CULLEN FROST BANKERS INC
Form 10-Q
October 25, 2006

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

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Form 10-Q

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

For the quarterly period ended: September 30, 2006

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)

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 [**X**] 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 [**X**] 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 [**X**]

As of October 19, 2006, there were 55,915,888 shares of the registrant's Common Stock, $.01 par value, outstanding.

Cullen/Frost Bankers, Inc.
Quarterly Report on Form 10-Q
September 30, 2006

Table of Contents

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,	
	2006	2005	2006	2005
Interest income:				
Loans, including fees	$ 131,006	$ 93,071	$ 370,304	$ 254,103
Securities:				
Taxable	32,404	30,137	99,159	91,965
Tax-exempt	2,822	2,710	8,342	7,833
Interest-bearing deposits	61	49	153	100
Federal funds sold and resell agreements	10,114	4,231	24,027	9,380
Total interest income	176,407	130,198	501,985	363,381

Interest expense:				
Deposits	42,277	20,502	109,959	52,659
Federal funds purchased and repurchase agreements	8,353	4,557	23,008	10,825
Junior subordinated deferrable interest debentures	4,439	3,796	12,845	10,938
Subordinated notes payable and other borrowings	2,812	2,058	8,239	5,493
Total interest expense	57,881	30,913	154,051	79,915
Net interest income	118,526	99,285	347,934	283,466
Provision for possible loan losses	1,711	2,725	10,750	7,300
Net interest income after provision for possible loan losses	116,815	96,560	337,184	276,166
Non-interest income:				
Trust fees	15,962	14,463	47,460	43,294
Service charges on deposit accounts	19,301	20,173	57,974	59,002
Insurance commissions and fees	7,204	7,389	22,323	22,192
Other charges, commissions and fees	6,558	6,135	20,668	17,008
Net gain (loss) on securities transactions	-	-	(1)	-
Other	10,871	9,894	32,495	32,330
Total non-interest income	59,896	58,054	180,919	173,826
Non-interest expense:				
Salaries and wages	48,743	41,818	142,312	122,272
Employee benefits	10,882	9,973	35,492	32,325
Net occupancy	8,964	8,111	25,909	22,863
Furniture and equipment	6,553	6,202	19,212	17,929
Intangible amortization	1,293	1,050	3,957	3,699
Other	26,505	24,838	76,448	72,841
Total non-interest expense	102,940	91,992	303,330	271,929
Income before income taxes	73,771	62,622	214,773	178,063
Income taxes	23,769	20,167	69,544	57,557
Net income	$ 50,002	$ 42,455	$ 145,229	$ 120,506
Earnings per common share:				
Basic	$ 0.90	$ 0.81	$ 2.64	$ 2.32
Diluted	0.88	0.79	2.58	2.26

See Notes to Consolidated Financial Statements.

Cullen/Frost Bankers, Inc.

Consolidated Balance Sheets

(Dollars in thousands, except per share amounts)

	September 30, 2006	December 31, 2005	September 30, 2005
Assets:			
Cash and due from banks	$ 558,997	$ 873,015	$ 562,107
Interest-bearing deposits	2,279	6,438	2,773
Federal funds sold and resell agreements	1,016,650	1,033,975	785,625
Total cash and cash equivalents	1,577,926	1,913,428	1,350,505
Securities held to maturity, at amortized cost	10,625	12,701	13,685
Securities available for sale, at estimated fair value	2,770,409	3,059,111	2,667,684
Trading account securities	8,024	6,217	5,937
Loans, net of unearned discounts	6,516,256	6,085,055	5,709,519
Less: Allowance for possible loan losses	(85,667)	(80,325)	(77,117)
Net loans	6,430,589	6,004,730	5,632,402
Premises and equipment, net	202,717	182,356	175,012
Goodwill	246,957	168,983	100,404
Other intangible assets, net	21,117	14,903	10,302
Cash surrender value of life insurance policies	110,673	102,604	101,655
Accrued interest receivable and other assets	268,377	276,404	222,643
Total assets	$ 11,647,414	$ 11,741,437	$ 10,280,229

Liabilities:			
Deposits:			
Non-interest-bearing demand deposits	$ 3,380,986	$ 3,484,932	$ 3,201,929
Interest-bearing deposits	5,889,462	5,661,462	5,080,871
Total deposits	9,270,448	9,146,394	8,282,800
Federal funds purchased and repurchase agreements	725,779	740,529	608,174
Subordinated notes payable and other borrowings	171,427	188,617	150,678
Junior subordinated deferrable interest debentures	229,898	226,805	226,805
Accrued interest payable and other liabilities	128,441	456,856	115,019
	10,525,993	10,759,201	9,383,476
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; 55,820,763 shares, 54,961,616 shares and 53,561,616 shares issued	558	550	536
Additional paid-in capital	324,534	279,627	216,966
Retained earnings	853,738	776,193	754,798
Accumulated other comprehensive income (loss), net of tax	(57,409)	(50,442)	(31,715)
Treasury stock, no shares, 478,881 shares and 905,097 shares, at cost	-	(23,692)	(43,832)
	1,121,421	982,236	896,753
Total shareholders' equity			
	$ 11,647,414	$ 11,741,437	$ 10,280,229
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,	
	2006	2005
Total shareholders' equity at beginning of period	$ 982,236	$ 822,395
Comprehensive income:		
Net income	145,229	120,506
Other comprehensive income:		
Change in unrealized gain/loss on securities available for sale of $(9,758) in 2006 and $(32,202) in 2005, net of reclassification adjustment of $1 in 2006 and tax effect of $(3,415) in 2006 and $(11,271) in 2005	(6,342)	(20,931)
Change in accumulated gain/loss on effective cash flow hedging derivatives of $(963) in 2006 net of tax effect of $(338)	(625)	-
Total other comprehensive income	(6,967)	(20,931)
Total comprehensive income	138,262	99,575
Stock option exercises (1,404,780 shares in 2006 and 1,044,595 shares in 2005)	37,270	25,286
Stock compensation expense recognized in earnings	7,030	1,333
Excess tax benefits related to stock compensation	14,563	8,279
Purchase of treasury stock (66,752 shares in 2006 and 311,928 shares in 2005)	(3,580)	(14,946)
Cash dividends ($0.98 per share in 2006 and $0.865 per share in 2005)	(54,360)	(45,169)
Total shareholders' equity at end of period	$ 1,121,421	$ 896,753

See Notes to Consolidated Financial Statements.

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

	Nine Months Ended September 30, 2006	Nine Months Ended September 30, 2005
Operating Activities:		
Net income	$ 145,229	$ 120,506
Adjustments to reconcile net income to net cash from operating activities:		
Provision for possible loan losses	10,750	7,300
Deferred tax expense (benefit)	(1,779)	1,227
Accretion of loan discounts	(7,593)	(4,827)
Securities premium amortization (discount accretion), net	(1,366)	(92)
Net (gain) loss on securities transactions	1	-
Depreciation and amortization	18,323	18,461
Origination of loans held for sale	(58,954)	(55,173)
Proceeds from sales of loans held for sale	59,171	57,183
Net gain on sale of loans held for sale and other assets	(1,633)	(2,375)
Stock-based compensation expense	7,030	1,333
Tax benefit from stock-based compensation arrangements	-	8,279
Excess tax benefits from stock-based compensation arrangements	(14,563)	-
Net proceeds from settlement of legal claims	-	(2,389)
Earnings on life insurance policies	(3,054)	(2,985)
Net change in:		
Trading account securities	(1,807)	(1,266)
Accrued interest receivable and other assets	9,902	(15,187)
Accrued interest payable and other liabilities	(320,790)	(25,676)
Net cash from operating activities	(161,133)	104,319
Investing Activities:		
Securities held to maturity:		
Maturities, calls and principal repayments	2,069	3,020
Securities available for sale:		
Purchases	(13,028,949)	(10,548,635)

Sales	25,689	2,289
Maturities, calls and principal repayments	13,351,918	10,803,857
Net change in loans	(141,303)	(545,756)
Net cash paid in acquisitions	(61,016)	-
Proceeds from sales of premises and equipment	202	36
Purchases of premises and equipment	(21,055)	(15,711)
Benefits received on life insurance policies	-	6,553
Proceeds from sales of repossessed properties	1,571	2,813
Net cash from investing activities	129,126	(291,534)
Financing Activities:		
Net change in deposits	(257,529)	177,122
Net change in short-term borrowings	(20,669)	101,832
Principal payments on notes payable and other borrowings	(19,190)	(194)
Proceeds from stock option exercises	37,270	25,286
Excess tax benefits from stock-based compensation arrangements	14,563	-
Purchase of treasury stock	(3,580)	(14,946)
Cash dividends paid	(54,360)	(45,169)
Net cash from financing activities	(303,495)	243,931
Net change in cash and cash equivalents	(335,502)	56,716
Cash and equivalents at beginning of period	1,913,428	1,293,789
Cash and equivalents at end of period	$ 1,577,926	$ 1,350,505
Supplemental disclosures:		
Cash paid for interest	$ 157,237	$ 81,529
Cash paid for income taxes	54,099	41,945

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 12 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, 2005, included in the Corporation's Annual Report on Form 10-K filed with the SEC on February 3, 2006 (the "2005 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.

