Post-restructuring outstanding recorded investment | \$ - | \$ 3,797 | \$ - | \$ - | \$ - | \$ - | \$ 3,797 |

There were no TDR's during the previous twelve months that subsequently defaulted during the years ended December 31, 2012 and 2011, respectively.

Independent Bankers Financial Corporation and Subsidiaries

Notes to Consolidated Financial Statements (Dollar amounts in thousands)

Year-end impaired loans are set forth in the following table. Interest income of \$290 was recognized on impaired loans subsequent to their classification as impaired during the year ended December 31, 2012. There was no interest income recognized on impaired loans subsequent to their classification as impaired during the year ended December 31, 2011.

| | Unpaid Contractual Principal Balance | Recorded Investment With No Allowance | Recorded Investment With Allowance | Total Recorded Investment | Related Allowance | Average Recorded Investment During Year |
|-------------------------------|---|--|---|---------------------------------|----------------------|--|
| 2012: | | | | | | |
| Correspondent loans: | | | | | | |
| Bank stock | \$ 202 | \$ 198 | \$ - | \$ 198 | \$ - | \$ 100 |
| Real estate | 9,084 | 7,901 | - | 7,901 | - | 8,869 |
| Agriculture | - | - | - | - | - | - |
| Commercial and industrial | - | - | - | - | - | - |
| Consumer | - | - | - | - | - | - |
| Other | - | - | - | - | - | 37 |
| | <u>9,286</u> | <u>8,099</u> | <u>-</u> | <u>8,099</u> | <u>-</u> | <u>9,006</u> |
| Municipal Mortgage | - | - | - | - | - | - |
| | <u>709</u> | <u>703</u> | <u>-</u> | <u>703</u> | <u>-</u> | <u>1,009</u> |
| | <u>\$ 9,995</u> | <u>\$ 8,802</u> | <u>\$ -</u> | <u>\$ 8,802</u> | <u>\$ -</u> | <u>\$ 10,015</u> |
| 2011: | | | | | | |
| Correspondent loans: | | | | | | |
| Bank stock | \$ - | \$ - | \$ - | \$ - | \$ - | \$ - |
| Real estate | 14,736 | 11,145 | - | 11,145 | - | 11,329 |
| Agriculture | - | - | - | - | - | - |
| Commercial and industrial | - | - | - | - | - | - |
| Consumer | - | - | - | - | - | - |
| Other | - | - | - | - | - | 395 |
| | <u>14,736</u> | <u>11,145</u> | <u>-</u> | <u>11,145</u> | <u>-</u> | <u>11,724</u> |
| Municipal Mortgage | - | - | - | - | - | - |
| | <u>697</u> | <u>691</u> | <u>-</u> | <u>691</u> | <u>-</u> | <u>651</u> |
| | <u>\$ 15,433</u> | <u>\$ 11,836</u> | <u>\$ -</u> | <u>\$ 11,836</u> | <u>\$ -</u> | <u>\$ 12,375</u> |

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

Loans are graded on a scale of 1 to 10. A description of the general characteristics of the 10 risk grades is as follows:

- Grade 1 – A SUPERIOR asset is generally secured by highly liquid collateral. If a loan is secured by marketable securities, it should be adequately margined. This loan grade includes Municipal Loans that have the guarantee of the Texas Permanent School Fund. A superior asset will have no documentation deficiencies and minimal servicing issues.

Independent Bankers Financial Corporation and Subsidiaries

Notes to Consolidated Financial Statements (Dollar amounts in thousands)

- Grade 2 – A STRONG asset is generally a secured loan with some other form of credit enhancement, other than liquid collateral, adequately margined. This will typically apply to Municipal Loans that are backed by the local taxing authority where law requires taxes to be sufficient to cover the debt obligation (i.e. General Obligations or Certificates of Obligations). Loans could be secured by marketable securities, but have smaller margins than those in the Superior category. A strong asset will have no documentation deficiencies and minimal servicing issues.
- Grade 3 – A GOOD asset is based on an individual's or a company's financial capacity and/or secured by collateral where there is no impairment to liquidation. A good asset may have some vulnerability to changing economic or industry conditions but is currently a satisfactory risk. Revenue backed Municipal Loans generally fall into this loan grade.
- Grade 4 – A SATISFACTORY asset is based on an individual's or a company's financial capacity and/or secured by collateral where there is no impairment to liquidation. A satisfactory asset may have some deficiency or vulnerability above normal, based on adverse economic trends and/or industry conditions but is currently an acceptable risk with the vulnerability noted. Borrowers typically reflect acceptable, but minimum debt service coverage ratios.
- Grade 5 – An ACCEPTABLE asset is similar in repayment capacity with increased vulnerability to changing economic or industry conditions based on underwriting concessions, excessive levels of guideline non-compliance (for bank stock loans), acceptable, but marginal debt service coverage ratios (for real estate loans) and acceptable erratic financial trends but not to the point of potential weakness. Generally, this loan grade would include unsecured or marginally secured loans to Borrower's with reasonable credit risk.
- Grade 6 – A PASS/NEEDS ATTENTION asset is used to identify credits which may have one or some of the following characteristics: collateral documentation deficiencies, marginal collateral support, weak or unsupported collateral valuations, lack current or complete financial data and/or analysis, need additional monitoring increased, recent changes in management or operations, terms beyond policy guidelines, variations in balance sheet or cash flow/operating components or trends from prior periods or forecasts, past credit problems, high leverage, or untested performance under repayment terms, among others. This loan grade may include loan participations with a financially weak selling bank or a selling bank lacking the knowledge or expertise to lead the credit.
- Grade 7 – A SPECIAL MENTION asset has potential weaknesses that deserve management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the asset or in the institution's credit position at some future date. Special Mention assets are not adversely classified and do not expose the Corporation to sufficient risk to warrant adverse classification.
- Grade 8 – A SUBSTANDARD asset is inadequately protected by the current sound worth and paying capacity of the borrower or of the collateral pledged, if any. Assets so classified must have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the bank will sustain some loss if the deficiencies are not corrected.
- Grade 9 – An asset classified as DOUBTFUL has all the weaknesses inherent in a substandard loan with the added factor that the weaknesses are pronounced to a point where on the basis of current information, and values, collection or liquidation in full is highly improbable. The length of time an asset may be classified doubtful is a matter of judgment.

Independent Bankers Financial Corporation and Subsidiaries

Notes to Consolidated Financial Statements (Dollar amounts in thousands)

- Grade 10 – Assets classified LOSS are considered uncollectible and of such little value that their continuance as active assets of the bank is not warranted. This classification does not mean that an asset has absolutely no recovery or salvage value, but rather that it is not practical or desirable to defer writing off this basically worthless asset, even though partial recovery may be affected in the future. Amounts classified Loss are promptly charged off.

