



INTERNATIONAL BANCSHARES CORPORATION

2017 Dodd-Frank Act Stress Test (DFAST)

Disclosure of Stressed Results under a Hypothetical Severely
Adverse Economic Scenario

October 15, 2017

Important Considerations

This disclosure contains certain projected financial measures required by regulations implementing the Dodd-Frank Wall Street Reform and Consumer Protection Act stress test (“DFAST”) that have not been prepared under U.S. Generally Accepted Accounting Principles (“GAAP”). This disclosure contains forward-looking statements, including estimated results of financial performance under a hypothetical severely adverse economic scenario published by the Board of Governors of the Federal Reserve System (the “Federal Reserve”) and other assumptions described herein. Investors should not rely on these results as expected or likely outcomes of financial results for International Bancshares Corporation (the “Company”). The Company’s future financial results and conditions may be influenced by actual economic and financial conditions and other factors described in our reports filed with the Securities and Exchange Commission (“SEC”).

Each banking organization subject to DFAST is responsible for the development of its own stress testing program, including assumptions and methodologies that reflect the specific exposures of the organization. Therefore, the results in this disclosure may not be directly comparable to those of other banking organizations utilizing different stress test methods and capturing different exposures to products, activities, geographic markets and any other factor that can impact solvency.

About International Bancshares Corporation

International Bancshares Corporation is a multi-bank holding company headquartered in Laredo, Texas, which provides banking services for commercial, consumer, and international customers of South, Central, and Southeast Texas and the State of Oklahoma. It is one of the largest independent commercial bank holding companies headquartered in Texas. Its mission is to build customer relationships using a community banking approach.

The Company, through its five bank subsidiaries, is in the business of gathering funds from various sources and investing those funds in order to earn a return. The Company’s primary earnings come from the spread between the interest earned on interest-bearing assets and the interest paid on interest-bearing liabilities. In addition, the Company generates income from fees on products offered to commercial, consumer, and international customers. Expense control is an essential element in the Company’s long-term profitability.

Requirements of the Dodd-Frank Act Stress Test (“DFAST”)

Final rules issued by the Federal Reserve under 12 CFR Part 252 (“DFAST Rules”) require bank holding companies with total assets greater than \$10 billion but less than \$50 billion to conduct annual company-run stress tests as required by Section 165(i)(2) of the Dodd-Frank Wall Street Reform and Consumer Protection Act. As a bank holding company within this range, the Company is subject to DFAST Rules under the regulatory supervision of the Federal Reserve.

On February 10, 2017, the Federal Reserve published three hypothetical economic scenarios, specifically a baseline, an adverse, and a severely adverse scenario, for banking organizations to use in conducting DFAST. In accordance to DFAST Rules, the results of the hypothetical severely adverse scenario are

required to be publicly disclosed. The following requirements of the DFAST Rules should be noted in reviewing the disclosed results:

- Stress test results cover a nine quarter planning horizon, beginning with the first quarter of 2017 and ending the first quarter of 2019.
- DFAST Rules require specific assumptions on capital actions and are not to be interpreted as planned capital actions by the Company:
 1. As required, for the first quarter of the planning horizon, the Company took into account its actual capital actions as of the end of that quarter.
 2. As required, for each of the second through ninth quarters of the planning horizon, the Company:
 - a. Assumed no redemption or repurchase of any capital instrument that is eligible for inclusion in the numerator of a regulatory capital ratio;
 - b. Assumed no issuances of common stock or preferred stock; and
 - c. Made reasonable assumptions regarding payments of dividends consistent with internal capital needs and projections. The Company decided that reasonable assumptions regarding the payment of dividends under a hypothetical severely adverse scenario should be in compliance with the Federal Reserve’s Supervision and Regulation Letter (“SR”) 09-4 titled “Applying Supervisory Guidance and Regulations on the Payment of Dividends, Stock Redemptions, and Stock Repurchases at Bank Holding Companies”. SR 09-4 offers guidance over the factors that should be considered in paying dividends, including a decline in earnings and a deterioration of the macroeconomic outlook. As a result, for the second through ninth quarters of the planning horizon, the Company assumed a \$20.5 million dividend payment in the third quarter of 2017 and a \$21.5 million dividend payment in the first quarter of 2019.
- The disclosed results are based on a hypothetical severely adverse economic scenario published by the Federal Reserve. According to the Federal Reserve, this scenario is “characterized by a severe global recession that is accompanied by a period of heightened stress in corporate loan markets and commercial real estate markets.” The Federal Reserve also notes that “this is a hypothetical scenario designed to assess the strength of banking organizations and their resilience to unfavorable economic conditions. This scenario does not represent a forecast of the Federal Reserve.” Further information on the scenario can be found in the Federal Reserve’s publication, “2017 Supervisory Scenarios for Annual Stress Tests Required under the Dodd-Frank Act Stress Testing Rules and the Capital Plan Rule” (February 10, 2017).