Stock-Based Compensation. On January 1, 2006, the Corporation changed its accounting policy related to stock-compensation in connection with the adoption of Statement of Financial Accounting Standards (SFAS) No. 123, "Share-Based Payment (Revised 2004)." See Note 12 - Stock-Based Compensation 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 additional minimum pension liability and changes in the accumulated gain/loss on effective cash flow hedging instruments. Comprehensive income for the nine months ended September 30, 2006 and 2005 is reported in the accompanying consolidated statements of changes in shareholders' equity. The Corporation had comprehensive income of $99.1 million and $21.5 million for the three months ended September 30, 2006 and 2005. Comprehensive income during the three months ended September 30, 2006 included a $48.8 million net after-tax gain due to a decrease in the net unrealized loss on securities available for sale and a

$344 thousand net after-tax decrease in the accumulated loss on effective cash flow hedging derivatives. Comprehensive income during the three months ended September 30, 2005 included a $20.9 million net after-tax loss due to an increase 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. Neither of the acquisitions had a significant impact on the Corporation's financial statements.

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 includes $31.1 million in cash and approximately $1.0 million in acquisition-related costs. Upon completion of the acquisition, TCB was fully integrated into Cullen/Frost and Frost Bank. As of September 30, 2006, the Corporation had a liability totaling $2.3 million 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 $87.8 million. The purchase price includes $87.0 million in cash and $834 thousand in acquisition-related costs. Alamo was fully integrated into Frost Bank during the second quarter of 2006.

The total purchase prices paid for the acquisitions of TCB and Alamo were allocated based on the estimated fair values of the assets acquired and liabilities assumed as set forth below. The purchase price allocations are preliminary and are subject to final determination and valuation of the fair value of assets acquired and liabilities assumed.

	TCB	Alamo
Cash and cash equivalents	$ 27,595	$ 27,282
Securities available for sale	15,842	52,499
Loans, net	64,376	222,887
Premises and equipment, net	427	10,805
Core deposit intangible asset	3,762	6,410

Goodwill	19,864	58,943
Other assets	3,661	5,494
Deposits	(101,298)	(280,285)
Other borrowings	-	(11,012)
Other liabilities	(2,134)	(5,191)
	$ 32,095	$ 87,832

The core deposit intangible assets acquired in these transactions are expected to be amortized over a period of 8 years. Additional information related to intangible assets and goodwill is included in Note 6 - Goodwill and Other Intangible Assets. Pro forma condensed consolidated results of operations assuming TCB and Alamo had been acquired at the beginning of the reported periods are not presented because the combined effect of these acquisitions was not considered significant.

Horizon Capital Bank. The Corporation previously reported the acquisition of Horizon Capital Bank ("Horizon"), a privately-held bank located in Houston, Texas in the 2005 Form 10-K. During 2006, the purchase price allocation was revised based on additional information related to the valuation of certain assets acquired and liabilities assumed. The revised total purchase price of $109.2 million includes $61.4 million of the Corporation's common stock (1.4 million shares), $46.9 million in cash and $996 thousand in acquisition-related costs primarily for professional fees. The purchase price paid for the acquisition was allocated based on the estimated fair values of the assets acquired and liabilities assumed. The purchase price allocation is still preliminary and subject to final determination and valuation of the fair value of assets acquired and liabilities assumed.

Summit Bancshares, Inc. On July 2, 2006, the Corporation and Summit Bancshares, Inc. ("Summit") entered into an Agreement and Plan of Merger (the "Merger Agreement") that provides for the merger of Summit with and into Cullen/Frost (the "Merger") and the subsequent merger of Summit Bank, a wholly-owned subsidiary of Summit, with and into The Frost National Bank, a wholly-owned subsidiary of Cullen/Frost.

Under the terms of the Merger Agreement, the consideration for the Merger will consist of approximately 3.8 million shares (assuming the treasury stock method of accounting for options before giving effect to any exercises in outstanding options) of Cullen/Frost's common stock, par value $0.01 per share ("Cullen/Frost Common Stock"), and approximately $143.4 million in cash. The Merger is intended to constitute a "reorganization" for United States federal income tax purposes. Consummation of the Merger is subject to receipt of requisite regulatory approvals. The Corporation expects to consummate the Merger in the fourth quarter of 2006.

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, 2006				December 31, 2005			
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	$ 9,625	$ 100	$ 11	$ 9,714	$ 11,701	$ 126	$ 25	$11,802
Other	1,000	-	14	986	1,000	-	12	988
Total	$10,625	$ 100	$ 25	$ 10,700	$ 12,701	$ 126	$ 37	$12,790
Securities Available for Sale:								
U.S. Treasury	$94,925	$ -	$ 494	$ 94,431	$ 84,897	$ -	$ 588	$84,309
U.S. government agencies and corporations	2,412,945	3,354	48,922	2,367,377	2,710,445	6,632	40,974	2,676,103
States and political subdivisions	279,097	4,313	620	282,790	268,975	3,741	1,423	271,293
Other	25,811	-	-	25,811	27,406	-	-	27,406
Total	$2,812,778	$7,667	$50,036	$2,770,409	$3,091,723	$ 10,373	$42,985	$3,059,111

Securities with a carrying value totaling $1.8 billion at September 30, 2006 and $2.1 billion at December 31, 2005 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,	
	2006	2005	2006	2005
Proceeds from sales	$ -	$ -	$ 25,689	$2,289
Gross realized gains	-	-	117	-
Gross realized losses	-	-	(118)	-

As of September 30, 2006, 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	$ 2,548	$ 6	$ 479	$ 5	$ 3,027	$ 11
Other	-	-	986	14	986	14
Total	$ 2,548	$ 6	$ 1,465	$ 19	$ 4,013	$ 25
Available for Sale						
U.S. Treasury	$ 9,966	$ 1	$ 84,465	$ 493	$ 94,431	$ 494
U.S. government agencies and corporations	956,691	7,190	1,224,606	41,732	2,181,297	48,922
States and political subdivisions	2,122	4	33,612	616	35,734	620
Total	$968,779	$ 7,195	$ 1,342,683	$ 42,841	$ 2,311,462	$ 50,036

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, 2006, 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, 2006	Percentage of Total	December 31, 2005	Percentage of Total	September 30, 2005	Percentage of Total
Commercial and industrial:						
Commercial	$ 2,852,027	43.8 %	$ 2,610,178	42.9 %	$ 2,549,846	44.7 %
Leases	165,465	2.5	148,750	2.4	134,119	2.3
Asset-based	46,387	0.7	41,288	0.7	45,618	0.8
Total commercial and industrial	3,063,879	47.0	2,800,216	46.0	2,729,583	47.8
Real estate:						
Construction:						
Commercial	607,749	9.4	590,635	9.7	498,762	8.7
Consumer	104,781	1.6	87,746	1.4	54,595	1.0
Land:						
Commercial	352,775	5.4	301,907	5.0	242,490	4.2
Consumer	4,323	0.1	10,369	0.2	5,560	0.1
Commercial mortgages	1,494,114	22.9	1,409,811	23.2	1,334,096	23.4
1-4 family residential mortgages	97,453	1.5	95,032	1.5	72,002	1.3
Home equity and other consumer	470,088	7.2	460,941	7.6	439,367	7.7
Total real estate	3,131,283	48.1	2,956,441	48.6	2,646,872	46.4
Consumer:						
Indirect	2,150	-	2,418	-	2,665	-
Student loans held for sale	53,428	0.8	51,189	0.8	63,966	1.1
Other	276,219	4.2	265,038	4.4	256,358	4.5
Other	19,188	0.3	27,201	0.5	26,344	0.5
Unearned discounts	(29,891)	(0.4)	(17,448)	(0.3)	(16,269)	(0.3)
Total loans	$ 6,516,256	100.0 %	$ 6,085,055	100.0 %	$ 5,709,519	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 eight other markets.