The following table presents weighted average risk grades and classified loans by category of loans as of December 31, 2012 and 2011. Classified loans include loans in Risk Grades 8, 9 and 10.

| | Pass (Rating 1-6) | Special Mention | Substandard | Doubtful | Loss | Total |
|------------------------------|----------------------|--------------------|------------------|---------------|-------------|-------------------|
| 2012: | | | | | | |
| Correspondent loans: | | | | | | |
| Bank stock | \$ 93,880 | \$ 1,722 | \$ 198 | \$ - | \$ - | \$ 95,800 |
| Real estate | 150,326 | 2,452 | 6,247 | - | - | 159,025 |
| Agriculture | 3,065 | - | - | - | - | 3,065 |
| Commercial and industrial | 9,496 | - | 4,165 | - | - | 13,661 |
| Consumer | 1,542 | - | - | - | - | 1,542 |
| Other | 4,216 | 69 | 117 | - | - | 4,402 |
| | <u>262,525</u> | <u>4,243</u> | <u>10,727</u> | <u>-</u> | <u>-</u> | <u>277,495</u> |
| Municipal | 172,169 | - | - | - | - | 172,169 |
| Mortgage | 8,345 | - | 651 | - | - | 8,996 |
| Credit card | 142,176 | - | 521 | 41 | - | 142,738 |
| | <u>\$ 585,215</u> | <u>\$ 4,243</u> | <u>\$ 11,899</u> | <u>\$ 41</u> | <u>\$ -</u> | <u>\$ 601,398</u> |
| 2011: | | | | | | |
| Correspondent loans: | | | | | | |
| Bank stock | \$ 98,317 | \$ - | \$ - | \$ - | \$ - | \$ 98,317 |
| Real estate | 134,607 | 3,352 | 11,402 | - | - | 149,361 |
| Agriculture | 646 | - | - | - | - | 646 |
| Commercial and industrial | 12,459 | 4,305 | - | - | - | 16,764 |
| Consumer | 1,159 | - | - | - | - | 1,159 |
| Other | 4,532 | 62 | 39 | - | - | 4,633 |
| | <u>251,720</u> | <u>7,719</u> | <u>11,441</u> | <u>-</u> | <u>-</u> | <u>270,880</u> |
| Municipal | 187,505 | - | - | - | - | 187,505 |
| Mortgage | 9,010 | 742 | 803 | - | - | 10,555 |
| Credit card | 136,621 | - | 611 | 315 | - | 137,547 |
| | <u>\$ 584,856</u> | <u>\$ 8,461</u> | <u>\$ 12,855</u> | <u>\$ 315</u> | <u>\$ -</u> | <u>\$ 606,487</u> |

Independent Bankers Financial Corporation and Subsidiaries

Notes to Consolidated Financial Statements (Dollar amounts in thousands)

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

The level of the allowance reflects management's continuing evaluation of industry concentrations, specific credit risks, loan loss experience, current loan portfolio quality, present economic, political and regulatory conditions and unidentified losses inherent in the current loan portfolio. Portions of the allowance may be allocated for specific impaired credits; however, the entire allowance is available for any credit that, in management's judgment, should be charged off. While management utilizes its best judgment and information available, the ultimate adequacy of the allowance is dependent upon a variety of factors beyond the Corporation's control, including, among other things, the performance of the Corporation's loan portfolio, the economy, changes in interest rates and the view of the regulatory authorities toward loan classifications.

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

The allowances established for probable losses on specific impaired loans are based on a regular analysis and evaluation of problem loans. Loans are classified based on an internal credit risk grading process that evaluates, among other things: (i) the obligor's ability to repay; (ii) the underlying collateral, if any; and (iii) the economic environment and industry in which the borrower operates. This analysis is performed at the relationship manager level for all commercial loans. When a loan has a calculated grade of 7 or higher over a specified dollar amount, a special assets officer analyzes the loan to determine whether the loan is impaired and, if impaired, the need to specifically allocate a portion of the allowance for possible loan losses to the loan. Specific valuation allowances are determined by analyzing the borrower's ability to repay amounts owed, collateral deficiencies, the relative risk grade of the loan and economic conditions affecting the borrower's industry, among other things.

Independent Bankers Financial Corporation and Subsidiaries

Notes to Consolidated Financial Statements (Dollar amounts in thousands)

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

General valuation allowances are based on general economic conditions and other qualitative risk factors both internal and external to the Corporation. In general, such valuation allowances are determined by evaluating, among other things: (i) the experience, ability and effectiveness of the bank's lending management and staff; (ii) the effectiveness of the Corporation's loan policies, procedures and internal controls; (iii) changes in asset quality; (iv) changes in loan portfolio volume; (v) the composition and concentrations of credit; (vi) the impact of competition on loan structuring and pricing; (vii) the effectiveness of the internal loan review function; (viii) the impact of environmental risks on portfolio risks; (ix) the impact of rising interest rates on portfolio risk; and (x) changes in the value of the underlying collateral. Management evaluates the degree of risk that each one of these components has on the quality of the loan portfolio on a quarterly basis. Each component is determined to have either a high, moderate or low degree of risk. The results are then input into a "general allocation matrix" to determine an appropriate general valuation allowance.

Included in the general valuation allowances are allocations for groups of similar loans with risk characteristics that exceed certain concentration limits established by management. Concentration risk limits have been established, among other things, for certain industry concentrations, large balance and highly leveraged credit relationships that exceed specified risk grades, and loans originated with policy exceptions that exceed specified risk grades.

Loans identified as losses by management, internal loan review and/or bank examiners are charged-off. Furthermore, consumer loan accounts are charged-off automatically at 180 days based on regulatory requirements.

Independent Bankers Financial Corporation and Subsidiaries

Notes to Consolidated Financial Statements (Dollar amounts in thousands)

The following table details activity in the allowance for possible loan losses by portfolio segment for the years ended December 31, 2012 and 2011. For presentation purposes, agriculture, commercial and industrial, and consumer loan segments are included in the "other correspondent" segment due to their relatively insignificant balances. Allocation of a portion of the allowance to one category of loans does not preclude its availability to absorb losses in other categories.

| | Bank Stock | Real Estate | Other Correspondent | Municipal | Mortgage | Credit Card | Total |
|---------------------------------------|-----------------|-----------------|------------------------|-----------------|---------------|-----------------|------------------|
| 2012: | | | | | | | |
| Beginning balance | \$ 3,971 | \$ 8,290 | \$ 649 | \$ 1,112 | \$ 222 | \$ 3,246 | \$ 17,490 |
| Provision for possible loan losses | (111) | 1,721 | 258 | (512) | 31 | 1,575 | 2,962 |
| Charge-offs | - | (1,105) | - | - | (49) | (2,982) | (4,136) |
| Recoveries | 3 | 183 | 86 | - | - | 370 | 642 |
| Net charge-offs | 3 | (922) | 86 | - | (49) | (2,612) | (3,494) |
| Other adjustments | - | - | - | - | - | - | - |
| Ending balance | \$ 3,863 | \$ 9,089 | \$ 993 | \$ 600 | \$ 204 | \$ 2,209 | \$ 16,958 |
| 2011: | | | | | | | |
| Beginning balance | \$ 3,670 | \$ 11,652 | \$ 1,131 | \$ 753 | \$ 651 | \$ 4,776 | \$ 22,633 |
| Provision for possible loan losses | 375 | 1,366 | (509) | 359 | (286) | 1,414 | 2,719 |
| Charge-offs | (78) | (4,755) | - | - | (145) | (3,540) | (8,518) |
| Recoveries | 4 | 27 | 27 | - | 2 | 278 | 338 |
| Net charge-offs | (74) | (4,728) | 27 | - | (143) | (3,262) | (8,180) |
| Other adjustments | - | - | - | - | - | 318 | 318 |
| Ending balance | \$ 3,971 | \$ 8,290 | \$ 649 | \$ 1,112 | \$ 222 | \$ 3,246 | \$ 17,490 |

