CULLEN FROST BANKERS INC
Form 10-Q
October 24, 2007

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, 2007

or

[ ] Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the transition period from _______________ to ________________

Commission file number: 0-7275

Cullen/Frost Bankers, Inc.
(Exact name of registrant as specified in its charter)

Texas	74-1751768
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
100 W. Houston Street, San Antonio, Texas	78205
(Address of principal executive offices)	(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 18, 2007, there were 58,479,130 shares of the registrant's Common Stock, $.01 par value, outstanding.

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

Table of Contents

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

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

Signatures 43

Part I. Financial Information
Item 1. Financial Statements (Unaudited)

Cullen/Frost Bankers, Inc.
Consolidated Statements of Income
(Dollars in thousands, except per share amounts)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2007	2006	2007	2006
Interest income:				
Loans, including fees	$ 145,106	$ 131,006	$ 432,607	$ 370,304
Securities:				
Taxable	35,675	32,404	110,271	99,159
Tax-exempt	4,706	2,822	11,798	8,342
Interest-bearing deposits	99	61	272	153
Federal funds sold and resell agreements	9,288	10,114	25,529	24,027
Total interest income	194,874	176,407	580,477	501,985

Interest expense:				
Deposits	49,441	42,277	146,897	109,959
Federal funds purchased and repurchase agreements	7,981	8,353	24,453	23,008
Junior subordinated deferrable interest debentures	2,548	4,439	8,740	12,845
Subordinated notes payable and other borrowings	4,280	2,812	12,410	8,239
Total interest expense	64,250	57,881	192,500	154,051
Net interest income	130,624	118,526	387,977	347,934
Provision for possible loan losses	5,784	1,711	11,084	10,750
Net interest income after provision for possible loan losses	124,840	116,815	376,893	337,184
Non-interest income:				
Trust fees	17,749	15,962	52,350	47,460
Service charges on deposit accounts	20,696	19,301	59,674	57,974
Insurance commissions and fees	7,695	7,204	24,868	22,323
Other charges, commissions and fees	10,772	7,228	24,609	22,096
Net gain (loss) on securities transactions	-	-	-	(1)
Other	13,844	10,871	40,347	32,495
Total non-interest income	70,756	60,566	201,848	182,347
Non-interest expense:				
Salaries and wages	52,996	48,743	155,913	142,312
Employee benefits	10,727	10,882	37,150	35,492
Net occupancy	9,509	8,964	28,626	25,909
Furniture and equipment	8,793	6,553	23,951	19,212
Intangible amortization	2,184	1,293	6,698	3,957
Other	29,358	27,175	95,958	77,876
Total non-interest expense	113,567	103,610	348,296	304,758
Income before income taxes	82,029	73,771	230,445	214,773
Income taxes	25,566	23,769	73,074	69,544
Net income	$ 56,463	$ 50,002	$ 157,371	$ 145,229
Earnings per common share:				
Basic	$ 0.97	$ 0.90	$ 2.66	$ 2.64
Diluted	0.95	0.88	2.62	2.58

See Notes to Consolidated Financial Statements.

Cullen/Frost Bankers, Inc.

Consolidated Balance Sheets

(Dollars in thousands, except per share amounts)

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

Liabilities:			
Deposits:			
Non-interest-bearing demand deposits	$ 3,602,780	$ 3,699,701	$ 3,380,986
Interest-bearing deposits	6,493,052	6,688,208	5,889,462
Total deposits	10,095,832	10,387,909	9,270,448
Federal funds purchased and repurchase agreements	893,266	864,190	725,779
Subordinated notes payable and other borrowings	261,202	186,366	171,427
Junior subordinated deferrable interest debentures	139,177	242,270	229,898
Accrued interest payable and other liabilities	390,483	166,571	128,441
Total liabilities	11,779,960	11,847,306	10,525,993
Shareholders' Equity:			
Preferred stock, par value $0.01 per share; 10,000,000 shares authorized; none issued	-	-	-
Junior participating preferred stock, par value $0.01 per share; 250,000 shares authorized; none issued	-	-	-
Common stock, par value $0.01 per share; 210,000,000 shares authorized; 60,236,862 shares, 59,839,144 shares and 55,820,763 shares issued	602	598	558
Additional paid-in capital	572,421	548,117	324,534
Retained earnings	966,312	883,060	853,738
Accumulated other comprehensive income (loss), net of tax	(58,018)	(54,892)	(57,409)
Treasury stock, 1,813,461 shares, no shares and no shares, at cost	(94,596)	-	-
Total shareholders' equity	1,386,721	1,376,883	1,121,421
Total liabilities and shareholders' equity	$ 13,166,681	$ 13,224,189	$ 11,647,414