The majority of the Corporation's loan portfolio consists of commercial and industrial and commercial real estate loans. As of September 30, 2006, 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, 2006 or December 31, 2005.

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 $30.0 million at September 30, 2006 and $33.2 million at December 31, 2005. Accruing loans past due more than 90 days totaled $7.9 million at September 30, 2006 and $7.9 million at December 31, 2005.

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, 2006	December 31, 2005	September 30, 2005
Balance of impaired loans with no allocated allowance	$ 8,204	$ 8,491	$ 9,058
Balance of impaired loans with an allocated allowance	15,518	17,520	19,462
Total recorded investment in impaired loans	$ 23,722	$ 26,011	$ 28,520
Amount of the allowance allocated to impaired loans	$ 6,672	$ 8,811	$ 9,881

The impaired loans included in the table above were primarily comprised of collateral dependent commercial loans. The average recorded investment in impaired loans was $23.9 million and $25.4 million during the three and nine months ended September 30, 2006 and $28.8 million and $27.8 million for the three and nine months ended September 30, 2005. 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,	
	2006	2005	2006	2005
Balance at the beginning of the period	$ 85,552	$77,103	$ 80,325	$ 75,810
Provision for possible loan losses	1,711	2,725	10,750	7,300
Allowance for possible loan losses acquired	-	-	2,373	-
Net charge-offs:				
Losses charged to the allowance	(3,437)	(4,106)	(13,798)	(10,361)
Recoveries of loans previously charged off	1,841	1,395	6,017	4,368
Net charge-offs	(1,596)	(2,711)	(7,781)	(5,993)
Balance at the end of the period	$ 85,667	$77,117	$ 85,667	$ 77,117

Note 6 - Goodwill and Other Intangible Assets

Goodwill. Goodwill totaled $247.0 million at September 30, 2006 and $169.0 million at December 31, 2005. During the first nine months of 2006, the Corporation recorded goodwill totaling $78.8 million in connection with the acquisitions of TCB and Alamo. Additionally, goodwill recorded in connection with the acquisition of Horizon during the fourth quarter of 2005 was reduced $833 thousand 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. See Note 2 - Mergers and Acquisitions.

Other Intangible Assets. Other intangible assets totaled $21.1 million at September 30, 2006 including $18.2 million related to core deposits, $2.0 million related to customer relationships and $903 thousand related to non-compete agreements. Other intangible assets totaled $14.9 million at December 31, 2005 including $11.1 million related to core deposits, $2.4 million related to non-compete agreements and $1.4 million related to customer relationships. During the nine months ended September 30, 2006, the Corporation recorded core deposit intangibles totaling $10.2 million in connection with the acquisitions of TCB and Alamo. See Note 2 - Mergers and Acquisitions.

Amortization expense related to intangible assets totaled $1.3 million and $4.0 million during the three and nine months ended September 30, 2006 and totaled $1.1 million and $3.7 million during the three and nine months ended September 30, 2005. The estimated aggregate future amortization expense for intangible assets remaining as of September 30, 2006 is as follows:

Remainder of 2006	$	1,261
2007		4,658
2008		3,733
2009		2,847
2010		2,242
Thereafter		6,376
	$	21,117

Note 7 - Deposits

Deposits were as follows:

		September 30, 2006	Percentage of Total		December 31, 2005	Percentage of Total		September 30, 2005	Percentage of Total
Non-interest-bearing demand deposits:									
Commercial and individual	$	3,092,177	33.4 %	$	2,945,366	32.2 %	$	2,721,812	32.9 %
Correspondent banks		208,469	2.2		458,821	5.0		365,853	4.4
Public funds		80,340	0.9		80,745	0.9		114,264	1.4
Total non-interest-bearing demand deposits		3,380,986	36.5		3,484,932	38.1		3,201,929	38.7

Interest-bearing deposits:						
Private accounts:						
Savings and interest checking	1,255,776	13.5	1,320,781	14.4	1,190,342	14.4
Money market accounts	3,116,532	33.6	2,761,944	30.2	2,676,641	32.3
Time accounts under $100,000	513,573	5.5	431,741	4.7	390,625	4.7
Time accounts of $100,000 or more	627,159	6.8	534,151	5.9	504,822	6.1
Public funds	376,422	4.1	612,845	6.7	318,441	3.8
Total interest-bearing deposits	5,889,462	63.5	5,661,462	61.9	5,080,871	61.3
Total deposits	$ 9,270,448	100.0 %	$ 9,146,394	100.0 %	$ 8,282,800	100.0 %

At September 30, 2006 and December 31, 2005, interest-bearing public funds deposits included $97.8 million and $314.3 million in savings and interest checking accounts, $90.1 million and $84.4 million in money market accounts, $6.6 million and $6.1 million in time accounts under $100 thousand, and $181.9 million and $208.0 million in time accounts of $100 thousand or more.

Deposits from foreign sources, primarily Mexico, totaled $677.0 million at September 30, 2006 and $641.2 million at December 31, 2005.

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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 accounting principles generally accepted in the United States, 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 $3.6 billion and $3.3 billion at September 30, 2006 and December 31, 2005.

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 $221.7 million at September 30, 2006 and $241.6 million at December 31, 2005. The Corporation had an accrued liability totaling $1.1 million at September 30, 2006 and $1.3 million at December 31, 2005 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 $3.8 million and $11.3 million for the three and nine months ended September 30, 2006 and $3.3 million and $9.7 million for the three and nine months ended September 30, 2005. There has been no significant change in the future minimum lease payments payable by the Corporation since December 31, 2005. See the 2005 Form 10-K for information regarding these commitments.

Litigation. The Corporation and its subsidiaries are 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 - Regulatory Matters

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, goodwill and other intangible assets. Tier 1 capital for Cullen/Frost also includes $223 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 plus $150 million of subordinated notes payable and a permissible portion of the allowance for possible loan losses.

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 assets, which exclude goodwill and other intangible assets.

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

	Minimum	Required to be Well Capitalized Under

	Actual		Required for Capital Adequacy Purposes		Prompt Corrective Action Regulations	
	Capital Amount	Ratio	Capital Amount	Ratio	Capital Amount	Ratio
September 30, 2006						
Total Capital to Risk-Weighted Assets						
Cullen/Frost	$ 1,316,782	14.68 %	$ 717,410	8.00 %	N/A	N/A
Frost Bank	1,083,690	12.09	716,791	8.00	$ 895,989	10.00 %
Tier 1 Capital to Risk-Weighted Assets						
Cullen/Frost	1,111,115	12.39	358,704	4.00	N/A	N/A
Frost Bank	878,021	9.80	358,395	4.00	537,593	6.00
Leverage Ratio						
Cullen/Frost	1,111,115	9.76	455,404	4.00	N/A	N/A
Frost Bank	878,021	7.72	454,908	4.00	568,634	5.00

	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
December 31, 2005						
Total Capital to Risk-Weighted Assets						
Cullen/Frost	$ 1,273,702	14.94 %	$ 682,154	8.00 %	N/A	N/A
Frost Bank	991,846	11.64	681,703	8.00	$ 852,129	10.00 %

Tier 1 Capital to Risk-Weighted Assets						
Cullen/Frost	1,043,377	12.24	341,077	4.00	N/A	N/A
Frost Bank	761,521	8.94	340,852	4.00	511,277	6.00
Leverage Ratio						
Cullen/Frost	1,043,377	9.62	433,819	4.00	N/A	N/A
Frost Bank	761,521	7.03	433,269	4.00	541,586	5.00

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, 2006, 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 I, Cullen/Frost Capital Trust II and Alamo Corporation of Texas Trust I have not been included in the Corporation's consolidated financial statements. However, the $223 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. In February 2005, the Federal Reserve Board issued a final rule that allows the continued inclusion of trust preferred securities in the Tier 1 capital of bank holding companies. The Board's final rule limits the aggregate amount of restricted core capital elements (which includes trust preferred securities, among other things) that may be included in the Tier 1 capital of most bank holding companies to 25% of all core capital elements, including restricted core capital elements, net of goodwill less any associated deferred tax liability. Large, internationally active bank holding companies (as defined) are subject to a 15% limitation. Amounts of restricted core capital elements in excess of these limits generally may be included in Tier 2 capital. The final rule provides a five-year transition period, ending March 31, 2009, for application of the quantitative limits. The Corporation does not expect that the quantitative limits will preclude it from including the $223 million in trust preferred securities in Tier 1 capital.

