

CULLEN FROST BANKERS INC

Form 10-Q

October 24, 2007

United States Securities and Exchange Commission
Washington, D.C. 20549

[For a printer-friendly
version, click here](#)

Form 10-Q

☒ Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the quarterly period ended: September 30, 2007

or

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

For the transition period from _____ to _____

Commission file number: 0-7275

Cullen/Frost Bankers, Inc.

(Exact name of registrant as specified in its charter)

Texas

(State or other jurisdiction of
incorporation or organization)

74-1751768

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

100 W. Houston Street, San Antonio, Texas

(Address of principal executive offices)

78205

(Zip code)

(210) 220-4011

(Registrant's telephone number, including area code)

N/A

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

Edgar Filing: CULLEN FROST BANKERS INC - Form 10-Q

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer [☒]

Accelerated filer [☐]

Non-accelerated filer [☐]

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

As of October 18, 2007, there were 58,479,130 shares of the registrant's Common Stock, \$.01 par value, outstanding.

Cullen/Frost Bankers, Inc.
Quarterly Report on Form 10-Q
September 30, 2007

Table of Contents

	<u>Page</u>
Part I - Financial Information	
Item 1. Financial Statements (Unaudited)	
Consolidated Statements of Income	3
Consolidated Balance Sheets	4
Consolidated Statements of Changes in Shareholders' Equity	5
Consolidated Statements of Cash Flows	6
Notes to Consolidated Financial Statements	7
Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations	20
Item 3. Quantitative and Qualitative Disclosures About Market Risk	40
Item 4. Controls and Procedures	41
Part II - Other Information	
Item 1. Legal Proceedings	42

Edgar Filing: CULLEN FROST BANKERS INC - Form 10-Q

Item 1A.	Risk Factors	42
Item 2.	Unregistered Sales of Equity Securities and Use of Proceeds	42
Item 3.	Defaults Upon Senior Securities	42
Item 4.	Submission of Matters to a Vote of Security Holders	42
Item 5.	Other Information	42
Item 6.	Exhibits	42
Signatures		43

Part I. Financial Information

Item 1. Financial Statements (Unaudited)

Cullen/Frost Bankers, Inc.

Consolidated Statements of Income

(Dollars in thousands, except per share amounts)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2007	2006	2007	2006
Interest income:				
Loans, including fees	\$ 145,106	131,006	438,607	370,304
Securities:				
Taxable	35,675	32,404	110,271	99,159
Tax-exempt	4,706	2,822	11,798	8,342
Interest-bearing deposits	99	61	272	153
Federal funds sold and resell agreements	9,288	10,114	25,529	24,027
Total interest income	194,874	176,407	580,477	501,985

Edgar Filing: CULLEN FROST BANKERS INC - Form 10-Q

Interest expense:

Deposits	49,441	42,277	146,897	109,959
Federal funds purchased and repurchase agreements	7,981	8,353	24,453	23,008
Junior subordinated deferrable interest debentures	2,548	4,439	8,740	12,845
Subordinated notes payable and other borrowings	4,280	2,812	12,410	8,239
Total interest expense	64,250	57,881	192,500	154,051

Net interest income	130,624	118,526	387,977	347,934
---------------------	---------	---------	---------	---------

Provision for possible loan losses	5,784	1,711	11,084	10,750
------------------------------------	-------	-------	--------	--------

Net interest income after provision for possible loan losses	124,840	116,815	376,893	337,184
--	---------	---------	---------	---------

Non-interest income:

Trust fees	17,749	15,962	52,350	47,460
Service charges on deposit accounts	20,696	19,301	59,674	57,974
Insurance commissions and fees	7,695	7,204	24,868	22,323
Other charges, commissions and fees	10,772	7,228	24,609	22,096
Net gain (loss) on securities transactions	-	-	-	(1)
Other	13,844	10,871	40,347	32,495
Total non-interest income	70,756	60,566	201,848	182,347

Non-interest expense:

Salaries and wages	52,996	48,743	155,913	142,312
Employee benefits	10,727	10,882	37,150	35,492
Net occupancy	9,509	8,964	28,626	25,909
Furniture and equipment	8,793	6,553	23,951	19,212
Intangible amortization	2,184	1,293	6,698	3,957
Other	29,358	27,175	95,958	77,876
Total non-interest expense	113,567	103,610	348,296	304,758

Income before income taxes	82,029	73,771	230,445	214,773
----------------------------	--------	--------	---------	---------

Income taxes	25,566	23,769	73,074	69,544
--------------	--------	--------	--------	--------

Net income	\$ 56,463	\$0,002	158,371	145,229
------------	-----------	---------	---------	---------

Earnings per common share:

Basic	\$ 0.97	\$ 0.90	\$2.66	\$ 2.64
Diluted	0.95	0.88	2.62	2.58

See Notes to Consolidated Financial Statements.

Cullen/Frost Bankers, Inc.

Consolidated Balance Sheets

(Dollars in thousands, except per share amounts)

	September 30, 2007	December 31, 2006	September 30, 2006
Assets:			
Cash and due from banks	\$ 608,336	\$ 707,683	\$ 558,997
Interest-bearing deposits	8,727	1,677	2,279
Federal funds sold and resell agreements	556,652	735,225	1,016,650
Total cash and cash equivalents	1,173,715	1,444,585	1,577,926
Securities held to maturity, at amortized cost	8,550	10,096	10,625
Securities available for sale, at estimated fair value	3,446,752	3,330,953	2,770,409
Trading account securities	10,779	9,406	8,024
Loans, net of unearned discounts	7,460,755	7,373,384	6,516,256
Less: Allowance for possible loan losses	(92,263)	(96,085)	(85,667)
Net loans	7,368,492	7,277,299	6,430,589
Premises and equipment, net	217,332	219,533	202,717
Goodwill	528,491	524,117	246,957
Other intangible assets, net	31,782	38,480	21,117
Cash surrender value of life insurance policies	115,082	111,742	110,673
Accrued interest receivable and other assets	265,706	257,978	268,377
	\$ 13,166,681	\$ 13,224,189	\$ 11,647,414
Total assets			

Edgar Filing: CULLEN FROST BANKERS INC - Form 10-Q

Liabilities:

Deposits:

Non-interest-bearing demand deposits	\$ 3,602,780	\$ 3,699,701	\$ 3,380,986
Interest-bearing deposits	6,493,052	6,688,208	5,889,462
Total deposits	10,095,832	10,387,909	9,270,448

Federal funds purchased and repurchase agreements	893,266	864,190	725,779
Subordinated notes payable and other borrowings	261,202	186,366	171,427
Junior subordinated deferrable interest debentures	139,177	242,270	229,898
Accrued interest payable and other liabilities	390,483	166,571	128,441
	11,779,960	11,847,306	10,525,993

Total liabilities

Shareholders' Equity:

Preferred stock, par value \$0.01 per share; 10,000,000 shares authorized; none issued	-	-	-
Junior participating preferred stock, par value \$0.01 per share; 250,000 shares authorized; none issued	-	-	-
Common stock, par value \$0.01 per share; 210,000,000 shares authorized; 60,236,862 shares, 59,839,144 shares and 55,820,763 shares issued	602	598	558
Additional paid-in capital	572,421	548,117	324,534
Retained earnings	966,312	883,060	853,738
Accumulated other comprehensive income (loss), net of tax	(58,018)	(54,892)	(57,409)
Treasury stock, 1,813,461 shares, no shares and no shares, at cost	(94,596)	-	-
	1,386,721	1,376,883	1,121,421

Total shareholders' equity

\$ 13,166,681	\$ 13,224,189	\$ 11,647,414
---------------	---------------	---------------

Total liabilities and shareholders' equity

See Notes to Consolidated Financial Statements.