See Notes to Consolidated Financial Statements.

Cullen/Frost Bankers, Inc.
Consolidated Statements of Changes in Shareholders' Equity
(Dollars in thousands, except per share amounts)

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

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

See Notes to Consolidated Financial Statements.

Cullen/Frost Bankers, Inc.

Consolidated Statements of Cash Flows

(Dollars in thousands)

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

Investing Activities:		
Securities held to maturity:		
Maturities, calls and principal repayments	1,541	2,069
Securities available for sale:		
Purchases	(8,191,457)	(13,028,949)
Sales	14,443	25,689
Maturities, calls and principal repayments	8,254,107	13,351,918
Net change in loans	(74,584)	(141,303)
Net cash paid in acquisitions	(1,903)	(61,016)
Proceeds from sales of premises and equipment	4,473	202
Purchases of premises and equipment	(18,881)	(21,055)
Proceeds from sales of repossessed properties	5,282	1,571
Net cash from investing activities	(6,979)	129,126
Financing Activities:		
Net change in deposits	(292,077)	(257,529)
Net change in short-term borrowings	29,076	(20,669)
Proceeds from notes payable	98,799	-
Principal payments on notes payable and other borrowings	(128,257)	(19,190)
Proceeds from stock option exercises	18,523	37,270
Excess tax benefits from stock-based compensation	6,231	14,563
Purchase of treasury stock	(109,423)	(3,580)
Cash dividends paid	(67,360)	(54,360)
Net cash from financing activities	(444,488)	(303,495)
Net change in cash and cash equivalents	(270,870)	(335,502)
Cash and equivalents at beginning of period	1,444,585	1,913,428
Cash and equivalents at end of period	$ 1,173,715	$ 1,577,926
Supplemental disclosures:		
Cash paid for interest	$ 196,787	$ 157,237
Cash paid for income taxes	60,517	54,099

See Notes to Consolidated Financial Statements.

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

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

Note 1 - Significant Accounting Policies

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

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

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

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

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

Comprehensive Income. Comprehensive income includes all changes in shareholders' equity during a period, except those resulting from transactions with shareholders. Besides net income, other components of the Corporation's comprehensive income include the after tax effect of changes in the net unrealized gain/loss on securities available for sale, changes in the funded status of defined benefit post-retirement benefit plans and changes in the accumulated gain/loss on effective cash flow hedging instruments. Comprehensive income for the nine months ended September 30, 2007 and 2006 is reported in the accompanying consolidated statements of changes in shareholders' equity. The Corporation had comprehensive income of $85.9 million and $99.1 million for the three months ended September 30, 2007 and 2006. Comprehensive income during the three months ended September 30, 2007 and 2006 included net after-tax gains of $28.5 million and $48.8 million due to decreases in the net unrealized loss on securities available for sale.

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

Note 2 - Mergers and Acquisitions

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

Texas Community Bancshares, Inc.