Note 10 - 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, 2006 and December 31, 2005 are presented in the following table. The estimated fair value of the subordinated debt interest rate swap and 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, 2006		December 31, 2005	
	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	$ 15,662	$ 175	$ 163,068	$ 1,513
Commercial loan/lease interest rate caps	-	-	4,810	41
Interest rate swaps related to subordinated notes	-	-	300,000	450
Interest rate derivatives designated as hedges of cash flows:				
Interest rate floors on variable-rate loans	1,300,000	737	1,300,000	1,702
Non-hedging interest rate derivatives:				
Commercial loan/lease interest rate swaps	176,708	3,335	138,546	2,409
Commercial loan/lease interest rate swaps	176,708	(3,335)	138,546	(2,409)
Commercial loan/lease interest rate caps	17,500	9	19,375	24
Commercial loan/lease interest rate caps	17,500	(9)	19,375	(24)
Commercial loan/lease interest rate floors	17,500	19	19,375	53
Commercial loan/lease interest rate floors	17,500	(19)	19,375	(53)

The weighted-average receive and pay interest rates for interest rate swaps and the weighted-average strike rates for interest rate caps and floors outstanding at September 30, 2006 were as follows:

	Weighted-Average		
	Interest Rate Paid	Interest Rate Received	Strike Rate
Interest rate swaps:			
Commercial loan/lease interest rate swaps	4.67 %	5.33 %	-
Non-hedging interest rate swaps	5.61	5.61	-
Interest rate caps and floors:			
Interest rate floors on variable-rate loans	-	-	6.00 %
Non-hedging commercial loan/lease interest rate caps	-	-	6.00
Non-hedging commercial loan/lease interest rate floors	-	-	4.17

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, net of any collateral pledged, relating to interest rate swaps was approximately $2.4 million at September 30, 2006. This 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 $905 thousand at September 30, 2006.

During the first quarter of 2006, the Corporation terminated certain interest rate swaps with a total notional amount of $334.6 million. The swaps were designated as hedging instruments in fair value hedges of certain fixed-rate commercial loans. The cumulative basis adjustment to fair value resulting from the designation of these loans as hedged items totaled $4.4 million upon termination of the swaps. This cumulative basis adjustment will be treated similar to a premium and amortized as an offset to interest income over the expected remaining life of the underlying loans using the effective yield method.

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, 2006		December 31, 2005	
	Notional Units	Notional Amount	Estimated Fair Value	Notional Amount	Estimated Fair Value
Commodity swaps:					
Oil	Barrels	30	$ 87	-	$ -
Oil	Barrels	30	(79)	-	-
Natural gas	MMBTUs	760	1,180	130	267
Natural gas	MMBTUs	760	(1,166)	130	(261)
Commodity options:					
Oil	Barrels	581	1,829	117	155
Oil	Barrels	581	(1,826)	117	(155)
Natural gas	MMBTUs	1,440	1,085	500	594
Natural gas	MMBTUs	1,440	(1,085)	500	(594)

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 or option 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 and option contracts were not significant at September 30, 2006 and December 31, 2005.

Note 11 - 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 September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005

Weighted-average shares outstanding for basic earnings per share	55,440	52,345	55,043	51,963
Dilutive effect of stock options and non-vested stock awards	1,147	1,285	1,233	1,315
Weighted-average shares outstanding for diluted earnings per share	56,587	53,630	56,276	53,278

Note 12 - Stock-Based Compensation

Prior to January 1, 2006, employee compensation expense under stock option plans was reported only if options were granted below market price at grant date in accordance with the intrinsic value method of Accounting Principles Board Opinion (APB) No. 25, "Accounting for Stock Issued to Employees," and related interpretations. Because the exercise price of the Corporation's employee stock options always equaled the market price of the underlying stock on the date of grant, no compensation expense was recognized on options granted. As stated in Note 1 - Significant Accounting Policies, the Corporation adopted the provisions of SFAS 123R on January 1, 2006. SFAS 123R eliminates the ability to account for stock-based compensation using APB 25 and requires that such transactions be recognized as compensation cost in the income statement based on their fair values on the measurement date, which, for the Corporation, is the date of the grant. The Corporation transitioned to fair-value based accounting for stock-based compensation using a modified version of prospective application ("modified prospective application"). Under modified prospective application, as it is applicable to the Corporation, SFAS 123R applies to new awards and to awards modified, repurchased, or cancelled after January 1, 2006. Additionally, compensation cost for the portion of awards for which the requisite service has not been rendered (generally referring to non-vested awards) that were outstanding as of January 1, 2006 will be recognized as the remaining requisite service is rendered during the period of and/or the periods after the adoption of SFAS 123R. The attribution of compensation cost for those earlier awards is based on the same method and on the same grant-date fair values previously determined for the pro forma disclosures required for companies that did not previously adopt the fair value accounting method for stock-based employee compensation.

The fair value of the Corporation's employee stock options granted is estimated at the date of grant using the Black-Scholes option-pricing model. This model requires the input of highly subjective assumptions, changes to which can materially affect the fair value estimate. Additionally, there may be other factors that would otherwise have a significant effect on the value of employee stock options granted but are not considered by the model. Accordingly, while management believes that the Black-Scholes option-pricing model provides a reasonable estimate of fair value, the model does not necessarily provide the best single measure of fair value for the Corporation's employee stock options.

As a result of applying the provisions of SFAS 123R during the three and nine months ended September 30, 2006, the Corporation recognized additional stock-based compensation expense related to stock options of $1.7 million, or $1.1 million net of tax, and $5.1 million, or $3.3 million net of tax. The increase in stock-based compensation expense related to stock options, resulted in a $0.02 decrease in both basic and diluted earnings per share during the three months ended September 30, 2006 and a $0.06 decrease in both basic and diluted earnings per share during the nine months ended September 30, 2006. Cash flows from financing activities for the nine months ended September 30, 2006 included $14.6 million in cash inflows from excess tax benefits related to stock compensation. Such cash flows were previously reported as operating activities.

A combined summary of activity in the Corporation's active stock plans for the nine months ended September 30, 2006 is presented in the following table.

	Shares Available for Grant	Non-vested Stock Awards Outstanding	Stock Options Outstanding: Number of Shares	Stock Options Outstanding: Weighted-Average Exercise Price
Balance, January 1, 2006	3,206,400	246,552	5,394,750	$34.61
Granted	(21,000)	-	21,000	56.83
Stock options exercised	-	-	(1,404,780)	26.53
Stock awards vested	-	(2,796)	-	-
Forfeited	67,806	(1,306)	(66,500)	46.45
Cancelled	(38,906)	-	-	-
Balance, September 30, 2006	3,214,300	242,450	3,944,470	37.49

The weighted-average fair value of options granted during the nine months ended September 30, 2006 was $12.80. The following weighted-average assumptions were used to estimate the fair value of options granted during the nine months ended September 30, 2006:

Risk-free interest rate	4.93 %
Dividend yield	2.49
Market price volatility factor	0.23
Weighted-average expected life of options	5.1 Years

Stock-based compensation expense totaled $2.3 million and $7.0 million during the three and nine months ended September 30, 2006 and $491 thousand and $1.3 million during the three and nine months ended September 30, 2005. 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 $8.9 million at September 30, 2006. At such date, the weighted-average period over which this unrecognized expense is expected to be recognized was 1.5 years. Unrecognized stock-based compensation expense related to non-vested, non-option stock awards was $4.2 million at September 30, 2006. At such date, the weighted-average period over which this unrecognized expense was expected to be recognized was 1.5 years.

The following pro forma information presents net income and earnings per share for the three and nine months ended September 30, 2005 as if the fair value method of SFAS 123R had been used to measure compensation cost for stock-based compensation plans. For purposes of these pro forma disclosures, the estimated fair value of stock options and non-vested, non-option stock awards is amortized to expense over the related vesting periods.