Risk Types

Stress testing is generally defined as a process in which the risks underlying a bank’s assets and liabilities are simulated under hypothetical adverse scenarios to evaluate its capital resiliency. The Company considered the following risks under DFAST: (1) Credit Risk, (2) Interest Rate and Liquidity Risk, and (3) Operational Risk (including Legal Risk).

Credit Risk

Credit risk is the potential loss of earnings or capital that arises from a borrower or counter-party to a funded or unfunded exposure defaulting on their contractual obligations. It is the strategy of the Company to contain credit risk within its loan portfolio and thus maintain minimum levels of credit risk within its investment portfolio. Through its business risk assessments, the Company has identified credit risk within the loan portfolio as a predominant risk. It is the Company's strategy to reduce loss exposure by maintaining long-standing practices that emphasize strong collateral positions and guarantor support.

Interest Rate and Liquidity Risk

Market risk is the potential loss of earnings or capital that arises from the fluctuations or movements of market interest rates and prices. The Company is exposed to interest rate risk as net interest margin is affected by changing interest rates on assets and liabilities. It is the Company's strategy to minimize liquidity risk, and consequently price risk by maintaining a sizable, high quality investment portfolio with strong cash flows and broad marketability. The Company does not have any trading assets and does not have a significant loans held-for-sale portfolio.

Operational Risk (including Legal Risk)

Operational risk is the potential loss of earnings or capital that arises from adverse events related to internal processes, systems, and through the people who perform business activities. Included within operational risk, legal risk is the potential loss of earnings or capital resulting from legal actions that may arise from business operations and activities. The Company manages operational risk through its internal control structure. The Company assesses the effectiveness of the design and operation of the Company's internal controls based on the criteria for effective internal control established in the 2013 "Internal Control—Integrated Framework," issued by the Committee of Sponsoring Organizations (COSO) of the Treadway Commission.

Stress Test Methodologies

The Company developed stress testing methodologies that consider the risks discussed within this disclosure under the section titled "Risk Types". A tailored approach is utilized based on the materiality of each risk. Robust quantitative methodologies were generally pursued for those risks deemed most material. Qualitative methodologies were utilized in cases where the potential impact was considered to be immaterial to the exercise given such methodologies could produce appropriate results.

The Company has identified credit risk within the loan portfolio as a predominant risk. Accordingly, the Company set up stress-testing methodologies utilizing quantitative estimation to project loan growth, non-performing balances, and losses. The model development process involved finding a statistical correlation between a Company's historical performance and historical macroeconomic variables. In cases where the Company's historical performance lacked severity and in cases where statistical correlation could not be found, the Company utilized peer group performance in place of its own. Various candidate models were developed in which the Company relied on both statistical measures and managerial judgment to select a final model. Managerial judgment typically involved business intuition and a willingness to be conservative in capturing higher levels of stress. Qualitative methodologies were utilized

to create managerial judgment models where the potential impact was considered to be immaterial to the exercise. The models are used to simulate credit losses under the Federal Reserve’s hypothetical severely adverse economic scenario.