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

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

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

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

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

September 30, 2007	December 31, 2006

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Securities Held to Maturity:								
U.S. government agencies and corporations	$ 7,550	$ 98	$ 4	$ 7,644	$ 9,096	$ 87	$ 14	$ 9,169
Other	1,000	-	1	999	1,000	-	11	989
Total	$ 8,550	$ 98	$ 5	$ 8,643	$ 10,096	$ 87	$ 25	$ 10,158
Securities Available for Sale:								
U.S. Treasury	$ -	$ -	$ -	$ -	$ 89,954	$ 1	$ 272	$ 89,683
U.S. government agencies and corporations	2,958,284	3,380	49,433	2,912,231	2,946,212	5,507	49,110	2,902,609
States and political subdivisions	500,393	2,021	5,850	496,564	309,002	2,672	1,298	310,376
Other	37,957	-	-	37,957	28,285	-	-	28,285
Total	$ 3,496,634	$ 5,401	$ 55,283	$ 3,446,752	$ 3,373,453	$ 8,180	$ 50,680	$ 3,330,953

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

Sales of securities available for sale were as follows:

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

Gross realized losses	-	-	-	118

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

	Less than 12 Months		More than 12 Months		Total	
	Estimated Fair Value	Unrealized Losses	Estimated Fair Value	Unrealized Losses	Estimated Fair Value	Unrealized Losses
Held to Maturity						
U.S. government agencies and corporations	$ 1,907	$ 2	$ 351	$ 2	$ 2,258	$ 4
Other	-	-	999	1	999	1
Total	$ 1,907	$ 2	$ 1,350	$ 3	$ 3,257	$ 5
Available for Sale						
U.S. government agencies and corporations	$525,337	$ 2,989	$ 1,706,147	$ 46,444	$ 2,231,484	$ 49,433
States and political subdivisions	258,753	5,153	34,372	697	293,125	5,850
Total	$784,090	$ 8,142	$ 1,740,519	$ 47,141	$ 2,524,609	$ 55,283

Declines in the fair value of held-to-maturity and available-for-sale securities below their cost that are deemed to be other than temporary are reflected in earnings as realized losses. In estimating other-than-temporary impairment losses, management considers, among other things, (i) the length of time and the extent to which the fair value has been less than cost, (ii) the financial condition and near-term prospects of the issuer, and (iii) the intent and ability of the Corporation to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value.

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

Note 4 - Loans

Loans were as follows:

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

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

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

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

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

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

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

Impaired loans were as follows:

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

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

Note 5 - Allowance for Possible Loan Losses

The allowance for possible loan losses is a reserve established through a provision for possible loan losses charged to expense, which represents management's best estimate of probable losses that have been incurred within the existing portfolio of loans. The allowance, in the judgment of management, is necessary to reserve for estimated loan losses and risks inherent in the loan portfolio. The level of the allowance reflects management's continuing evaluation of industry concentrations, specific credit risks, loan loss experience, current loan portfolio quality, present economic, political and regulatory conditions and unidentified losses inherent in the current loan portfolio, as well as trends in the foregoing. Portions of the allowance may be allocated for specific credits; however, the entire allowance is available for any credit that, in management's judgment, should be charged off. While management utilizes its best judgment and information available, the ultimate adequacy of the allowance is dependent upon a variety of factors beyond the Corporation's control, including the performance of the Corporation's loan portfolio, the economy, changes in interest rates and the view of the regulatory authorities toward loan classifications.

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

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

Note 6 - Goodwill and Other Intangible Assets

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

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

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

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

Note 7 - Deposits

Deposits were as follows:

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

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

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

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

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

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

Standby Letters of Credit. Standby letters of credit are written conditional commitments issued by the Corporation to guarantee the performance of a customer to a third party. In the event the customer does not perform in accordance with the terms of the agreement with the third party, the Corporation would be required to fund the commitment. The maximum potential amount of future payments the Corporation could be required to make is represented by the contractual amount of the commitment. If the commitment is funded, the Corporation would be entitled to seek recovery from the customer. The Corporation's policies generally require that standby letter of credit arrangements contain security and debt covenants similar to those contained in loan agreements. Standby letters of credit totaled $217.3 million at September 30, 2007 and $254.8 million at December 31, 2006. The Corporation had an accrued liability totaling $1.3 million at September 30, 2007 and $1.2 million at December 31, 2006 related to potential obligations under these guarantees.