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

| | Bank Stock | Real Estate | Other Correspondent | Municipal | Mortgage | Credit Card | Total |
|---|------------------|-------------------|------------------------|-------------------|------------------|-------------------|-------------------|
| 2012: | | | | | | | |
| Loans individually evaluated for impairment | \$ 198 | \$ 7,901 | \$ - | \$ - | \$ 703 | \$ - | \$ 8,802 |
| Loans collectively evaluated for impairment | 95,602 | 151,124 | 22,670 | 172,169 | 8,293 | 142,738 | 592,596 |
| Ending balance | \$ 95,800 | \$ 159,025 | \$ 22,670 | \$ 172,169 | \$ 8,996 | \$ 142,738 | \$ 601,398 |
| 2011: | | | | | | | |
| Loans individually evaluated for impairment | \$ - | \$ 11,145 | \$ - | \$ - | \$ 691 | \$ - | \$ 11,836 |
| Loans collectively evaluated for impairment | 98,317 | 138,216 | 23,202 | 187,505 | 9,864 | 137,547 | 594,651 |
| Ending balance | \$ 98,317 | \$ 149,361 | \$ 23,202 | \$ 187,505 | \$ 10,555 | \$ 137,547 | \$ 606,487 |

Independent Bankers Financial Corporation and Subsidiaries

Notes to Consolidated Financial Statements (Dollar amounts in thousands)

Note 4. Premises and Equipment

Year-end premises and equipment was as follows:

| | <u>2012</u> | <u>2011</u> |
|--|------------------|-----------------|
| Land | \$ 2,916 | \$ 582 |
| Building | 20,446 | 5,760 |
| Equipment | 11,466 | 11,186 |
| Leasehold and tenant improvements | 427 | 419 |
| | <u>35,255</u> | <u>17,947</u> |
| Less accumulated depreciation and amortization | <u>(14,848)</u> | <u>(14,062)</u> |
| | <u>\$ 20,407</u> | <u>\$ 3,885</u> |

Note 5. Other Real Estate Owned

Year-end other real estate owned was as follows:

| | <u>2012</u> | <u>2011</u> |
|---|-----------------|-----------------|
| Residential property | \$ 690 | \$ 268 |
| Commercial property | 2,945 | 5,272 |
| | <u>3,635</u> | <u>5,540</u> |
| Less valuation allowance | <u>(900)</u> | <u>(1,432)</u> |
| Other real estate owned, net of valuation allowance | <u>\$ 2,735</u> | <u>\$ 4,108</u> |

Note 6. Mortgage Servicing Rights

Transactions affecting mortgage servicing rights were as follows:

| | <u>2012</u> | <u>2011</u> |
|---|-----------------|-----------------|
| Balance at beginning of year | \$ 9,509 | \$ 12,878 |
| Purchased mortgage servicing rights | 3,609 | 2,231 |
| Decrease in fair value of mortgage servicing rights | <u>(4,252)</u> | <u>(5,600)</u> |
| Balance at end of year | <u>\$ 8,866</u> | <u>\$ 9,509</u> |

Loans serviced for others are not included in the accompanying consolidated balance sheets. The unpaid principal balances of mortgages serviced for others was \$1,355,421 and \$1,446,537 at December 31, 2012 and 2011, respectively. At such dates, the Corporation held borrowers' escrow balances related to these loans totaling \$7,328 and \$7,637, respectively. The Corporation purchased various 10-year treasury puts, calls and futures contracts with a net fair value of \$(104) and \$104 at December 31, 2012 and 2011, respectively, and are included in derivatives in the assets and liability sections of the consolidated balance sheets. The contracts provide an economic hedge against changes in fair value for the Corporation's mortgage servicing rights portfolio.

Independent Bankers Financial Corporation and Subsidiaries

Notes to Consolidated Financial Statements (Dollar amounts in thousands)

Note 7. Intangible Assets

| | <u>2012</u> | <u>2011</u> |
|---|-----------------|-----------------|
| Purchased merchant contract relationships | \$ 7,150 | \$ 7,150 |
| Less accumulated amortization | (2,510) | (1,770) |
| Net purchased merchant contract relationships | <u>4,640</u> | <u>5,380</u> |
| Deposit acquisition premium | 1,066 | 1,066 |
| Less accumulated amortization | (622) | (409) |
| Net deposit acquisition premium | <u>444</u> | <u>657</u> |
| Net intangible assets | <u>\$ 5,084</u> | <u>\$ 6,037</u> |

The deposit acquisition premium and purchased merchant contract relationships are amortized on a straight-line basis over their estimated lives, which range from 5 to 10 years. Amortization expense of \$953 and \$1,303 was recorded in 2012 and 2011, respectively. The purchased merchant contract relationships have an average remaining life of 65 months and the deposit acquisition premiums have an average remaining life of 25 months. The estimated aggregate future amortization expense for the purchased merchant contract relationships and deposit acquisition premiums remaining as of December 31, 2012 are as follows:

| | |
|------------|-----------------|
| 2013 | \$ 953 |
| 2014 | 936 |
| 2015 | 708 |
| 2016 | 690 |
| 2017 | 690 |
| Thereafter | <u>1,107</u> |
| | <u>\$ 5,084</u> |

Note 8. Interest Rate Swap Derivatives

The Corporation maintains an interest-rate risk-management strategy that uses derivative instruments to minimize significant, unanticipated earnings fluctuations caused by interest rate volatility. The Corporation's specific goal is to lower (where possible) the exposure to the volatility within its variable-rate fed funds and brokered deposits. The swaps are designated as highly effective cash flow hedges.

The swap contracts at December 31, 2012 are summarized as follows:

| | Effective Date | Termination Date | Fixed Rate | Variable Rate | Notional Amount | Fair Value |
|-------------|-------------------|---------------------|---------------|----------------------|--------------------|--------------------|
| Agreement 1 | September 8, 2008 | September 8, 2014 | 3.445% | Fed Funds Daily Rate | \$ 50,000 | \$ (2,907) |
| Agreement 2 | September 8, 2008 | September 8, 2014 | 3.445% | Fed Funds Daily Rate | 50,000 | (2,909) |
| Agreement 3 | November 28, 2008 | May 31, 2016 | 2.685% | Fed Funds Daily Rate | 50,000 | (4,122) |
| Agreement 4 | November 28, 2008 | November 30, 2015 | 2.620% | Fed Funds Daily Rate | 50,000 | (3,515) |
| Agreement 5 | May 4, 2011 | May 1, 2017 | 2.258% | Fed Funds Daily Rate | 25,000 | (2,020) |
| Agreement 6 | May 4, 2011 | November 1, 2016 | 2.097% | Fed Funds Daily Rate | 25,000 | <u>(1,719)</u> |
| | | | | | | <u>\$ (17,192)</u> |

Independent Bankers Financial Corporation and Subsidiaries

Notes to Consolidated Financial Statements (Dollar amounts in thousands)

A liability of \$17,192 and \$21,606 is included in derivative liabilities at December 31, 2012 and 2011, respectively, and an unrealized gain (loss) of \$2,869 and \$(5,946), net of deferred tax of \$(1,545) and \$3,201, is included in other comprehensive income for the years ended December 31, 2012 and 2011, respectively.