Cullen/Frost Bankers, Inc.

Consolidated Statements of Changes in Shareholders' Equity

(Dollars in thousands, except per share amounts)

	Nine Months Ended September 30,	
	2007	2006
Total shareholders' equity at beginning of period	\$ 1,376,883	\$ 982,236
Comprehensive income:		
Net income	157,371	145,229
Other comprehensive income:		
Change in unrealized gain/loss on securities available for sale of \$(7,382) in 2007 and \$(9,758) in 2006, net of reclassification adjustment of \$1 in 2006 and tax effect of \$(2,584) in 2007 and \$(3,415) in 2006	(4,798)	(6,342)
Change in funded status of defined benefit post-retirement benefit plans related to the amortization of actuarial losses to net periodic benefit cost of \$1,991 in 2007, net of tax effect of \$697	1,294	-
Change in accumulated gain/loss on effective cash flow hedging derivatives of \$582 in 2007 and \$(963) in 2006 net of tax effect of \$204 in 2007 and \$(338) in 2006	378	(625)
Total other comprehensive income	(3,126)	(6,967)
Total comprehensive income	154,245	138,262
Stock option exercises (680,534 shares in 2007 and 1,404,780 shares in 2006)	18,523	37,270
Stock compensation expense recognized in earnings	7,471	7,030
Tax benefits related to stock compensation, includes excess tax benefits of \$6,231 in 2007 and \$14,563 in 2006	6,382	14,563
Purchase of treasury stock (2,096,277 shares in 2007 and 66,752 shares in 2006)	(109,423)	(3,580)

Edgar Filing: CULLEN FROST BANKERS INC - Form 10-Q

Cash dividends (\$1.14 per share in 2007 and \$0.98 per share in 2006)	(67,360)	(54,360)
Total shareholders' equity at end of period	\$ 1,386,721	\$ 1,121,421

See Notes to Consolidated Financial Statements.

Cullen/Frost Bankers, Inc.

Consolidated Statements of Cash Flows

(Dollars in thousands)

	Nine Months Ended September 30,	
	2007	2006
Operating Activities:		
Net income	\$ 157,371	\$ 145,229
Adjustments to reconcile net income to net cash from operating activities:		
Provision for possible loan losses	11,084	10,750
Deferred tax expense (benefit)	231	(1,779)
Accretion of loan discounts	(9,750)	(7,593)
Securities premium amortization (discount accretion), net	(1,644)	(1,366)
Net (gain) loss on securities transactions	-	1
Depreciation and amortization	23,031	18,323
Origination of loans held for sale	(71,647)	(58,954)
Proceeds from sales of loans held for sale	49,911	59,171
Net gain on sale of loans held for sale and other assets	(1,059)	(1,633)
Stock-based compensation expense	7,471	7,030
Tax benefit from stock-based compensation	151	-
Excess tax benefits from stock-based compensation	(6,231)	(14,563)
Earnings on life insurance policies	(3,340)	(3,054)
Net change in:		
Trading account securities	(1,373)	(1,807)
Accrued interest receivable and other assets	(6,124)	9,902
Accrued interest payable and other liabilities	32,515	(320,790)
Net cash from operating activities	180,597	(161,133)

Investing Activities:

Securities held to maturity:

Maturities, calls and principal repayments	1,541	2,069
--	-------	-------

Securities available for sale:

Purchases	(8,191,457)	(13,028,949)
-----------	--------------	---------------

Sales	14,443	25,689
-------	--------	--------

Maturities, calls and principal repayments	8,254,107	13,351,918
--	-----------	------------

Net change in loans	(74,584)	(141,303)
---------------------	-----------	------------

Net cash paid in acquisitions	(1,903)	(61,016)
-------------------------------	----------	-----------

Proceeds from sales of premises and equipment	4,473	202
---	-------	-----

Purchases of premises and equipment	(18,881)	(21,055)
-------------------------------------	-----------	-----------

Proceeds from sales of repossessed properties	5,282	1,571
---	-------	-------

Net cash from investing activities	(6,979)	129,126
------------------------------------	----------	---------

Financing Activities:

Net change in deposits	(292,077)	(257,529)
------------------------	------------	------------

Net change in short-term borrowings	29,076	(20,669)
-------------------------------------	--------	-----------

Proceeds from notes payable	98,799	-
-----------------------------	--------	---

Principal payments on notes payable and other borrowings	(128,257)	(19,190)
--	------------	-----------

Proceeds from stock option exercises	18,523	37,270
--------------------------------------	--------	--------

Excess tax benefits from stock-based compensation	6,231	14,563
---	-------	--------

Purchase of treasury stock	(109,423)	(3,580)
----------------------------	------------	----------

Cash dividends paid	(67,360)	(54,360)
---------------------	-----------	-----------

Net cash from financing activities	(444,488)	(303,495)
------------------------------------	------------	------------

Net change in cash and cash equivalents	(270,870)	(335,502)
---	------------	------------

Cash and equivalents at beginning of period	1,444,585	1,913,428
---	-----------	-----------

Cash and equivalents at end of period	\$ 1,173,715	\$ 1,577,926
---------------------------------------	--------------	--------------

Supplemental disclosures:

Cash paid for interest	\$ 196,787	\$ 157,237
------------------------	------------	------------

Cash paid for income taxes	60,517	54,099
----------------------------	--------	--------

See Notes to Consolidated Financial Statements.

Cullen/Frost Bankers, Inc.
Notes to Consolidated Financial Statements

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

Note 1 - Significant Accounting Policies

Nature of Operations. Cullen/Frost Bankers, Inc. (Cullen/Frost) is a financial holding company and a bank holding company headquartered in San Antonio, Texas that provides, through its subsidiaries, a broad array of products and services throughout numerous Texas markets, including commercial and consumer banking services, as well as trust and investment management, investment banking, insurance, brokerage, leasing, asset-based lending, treasury management and item processing services.

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

The consolidated financial statements in this Quarterly Report on Form 10-Q have not been audited by an independent registered public accounting firm, but in the opinion of management, reflect all adjustments necessary for a fair presentation of the Corporation's financial position and results of operations. All such adjustments were of a normal and recurring nature. The consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and with the instructions to Form 10-Q adopted by the Securities and Exchange Commission (SEC). Accordingly, the financial statements do not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements and should be read in conjunction with the Corporation's consolidated financial statements, and notes thereto, for the year ended December 31, 2006, included in the Corporation's Annual Report on Form 10-K filed with the SEC on February 2, 2007 (the "2006 Form 10-K"). Operating results for the interim periods disclosed herein are not necessarily indicative of the results that may be expected for a full year or any future period.

Use of Estimates. The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements. Actual results could differ from those estimates. The allowance for possible loan losses, the fair value of stock-based compensation awards, the fair values of financial instruments and the status of contingencies are particularly susceptible to significant change in the near term.

Income Taxes. On January 1, 2007, the Corporation changed its accounting policy related to accounting for tax contingencies in connection with the adoption of Financial Accounting Standards Board (FASB) Interpretation No. 48, "Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement 109." See Note 15 - Income Taxes for additional information.

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 on securities available

for sale, changes in the funded status of defined benefit post-retirement benefit plans and changes in the accumulated gain/loss on effective cash flow hedging instruments. Comprehensive income for the nine months ended September 30, 2007 and 2006 is reported in the accompanying consolidated statements of changes in shareholders' equity. The Corporation had comprehensive income of \$85.9 million and \$99.1 million for the three months ended September 30, 2007 and 2006. Comprehensive income during the three months ended September 30, 2007 and 2006 included net after-tax gains of \$28.5 million and \$48.8 million due to decreases in the net unrealized loss on securities available for sale.