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

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

Note 9 - Borrowed Funds

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

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

Note 10 - Regulatory Matters and Shareholders' Equity

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

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

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

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

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

	Actual		Minimum Required for Capital Adequacy Purposes		Required to be Well Capitalized Under Prompt Corrective Action Regulations	
	Capital Amount	Ratio	Capital Amount	Ratio	Capital Amount	Ratio
September 30, 2007						
Total Capital to Risk-Weighted Assets						
Cullen/Frost	$ 1,312,092	12.83 %	$ 818,270	8.00 %	N/A	N/A
Frost Bank	1,258,254	12.31	817,833	8.00	$ 1,022,291	10.00 %
Tier 1 Capital to Risk-Weighted Assets						
Cullen/Frost	1,029,829	10.07	409,134	4.00	N/A	N/A
Frost Bank	1,075,991	10.53	408,916	4.00	613,375	6.00
Leverage Ratio						

Cullen/Frost	1,029,829	8.01	514,084	4.00	N/A	N/A
Frost Bank	1,075,991	8.38	513,720	4.00	642,150	5.00
December 31, 2006						
Total Capital to Risk-Weighted Assets						
Cullen/Frost	$ 1,332,744	13.43 %	$ 793,889	8.00 %	N/A	N/A
Frost Bank	1,234,583	12.45	793,555	8.00	$ 991,944	10.00 %
Tier 1 Capital to Risk-Weighted Assets						
Cullen/Frost	1,116,659	11.25	396,944	4.00	N/A	N/A
Frost Bank	1,018,498	10.27	396,778	4.00	595,166	6.00
Leverage Ratio						
Cullen/Frost	1,116,659	9.56	467,275	4.00	N/A	N/A
Frost Bank	1,018,498	8.73	466,835	4.00	583,543	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, 2007, that Cullen/Frost and Frost Bank meet all capital adequacy requirements to which they are subject.

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

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

Note 11 - Derivative Financial Instruments

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

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

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

Commercial loan/lease interest rate caps				
Commercial loan/lease interest rate caps	-	-	17,500	(5)
Commercial loan/lease interest rate floors	-	-	17,500	8
Commercial loan/lease interest rate floors	-	-	17,500	(8)

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

	Weighted-Average		
	Interest Rate Paid	Interest Rate Received	Strike Rate
Interest rate swaps:			
Commercial loan/lease interest rate swaps	4.79 %	5.09 %	-
Non-hedging interest rate swaps	5.48	5.48	-
Interest rate caps and floors:			
Interest rate floors on variable-rate loans	-	-	6.00 %

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

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

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

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

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

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

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

Note 12 - Earnings Per Common Share

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

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

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

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

Note 13 - Stock-Based Compensation

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

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

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

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

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

Note 14 - Defined Benefit Plans

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

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

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

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

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

Note 15 - Income Taxes

Income tax expense was as follows:

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

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

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

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

Note 16 - Operating Segments

The Corporation has two reportable operating segments, Banking and the Financial Management Group (FMG), that are delineated by the products and services that each segment offers. Banking includes both commercial and consumer banking services, Frost Insurance Agency and Frost Securities, Inc. Commercial banking services are provided to corporations and other business clients and include a wide array of lending and cash management products. Consumer banking services include direct lending and depository services. FMG includes fee-based services within private trust, retirement services, and financial management services, including personal wealth management and brokerage services.

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

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

Summarized operating results by segment were as follows:

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

Note 17 - New Accounting Standards

Statements of Financial Accounting Standards

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

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

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

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

SFAS No. 157, "Fair Value Measurements."

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

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

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

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

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

Financial Accounting Standards Board Interpretations

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

Note 18 - Subsequent Event

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

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

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

Financial Review

Cullen/Frost Bankers, Inc.

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

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

Forward-Looking Statements and Factors that Could Affect Future Results

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

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

- Local, regional, national and international economic conditions and the impact they may have on the Corporation and its customers and the Corporation's assessment of that impact.
- Changes in the level of non-performing assets and charge-offs.
- 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 God or 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.

- 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 are considered to be critical, as these policies involve considerable subjective judgment and estimation by management.