Note 9. Deposits

Year-end deposits consisted of the following:

| | 2012 | | 2011 | |
|-------------------------------|---------------------|---------------|---------------------|---------------|
| | Amount | Percent | Amount | Percent |
| Noninterest-bearing demand | \$ 722,488 | 38.4% | \$ 727,386 | 42.2% |
| Interest-bearing demand | 43,141 | 2.3% | 28,992 | 1.7% |
| NOW and money market accounts | 674,146 | 35.8% | 699,209 | 40.6% |
| Certificates of deposit: | | | | |
| Less than \$100,000 | 11,918 | 0.6% | 14,542 | 0.9% |
| \$100,000 and greater | 430,672 | 22.9% | 251,643 | 14.6% |
| | \$ 1,882,365 | 100.0% | \$ 1,721,772 | 100.0% |

At December 31, 2012, all time deposits have scheduled maturities during the year ending December 31, 2013.

Note 10. Derivative Financial Instruments

The fair value of derivative positions outstanding is shown in separate line items in assets and liabilities on the consolidated balance sheets. The net change in the interest rate derivatives designated as cash flow hedges, net of tax affect, is shown in the consolidated statements of comprehensive income. The tax effect of the net change in the interest rate derivatives is shown in deferred taxes on the consolidated balance sheets. The net change in non-hedging derivatives is included in other income or expense in the consolidated statements of income.

Interest rate swap derivatives: The Corporation utilizes interest rate swaps to mitigate interest rate risk in a rising rate environment. The Corporation entered into certain interest rate swap contracts that are designed to offset some of its risk on forecasted variable interest obligations arising from its federal funds principal purchases and brokered deposits. The Corporation entered into two contracts with notional amounts totaling \$50 million in 2011. There were no new interest rate swap contracts entered in 2012. There were no amounts reclassified to earnings due to ineffectiveness during 2012 or 2011. See Note 8 for further discussion.

Independent Bankers Financial Corporation and Subsidiaries

Notes to Consolidated Financial Statements (Dollar amounts in thousands)

Non-hedging derivatives: The Corporation purchases various 10-year treasury puts, calls and futures contracts to offset changes in the fair value of mortgage servicing rights. These positions turn over approximately every 90 days and are replaced with similar positions. The average positions outstanding during the year are materially consistent with the positions outstanding at December 31, 2012. The gain recorded in 2012 and 2011 for these derivatives was \$598 and \$3,553, respectively.

| | 2012 | | 2011 | |
|---|-------------------|----------------------|-------------------|----------------------|
| | Notional Amount | Estimated Fair Value | Notional Amount | Estimated Fair Value |
| Interest rate derivatives designated as cash flow hedges: | | | | |
| Interest rate swaps on federal funds purchased | \$ 100,000 | \$ (5,816) | \$ 100,000 | \$ (8,958) |
| Interest rate swaps on brokered deposits | 150,000 | (11,376) | 150,000 | (12,648) |
| | <u>250,000</u> | <u>(17,192)</u> | <u>250,000</u> | <u>(21,606)</u> |
| Non-hedging derivatives: | | | | |
| Future contracts | 10,500 | (44) | 10,000 | 163 |
| Written options | 8,000 | (64) | 8,000 | (78) |
| Purchased options | 4,500 | 4 | 5,000 | 19 |
| | <u>23,000</u> | <u>(104)</u> | <u>23,000</u> | <u>104</u> |
| | <u>\$ 273,000</u> | <u>\$ (17,296)</u> | <u>\$ 273,000</u> | <u>\$ (21,502)</u> |
| Derivative - assets | \$ - | \$ 4 | \$ - | \$ 182 |
| Derivative - liabilities | - | (17,300) | - | (21,684) |
| | <u>\$ -</u> | <u>\$ (17,296)</u> | <u>\$ -</u> | <u>\$ (21,502)</u> |

Note 11. Other Borrowings

Other borrowings consisted of the following:

| | 2012 | 2011 |
|--|-------------------|-------------------|
| Federal Home Loan Bank advance originated May 13, 2008 Interest rate: 4.06% Maturity date: May 13, 2013 | \$ 100,000 | \$ 100,000 |
| Federal Home Loan Bank advance originated May 14, 2008 Interest rate: 3.88% Maturity date: May 14, 2012 | - | 100,000 |
| | <u>\$ 100,000</u> | <u>\$ 200,000</u> |

The Federal Home Loan Bank borrowings are secured by a blanket lien on real estate mortgage loans and marketable securities with a carrying value of \$459,946 at December 31, 2012.

As of December 31, 2012, the Bank had a primary credit line with the Federal Reserve Bank of Dallas with an advanceable amount of up to \$238 million. This borrowing is secured by municipal loans, bank stock loans and marketable securities. There was no balance outstanding at any time in 2012 or 2011.

Independent Bankers Financial Corporation and Subsidiaries

Notes to Consolidated Financial Statements (Dollar amounts in thousands)

Note 12. Junior Subordinated Debentures

On January 25, 2006, IBFC issued \$30,928 of Floating Rate Junior Subordinated Debentures to a newly formed wholly owned subsidiary, IBFC Statutory Trust II (Trust II). Trust II sold Capital Securities of \$30,000. IBFC also made an equity contribution of \$928 to form Trust II. Interest on the debentures is payable quarterly at LIBOR plus 1.48% (1.788% at December 31, 2012) and the debentures mature on March 15, 2036.

IBFC's obligations under the Capital Securities and Junior Subordinated Debentures are unsecured and rank junior in priority to any existing and future indebtedness of IBFC. IBFC may, at any time, dissolve Trust II and distribute the Junior Subordinated Debentures to holders of the Capital Securities in exchange for the Capital Securities.

The Corporation accounts for the Trust in accordance with ASC Topic 810 "Consolidation." ASC 810 establishes accounting guidance for consolidation of variable interest entities ("VIEs") that function to support the activities of the primary beneficiary. The primary beneficiary of a VIE is the entity that absorbs a majority of the VIE's expected losses, receives a majority of the VIE's expected residual returns, or both, as a result of ownership, controlling interest, contractual relationship, or other business relationship with the VIE. Prior to the implementation of ASC 810, VIEs were generally consolidated when an enterprise had a controlling financial interest through ownership of a majority of voting interest in the entity. ASC 810 requires the Corporation to deconsolidate its investment in trust subsidiaries because the Corporation is not the primary beneficiary.