The Company’s primary earnings come from the spread between the interest earned on interest-bearing assets and the interest paid on interest-bearing liabilities. Simulation analysis is utilized to capture interest rate risk and project net interest margin under the interest rate environment described by the Federal Reserve’s hypothetical severely adverse economic scenario. The detailed inventory of instruments found on the balance sheet ending the fourth quarter of 2016 are utilized as the starting point for the simulation. Pricing inputs and other assumptions are captured from historical data and in accordance to the Company’s policy to maintain an investment portfolio that provides liquidity.

The Company’s non-interest income and expense are essential elements to profitability. Historical analysis is utilized to capture operational and legal risk and project non-interest income and non-interest expense. Typically, management reviewed historical performance, evaluated drivers for potential future performance, evaluated the potential for future loss events, and created models based on business intuition and a willingness to be conservative in capturing higher levels of stress. Included in this approach is a projection of other real estate expenses driven by the projections of the credit risk models.

Stress Test Results under the Hypothetical Severely Adverse Economic Scenario

Table 1 presents cumulative projections across the nine-quarter planning horizon, beginning with the first quarter of 2017 and ending the first quarter of 2019. These projections should not be interpreted as forecasts of actual financial results for the Company and should instead be interpreted as stressed projections under the hypothetical severely adverse economic scenario.

Table 1. Pre-Provision Net Revenue, Provision for Loan and Lease Losses, and Net Income under the Hypothetical Severely Adverse Economic Scenario ⁽¹⁾

	Nine Quarter Cumulative Ending March 31, 2019 (in millions)
Pre-provision Net Revenue ⁽²⁾	\$410.4
Provision for Loan and Lease Losses ⁽³⁾	355.4
Net Income	35.7
<u>Memo Items:</u>	
Aggregate Loan Losses ⁽⁴⁾	272.5

(1) All figures in this table are reported in accordance with the Federal Reserve's FR Y-16 template and do not necessarily adhere to GAAP.

(2) Pre-provision net revenue includes costs related to other real estate owned and losses resulting from operational and legal risk events.

(3) Provision for loan and lease losses is the cost to adequately reserve for potential losses under the allowance for loan and lease losses.

(4) Aggregate loan losses are the aggregate net charge-offs taken from the allowance for loan and lease losses.

Table 2 presents the stressed projections of the Company’s regulatory capital ratios within the nine-quarter planning horizon, specifically the lowest value of each capital ratio from the first quarter of 2017 through the first quarter of 2019 and the first quarter of 2019 ending value of each capital ratio. These projections should not be interpreted as forecasts of actual financial results for the Company and should instead be interpreted as stressed projections under the hypothetical severely adverse economic scenario.

Table 2. Regulatory Capital Ratios under the Hypothetical Severely Adverse Economic Scenario ⁽¹⁾⁽²⁾

	Actual	Stressed Capital Ratios	
	Q4 2016	Minimum ⁽³⁾	Q1 2019
Common equity tier 1 capital ratio	16.95%	16.23%	16.24%
Tier 1 risk-based capital ratio	18.68%	17.93%	17.93%
Total risk-based capital ratio	19.47%	19.18%	19.18%
Tier 1 leverage ratio	13.91%	13.19%	13.19%

(1) All figures in this table are reported in accordance with the Federal Reserve's FR Y-16 template and do not necessarily adhere to GAAP.

(2) The projected stressed capital ratios assume capital actions described in the section of this disclosure titled "Requirements of the Dodd-Frank Stress Test (DFAST)".

(3) The minimum stressed capital ratio is the lowest value over the planning horizon, beginning with the first quarter of 2017 and ending the first quarter of 2019.

Explanation of the Most Significant Causes for Changes in Regulatory Capital Ratios

The regulatory capital ratios shown in this disclosure under the section titled "Stress Test Result under the Hypothetical Severely Adverse Economic Scenario", remain above the regulatory well-capitalized thresholds. However, the most significant declining factor to the capital ratios is the provision for loan and lease losses needed to maintain an adequate allowance for loan and lease losses under the severely adverse environment. Other declining factors include an increase in leverage and risk-weighted assets due to balance sheet growth assumptions and the capital actions described in the section of this disclosure titled "Requirements of the Dodd-Frank Stress Test (DFAST)". Pre-provision net revenue continues to perform at a level that largely offsets the declining factors under the severely adverse scenario.