Reclassifications. Certain items in prior financial statements have been reclassified to conform to the current presentation.

Note 2 - Mergers and Acquisitions

The acquisitions described below were accounted for as purchase transactions with all cash consideration funded through internal sources. The purchase price has been allocated to the underlying assets and liabilities based on estimated fair values at the date of acquisition. The operating results of the acquired companies are included with the Corporation's results of operations since their respective dates of acquisition.

Texas Community Bancshares, Inc.

On February 9, 2006, the Corporation acquired Texas Community Bancshares, Inc. including its subsidiary, Texas Community Bank and Trust, N.A. ("TCB"), a privately-held bank holding company and bank located in Dallas, Texas. The Corporation purchased all of the outstanding shares of TCB for approximately \$32.1 million. The purchase price included \$31.1 million in cash and \$1.0 million in acquisition-related costs. Upon completion of the acquisition, TCB was fully integrated into Frost Bank. As of September 30, 2007, the Corporation had a liability totaling \$352 thousand related to TCB shares that have not yet been tendered for payment.

Alamo Corporation of Texas. On February 28, 2006, the Corporation acquired Alamo Corporation of Texas ("Alamo") including its subsidiary, Alamo Bank of Texas, a privately-held bank holding company and bank located in the Rio Grande Valley of Texas. The Corporation purchased all of the outstanding shares of Alamo for approximately \$88.0 million. The purchase price included \$87.0 million in cash and \$1.0 million in acquisition-related costs. Alamo was fully integrated into Frost Bank during the second quarter of 2006.

Summit Bancshares, Inc. On December 8, 2006, the Corporation acquired Summit Bancshares, Inc. including its subsidiary, Summit Bank, N.A. ("Summit"), a publicly-held bank holding company and bank located in Fort Worth, Texas. The Corporation purchased all of the outstanding shares of Summit for approximately \$370.1 million. The total purchase price included \$215.3 million of the Corporation's common stock (3.8 million shares), \$149.7 million in cash and approximately \$5.1 million in acquisition-related costs. Upon completion of the acquisition, Summit was fully integrated into Frost Bank.

Note 3 - Securities Held to Maturity and Securities Available for Sale

A summary of the amortized cost and estimated fair value of securities, excluding trading securities, is presented below.

September 30, 2007

December 31, 2006

Edgar Filing: CULLEN FROST BANKERS INC - Form 10-Q

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Securities Held to Maturity:								
U.S. government agencies and corporations	\$ 7,550	\$ 98	\$ 4	\$ 7,644	\$ 9,096	\$ 87	\$ 14	\$ 9,169
Other	1,000	-	1	999	1,000	-	11	989
Total	\$ 8,550	\$ 98	\$ 5	\$ 8,643	\$ 10,096	\$ 87	\$ 25	\$ 10,158

Securities Available for Sale:								
U.S. Treasury	\$ -	\$ -	\$ -	\$ -	\$ 89,954	\$ 1	\$ 272	\$ 9,683
U.S. government agencies and corporations	\$ 2,058,284	3,380	49,433	2,912,231	2,946,212	5,507	49,110	2,902,609
States and political subdivisions	500,393	2,021	5,850	496,564	309,002	2,672	1,298	310,376
Other	37,957	-	-	37,957	28,285	-	-	28,285
Total	\$ 3,496,634	\$ 5,401	\$ 55,283	\$ 3,446,752	\$ 3,373,453	\$ 8,180	\$ 50,680	\$ 3,380,953

Securities with a carrying value totaling \$1.8 billion at September 30, 2007 and \$2.1 billion at December 31, 2006 were pledged to secure public funds, trust deposits, repurchase agreements and for other purposes, as required or permitted by law.

Sales of securities available for sale were as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2007	2006	2007	2006
Proceeds from sales	\$ 603	\$ -	\$ 14,443	\$ 25,689
Gross realized gains	-	-	-	117

Gross realized losses - - - 118

As of September 30, 2007, securities, with unrealized losses segregated by length of impairment, were as follows:

	Less than 12 Months		More than 12 Months		Total	
	Estimated Fair Value	Unrealized Losses	Estimated Fair Value	Unrealized Losses	Estimated Fair Value	Unrealized Losses
Held to Maturity						
U.S. government agencies and corporations	\$ 1,907	\$ 2	\$ 351	\$ 2	\$ 2,258	\$ 4
Other	-	-	999	1	999	1
Total	\$ 1,907	\$ 2	\$ 1,350	\$ 3	\$ 3,257	\$ 5
Available for Sale						
U.S. government agencies and corporations	\$25,337	\$ 2,989	\$ 1,706,147	\$ 46,444	\$ 2,231,484	\$ 49,433
States and political subdivisions	258,753	5,153	34,372	697	293,125	5,850
Total	\$84,090	\$ 8,142	\$ 1,740,519	\$ 47,141	\$ 2,524,609	\$ 55,283

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, among other things, (i) the length of time and the extent to which the fair value has been less than cost, (ii) the financial condition and near-term prospects of the issuer, and (iii) the intent 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.

Management has the ability and intent to hold the securities classified as held to maturity until they mature, at which time the Corporation will receive full value for the securities. Furthermore, management also has the ability and intent to hold the securities classified as available for sale for a period of time sufficient for a recovery of cost. The unrealized losses are largely due to increases in market interest rates over the yields available at the time the underlying securities were purchased. The fair value is expected to recover as the bonds approach their maturity date or repricing date or if market yields for such investments decline. Management does not believe any of the securities are impaired due to reasons of credit quality. Accordingly, as of September 30, 2007, management believes the impairments detailed in the table above are temporary and no impairment loss has been realized in the Corporation's

consolidated income statement.

Note 4 - Loans

Loans were as follows:

	September 30, 2007	Percentage of Total	December 31, 2006	Percentage of Total	September 30, 2006	Percentage of Total
Commercial and industrial:						
Commercial	\$ 3,234,509	43.4 %	\$ 3,229,570	43.8 %	\$ 2,852,027	43.8 %
Leases	182,553	2.4	174,075	2.4	165,465	2.5
Asset-based	35,879	0.5	33,856	0.4	46,387	0.7
Total commercial and industrial	3,452,941	46.3	3,437,501	46.6	3,063,879	47.0
Real estate:						
Construction:						
Commercial	580,865	7.8	649,140	8.8	607,749	9.4
Consumer	73,209	1.0	114,142	1.5	104,781	1.6
Land:						
Commercial	390,796	5.2	407,055	5.5	352,775	5.4
Consumer	3,631	0.1	5,394	0.1	4,323	0.1
Commercial mortgages	1,892,456	25.3	1,766,469	24.0	1,494,114	22.9
1-4 family residential mortgages	104,073	1.4	125,294	1.7	97,453	1.5
Home equity and other consumer	559,860	7.5	508,574	6.9	470,088	7.2
Total real estate	3,604,890	48.3	3,576,068	48.5	3,131,283	48.1
Consumer:						
Indirect	2,324	-	3,475	0.1	2,150	-
Student loans held for sale	71,100	1.0	47,335	0.6	53,428	0.8
Other	317,045	4.2	310,752	4.2	276,219	4.2
Other	41,863	0.6	27,703	0.4	19,188	0.3
Unearned discounts	(29,408)	(0.4)	(29,450)	(0.4)	(29,891)	(0.4)

Edgar Filing: CULLEN FROST BANKERS INC - Form 10-Q

Total loans	\$ 7,460,755	100.0 %	\$ 7,373,384	100.0 %	\$ 6,516,256	100.0 %
-------------	--------------	---------	--------------	---------	--------------	---------

Concentrations of Credit. Most of the Corporation's lending activity occurs within the State of Texas, including the four largest metropolitan areas of Austin, Dallas/Ft. Worth, Houston and San Antonio as well as other markets. The majority of the Corporation's loan portfolio consists of commercial and industrial and commercial real estate loans. As of September 30, 2007, there were no concentrations of loans related to any single industry in excess of 10% of total loans.