Note 13. Federal Income Taxes

Actual income tax expense differed from the amounts computed by applying the U.S. federal income tax rate of 35% as of December 31, 2012 and 2011 to pretax accounting income as follows:

| | <u>2012</u> | <u>2011</u> |
|---|--------------|--------------|
| Income tax expense computed at statutory rate | \$ 9,634 | \$ 7,001 |
| Increase in cash value of life insurance | (274) | (293) |
| Tax-exempt interest | (2,197) | (2,724) |
| Other | 267 | 158 |
| | <u>7,430</u> | <u>4,142</u> |
| Actual income tax expense | \$ 7,430 | \$ 4,142 |

Independent Bankers Financial Corporation and Subsidiaries

Notes to Consolidated Financial Statements (Dollar amounts in thousands)

Year-end deferred taxes were as follows:

| | <u>2012</u> | <u>2011</u> |
|---------------------------------------|-----------------|------------------|
| Deferred tax assets: | | |
| Loans | \$ 5,916 | \$ 6,254 |
| Accrued expense and other liabilities | 3,901 | 4,531 |
| Premises and equipment | 210 | 136 |
| Interest rate swap derivative | 6,017 | 7,562 |
| Other real estate owned | 53 | - |
| Derivatives | 72 | - |
| Other | 522 | 375 |
| Total deferred tax assets | <u>16,691</u> | <u>18,858</u> |
| Deferred tax liabilities: | | |
| Securities available for sale | 5,395 | 4,566 |
| Derivatives | - | 168 |
| Credit card premiums and intangibles | 1,471 | - |
| Mortgage servicing rights | 2,410 | 2,230 |
| FHLB stock | 59 | 94 |
| Total deferred tax liabilities | <u>9,335</u> | <u>7,058</u> |
| Net deferred tax asset | <u>\$ 7,356</u> | <u>\$ 11,800</u> |

Note 14. Employee Benefits

The Corporation maintains a savings plan for employees. Employees are eligible to participate immediately upon hire subject to the next enrollment date. Maximum annual employer and employee contributions to the plan are limited to \$50 or 100% of an employee's gross earnings, whichever is less. The Corporation may make contributions in an amount necessary to match up to a maximum of 5% of the employee's annual compensation. Both employer and employee contributions to the savings plan vest immediately. The Corporation's contributions were \$984 and \$949 in 2012 and 2011, respectively.

The Corporation has nonqualified deferred compensation plans which provide death and retirement benefits to certain officers. Benefits under the plans are payable over a 15 year period following death or retirement. Deferred compensation expense of \$705 and \$999 was recorded in 2012 and 2011, respectively. Deferred compensation payable totaled \$8,523 and \$8,259 at December 31, 2012 and 2011, respectively. The Corporation purchased life insurance policies to fund future plan obligations. These policies had an aggregate cash surrender value of \$42,296 and \$26,002 at December 31, 2012 and 2011, respectively.

During 2002, the Corporation adopted a Phantom Stock Ownership and Long-Term Incentive Plan under which eligible employees may be granted phantom shares from an initial pool of 108,000 shares and such shares generally vest over five years. The value of the phantom shares is calculated using an intrinsic method based on the change in the book value of the Corporation's stock from the original grant date. Holders of the phantom shares have no rights as a shareholder of the Corporation, but may redeem vested phantom shares held for cash in an amount equal to the increase in the book value of the Corporation's common stock subsequent to the grant date.

Independent Bankers Financial Corporation and Subsidiaries

Notes to Consolidated Financial Statements (Dollar amounts in thousands)

Information regarding phantom shares is as follows:

| | <u>2012</u> | <u>2011</u> |
|---|-----------------|-------------|
| Phantom shares outstanding at beginning of year | 24,868 | 32,638 |
| Redeemed | (16,733) | (7,770) |
| Phantom shares outstanding at end of year | 8,135 | 24,868 |
| Available for grant at end of year | 27,039 | 27,039 |
| Vested at end of year | 8,135 | 24,868 |

All phantom shares were vested as of December 31, 2009. The value of phantom shares redeemed in 2012 and 2011 was \$1,666 and \$639, respectively. The tax benefit recognized in 2012 and 2011 was \$583 and \$224, respectively. There were no phantom shares granted in 2012 or 2011.

In 2006, the Corporation adopted a Stock Appreciation Right Plan (SAR) under which eligible employees are awarded the right to receive a lump sum cash payment in an amount equal to the increase in the fair market value of the Corporation's stock on an established date, after the vesting period of generally five years, over the grant date price of the SAR. The value of the SAR awards is calculated using an intrinsic method based on the change in the book value of the Corporation's stock from the original grant date.

| | <u>2012</u> | <u>2011</u> |
|---|-----------------|-------------|
| SAR awards outstanding at beginning of year | 63,250 | 56,000 |
| Redeemed | (10,973) | (6,000) |
| Forfeited | (4,877) | (250) |
| Granted | 12,550 | 13,500 |
| SAR awards outstanding at end of year | 59,950 | 63,250 |

The number of shares of SAR awards granted in 2012 and 2011 was 12,550 and 13,500, respectively. The value of SAR awards vested and redeemed totaled \$508 and \$295 in 2012 and 2011, respectively. The tax benefit recognized in 2012 and 2011 was \$178 and \$103, respectively.

Compensation expense related to phantom shares and stock appreciation rights is accrued over the vesting period of the award plus any increases in intrinsic value. Accrued compensation payable under the Plans totaled \$1,747 and \$3,190 at December 31, 2012 and 2011, respectively. Compensation expense recognized under the Plans totaled \$730 and \$300 in 2012 and 2011, respectively.

Independent Bankers Financial Corporation and Subsidiaries

Notes to Consolidated Financial Statements (Dollar amounts in thousands)

Note 15. Noninterest Income

Noninterest income consisted of the following for the years ended December 31, 2012 and 2011:

| | <u>2012</u> | <u>2011</u> |
|------------------------------------|-------------------|-------------------|
| Credit card fees | \$ 65,308 | \$ 66,386 |
| Safekeeping fees | 3,379 | 2,977 |
| Mortgage loan servicing fees | 4,093 | 4,530 |
| Customer security transaction fees | 11,246 | 11,331 |
| Audit and loan review fees | 1,607 | 1,659 |
| Gain on sale of loans | 10,522 | 3,855 |
| Gain on sale of securities, net | 1,036 | 1,381 |
| Gain on derivative transactions | 598 | 3,553 |
| Gain on sale of other real estate | 155 | - |
| Other | 12,647 | 10,821 |
| | <u>\$ 110,591</u> | <u>\$ 106,493</u> |

Note 16. Noninterest Expense

Noninterest expense consists of the following for the years ended December 31, 2012 and 2011:

| | <u>2012</u> | <u>2011</u> |
|---|-------------------|-------------------|
| Salaries and benefits | \$ 37,347 | \$ 36,248 |
| Premises, furniture and equipment | 3,068 | 2,996 |
| Telephone expense | 1,336 | 1,391 |
| Software maintenance | 2,515 | 2,658 |
| Credit card expenses | 44,006 | 46,885 |
| Mortgage operation expenses | 4,579 | 3,358 |
| Decrease in fair value of mortgage servicing rights | 4,252 | 5,600 |
| Writedowns of investments and other ORE | - | 2,130 |
| Item processing expense | 823 | 871 |
| Intangible amortization | 953 | 1,303 |
| Professional fees | 2,353 | 2,247 |
| Other | 8,359 | 8,307 |
| | <u>\$ 109,591</u> | <u>\$ 113,994</u> |

Note 17. Commitments and Contingencies

Financial instruments with off-balance sheet risk: The Corporation is a party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit, credit card line commitments and standby letters of credit and involve, to varying degrees, elements of credit risk and interest rate risk in excess of the amount recognized in the consolidated balance sheets. The contract or notional amounts of those instruments reflect the extent of involvement the Corporation has in particular classes of financial instruments.