	Three Months	Nine Months

	Ended September 30, 2005	Ended September 30, 2005
Net income, as reported	$ 42,455	$ 120,506
Add: Stock-based employee compensation expense included in reported net income, net of related tax effects	319	866
Less: Total stock-based employee compensation expense determined under fair value method for all awards, net of related tax effects	(1,250)	(3,779)
Pro forma net income	$ 41,524	$ 117,593
Earnings per share:		
Basic - as reported	$ 0.81	$ 2.32
Basic - pro forma	0.79	2.26
Diluted - as reported	0.79	2.26
Diluted - pro forma	0.77	2.21

During the nine months ended September 30, 2006 and 2005, proceeds from stock option exercises totaled $37.3 million and $25.3 million. During the nine months ended September 30, 2006 and 2005, 1,404,780 shares and 1,044,595 shares, respectively, were issued in connection with stock option exercises. During the nine months ended September 30, 2006, 859,147 shares issued in connection with stock option exercises were new shares issued from available authorized shares, while 545,633 shares were issued from available treasury stock. During the nine months ended September 30, 2005, all shares issued in connection with stock option exercises and non-vested, non-option stock awards were issued from available treasury stock.

Note 13 - 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,	
	2006	2005	2006	2005
Expected return on plan assets, net of expenses	$ (1,863)	$ (1,752)	$ (5,589)	$ (5,256)
Interest cost on projected benefit obligation	1,795	1,692	5,385	5,076
Net amortization and deferral	749	536	2,247	1,608

Net periodic benefit cost	$ 681	$ 476	$ 2,043	$ 1,428

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, 2006. The Corporation does not expect to make any additional contributions during the remainder of 2006.

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.

Note 14 - Income Taxes

Income tax expense was as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Current income tax expense	$23,816	$17,452	$ 71,323	$ 56,330
Deferred income tax expense (benefit)	(47)	2,715	(1,779)	1,227
Income tax expense as reported	$23,769	$20,167	$ 69,544	$ 57,557
Effective tax rate	32.2 %	32.2 %	32.4 %	32.3 %

Net deferred tax assets totaled $59.5 million at September 30, 2006 and $57.4 million at December 31, 2005. No valuation allowance was recorded against these deferred tax assets, as the amounts are recoverable through taxes paid in prior years.

Note 15 - 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, 2006	$ 156,582	$ 26,044	$ (4,204)	$ 178,422
September 30, 2005	139,224	21,720	(3,605)	157,339
Nine months ended:				
September 30, 2006	$ 466,086	$ 74,937	$ (12,170)	$ 528,853
September 30, 2005	405,164	62,291	(10,163)	457,292
Net income (loss):				
Three months ended:				
September 30, 2006	$ 47,109	$ 6,089	$ (3,196)	$ 50,002
September 30, 2005	40,836	4,592	(2,973)	42,455
Nine months ended:				
September 30, 2006	$ 138,557	$ 16,447	$ (9,775)	$ 145,229
September 30, 2005	116,485	12,079	(8,058)	120,506

Note 16 - New Accounting Standards

Statements of Financial Accounting Standards

SFAS No. 155, "Accounting for Certain Hybrid Financial Instruments - an amendment of FASB Statements No. 133 and 140."

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. SFAS 155 is effective for the Corporation on January 1, 2007 and is not expected to 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. SFAS 156 is effective for the Corporation on January 1, 2007 and is not expected to 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)."

SFAS 158 requires an employer to recognize the overfunded or underfunded status of defined benefit postretirement plans as an asset or a liability in its statement of financial position. 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 postretirement benefit plans). An employer is also required to measure the funded status of a plan as of the date of its year-end statement of financial position with changes in the funded status recognized through comprehensive income. SFAS 158 also requires certain disclosures regarding the effects on net periodic benefit cost for the next fiscal year that arise from delayed recognition of gains or losses, prior service costs or credits, and the transition asset or obligation. The Corporation will be required to recognize the funded status of its defined benefit postretirement benefit plans in its financial statements for the year ended December 31, 2006. 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. SFAS 158 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." 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. Interpretation 48 is effective for the Corporation on January 1, 2007 and is not expected to have a significant impact on the Corporation's financial statements.

SEC Staff Accounting Bulletins

Staff Accounting Bulletin (SAB) No. 108, "Considering the Effects of a Prior Year Misstatements When Quantifying Misstatements in Current Year Financial Statements." SAB 108 addresses how the effects of prior year uncorrected errors must be considered in quantifying misstatements in the current year financial statements. The effects of prior year uncorrected errors include the potential accumulation of improper amounts that may result in a material misstatement on the balance sheet or the reversal of prior period errors in the current period that result in a material misstatement of the current period income statement amounts. Adjustments to current or prior period financial statements would be required in the event that after application of various approaches for assessing materiality of a misstatement in current period financial statements and consideration of all relevant quantitative and qualitative factors, a misstatement is determined to be material. SAB 108 will be applicable to all financial statements issued by the Corporation after November 15, 2006.

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, 2005, included in the 2005 Form 10-K. Operating results for the three and nine months ended September 30, 2006 are not necessarily indicative of the results for the year ending December 31, 2006 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. 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.
- 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.
- Political instability.
- Acts of war or terrorism.
- The timely development and acceptance of new products and services and perceived overall value of these products and services by users.
- Changes in consumer spending, borrowings and savings habits.
- Changes in the financial performance and/or condition of the Corporation's borrowers.
- Technological changes.
- Acquisitions and integration of acquired businesses. See the Corporation's Current Reports on Form 8-K filed with the SEC on July 3, 2006 and July 7, 2006 and the registration statements on Form S-4 and Form S-4/A filed with the SEC on August 15, 2006 and September 14, 2006.
- 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.
- 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.
- The Corporation's success at managing the risks involved in the foregoing items.

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 and stock-based compensation 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 2005 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, 2005. As more fully discussed in Note 12 - Stock-Based Compensation in the accompanying notes to consolidated financial statements included elsewhere in this report, the Corporation changed its method of accounting for stock options in connection with the adoption of a new accounting standard which eliminated the ability to account for stock-based compensation using the intrinsic value method of APB 25 and requires such transactions to be recognized ratably over the service period in the income statement based on their fair values at the date of grant.

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. As more fully discussed in Note 2 - Mergers and Acquisitions in the notes to consolidated financial statements, the Corporation acquired Texas Community Bancshares, Inc. and Alamo Corporation of Texas during the first quarter of 2006. The operating results of the acquired companies are included with the Corporation's results of operations since their respective dates of acquisition.

Results of Operations

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

	Three Months Ended			Nine Months Ended	
	September 30, 2006	June 30, 2006	September 30, 2005	September 30, 2006	September 30, 2005
Taxable-equivalent net interest income	$ 121,093	$ 119,309	$101,255	$ 355,119	$ 288,971
Taxable-equivalent adjustment	2,567	2,341	1,970	7,185	5,505
Net interest income, as reported	118,526	116,968	99,285	347,934	283,466
Provision for possible loan losses	1,711	5,105	2,725	10,750	7,300
Net interest income after provision for possible loan losses	116,815	111,863	96,560	337,184	276,166
Non-interest income	59,896	60,265	58,054	180,919	173,826
Non-interest expense	102,940	100,194	91,992	303,330	271,929
Income before income taxes	73,771	71,934	62,622	214,773	178,063
Income taxes	23,769	23,384	20,167	69,544	57,557
Net income	$ 50,002	$ 48,550	$ 42,455	$ 145,229	$ 120,506
Net income per share - basic	$ 0.90	$ 0.88	$ 0.81	$ 2.64	$ 2.32
	0.88	0.86	0.79	2.58	2.26

Net income per share - diluted					
Dividends per share	0.34	0.34	0.30	0.98	0.865
Return on average assets	1.72 %	1.70 %	1.68 %	1.70 %	1.63 %
Return on average equity	18.56	19.02	18.98	18.81	18.88

Net income for the three and nine months ended September 30, 2006 increased $7.5 million, or 17.8%, and $24.7 million, or 20.5%, compared to the same periods in 2005. The increase during the three months ended September 30, 2006 was primarily the result of a $19.2 million increase in net interest income, a $1.8 million increase in non-interest income and a $1.0 million decrease in the provision for possible loan losses partly offset by an $10.9 million increase in non-interest expense and a $3.6 million increase in income tax expense. The increase during the nine months ended September 30, 2006 was primarily the result of a $64.5 million increase in net interest income and a $7.1 million increase in non-interest income partly offset by a $31.4 million increase in non-interest expense, a $3.5 million increase in the provision for possible loan losses and a $12.0 million increase in income tax expense.

Net income for the third quarter of 2006 increased $1.5 million, or 3.0%, from the second quarter of 2006. The increase was primarily the result of a $1.6 million increase in net interest income and a $3.4 million decrease in the provision for possible loan losses offset by a $2.7 million increase in non-interest expense, a $369 thousand decrease in non-interest income and a $385 thousand increase in income tax expense.