Student Loans Held for Sale. Student loans are primarily originated for resale on the secondary market. These loans, which are generally sold on a non-recourse basis, are carried at the lower of cost or market on an aggregate basis.

Foreign Loans. The Corporation has U.S. dollar denominated loans and commitments to borrowers in Mexico. The outstanding balance of these loans and the unfunded amounts available under these commitments were not significant at September 30, 2007 or December 31, 2006.

Non-Performing/Past Due Loans. Loans are placed on non-accrual status when, in management's opinion, the borrower may be unable to meet payment obligations, which typically occurs when principal or interest payments are more than 90 days past due. Non-accrual loans totaled \$21.4 million at September 30, 2007 and \$52.2 million at December 31, 2006. Accruing loans past due more than 90 days totaled \$10.9 million at September 30, 2007 and \$10.9 million at December 31, 2006.

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. 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 collectibility of the principal amount is reasonably assured, in which case interest is recognized on a cash basis. Impaired loans, or portions thereof, are charged off when deemed uncollectible.

Impaired loans were as follows:

	September 30, 2007	December 31, 2006	September 30, 2006
Balance of impaired loans with no allocated allowance	\$ 7,690	\$ 5,933	\$ 8,204
Balance of impaired loans with an allocated allowance	6,071	38,254	15,518
Total recorded investment in impaired loans	\$ 13,761	\$ 44,187	\$ 23,722
Amount of the allowance allocated to impaired loans	\$ 2,366	\$ 8,729	\$ 6,672

The impaired loans included in the table above were primarily comprised of collateral dependent commercial loans. The average recorded investment in impaired loans was \$25.9 million and \$34.0 million during the three and nine months ended September 30, 2007 and \$23.9 million and \$25.4 million for the three and nine months ended September 30, 2006. No interest income was recognized on these loans subsequent to their classification as impaired.

Note 5 - 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 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 the performance of the Corporation's loan portfolio, the economy, changes in interest rates and the view of the regulatory authorities toward loan classifications.

Activity in the allowance for possible loan losses was as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2007	2006	2007	2006
Balance at the beginning of the period	\$ 96,071	\$ 85,552	\$ 96,085	\$80,325
Provision for possible loan losses	5,784	1,711	11,084	10,750
Allowance for possible loan losses acquired	-	-	-	2,373
Net charge-offs:				
Losses charged to the allowance	(11,739)	(3,437)	(19,877)	(13,798)
Recoveries of loans previously charged off	2,147	1,841	4,971	6,017
Net charge-offs	(9,592)	(1,596)	(14,906)	(7,781)
Balance at the end of the period	\$ 92,263	\$ 85,667	\$ 92,263	\$85,667

Note 6 - Goodwill and Other Intangible Assets

Goodwill. Goodwill totaled \$528.5 million at September 30, 2007 and \$524.1 million at December 31, 2006. During the first and second quarters of 2007, as a result of a reallocation of the purchase price based on additional information related to the valuation of certain assets acquired and liabilities assumed, goodwill recorded in connection with the acquisition of TCB was decreased \$470 thousand, goodwill recorded in connection with the acquisition of Alamo was decreased \$196 thousand and goodwill recorded in connection with the acquisition of Summit was increased \$5.0 million. See Note 2 - Mergers and Acquisitions.

Other Intangible Assets. Other intangible assets totaled \$31.8 million at September 30, 2007 including \$29.7 million related to core deposits, \$1.5 million related to customer relationships and \$545 thousand related to non-compete agreements. Other intangible assets totaled \$38.5 million at December 31, 2006 including \$35.8 million related to core deposits, \$1.9 million related to non-compete agreements and \$814 thousand related to customer relationships.

Amortization expense related to intangible assets totaled \$2.2 million and \$6.7 million during the three and nine months ended September 30, 2007 and totaled \$1.3 million and \$4.0 million during the three and nine months ended September 30, 2006. The estimated aggregate future amortization expense for intangible assets remaining as of September 30, 2007 is as follows:

Remainder of 2007	\$ 2,131
2008	7,268
2009	5,734
2010	4,483
2011	3,737
Thereafter	8,429
	<u>\$ 31,782</u>

Note 7 - Deposits

Deposits were as follows:

	September 30, 2007	Percentage of Total	December 31, 2006	Percentage of Total	September 30, 2006	Percentage of Total
Non-interest-bearing demand deposits:						
Commercial and individual	\$ 3,319,808	32.9 %	\$ 3,384,232	32.6 %	\$ 3,092,177	33.4 %
Correspondent banks	207,109	2.1	237,463	2.3	208,469	2.2
Public funds	75,863	0.7	78,006	0.7	80,340	0.9
Total non-interest-bearing demand deposits	3,602,780	35.7	3,699,701	35.6	3,380,986	36.5

Interest-bearing deposits:

Private accounts:

Savings and interest checking	1,319,010	13.1	1,470,792	14.2	1,255,776	13.5
Money market accounts	3,413,701	33.8	3,393,961	32.7	3,116,532	33.6
Time accounts under \$100,000	622,758	6.2	612,466	5.9	513,573	5.5
Time accounts of \$100,000 or more	803,752	7.9	791,699	7.6	627,159	6.8
Public funds	333,831	3.3	419,290	4.0	376,422	4.1
Total interest-bearing deposits	6,493,052	64.3	6,688,208	64.4	5,889,462	63.5
<hr/>						
Total deposits	\$ 10,095,832	100.0 %	\$387,909	100.0 %	\$9,270,448	100.0 %

At September 30, 2007 and December 31, 2006, interest-bearing public funds deposits included \$126.6 million and \$127.0 million in savings and interest checking accounts, \$100.4 million and \$97.8 million in money market accounts, \$3.8 million and \$6.6 million in time accounts under \$100 thousand, and \$103.0 million and \$187.9 million in time accounts of \$100 thousand or more.

Deposits from foreign sources, primarily Mexico, totaled \$683.9 million at September 30, 2007 and \$711.0 million at December 31, 2006.

-

Note 8 - Commitments and Contingencies

Financial Instruments with Off-Balance-Sheet Risk. In the normal course of business, the Corporation enters into various transactions, which, in accordance with generally accepted accounting principles are not included in its consolidated balance sheets. The Corporation enters into these transactions to meet the financing needs of its customers. These transactions include commitments to extend credit and standby letters of credit, which involve, to varying degrees, elements of credit risk and interest rate risk in excess of the amounts recognized in the consolidated balance sheets. The Corporation minimizes its exposure to loss under these commitments by subjecting them to credit approval and monitoring procedures.

Commitments to Extend Credit. The Corporation enters into contractual commitments to extend credit, normally with fixed expiration dates or termination clauses, at specified rates and for specific purposes. Substantially all of the Corporation's commitments to extend credit are contingent upon customers maintaining specific credit standards at the time of loan funding. Commitments to extend credit totaled \$4.6 billion and \$4.0 billion at September 30, 2007 and December 31, 2006.

Standby Letters of Credit. Standby letters of credit are written conditional commitments issued by the Corporation to guarantee the performance of a customer to a third party. 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 of the commitment. If the commitment is funded, the Corporation would be entitled to seek recovery from the customer. The Corporation's policies generally require that standby letter of credit arrangements contain security and debt covenants similar to those contained in loan agreements. Standby letters of credit totaled \$217.3 million at September 30, 2007 and \$254.8 million at December 31, 2006. The Corporation had an accrued liability totaling \$1.3 million at September 30, 2007 and \$1.2 million at December 31, 2006 related to potential obligations under these guarantees.