Independent Bankers Financial Corporation and Subsidiaries

Notes to Consolidated Financial Statements (Dollar amounts in thousands)

The Corporation's exposure to credit loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit, credit card line commitments and standby letters of credit is represented by the contractual amount of those instruments. The Corporation uses the same credit policies in making commitments and conditional obligations as it does for on-balance sheet instruments. At December 31, 2012 and 2011, the amounts of these financial instruments were as follows:

| | <u>2012</u> | <u>2011</u> |
|------------------------------|-------------------|-------------------|
| Commitments to extend credit | \$ 146,658 | \$ 135,566 |
| Standby letters of credit | 2,527 | 4,656 |
| Credit card lines | <u>753,708</u> | <u>771,198</u> |
| | <u>\$ 902,893</u> | <u>\$ 911,420</u> |

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. Such commitments generally have fixed expiration dates or other termination clauses and may require 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 Corporation evaluates each customer's credit worthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Corporation upon extension of credit, is based on management's credit evaluation of the counterparty. Collateral held varies but may include accounts receivable, inventory, single and multi-family residences, property and equipment and income-producing commercial properties.

Standby letters of credit are conditional commitments issued by the Corporation to guarantee the performance of a customer to a third party. The Corporation's policies generally require that letter of credit arrangements contain security and debt covenants similar to those contained in loan arrangements. The amount of collateral obtained, if deemed necessary by the Corporation upon extension of credit, is based on management's credit evaluation of the counterparty. Collateral held varies but may include accounts receivable, inventory, single and multi-family residences, property and equipment and income-producing commercial properties. In the event the customer does not perform in accordance with the terms of the agreement with the third party, the Corporation would be required to fund the commitment. The maximum potential amount of future payments the Corporation could be required to make is represented by the contractual amount shown in the table above. If the commitment is funded, the Corporation would be entitled to seek recovery from the customer. As of December 31, 2012 and 2011, no amounts have been recorded as liabilities for the Corporation's potential obligations under these guarantees.

Credit card commitments are unsecured.

Lease commitments: The Corporation leases certain office facilities and office equipment under operating leases that expire at various dates through 2015. The Corporation has renewal options for most of its operating leases. Rent expense for all operating leases and month to month rentals totaled \$1,140 and \$1,188 in 2012 and 2011, respectively. Total rents paid under escalating lease agreements are expensed over the life of the lease on a straight-line basis. The rental payments on operating leases are based on a minimum rental plus a percentage of operating costs, some of which are restricted as to the maximum annual increase.

Independent Bankers Financial Corporation and Subsidiaries

Notes to Consolidated Financial Statements (Dollar amounts in thousands)

Future minimum lease payments under all noncancelable operating leases as of December 31, 2012 are as follows:

| | | |
|------|----|--------------|
| 2013 | \$ | 785 |
| 2014 | | 414 |
| 2015 | | 55 |
| | | <hr/> |
| | \$ | <u>1,254</u> |

Contingencies: Various other contingent liabilities are not reflected in the financial statements, including claims and legal actions arising in the ordinary course of business. In the opinion of management, after consultation with legal counsel, the ultimate disposition of these matters is not expected to have a material effect on the Corporation's financial condition, results of operations or cash flows.

Note 18. Fair Value of Financial Instruments

The estimated fair value approximates carrying value for financial instruments except those described below:

Securities available for sale and derivatives: Fair values for securities and derivatives are based on quoted market prices or dealer quotes. If a quoted market price is not available, fair value is estimated using quoted market prices for similar instruments. The fair values of Federal Reserve Bank ("FRB") and Federal Home Loan Bank – Dallas ("FHLB") stocks approximate their carrying values based on their respective redemption provisions.

Loans held for sale: Fair values are based on quoted market prices of similar loans sold on the secondary market.

Loans: The fair value of fixed-rate loans and variable-rate loans which reprice on an infrequent basis is estimated by discounting future cash flows using the current interest rates at which similar loans with similar terms would be made to borrowers of similar credit quality. For variable-rate loans that reprice frequently and have no significant changes in credit risk, fair values are based on carrying values.

Deposits: The fair value of fixed-rate deposit liabilities with defined maturities is estimated by discounting future cash flows using the interest rates currently offered for deposits of similar remaining maturities.

Other borrowings: The fair value of fixed rate borrowings is estimated based on the present value of expected cash flows using current interest rates for similar financial instruments.

Off-balance sheet instruments: The fair values of these items are not material and are therefore not included on the following schedule.

Independent Bankers Financial Corporation and Subsidiaries

Notes to Consolidated Financial Statements (Dollar amounts in thousands)

The estimated fair values of the Corporation's financial instruments as of December 31, 2012 and 2011 were as follows:

| | 2012 | | 2011 | |
|--|-----------------|----------------------|-----------------|----------------------|
| | Carrying Amount | Estimated Fair Value | Carrying Amount | Estimated Fair Value |
| Financial assets: | | | | |
| Cash equivalents | \$ 1,144,681 | \$ 1,144,681 | \$ 1,366,424 | \$ 1,366,424 |
| Interest-bearing time deposits | - | - | 240 | 241 |
| Other investments | 7,598 | 7,598 | 11,842 | 11,842 |
| Securities | 669,696 | 669,696 | 401,697 | 401,697 |
| Loans held for sale | 67,532 | 67,532 | 49,833 | 49,833 |
| Loans, net | 584,440 | 595,387 | 588,997 | 594,248 |
| Mortgage servicing rights | 8,866 | 8,866 | 9,509 | 9,509 |
| Derivatives | 4 | 4 | 182 | 182 |
| Accrued interest receivable | 5,860 | 5,860 | 5,586 | 5,586 |
| Financial liabilities: | | | | |
| Deposits | 1,882,365 | 1,885,571 | 1,721,772 | 1,725,473 |
| Federal funds purchased and securities sold under agreements to repurchase | 325,836 | 325,836 | 303,262 | 303,262 |
| Other borrowings | 100,000 | 101,329 | 200,000 | 204,755 |
| Junior subordinated debentures | 30,928 | 30,928 | 30,928 | 30,928 |
| Derivatives | 17,300 | 17,300 | 21,684 | 21,684 |
| Accrued interest payable | 381 | 381 | 720 | 720 |

Note 19. Fair Value Measurements

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

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

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

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

Independent Bankers Financial Corporation and Subsidiaries

Notes to Consolidated Financial Statements (Dollar amounts in thousands)

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.