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

Net Interest Income

Net interest income is the difference between interest income on earning assets, such as loans and securities, and interest expense on liabilities, such as deposits and borrowings, which are used to fund those assets. Net interest income is the Corporation's largest source of revenue, representing 65.8% of total revenue during the first nine months of 2006. Net interest margin is the ratio of taxable-equivalent net interest income to average earning assets for the period. The level of interest rates and the volume and mix of earning assets and interest-bearing liabilities impact net interest income and net interest margin.

The Federal Reserve Board influences the general market rates of interest, including the deposit and loan rates offered by many financial institutions. The Corporation's loan portfolio is significantly affected by changes in the prime interest rate. The prime interest rate, which is the rate offered on loans to borrowers with strong credit, began 2005 at 5.25% and increased 50 basis points in each of the four quarters to end the year at 7.25%. During the first nine months of 2006, the prime interest rate increased 50 basis points in the first quarter and 50 basis points in the second quarter to end the period at 8.25%. The federal funds rate, which is the cost of immediately available overnight funds, has moved in a similar manner, beginning 2005 at 2.25%. During 2005, the federal funds rate increased 50 basis points in each of the four quarters to end the year at 4.25%. During the first nine months of 2006, the federal funds rate increased 50 basis points in the first quarter and 50 basis points in the second quarter to end the period at 5.25%.

The Corporation's balance sheet is asset sensitive, meaning that earning assets generally reprice more quickly than interest-bearing liabilities. Therefore, the Corporation's net interest margin is likely to increase in sustained periods of rising interest rates and decrease in sustained periods of declining interest rates. The Corporation is primarily funded by core deposits, with non-interest-bearing demand deposits historically being a significant source of funds. This lower-cost funding base is expected to have a positive impact on the Corporation's net interest income and net interest margin in a rising interest rate environment. Since 2004, there has been an upward trend in the prime interest rate and the federal funds rate. The Corporation does not currently expect this upward trend to continue in the foreseeable future; however, there can be no assurance to that effect as changes in market interest rates are dependent upon a variety of factors that are beyond the Corporation's control. Further analysis of the components of the Corporation's net interest margin is presented below.

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

	Third Quarter 2006 vs. Third Quarter 2005	Third Quarter 2006 vs. Second Quarter 2006	First Nine Months 2006 vs. First Nine Months 2005
Due to changes in average volumes	$ 15,895	$ 790	$ 47,594
Due to changes in average interest rates	3,943	(322)	18,554
Due to difference in the number days in each of the comparable periods	-	1,316	-
Total change	$ 19,838	$ 1,784	$ 66,148

Taxable-equivalent net interest income for the three and nine months ended September 30, 2006 increased $19.8 million, or 19.6%, and $66.1 million, or 22.9%, compared to the same periods in 2005. The increases primarily resulted from increases in the average volume of earning assets combined with increases in the net interest margin. The average volume of earning assets for the third quarter of 2006 increased $1.3 billion compared to the third quarter of 2005. Over the same time frame, the net interest margin increased 17 basis points from 4.52% in 2005 to 4.69% in 2006. The average volume of earning assets for the nine months ended September 30, 2006 increased $1.3 billion compared to the same period in 2005. Over the same time frame, the net interest margin increased 27 basis points from 4.41% in 2005 to 4.68% in 2006. The increases in the average volume of earning assets were due in part to recent acquisitions (see Note 2 - Mergers and Acquisitions). The increases in the net interest margin were partly due to the increases in market interest rates discussed above. Additionally, the relative proportion of loans, which generally carry higher yields compared to other types of earning assets, increased from 62.3% of total average earning assets during the first nine months of 2005 to 64.3% of total average earning assets during the first nine months of 2006.

Taxable-equivalent net interest income for the third quarter of 2006 increased $1.8 million, or 1.5%, from the second quarter of 2006. The increase primarily resulted from an increase in the average volume of earning assets combined with an increase in the number of days in the third quarter. The average volume of earning assets for the third quarter of 2006 increased $90.5 million compared to the second quarter of 2006. Taxable-equivalent net interest income for the third quarter of 2006 included 92 days of interest accrual compared to 91 days for the second quarter of 2006. The additional day added approximately $1.3 million to taxable-equivalent net interest income during the third quarter of 2006. Excluding the impact of the additional day during the third quarter of 2006 results in an effective increase in taxable-equivalent net interest income of approximately $468 thousand compared to the second quarter of 2006. This effective increase was the result of the aforementioned increase in average earning assets partly offset by the impact of a decrease in the net interest margin. The net interest margin decreased one basis point from 4.70% in the second quarter of 2006 to 4.69% in the third quarter of 2006.

The average volume of loans, the Corporation's primary category of earning assets, increased $1.0 billion during the first nine months of 2006 compared to the same period in 2005. The average yield on loans was 7.70% during the first nine months of 2006 compared to 6.25% during the same period in 2005. As stated above, the Corporation had a larger proportion of average earning assets invested in loans during the first nine months of 2006 compared to the first nine months of 2005. Such investments have significantly higher yields compared to securities and federal funds sold and resell agreements and, as such, have a more positive effect on the net interest margin. The average volume of securities increased $48.7 million during the first nine months of 2006 compared to the same period in 2005. The average yield on securities was 4.97% during the first nine months of 2006 compared to 4.82% during the first nine months of 2005. Average federal funds sold and resell agreements during the first nine months of 2006 increased $235.5 million compared to the same period in 2005. The average yield on federal funds sold and resell agreements was 4.98% during the first nine months of 2006 compared to 3.02% during the first nine months of 2005.

Average deposits increased $1.1 billion during the first nine months of 2006 compared to the same period in 2005. The increase in the average volume of deposits was due in part to recent acquisitions (see Note 2 - Mergers and Acquisitions). Average interest-bearing deposits for the first nine months of 2006 increased $725.1 million compared to the same period in 2005. The ratio of average interest-bearing deposits to total average deposits was 63.6% for the first nine months of 2006 compared to 63.4% during the first nine months of 2005. The average cost of interest-bearing deposits and total deposits was 2.55% and 1.62% during the first nine months of 2006 compared to 1.40% and 0.89% during the first nine months of 2005. The increase in the average cost of interest-bearing deposits was primarily the result of increases in interest rates offered on deposit products due to increases in market interest rates.

The Corporation's net interest spread, which represents the difference between the average rate earned on earning assets and the average rate paid on interest-bearing liabilities, was 3.75% during the first nine months of 2006 compared to 3.85% during the first nine months of 2005. The net interest spread, as well as the net interest margin, will be impacted by future changes in short-term and long-term interest rate levels, as well as the impact from the competitive environment. A discussion of the effects of changing interest rates on net interest income is set forth in Item 3. Quantitative and Qualitative Disclosures About Market Risk included elsewhere in this report.

The Corporation's hedging policies permit the use of various derivative financial instruments, including interest rate swaps, swaptions, caps and floors, to manage exposure to changes in interest rates. Details of the Corporation's derivatives and hedging activities are set forth in Note 10 - Derivative Financial Instruments in the accompanying notes to consolidated financial statements included elsewhere in this report. Information regarding the impact of fluctuations in interest rates on the Corporation's derivative financial instruments is set forth in Item 3. Quantitative and Qualitative Disclosures About Market Risk included elsewhere in this report.

Provision for Possible Loan Losses

The provision for possible loan losses is determined by management as the amount to be added to the allowance for possible loan losses after net charge-offs have been deducted to bring the allowance to a level which, in management's best estimate, is necessary to absorb probable losses within the existing loan portfolio. The provision for possible loan losses totaled $1.7 million and $10.8 million for the three and nine months ended September 30, 2006 compared to $2.7 million and $7.3 million for the three and nine months ended September 30, 2005. See the section captioned "Allowance for Possible Loan Losses" elsewhere in this discussion for further analysis of the provision for possible loan losses.

Non-Interest Income

The components of non-interest income were as follows:

	Three Months Ended			Nine Months Ended	
	September 30, 2006	June 30, 2006	September 30, 2005	September 30, 2006	September 30, 2005
Trust fees	$ 15,962	$ 15,744	$ 14,463	$ 47,460	$ 43,294
Service charges on deposit accounts	19,301	19,566	20,173	57,974	59,002
Insurance commissions and fees	7,204	6,144	7,389	22,323	22,192
Other charges, commissions and fees	6,558	8,196	6,135	20,668	17,008
Net loss on securities transactions	-	-	-	(1)	-
Other	10,871	10,615	9,894	32,495	32,330
Total	$ 59,896	$ 60,265	$ 58,054	$ 180,919	$ 173,826

Total non-interest income for the three and nine months ended September 30, 2006 increased $1.8 million, or 3.2%, and $7.1 million, or 4.1%, compared to the same periods in 2005. Total non-interest income for the third quarter of 2006 decreased $369 thousand, or 0.6%, compared to the second quarter of 2006. Changes in the components of non-interest income are discussed below.