Lease Commitments. The Corporation leases certain office facilities and office equipment under operating leases. Rent expense for all operating leases totaled \$4.5 million and \$13.5 million for the three and nine months ended September 30, 2007 and \$3.8 million and \$11.3 million for the three and nine months ended September 30, 2006. There has been no significant change in the future minimum lease payments payable by the Corporation since December 31, 2006. See the 2006 Form 10-K for information regarding these commitments.

Litigation. The Corporation is subject to various claims and legal actions that have arisen in the normal course of conducting business. Management does not expect the ultimate disposition of these matters to have a material adverse impact on the Corporation's financial statements.

Note 9 - Borrowed Funds

On February 15, 2007, the Corporation issued \$100 million of 5.75% fixed-to-floating rate subordinated notes due February 15, 2017. The notes bear interest at the rate of 5.75% per annum, payable semi-annually on each February 15 and August 15, commencing on August 15, 2007 until February 15, 2012. From and including February 15, 2012, to but excluding the maturity date or date of earlier redemption, the notes will bear interest at a rate per annum equal to three-month LIBOR for the related interest period plus 0.53%, payable quarterly on each February 15, May 15, August 15 and November 15, commencing May 15, 2012. The notes are subordinated in right of payment to all our senior indebtedness and effectively subordinated to all existing and future debt and all other liabilities of our subsidiaries. The notes cannot be accelerated except in the event of bankruptcy or the occurrence of certain other events of bankruptcy, insolvency or reorganization. The Corporation may elect to redeem the notes (subject to regulatory approval), in whole or in part, on any interest payment date on or after February 15, 2012 at a redemption price equal to 100% of the principal amount plus any accrued and unpaid interest.

On February 21, 2007, the Corporation redeemed \$103.1 million of 8.42% junior subordinated deferrable interest debentures, Series A due February 1, 2027, held of record by Cullen/Frost Capital Trust I. As a result of the redemption, the Corporation incurred \$5.3 million in expense during the first quarter of 2007 related to a prepayment penalty and the write-off of the unamortized debt issuance costs. Concurrently, the \$100 million of 8.42% trust preferred securities issued by Cullen/Frost Capital Trust I were also redeemed.

Note 10 - Regulatory Matters and Shareholders' Equity

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

Quantitative measures established by regulations to ensure capital adequacy require the maintenance of minimum amounts and ratios (set forth in the table below) of total and Tier 1 capital (as defined in the regulations) to risk-weighted assets (as defined), and of Tier 1 capital to adjusted quarterly average assets (as defined).

Cullen/Frost's and Frost Bank's Tier 1 capital consists of shareholders' equity excluding unrealized gains and losses on securities available for sale, the funded status of the Corporation's defined benefit post-retirement benefit plans, goodwill and other intangible assets. Tier 1 capital for Cullen/Frost also includes \$135 million of trust preferred securities issued by unconsolidated subsidiary trusts. Cullen/Frost's and Frost Bank's total capital is comprised of Tier 1 capital for each entity plus \$90 million of the Corporation's aggregate \$150 million of 6.875% subordinated notes payable and a permissible portion of the allowance for possible loan losses. The \$100 million of 5.75% fixed-to-floating rate subordinated notes issued during the first quarter of 2007 are not included in Tier 1 capital but are included in total capital of Cullen/Frost.

The Tier 1 and total capital ratios are calculated by dividing the respective capital amounts by risk-weighted assets. Risk-weighted assets are calculated based on regulatory requirements and include total assets, excluding goodwill and other intangible assets, allocated by risk weight category and certain off-balance-sheet items (primarily loan commitments). The leverage ratio is calculated by dividing Tier 1 capital by adjusted quarterly average total assets, which exclude goodwill and other intangible assets.

Actual and required capital ratios for Cullen/Frost and Frost Bank were as follows:

	Actual		Minimum Required for Capital Adequacy Purposes		Required to be Well Capitalized Under Prompt Corrective Action Regulations	
	Capital Amount	Ratio	Capital Amount	Ratio	Capital Amount	Ratio
September 30, 2007						
Total Capital to Risk-Weighted Assets	1,312,092	12.83 %	\$18,270	8.00 %	N/A	N/A
Cullen/Frost	1,258,254	12.31	817,833	8.00	\$102,291	10.00 %
Frost Bank						
Tier 1 Capital to Risk-Weighted Assets	1,029,829	10.07	409,134	4.00	N/A	N/A
Cullen/Frost	1,075,991	10.53	408,916	4.00	613,375	6.00
Frost Bank						
Leverage Ratio						

Edgar Filing: CULLEN FROST BANKERS INC - Form 10-Q

	1,029,829	8.01	514,084	4.00	N/A	N/A
Cullen/Frost						
	1,075,991	8.38	513,720	4.00	642,150	5.00
Frost Bank						
December 31, 2006						
Total Capital to Risk-Weighted Assets						
	1,332,744	13.43 %	793,889	8.00 %	N/A	N/A
Cullen/Frost						
	1,234,583	12.45	793,555	8.00	\$ 991,944	10.00 %
Frost Bank						
Tier 1 Capital to Risk-Weighted Assets						
	1,116,659	11.25	396,944	4.00	N/A	N/A
Cullen/Frost						
	1,018,498	10.27	396,778	4.00	595,166	6.00
Frost Bank						
Leverage Ratio						
	1,116,659	9.56	467,275	4.00	N/A	N/A
Cullen/Frost						
	1,018,498	8.73	466,835	4.00	583,543	5.00
Frost Bank						

Frost Bank has been notified by its regulator that, as of its most recent regulatory examination, it is regarded as well capitalized under the regulatory framework for prompt corrective action. Such determination has been made based on Frost Bank's Tier 1, total capital, and leverage ratios. There have been no conditions or events since this notification that management believes would change Frost Bank's categorization as well capitalized under the aforementioned ratios.

Cullen/Frost is subject to the regulatory capital requirements administered by the Federal Reserve, while Frost Bank is subject to the regulatory capital requirements administered by the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation. Regulatory authorities can initiate certain mandatory actions if Cullen/Frost or Frost Bank fail to meet the minimum capital requirements, which could have a direct material effect on the Corporation's financial statements. Management believes, as of September 30, 2007, that Cullen/Frost and Frost Bank meet all capital adequacy requirements to which they are subject.

Trust Preferred Securities. In accordance with the applicable accounting standard related to variable interest entities, the accounts of the Corporation's wholly owned subsidiary trusts, Cullen/Frost Capital Trust II, Alamo Corporation of Texas Trust I and Summit Bancshares Statutory Trust I, have not been included in the Corporation's consolidated financial statements. However, the \$135 million in trust preferred securities issued by these subsidiary trusts have been included in the Tier 1 capital of Cullen/Frost for regulatory capital purposes pursuant to guidance

from the Federal Reserve Board.

Stock Repurchase Plan. In general, stock repurchase plans allow the Corporation to proactively manage its capital position and return excess capital to shareholders. Shares purchased under such plans also provide the Corporation with shares of common stock necessary to satisfy obligations related to stock compensation awards. Under the current plan, which was approved on April 26, 2007, the Corporation was authorized to repurchase up to 2.5 million shares of its common stock from time to time over a two-year period in the open market or through private transactions. Under the plan, the Corporation repurchased 1.2 million shares at a total cost of \$65.6 million during the second quarter of 2007 and 854 thousand shares at a total cost of \$43.8 million during the third quarter of 2007. No shares were repurchased under stock repurchase plans during 2006.