In general, fair value is based upon quoted market prices, where available. If such quoted market prices are not available, fair value is based upon internally developed models that primarily use, as inputs, observable market-based parameters. Valuation adjustments may be made to ensure that financial instruments are recorded at fair value. These adjustments may include amounts to reflect counterparty credit quality and the Corporation's creditworthiness, among other things, as well as unobservable parameters. Any such valuation adjustments are applied consistently over time. The Corporation's valuation methodologies may produce a fair value calculation that may not be indicative of net realizable value or reflective of future fair values. While management believes the Corporation's valuation methodologies are appropriate and consistent with other market participants, the use of different methodologies or assumptions to determine the fair value of certain financial instruments could result in a different estimate of fair value at the reporting date. Furthermore, the reported fair value amounts have not been comprehensively revalued since the presentation dates, and therefore, estimates of fair value after the balance sheet date may differ significantly from the amounts presented herein.

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

Derivatives: Derivatives are reported at fair value utilizing Level 1 and Level 2 inputs. The Corporation uses dealer quotations obtained from third party firms for derivatives used for hedging mortgage servicing rights. Third party firms make use of exchange settlement prices (Level 1) which are published daily to value these derivatives. The Corporation uses an independent valuation firm to estimate fair value of interest rate swap derivatives through the use of valuation models with observable market data inputs (Level 2).

Mortgage servicing rights: Mortgage servicing rights are reported at fair value utilizing Level 3 inputs. The Corporation uses an independent valuation firm to estimate fair value of mortgage servicing rights through the use of prevailing market participant assumptions and market participant valuation processes. This valuation and its techniques are periodically tested and validated against other third-party firm valuations. For purposes of determining the fair value of mortgage servicing rights, they are placed in homogeneous groups by investor, remittance requirements, loan type, interest rate and year of origination. At December 31, 2012 and 2011, prepayment speeds were determined using Andrew Davidson's MBS Enhanced Prepayment Model and resulted in weighted average years to payoff of 4.25 years and 3.76 years, respectively. At December 31, 2012 and 2011, the primary discount rates averaged 10.34% and 10.32%, respectively. During the years ended December 31, 2012 and 2011, the entire changes in fair value were attributable to changes in valuation inputs and assumptions.

Independent Bankers Financial Corporation and Subsidiaries

Notes to Consolidated Financial Statements (Dollar amounts in thousands)

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

| | Level 1 Inputs | Level 2 Inputs | Level 3 Inputs | Total Fair Value |
|--------------------------------------|-------------------|-------------------|-------------------|---------------------|
| 2012: | | | | |
| Securities available for sale | \$ - | \$ 669,696 | \$ - | \$ 669,696 |
| Mortgage servicing rights | - | - | 8,866 | 8,866 |
| Derivative assets | 4 | - | - | 4 |
| Derivative liabilities | 108 | 17,192 | - | 17,300 |
| 2011: | | | | |
| Securities available for sale | \$ - | \$ 401,697 | \$ - | \$ 401,697 |
| Mortgage servicing rights | - | - | 9,509 | 9,509 |
| Derivative assets | 182 | - | - | 182 |
| Derivative liabilities | 78 | 21,606 | - | 21,684 |

The following table reconciles the beginning and ending balances of derivative assets measured at fair value on a recurring basis using significant unobservable (Level 3) inputs:

| | 2012 | 2011 |
|--|----------|-----------|
| Balance at beginning of the year | \$ 9,509 | \$ 12,878 |
| Net losses included in noninterest expense | (4,252) | (5,600) |
| Purchased mortgage servicing rights | 3,609 | 2,231 |
| Balance at end of the year | \$ 8,866 | \$ 9,509 |

For the years ended December 31, 2012 and 2011, there were no significant transfers among Levels 1, 2 and 3.

Certain financial assets and financial liabilities are measured at fair value on a nonrecurring basis; that is, the instruments are not measured at fair value on an ongoing basis but are subject to fair value adjustments in certain circumstances (for example, when there is evidence of impairment). Financial assets and liabilities measured at fair value on a nonrecurring basis are as follows:

Other real estate owned: Other real estate owned is carried at the lower of cost or fair value less estimated selling costs. Fair value is estimated through current appraisals, real estate brokers or listing prices. As these properties are actively marketed, estimated fair values may be adjusted by management to reflect current economic and market conditions and, as such, are classified as Level 3.

Independent Bankers Financial Corporation and Subsidiaries

Notes to Consolidated Financial Statements (Dollar amounts in thousands)

The following table presents the assets carried on the consolidated balance sheet by caption and by level in the fair value hierarchy at December 31, 2012 and 2011, for which a nonrecurring change in fair value has been recorded:

| | Assets/ Liabilities Measured at Fair Value | Level 1 Inputs | Level 2 Inputs | Level 3 Inputs | Year Ended Losses |
|-------------------------|---|-------------------|-------------------|-------------------|----------------------|
| 2012: | | | | | |
| Other real estate owned | \$ 2,237 | \$ - | \$ - | \$ 2,237 | \$ 150 |
| 2011: | | | | | |
| Other real estate owned | 5,272 | - | - | 5,272 | 1,432 |

Note 20. Shareholders' Equity

The Corporation has 2,000,000 authorized shares of convertible redeemable Class B common stock, \$10.00 par value per share and 1,000,000 authorized shares of preferred stock (Series, A, B, C and D), \$1.00 par value per share. There were no shares outstanding of convertible redeemable common stock or preferred stock (Series B, C and D) as December 31, 2012 or 2011. There were 40,005 shares of Series A preferred stock outstanding as of December 31, 2012 and 2011.

Series A preferred stock dividend rights are cumulative and payable quarterly. The Corporation has the option after the fifth (5th) anniversary of the date of issuance to redeem the stock at a price equal to \$1 per share plus any accrued and unpaid dividends. Series A preferred stock shareholders have no voting rights. Although Common Stock generally has the exclusive right to vote, Series A preferred stock rank senior to Common Stock with respect to dividend rights and liquidation preferences.

The Corporation maintains a Dividend Reinvestment and Share Purchase Plan whereby shareholders may elect to: (1) reinvest common stock dividends in the common stock of the Corporation, and (2) make optional cash payments to purchase additional common stock of the Corporation. The purchase price of common shares issued under the Plan is based on the book value of the stock (excluding other comprehensive income) as of the quarter ended immediately preceding the reinvestment date. During 2012 and 2011, 5,738 and 5,811 shares of common stock were issued under the Plan with an average issue price of \$132.38 and \$122.45 per share, respectively.

Note 21. Regulatory Matters

Banks and bank holding companies are subject to various regulatory capital requirements administered by federal and state 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 Corporation's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, specific capital guidelines that involve quantitative measures of the Corporation's assets, liabilities, and certain off-balance-sheet items as calculated under regulatory accounting practices must be met. The Corporation's capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.