Trust Fees. Trust fee income for the three and nine months ended September 30, 2006 increased $1.5 million, or 10.4%, and $4.2 million, or 9.6%, compared to the same periods in 2005. Investment fees are the most significant component of trust fees, making up approximately 69% and 70% of total trust fees for the first nine months of 2006 and 2005, respectively. Investment and other custodial account fees are generally based on the market value of assets within a trust account. Volatility in the equity and bond markets impacts the market value of trust assets and the related investment fees.

The $1.5 million increase in trust fee income during the three months ended September 30, 2006 compared to the same period in 2005 was primarily the result of increases in investment fees (up $769 thousand), oil and gas trust management fees (up $344 thousand) and real estate fees (up $260 thousand). The $4.2 million increase in trust fee income during the nine months ended September 30, 2006 compared to the same period in 2005 was primarily the result of increases in investment fees (up $2.3 million), oil and gas trust management fees (up $1.1 million), estate fees (up $356 thousand) and custody fees (up $317 thousand). The increases in investment fees were primarily due to higher equity valuations during first nine months of 2006 compared to the same period in 2005 and growth in overall trust assets and the number of trust accounts. The increases in oil and gas trust management fees were partly due to increased market prices, new production and new lease bonuses.

Trust fee income for the third quarter of 2006 increased $218 thousand, or 1.4% compared to the second quarter of 2006. Increases in investment fees (up $645 thousand), real estate fees (up $249 thousand), financial consulting fees (up $128 thousand) and oil and gas trust management fees (up $125 thousand) were partially offset by decreases in tax fees (down $815 thousand) which are seasonally higher during the second quarter.

At September 30, 2006, trust assets, including both managed assets and custody assets, were primarily composed of fixed income securities (43.8% of trust assets), equity securities (38.5% of trust assets) and cash equivalents (11.2% of trust assets). The estimated fair value of trust assets was $22.6 billion (including managed assets of $8.9 billion and custody assets of $13.7 billion) at September 30, 2006, compared to $18.1 billion (including managed assets of $8.3 billion and custody assets of $9.8 billion) at December 31, 2005 and $18.2 billion (including managed assets of $8.3 billion and custody assets of $9.9 billion) at September 30,2005.

Service Charges on Deposit Accounts. Service charges on deposit accounts for the three and nine months ended September 30, 2006 decreased $872 thousand, or 4.3%, and $1.0 million, or 1.7%, compared to the same periods in 2005. The decrease during the three months ended September 30, 2006 compared to the same period in 2005 was primarily related to service charges on commercial accounts (down $1.0 million) and consumer accounts (down $117 thousand) partly offset by increases in overdraft/insufficient funds charges on commercial accounts (up $146 thousand). The decrease during the nine months ended September 30, 2006 compared to the same period in 2005 was primarily related to service charges on commercial accounts (down $2.9 million) and consumer accounts (down $452 thousand) partly offset by increases in overdraft/insufficient funds charges on consumer accounts (up $1.6 million) and commercial accounts (up $481 thousand). The decreases in service charges on commercial accounts were primarily related to decreased treasury management fees. The decreased treasury management fees resulted primarily from a higher earnings credit rate. The earnings credit rate is the value given to deposits maintained by treasury management customers. Because interest rates have trended upwards since the first quarter of 2005, deposit balances have become more valuable and are yielding a higher earnings credit rate relative to 2005. As a result, customers are able to pay for more of their services with earning credits applied to their deposit balances rather than through fees. The decrease in treasury management fees resulting from the higher earnings credit rate was partly offset by the additional fees from an increase in billable services. The increases in overdraft/insufficient funds charges on both commercial and consumer accounts was partly the result of growth in deposit accounts.

Service charges on deposit accounts for the third quarter of 2006 decreased $265 thousand, or 1.4%, compared to the second quarter of 2006. The decrease was primarily due to a decrease in service charges on commercial accounts (down $256 thousand) related to a higher earnings credit rate and overdraft/insufficient funds charges on consumer accounts (down $213 thousand) partly offset by an increase in overdraft/insufficient funds charges on commercial accounts (up $197 thousand).

Insurance Commissions and Fees. Insurance commissions and fees for the three and nine months ended September 30, 2006 decreased $185 thousand, or 2.5%, and increased $131 thousand, or 0.6%, compared to the same periods in 2005. The decrease for the three months ended September 30, 2006 was primarily related to lower commission income (down $155 thousand). The increase for the nine months ended September 30, 2006 was primarily related to higher commission income (up $355 thousand) partly offset by a decrease in contingent commissions (down $223 thousand).

Insurance commissions and fees include contingent commissions totaling $3.1 million during the nine months ended September 30, 2006 and $3.3 million during the nine months ended September 30, 2005. Contingent commissions primarily consist of amounts received from various property and casualty insurance carriers related to the loss performance of insurance policies previously placed. Such commissions are seasonal in nature and are generally received during the first quarter of each year. These commissions totaled $2.7 million and $2.8 million during the nine months ended September 30, 2006 and 2005. Contingent commissions also include amounts received from various benefit plan insurance companies related to the volume of business generated and/or the subsequent retention of such business. These commissions totaled $348 thousand and $530 thousand during the nine months ended September 30, 2006 and 2005.

Insurance commissions and fees for the third quarter of 2006 increased $1.1 million, or 17.3%, compared to the second quarter of 2006. The increase was primarily related to higher commission income (up $1.6 million) due to normal variation in the timing of renewals and in the market demand for insurance products. The increase in commission income was partly offset by a decrease in contingent commissions (down $493 thousand).

Other Charges, Commissions and Fees. Other charges, commissions and fees for the three and nine months ended September 30, 2006 increased $423 million, or 6.9%, and $3.7 million, or 21.5%, compared to the same periods in 2005. The increase during the three months ended September 30, 2006 was primarily related to an increase in investment banking fees related to corporate advisory services (up $1.1 million) and commission income related to the sale of money market accounts (up $289 thousand). These increases were partially offset by decreases in the realization of deferred loan commitment fees (down $686 thousand), letter of credit fees (down $278 thousand) and commission income related to the sale of annuities (down $259 thousand). The increase during the nine months ended September 30, 2006 was primarily related to an increase in investment banking fees related to corporate advisory services (up $3.6 million) and increases in commission income related to the sale of money market accounts (up $531 thousand) and mutual funds (up $416 thousand). These increases were partially offset by decreases in the realization of deferred loan commitment fees (down $1.3 million) and letter of credit fees (down $439 thousand). During the second quarter of 2006, the Corporation recognized investment banking fees related to corporate advisory services totaling $2.8 million, which was primarily related to a single transaction. During the third quarter of 2006, the Corporation recognized investment banking fees related to corporate advisory services totaling $1.3 million, which was primarily related to two transactions. Investment banking fees related to corporate advisory services are transaction based and can vary significantly from quarter to quarter.

Other charges, commissions and fees for the third quarter of 2006 decreased $1.6 million, or 20%, compared to the second quarter of 2006. The decrease was primarily due to the aforementioned investment banking fees related to corporate advisory services recognized in the second quarter.

Net Gain/Loss on Securities Transactions. The Corporation sold available-for-sale securities with an amortized cost totaling $25.7 million and $2.3 million during the nine months ended September 30, 2006 and 2005. The Corporation realized a net loss of $1 thousand on the 2006 sales. No gain or loss was realized on the 2005 sales.

Other Non-Interest Income. Other non-interest income increased $977 thousand, or 9.9%, during the three months ended September 30, 2006 compared to the same period in 2005. Contributing to the increase during the three months ended September 30, 2006 were increases in income from check card usage (up $759 thousand) and earnings on cashier's check balances (up $386 thousand), among other things. The impact of these increases was partly offset by a decrease in income from securities trading activities (down $249 thousand) as well as decreases in various other categories of non-interest income.