Note 11 - Derivative Financial Instruments

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

Interest Rate Derivatives. The notional amounts and estimated fair values of interest rate derivative positions outstanding at September 30, 2007 and December 31, 2006 are presented in the following table. The estimated fair value of the interest rate floors on variable-rate loans are based on a quoted market price. Internal present value models are used to estimate the fair values of the other interest rate swaps and caps.

	September 30, 2007		December 31, 2006	
	Notional Amount	Estimated Fair Value	Notional Amount	Estimated Fair Value
Interest rate derivatives designated as hedges of fair value:				
Commercial loan/lease interest rate swaps	\$ 175,173	\$ (1,395)	\$ 15,337	\$ 182
Interest rate derivatives designated as hedges of cash flows:				
Interest rate floors on variable-rate loans	1,300,000	660	1,300,000	366
Non-hedging interest rate derivatives:				
Commercial loan/lease interest rate swaps	231,147	5,098	200,910	3,320
Commercial loan/lease interest rate swaps	231,147	(5,098)	200,910	(3,320)
	-	-	17,500	5

Commercial loan/lease interest
rate caps

Commercial loan/lease interest rate caps	-	-	17,500	(5)
---	---	---	--------	------

Commercial loan/lease interest rate floors	-	-	17,500	8
---	---	---	--------	---

Commercial loan/lease interest rate floors	-	-	17,500	(8)
---	---	---	--------	------

The weighted-average rates paid and received for interest rate swaps and the weighted-average strike rates for interest rate floors outstanding at September 30, 2007 were as follows:

	Weighted-Average		
	Interest Rate Paid	Interest Rate Received	Strike Rate
Interest rate swaps:			
Commercial loan/lease interest rate swaps	4.79 %	5.09 %	-
Non-hedging interest rate swaps	5.48	5.48	-

Interest rate caps and floors:

Interest rate floors on variable-rate loans	-	-	6.00 %
---	---	---	--------

Interest rate contracts involve the risk of dealing with counterparties and their ability to meet contractual terms. These counterparties must have an investment grade credit rating and be approved by the Corporation's Asset/Liability Management Committee.

The Corporation's credit exposure on interest rate swaps is limited to the net favorable value and interest payments of all swaps by each counterparty. In such cases collateral is required from the counterparties involved if the net value of the swaps exceeds a nominal amount considered to be immaterial. The Corporation's credit exposure to upstream financial institution counterparties and bank customers, net of any collateral pledged, relating to interest rate swaps was approximately \$4.7 million at September 30, 2007. This total credit exposure was primarily related to bank customers. Collateral levels are monitored and adjusted on a monthly basis for changes in interest rate swap values.

For fair value hedges, the changes in the fair value of both the derivative hedging instrument and the hedged item are recorded in current earnings as other income or other expense. The extent that such changes in fair value do not offset represents hedge ineffectiveness. For cash flow hedges, the effective portion of the gain or loss on the derivative hedging instrument is reported in other comprehensive income, while the ineffective portion (indicated by the excess of the cumulative change in the fair value of the derivative over that which is necessary to offset the cumulative change in expected future cash flows on the hedge transaction) is recorded in current earnings as other income or other expense. The amount of hedge ineffectiveness reported in earnings was not significant during any of the reported periods. The accumulated net after-tax loss on the floor contracts included in accumulated other comprehensive income totaled \$760 thousand at September 30, 2007.

Commodity Derivatives. The Corporation enters into commodity swaps and option contracts to accommodate the business needs of its customers. Upon the origination of a commodity swap or option contract with a customer, the Corporation simultaneously enters into an offsetting contract with a third party to mitigate the exposure to fluctuations in commodity prices.

The notional amounts and estimated fair values of commodity derivative positions outstanding are presented in the following table. The estimated fair values are based on quoted market prices.

		September 30, 2007		December 31, 2006	
Notional Units		Notional Amount	Estimated Fair Value	Notional Amount	Estimated Fair Value
Commodity swaps:					
Oil	Barrels	409	\$ 3,373	27	\$ 36
Oil	Barrels	409	(3,273)	27	(29)
Natural gas	MMBTUs	1,680	1,173	600	952
Natural gas	MMBTUs	1,680	(1,134)	600	(953)
Commodity options:					
Oil	Barrels	496	1,674	566	1,837
Oil	Barrels	496	(1,671)	566	(1,835)
Natural gas	MMBTUs	360	149	1,440	1006
Natural gas	MMBTUs	360	(149)	1,440	(1,006)

Foreign Currency Derivatives. The Corporation enters into foreign currency forward and option contracts to accommodate the business needs of its customers. Upon the origination of a foreign currency forward contract with a customer, the Corporation simultaneously enters into an offsetting contract with a third party to negate the exposure to fluctuations in foreign currency exchange rates. The notional amounts and fair values of open foreign currency forward contracts were not significant at September 30, 2007 and December 31, 2006.

Note 12 - Earnings Per Common Share

Basic earnings per share is computed by dividing net income by the weighted-average number of shares outstanding during the applicable period. Diluted earnings per share is computed using the weighted-average number of shares determined for the basic computation plus the dilutive effect of stock options and non-vested stock granted using the treasury stock method.

The following table presents a reconciliation of the number of shares used in the calculation of basic and diluted earnings per common share.

Three Months Ended	Nine Months Ended
September 30,	September 30,

Edgar Filing: CULLEN FROST BANKERS INC - Form 10-Q

	2007	2006	2007	2006
Weighted-average shares outstanding for basic earnings per share	58,438,992	55,440,260	59,141,846	55,042,933
Dilutive effect of stock options and non-vested stock awards	730,618	1,146,277	820,485	1,232,789
Weighted-average shares outstanding for diluted earnings per share	59,169,610	56,586,537	59,962,331	56,275,722

Note 13 - Stock-Based Compensation

A combined summary of activity in the Corporation's active stock plans for the nine months ended September 30, 2007 is presented in the following table.

	Non-Vested Stock Awards Outstanding			Stock Options Outstanding	
	Shares Available for Grant	Number of Shares	Weighted-Average Grant-Date Fair Value	Number of Shares	Weighted-Average Exercise Price
Balance, January 1, 2007	2,386,025	235,800	\$ 47.72	4,545,195	\$41.19
Shares authorized - 2007					
Outside Directors Incentive Plan	500,000	-	-	-	-
Granted	(26,000)	-	-	26,000	52.58
Stock options exercised	-	-	-	(680,534)	27.22
Stock awards vested	-	-	-	-	-
Forfeited	70,800	-	-	(70,800)	48.29
Canceled	(70,150)	-	-	-	-
Balance, September 30, 2007	2,860,675	235,800	47.72	3,819,861	43.63

During the nine months ended September 30, 2007 and 2006, proceeds from stock option exercises totaled \$18.5 million and \$37.3 million. During the nine months ended September 30, 2007, 397,718 shares issued in connection with stock option exercises and non-vested stock awards were new shares issued from available authorized shares, while 282,816 shares were issued from available treasury stock.

Stock-based compensation expense totaled \$2.4 million and \$7.5 million during the three and nine months ended September 30, 2007 and \$2.3 million and \$7.0 million during the three and nine months ended September 30, 2006.

Stock-based compensation expense is recognized ratably over the requisite service period for all awards. Unrecognized stock-based compensation expense related to stock options totaled \$11.4 million at September 30, 2007, while unrecognized stock-based compensation expense related to non-vested stock awards was \$4.4 million at September 30, 2007.

Note 14 - Defined Benefit Plans

The components of the combined net periodic benefit cost for the Corporation's qualified and non-qualified defined benefit pension plans were as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2007	2006	2007	2006
Expected return on plan assets, net of expenses	\$(2,047)	\$ (1,863)	\$6,141)	\$ (5,589)
Interest cost on projected benefit obligation	1,869	1,795	5,607	5,385
Net amortization and deferral	663	749	1,991	2,247
Net periodic benefit cost	\$ 485	\$ 681	\$1,457	\$ 2,043

The Corporation's non-qualified defined benefit pension plan is not funded. Contributions to the qualified defined benefit pension plan totaled \$4.0 million through September 30, 2007. The Corporation does not expect to make any additional contributions during the remainder of 2007.