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

Independent Bankers Financial Corporation and Subsidiaries

Notes to Consolidated Financial Statements (Dollar amounts in thousands)

As of December 31, 2012 and 2011, the Bank met the level of capital necessary to be categorized as “well capitalized” under prompt corrective action regulations. To be categorized as “well capitalized,” the Bank must maintain minimum total risk-based, Tier I risk-based, and Tier I leverage ratios as set forth in the table. As of December 31, 2012 and 2011, the Corporation met all capital requirements under the regulatory framework specified by the Federal Reserve Board. Management is not aware of any conditions subsequent to December 31, 2012 that would change the Corporation’s or the Bank’s capital category.

The Corporation’s and the Bank’s actual capital amounts and ratios are presented in the following table.

| | Actual | | For Capital Adequacy Purposes | | To Be Well Capitalized Under Prompt Corrective Action Provisions | |
|--|------------|-------|-------------------------------|-------|--|-------|
| | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| December 31, 2012: | | | | | | |
| Total capital to risk weighted assets: | | | | | | |
| Consolidated | \$ 245,552 | 25.4% | \$ 77,210 | 8.0% | N/A | N/A |
| Bank only | 221,281 | 23.0% | 76,942 | 8.0% | \$ 96,178 | 10.0% |
| Tier I capital to risk weighted assets: | | | | | | |
| Consolidated | 219,452 | 22.7% | 38,605 | 4.0% | N/A | N/A |
| Bank only | 209,198 | 21.8% | 38,471 | 4.0% | 57,707 | 6.0% |
| Tier I capital to average assets: | | | | | | |
| Consolidated | 219,452 | 8.7% | 100,762 | 4.0% | N/A | N/A |
| Bank only | 209,198 | 8.3% | 100,627 | 4.0% | 125,784 | 5.0% |
| December 31, 2011: | | | | | | |
| Total capital to risk weighted assets: | | | | | | |
| Consolidated | 231,959 | 25.8% | 72,003 | 8.0% | N/A | N/A |
| Bank only | 203,714 | 22.9% | 71,058 | 8.0% | 88,822 | 10.0% |
| Tier I capital to risk weighted assets: | | | | | | |
| Consolidated | 199,499 | 22.2% | 36,002 | 4.0% | N/A | N/A |
| Bank only | 192,532 | 21.7% | 35,529 | 4.0% | 53,293 | 6.0% |
| Tier I capital to average assets: | | | | | | |
| Consolidated | 199,499 | 7.6% | 104,987 | 4.0% | N/A | N/A |
| Bank only | 192,532 | 7.4% | 104,845 | 4.0% | 131,056 | 5.0% |

Independent Bankers Financial Corporation and Subsidiaries

Notes to Consolidated Financial Statements
(Dollar amounts in thousands)

Note 22. Parent Company Only Financial Statements

Balance Sheets

| Assets | December 31, | |
|---|-------------------|-------------------|
| | 2012 | 2011 |
| Cash due from subsidiary bank | \$ 26,199 | \$ 23,038 |
| Investment in subsidiaries | 215,194 | 189,858 |
| Other assets | 3,298 | 11,648 |
| Total assets | \$ 244,691 | \$ 224,544 |
| Liabilities and Shareholders' Equity | | |
| Dividends payable | \$ 2,892 | \$ 2,754 |
| Junior subordinated debentures | 30,928 | 30,928 |
| Other liabilities | 1,780 | 3,238 |
| Total liabilities | 35,600 | 36,920 |
| Commitments and contingencies | | |
| Shareholders' equity: | | |
| Preferred stock, 1,000,000 shares authorized, par value \$1 per share, liquidation value \$1,000 per share: | | |
| Series A fixed rate preferred stock - issued and outstanding; 30,230 shares in 2012 and 2011 | 30 | 30 |
| Series A floating rate preferred stock - issued and outstanding; 9,775 shares in 2012 and 2011 | 10 | 10 |
| Common stock, par value \$10 per share, 5,000,000 shares authorized, 1,168,158 and 1,157,176 shares issued and outstanding in 2012 and 2011 | 11,681 | 11,572 |
| Preferred surplus | 39,965 | 39,965 |
| Capital surplus | 31,424 | 30,024 |
| Retained earnings | 127,137 | 111,588 |
| Accumulated other comprehensive loss | (1,156) | (5,565) |
| Total shareholders' equity | 209,091 | 187,624 |
| Total liabilities and shareholders' equity | \$ 244,691 | \$ 224,544 |

Independent Bankers Financial Corporation and Subsidiaries

Notes to Consolidated Financial Statements
(Dollar amounts in thousands)

| | Year Ended December 31, | |
|---|-------------------------|-------------------------|
| | 2012 | 2011 |
| Dividend income | \$ - | \$ 8,000 |
| Interest income | 18 | 17 |
| Interest expense | <u>(609)</u> | <u>(562)</u> |
| | (591) | 7,455 |
| Other income | 48 | 47 |
| Other expenses | <u>(735)</u> | <u>(351)</u> |
| Income (loss) before income taxes and equity in undistributed income of subsidiaries | <u>(1,278)</u> | 7,151 |
| Federal: | | |
| Federal income taxes - current benefit | <u>447</u> | <u>297</u> |
| Income (loss) before equity in undistributed income of subsidiaries | (831) | 7,448 |
| Equity in undistributed income of subsidiaries | <u>20,927</u> | 8,414 |
| Net income | <u><u>\$ 20,096</u></u> | <u><u>\$ 15,862</u></u> |

Independent Bankers Financial Corporation and Subsidiaries

Notes to Consolidated Financial Statements
(Dollar amounts in thousands)

Statements of Cash Flows

| | Year Ended December 31, | |
|---|-------------------------|------------------|
| | 2012 | 2011 |
| Cash flows from operating activities: | | |
| Net income | \$ 20,096 | \$ 15,862 |
| Adjustments to reconcile net income to net cash used in operating activities: | | |
| Equity in undistributed income of subsidiaries | (20,927) | (8,414) |
| Deferred compensation expense | 730 | 300 |
| Changes in operating assets and liabilities: | | |
| Other assets | 8,351 | (8,045) |
| Other liabilities | (2,189) | (930) |
| Net cash provided by (used in) operating activities | 6,061 | (1,227) |
| Cash flows from financing activities: | | |
| Sale of common stock | 1,559 | 1,012 |
| Purchase and retirement of common stock | (50) | - |
| Cash dividends paid on common and preferred stock | (4,409) | (4,268) |
| Net cash used in financing activities | (2,900) | (3,256) |
| Net increase (decrease) in cash equivalents | 3,161 | (4,483) |
| Cash equivalents at beginning of year | 23,038 | 27,521 |
| Cash equivalents at end of year | \$ 26,199 | \$ 23,038 |
| Supplemental cash flow information: | | |
| Cash paid during the year for interest | \$ 616 | \$ 559 |
| Cash paid during the year for taxes | \$ 8,606 | \$ 1,688 |