Other non-interest income increased $165 thousand, or 0.5%, during the nine months ended September 30, 2006 compared to the same period in 2005. During the second quarter of 2005, the Corporation realized $2.4 million in income from the net proceeds from the settlement of legal claims against certain former employees who were employed within the employee benefits line of business in the Austin region of Frost Insurance Agency. Also during 2005, the Corporation recognized $2.0 million ($1.7 million in the first quarter and $294 thousand in the second quarter) in income related to a distribution received from the sale of the PULSE EFT Association whereby the Corporation and other members of the Association received distributions based in part upon each member's volume of transactions through the PULSE network. Excluding the income related to these items during the nine months ended September 30, 2005, other non-interest income for the nine months ended September 30, 2006 increased $4.5 million, or 16.3%, compared to the same period in 2005. Contributing to the effective increase during the nine months ended September 30, 2006 were increases in income from check card usage (up $2.1 million), earnings on cashier's check balances (up $1.3 million), mineral interest income (up $295 thousand) and income from securities trading activities (up $255 thousand).

Other non-interest income for the third quarter of 2006 increased $256 thousand, or 2.4%, compared to the second quarter of 2006. Contributing to the increase were increases in income from check card usage (up $118 thousand) and mineral interest income (up $115 thousand), as well as increases in various other categories of non-interest income. Other non-interest income during the third quarter of 2006 also included approximately $165 thousand in income related to a settlement. The impact of these increases was partly offset by a decrease in income from securities trading activities (down $302 thousand) as well as decreases in various other categories of non-interest income.

Non-Interest Expense

The components of non-interest expense were as follows:

	Three Months Ended			Nine Months Ended	
	September 30, 2006	June 30, 2006	September 30, 2005	September 30, 2006	September 30, 2005
Salaries and wages	$ 48,743	$ 47,463	$ 41,818	$ 142,312	$ 122,272
Employee benefits	10,882	11,434	9,973	35,492	32,325
Net occupancy	8,964	8,512	8,111	25,909	22,863
Furniture and equipment	6,553	6,357	6,202	19,212	17,929
Intangible amortization	1,293	1,358	1,050	3,957	3,699
Other	26,505	25,070	24,838	76,448	72,841
Total	$ 102,940	$ 100,194	$ 91,992	$ 303,330	$ 271,929

Total non-interest expense for the three and nine months ended September 30, 2006 increased $10.9 million, or 11.9%, and $31.4 million, or 11.5%, compared to the same periods in 2005. Total non-interest expense for the third quarter of 2006 increased $2.7 million, or 2.7%, compared to the second quarter of 2006. Changes in the components of non-interest expense are discussed below.

Salaries and Wages. Salaries and wages for the three and nine months ended September 30, 2006 increased $6.9 million, or 16.6%, and $20.0 million, or 16.4%, compared to the same periods in 2005. The increases were primarily related to normal, annual merit increases and increases in headcount. The increases in headcount were primarily related to the acquisition of Horizon Capital Bank during the fourth quarter of 2005 and the acquisitions of Texas Community Bancshares and Alamo Corporation of Texas during the first quarter of 2006. Also, effective January 1, 2006, the Corporation began recognizing compensation expense related to stock options in connection with the adoption of a new accounting standard, as further discussed in Note 12 - Stock-Based Compensation. Stock-based compensation expense related to stock options and non-vested stock awards totaled $2.3 million and $7.0 million during the three and nine months ended September 30, 2006 compared to $491 thousand and $1.3 million during the three and nine months ended September 30, 2005.

Salaries and wages expense for the third quarter of 2006 increased $1.3 million, or 2.7%, compared to the second quarter of 2006. The increase was partly related to normal, annual merit increases, an increase in headcount and an increase in the incentive compensation accrual. The increase was also partly due to increased commissions related to higher insurance revenues.

Employee Benefits. Employee benefits expense for the three and nine months ended September 30, 2006 increased $909 thousand, or 9.1%, and $3.2 million, or 9.8%, compared to the same periods in 2005. The increase during the three months ended September 30, 2006 was primarily related to increases in medical insurance expense (up $259 thousand), payroll taxes (up $256 thousand), expenses related to the Corporation's 401(k) and profit sharing plans (up $231 thousand) and expenses related to the Corporation's defined benefit retirement and restoration plans (up $205 thousand). The increase during the nine months ended September 30, 2006 was primarily related to increases in payroll taxes (up $1.2 million), medical insurance expense (up $719 thousand), expenses related to the Corporation's defined benefit retirement and restoration plans (up $613 thousand) and expenses related to the Corporation's 401(k) and profit sharing plans (up $522 thousand). The increases in employee benefits expense for both the three and nine months ended September 30, 2006 compared to the same periods in 2005 were also partly the result of increases in headcount related to the acquisition of Horizon Capital Bank during the fourth quarter of 2005 and the acquisitions of Texas Community Bancshares and Alamo Corporation of Texas during the first quarter of 2006.

Employee benefits expense for the third quarter of 2006 decreased $552 thousand, or 4.8%, compared to the second quarter of 2006. The decrease is primarily due to decreases in payroll taxes (down $350 thousand) and expenses related to the Corporation's 401(k) and profit sharing plans (down $124 thousand).

The Corporation's defined benefit retirement and restoration plans were frozen effective as of December 31, 2001 and were replaced by the profit sharing plan. Management believes these actions reduce the volatility in retirement plan expense. However, the Corporation still has funding obligations related to the defined benefit and restoration plans and could recognize retirement expense related to these plans in future years, which would be dependent on the return earned on plan assets, the level of interest rates and employee turnover.

Net Occupancy. Net occupancy expense for the three and nine months ended September 30, 2006 increased $853 thousand, or 10.5%, and $3.0 million, or 13.3%, compared to the same periods in 2005. The increase during the three months ended September 30, 2006 was primarily due to increases in depreciation expense related to buildings (up $173 thousand), property taxes (up $135 thousand), utilities expense (up $125 thousand) and a decrease in rental income (down $102 thousand) as well as increases in various other categories of occupancy expense. The increase during the nine months ended September 30, 2006 was primarily due to increases in utilities expense (up $726 thousand), lease expense (up $466 thousand), property taxes (up $434 thousand), depreciation expense related to buildings (up $418 thousand) and a decrease in rental income (down $293 thousand) as well as increases in various other categories of occupancy expense. These increases are partly related to the additional facilities added in connection with recent acquisitions during the fourth quarter of 2005 and the first quarter of 2006 (see Note 2 - Mergers and Acquisitions).

Net occupancy expense for the third quarter of 2006 increased $452 thousand, or 5.3%, compared to the second quarter of 2006. The increase is primarily due to increases in lease expense (up $258 thousand), utilities expense (up $196 thousand) and service contracts (up $102 thousand) partly offset by an increase in rental income (up $192 thousand).

Furniture and Equipment. Furniture and equipment expense for the three and nine months ended September 30, 2006 increased $351 thousand, or 5.7%, and $1.3 million, or 7.2%, compared to the same periods in 2005. The increase during the three months ended September 30, 2006 was primarily related to increases in software maintenance expense (up $478 thousand), service contracts expense (up $327 thousand) and depreciation expense related to furniture and fixtures (up $173 thousand). The impact of these items was partially offset by a decrease in software amortization expense (down $641 thousand). The increase during the nine months ended September 30, 2006 was primarily related to increases in software maintenance expense (up $1.3 million), depreciation expense related to furniture and fixtures (up $824 thousand) and service contracts expense (up $628 thousand). The impact of these items was partially offset by a decrease in software amortization expense (down $1.7 million).

Furniture and equipment expense for the third quarter of 2006 increased $196 thousand, or 3.1%, compared to the second quarter of 2006. The increase is primarily related to increases in service contracts expense (up $206 thousand) and software maintenance expense (up $183 thousand) partly offset by a decrease in depreciation expense related to furniture and fixtures (down $93 thousand).

Intangible Amortization. Intangible amortization is primarily related to core deposit intangibles and, to a lesser extent, intangibles related to non-compete agreements and customer relationships. Intangible amortization totaled $1.3 million and $4.0 million for the three and nine months ended September 30, 2006 compared to $1.1 million and $3.7 million during the same periods in 2005 and $1.4 million during the second quarter of 2006. The increase in intangible amortization during 2006 compared to 2005 was primarily due to the amortization of new intangible assets acquired in connection with recent acquisitions during the fourth quarter of 2005 and the first quarter of 2006 (see Note 2 - Mergers and Acquisitions and Note 6 - Goodwill and Other Intangible Assets).

Other Non-Interest Expense. Other non-interest expense for the three and nine months ended September 30, 2006 increased $1.7 million, or 6.7%, and $3.6 million, or 5.0%, compared to the same periods in 2005. Components of the increase during the three months ended September 30, 2006 included professional service expense (up