The net periodic benefit cost related to post-retirement healthcare benefits offered by the Corporation to certain former employees was not significant during either of the reported periods.

On December 31, 2006, the Corporation adopted the recognition and disclosure provisions of SFAS No. 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans, an amendment of FASB Statements No. 87, 88, 106, and 132(R)." SFAS 158 required the Corporation to recognize the underfunded status of its defined benefit post-retirement benefit plans as a liability in its December 31, 2006 consolidated balance sheet, with a corresponding adjustment to accumulated other comprehensive income, net of tax. The funded status is measured as the difference between plan assets at fair value and the benefit obligation (the projected benefit obligation for pension plans or the accumulated benefit obligation for other post-retirement benefit plans). The amount recorded as accumulated other comprehensive income represents the net unrecognized actuarial loss remaining from the initial adoption of SFAS 87, "Employers' Accounting for Pensions." The net unrecognized actuarial loss is being amortized and recognized as net periodic pension cost. Further, actuarial gains and losses that arise in subsequent periods and are not recognized as net periodic pension cost in the same period will be recognized as a component of other comprehensive income. Those amounts will be subsequently recognized as a component of net periodic pension cost on the same basis as the amounts recognized in accumulated other comprehensive income at adoption of SFAS 158. SFAS 158 also requires an employer to measure the funded status of a plan as of the date of its year-end statement of financial position. The requirement to measure plan assets and benefit obligations as of the date of the year-end statement of financial position is effective for the Corporation's financial statements beginning with the year ended after December 31, 2008. The Corporation currently uses December 31 as the measurement date for its defined benefit post-retirement benefit plans.

Note 15 - Income Taxes

Income tax expense was as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2007	2006	2007	2006
Current income tax expense	\$25,314	\$23,816	\$ 72,843	\$ 71,323
Deferred income tax expense (benefit)	252	(47)	231	(1,779)
Income tax expense as reported	\$25,566	\$23,769	\$ 73,074	\$ 69,544
Effective tax rate	31.2 %	32.2 %	31.7 %	32.4 %

Net deferred tax assets totaled \$55.8 million at September 30, 2007 and \$54.4 million at December 31, 2006. No valuation allowance was recorded against these deferred tax assets, as the amounts are recoverable through taxes paid in prior years.

The Corporation adopted the provisions of FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement 109," effective January 1, 2007. Interpretation 48 prescribes a recognition threshold and a measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. Benefits from tax positions should be recognized in the financial statements only when it is more likely than not that the tax position will be sustained upon examination by the appropriate taxing authority that would have full knowledge of all relevant information. A tax position that meets the more-likely-than-not recognition threshold is measured at the largest amount of benefit that is greater than fifty percent likely of being realized upon ultimate settlement. Tax positions that previously failed to meet the more-likely-than-not recognition threshold should be recognized in the first subsequent financial reporting period in which that threshold is met. Previously recognized tax positions that no longer meet the more-likely-than-not recognition threshold should be derecognized in the first subsequent financial reporting period in which that threshold is no longer met. Interpretation 48 also provides guidance on the accounting for and disclosure of unrecognized tax benefits, interest and penalties. Adoption of Interpretation 48 did not have a significant impact on the Corporation's financial statements.

The Corporation files income tax returns in the U.S. federal jurisdiction. The Company is no longer subject to U.S. federal income tax examinations by tax authorities for years before 2004. During the third quarter of 2007, the Internal Revenue Service (IRS) completed an examination of the Corporation's U.S. income tax returns for 2004 and 2005. The adjustments resulting from the examination did not have a significant impact on the Corporation's financial statements.

Note 16 - Operating Segments

The Corporation has two reportable operating segments, Banking and the Financial Management Group (FMG), that are delineated by the products and services that each segment offers. Banking includes both commercial and consumer banking services, Frost Insurance Agency and Frost Securities, Inc. Commercial banking services are

provided to corporations and other business clients and include a wide array of lending and cash management products. Consumer banking services include direct lending and depository services. FMG includes fee-based services within private trust, retirement services, and financial management services, including personal wealth management and brokerage services.

The accounting policies of each reportable segment are the same as those of the Corporation except for the following items, which impact the Banking and FMG segments: (i) expenses for consolidated back-office operations are allocated to operating segments based on estimated uses of those services, (ii) general overhead-type expenses such as executive administration, accounting and internal audit are allocated based on the direct expense level of the operating segment, (iii) income tax expense for the individual segments is calculated essentially at the statutory rate, and (iv) the parent company records the tax expense or benefit necessary to reconcile to the consolidated total.

The Corporation uses a match-funded transfer pricing process to assess operating segment performance. The process helps the Corporation to (i) identify the cost or opportunity value of funds within each business segment, (ii) measure the profitability of a particular business segment by relating appropriate costs to revenues, (iii) evaluate each business segment in a manner consistent with its economic impact on consolidated earnings, and (iv) enhance asset and liability pricing decisions.

Summarized operating results by segment were as follows:

	Banking	FMG	Non-Banks	Consolidated
Revenues from (expenses to) external customers:				
Three months ended:				
September 30, 2007	\$176,534	\$ 28,776	\$ (3,930)	\$ 201,380
September 30, 2006	157,252	26,044	(4,204)	179,092
Nine months ended:				
September 30, 2007	\$518,047	\$ 83,581	\$11,803)	\$ 589,825
September 30, 2006	467,514	74,937	(12,170)	530,281
Net income (loss):				
Three months ended:				
September 30, 2007	\$ 51,904	\$ 7,435	\$ (2,876)	\$ 56,463
September 30, 2006	47,109	6,089	(3,196)	50,002
Nine months ended:				
September 30, 2007	\$150,603	\$ 19,541	\$12,773)	\$ 157,371
September 30, 2006	138,557	16,447	(9,775)	145,229

Note 17 - New Accounting Standards

Statements of Financial Accounting Standards

SFAS No. 155, "Accounting for Certain Hybrid Financial Instruments."

SFAS 155 amends SFAS 133, "Accounting for Derivative Instruments and Hedging Activities" and SFAS 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities." SFAS 155 (i) permits fair value remeasurement for any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation, (ii) clarifies which interest-only strips and principal-only strips are not subject to the requirements of SFAS 133, (iii) establishes a requirement to evaluate interests in securitized financial assets to identify interests that are freestanding derivatives or that are hybrid financial instruments that contain an embedded derivative requiring bifurcation, (iv) clarifies that concentrations of credit risk in the form of subordination are not embedded derivatives, and (v) amends SFAS 140 to eliminate the prohibition on a qualifying special purpose entity from holding a derivative financial instrument that pertains to a beneficial interest other than another derivative financial instrument. Adoption of SFAS 155 on January 1, 2007 did not have a significant impact on the Corporation's financial statements.

SFAS No. 156, "Accounting for Servicing of Financial Assets - an amendment of FASB Statement No. 140."

SFAS 156 amends SFAS 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities - a replacement of FASB Statement No. 125," by requiring, in certain situations, an entity to recognize a servicing asset or servicing liability each time it undertakes an obligation to service a financial asset by entering into a servicing contract. All separately recognized servicing assets and servicing liabilities are required to be initially measured at fair value. Subsequent measurement methods include the amortization method, whereby servicing assets or servicing liabilities are amortized in proportion to and over the period of estimated net servicing income or net servicing loss or the fair value method, whereby servicing assets or servicing liabilities are measured at fair value at each reporting date and changes in fair value are reported in earnings in the period in which they occur. If the amortization method is used, an entity must assess servicing assets or servicing liabilities for impairment or increased obligation based on the fair value at each reporting date. Adoption of SFAS 156 on January 1, 2007 did not have a significant impact on the Corporation's financial statements.

SFAS No. 157, "Fair Value Measurements."

SFAS 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS 157 is effective for the Corporation on January 1, 2008 and is not expected to have a significant impact on the Corporation's financial statements.

SFAS No. 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans, an amendment of FASB Statements No. 87, 88, 106, and 132(R)."

The recognition and disclosure provisions of SFAS 158 were adopted by the Corporation for its financial statements for the year ended December 31, 2006. See Note 14 - Defined Benefit Plans for additional information.

SFAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities-Including an amendment of FASB Statement No. 115."

SFAS 159 permits entities to choose to measure eligible items at fair value at specified election dates. Unrealized gains and losses on items for which the fair value option has been elected are reported in earnings at each subsequent reporting date. The fair value option (i) may be applied instrument by instrument, with certain exceptions, (ii) is irrevocable (unless a new election date occurs) and (iii) is applied only to entire instruments and not to portions of instruments. SFAS 159 is effective for the Corporation on January 1, 2008 and is not expected to have a significant impact on the Corporation's financial statements.

Financial Accounting Standards Board Interpretations

FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement 109." The Corporation adopted Interpretation No. 48 on January 1, 2007. See Note 15 - Income Taxes for additional information.

Note 18 - Subsequent Event

On October 23, 2007, the Corporation entered into three interest rate swap contracts with a total notional amount of \$1.2 billion. The interest rate swap contracts were designated as hedging instruments in cash flow hedges with the objective of protecting the overall cash flows from the Corporation's monthly interest receipts on a rolling portfolio of \$1.2 billion of variable-rate loans outstanding throughout the 84-month period beginning on October 25, 2007 and ending on October 25, 2014 from the risk of variability of those cash flows such that the yield on the underlying loans would remain constant. The desired constant yield is 7.559% in the case of the first contract (underlying loan pool totaling \$650.0 million carrying an interest rate equal to Prime), 8.059% in the case of the second contract (underlying loan pool totaling \$230.0 million carrying an interest rate equal to Prime plus a margin of 50 basis points) and 8.559% in the case of the third contract (underlying loan pool totaling \$320.0 million carrying an interest rate equal to Prime plus a margin of 100 basis points). The Corporation expects to maintain pools of such loans having the aforementioned total principal balances over the entire 84-month term of the swaps. Under the swaps, the Corporation will receive a fixed interest rate of 7.559% and pay a variable interest rate equal to the daily Federal Reserve Statistical Release H-15 Prime Rate ("Prime"), with monthly settlements. The interest rate swaps were entered into on October 23, 2007 at current market rates. Accordingly, no premium was paid or received in connection with the swaps.

In conjunction with entering into the interest rate swap contracts, the Corporation terminated its three interest rate floor contracts, which had a total notional amount of \$1.3 billion. These floor contracts would have otherwise expired on December 15, 2008.

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

Financial Review

Cullen/Frost Bankers, Inc.

The following discussion should be read in conjunction with the Corporation's consolidated financial statements, and notes thereto, for the year ended December 31, 2006, included in the 2006 Form 10-K. Operating results for the three and nine months ended September 30, 2007 are not necessarily indicative of the results for the year ending December 31, 2007 or any future period.

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

Forward-Looking Statements and Factors that Could Affect Future Results

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

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

Local, regional, national and international economic conditions and the impact they may have on the Corporation and its customers and the Corporation's assessment of that impact.

Changes in the level of non-performing assets and charge-offs.

w

Changes in estimates of future reserve requirements based upon the periodic review thereof under relevant regulatory and accounting requirements.

The effects of and changes in trade and monetary and fiscal policies and laws, including the interest rate policies of the Federal Reserve Board.

Inflation, interest rate, securities market and monetary fluctuations.

w

Political instability.

w

Acts of God or of war or terrorism.

w

The timely development and acceptance of new products and services and perceived overall value of these products and services by users.

Changes in consumer spending, borrowings and savings habits.

w

Changes in the financial performance and/or condition of the Corporation's borrowers.

w

Technological changes.

w

Acquisitions and integration of acquired businesses.

w

The ability to increase market share and control expenses.

Changes in the competitive environment among financial holding companies and other financial service providers.

The effect of changes in laws and regulations (including laws and regulations concerning taxes, banking, securities and insurance) with which the Corporation and its subsidiaries must comply.

The effect of changes in accounting policies and practices, as may be adopted by the regulatory agencies, as well as the Public Company Accounting Oversight Board, the Financial Accounting Standards Board and other accounting standard setters.

Changes in the Corporation's organization, compensation and benefit plans.

w

The costs and effects of legal and regulatory developments including the resolution of legal proceedings or regulatory or other governmental inquiries and the results of regulatory examinations or reviews.

Greater than expected costs or difficulties related to the integration of new products and lines of business.

w

The Corporation's success at managing the risks involved in the foregoing items.

w

Forward-looking statements speak only as of the date on which such statements are made. The Corporation undertakes no obligation to update any forward-looking statement to reflect events or circumstances after the date on which such statement is made, or to reflect the occurrence of unanticipated events.

Application of Critical Accounting Policies and Accounting Estimates

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

The Corporation considers accounting estimates to be critical to reported financial results if (i) the accounting estimate requires management to make assumptions about matters that are highly uncertain and (ii) different estimates that management reasonably could have used for the accounting estimate in the current period, or changes in the accounting estimate that are reasonably likely to occur from period to period, could have a material impact on the Corporation's financial statements. Accounting policies related to the allowance for possible loan losses are considered to be critical, as these policies involve considerable subjective judgment and estimation by management.

For additional information regarding critical accounting policies, refer to Note 1 - Summary of Significant Accounting Policies in the notes to consolidated financial statements and the sections captioned "Application of Critical Accounting Policies" and "Allowance for Possible Loan Losses" in Management's Discussion and Analysis of Financial Condition and Results of Operations included in the 2006 Form 10-K. There have been no significant changes in the Corporation's application of critical accounting policies related to the allowance for possible loan losses since December 31, 2006.

Overview

A discussion of the Corporation's results of operations is presented below. Certain reclassifications have been made to make prior periods comparable. Taxable-equivalent adjustments are the result of increasing income from tax-free loans and securities by an amount equal to the taxes that would be paid if the income were fully taxable based on a 35% federal income tax rate, thus making tax-exempt asset yields comparable to taxable asset yields. All of the Corporation's acquisitions during the reported periods were accounted for as purchase transactions, and as such, their related results of operations are included from the date of acquisition. See Note 2 - Mergers and Acquisitions in the accompanying notes to consolidated financial statements included elsewhere in this report.

Results of Operations

Net income totaled \$56.5 million, or \$0.95 diluted per share, for the three months ended September 30, 2007 compared to \$50.0 million, or \$0.88 diluted per share, for the three months ended September 30, 2006 and \$53.6 million, or \$0.89 diluted per share, for the three months ended June 30, 2007. Net income totaled \$157.4 million, or \$2.62 diluted per share, for the nine months ended September 30, 2007 compared to \$145.2 million, or \$2.58 diluted per share, for the nine months ended September 30, 2006.

Selected income statement data and other selected data for the comparable periods was as follows:

	Three Months Ended			Nine Months Ended	
	September 30,	June 30,	September 30,	September 30,	September 30,
	2007	2007	2006	2007	2006
Taxable-equivalent net interest income	\$ 134,704	\$ 133,095	\$		