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

Overview

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

Results of Operations

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

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

	Three Months Ended			Nine Months Ended	
	September 30, 2007	June 30, 2007	September 30, 2006	September 30, 2007	September 30, 2006
Taxable-equivalent net interest income	$ 134,704	$ 133,095	$121,093	$ 398,926	$ 355,119
Taxable-equivalent adjustment	4,080	3,575	2,567	10,949	7,185
Net interest income, as reported	130,624	129,520	118,526	387,977	347,934
Provision for possible loan losses	5,784	2,650	1,711	11,084	10,750
Net interest income after provision for possible loan losses	124,840	126,870	116,815	376,893	337,184
Non-interest income	70,756	64,020	60,566	201,848	182,347
Non-interest expense	113,567	112,642	103,610	348,296	304,758
Income before income taxes	82,029	78,248	73,771	230,445	214,773
Income taxes	25,566	24,619	23,769	73,074	69,544
Net income	$ 56,463	$ 53,629	$ 50,002	$ 157,371	$ 145,229

Net income per share - basic	$	0.97	$	0.90	$	0.90	$	2.66	$	2.64
Net income per share - diluted		0.95		0.89		0.88		2.62		2.58
Dividends per share		0.40		0.40		0.34		1.14		0.98
Return on average assets		1.72 %		1.66 %		1.72 %		1.62 %		1.70 %
Return on average equity		16.44		15.40		18.56		15.21		18.81

Net income for the three and nine months ended September 30, 2007 increased $6.5 million, or 12.9%, and $12.1 million, or 8.4%, compared to the same periods in 2006. The increase during the three months ended September 30, 2007 was primarily the result of a $12.1 million increase in net interest income, a $10.2 million increase in non-interest income partly offset by a $10.0 million increase in non-interest expense, a $4.1 million increase in the provision for possible loan losses and a $1.8 million increase in income tax expense. The increase during the nine months ended September 30, 2007 was primarily the result of a $40.0 million increase in net interest income and a $19.5 million increase in non-interest income partly offset by a $43.5 million increase in non-interest expense, a $3.5 million increase in income tax expense and a $334 thousand increase in the provision for possible loan losses.

Net income for the third quarter of 2007 increased $2.8 million, or 5.3%, from the second quarter of 2007. The increase was primarily the result of a $6.7 million increase in non-interest income and a $1.1 million increase in net interest income partly offset by a $3.1 million increase in the provision for possible loan losses, a $925 thousand increase in non-interest expense and a $947 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 2007. 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 2006 at 7.25% and increased 50 basis points in the first quarter and 50 basis in the second quarter to end the year at 8.25%. During the first nine months of 2007, the prime interest rate decreased 50 basis points in the third quarter to end the quarter at 7.75%. The federal funds rate, which is the cost of immediately available overnight funds, has moved in a similar manner, beginning 2006 at 4.25% and increasing 50 basis points in the first quarter and 50 basis in the second quarter to end the year at 5.25%. During the first nine months of 2007, the federal funds rate decreased 50 basis points in the third quarter to end the quarter at 4.75%.

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. The Corporation currently believes it is reasonably possible the prime interest rate and the federal funds rate will decrease from current levels in the foreseeable future; however, there can be no assurance to that effect or as to the magnitude of any decrease should a decrease occur, 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 the average volume change 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 2007 vs. Third Quarter 2006	Third Quarter 2007 vs. Second Quarter 2007	First Nine Months 2007 vs. First Nine Months 2006
Due to changes in average volumes	$ 13,611	$ 1,182	$ 43,058
Due to changes in average interest rates	-	(1,036)	749
Due to difference in the number of days in each of the comparable periods	-	1,463	-
Total change	$ 13,611	$ 1,609	$ 43,807

Taxable-equivalent net interest income for the three and nine months ended September 30, 2007 increased $13.6 million, or 11.2%, and $43.8 million, or 12.3%, compared to the same periods in 2006. The increases were for the most part the result of increases in the average volume of earning assets.

The average volume of earning assets during the three months ended September 30, 2007 increased $1.2 billion compared to the same period in 2006 while the net interest margin remained flat at 4.69% during both periods. The increase in the average volume of earning assets was due in part to recent acquisitions (see Note 2 - Mergers and Acquisitions). The average yield on interest earning assets during the three months ended September 30, 2007 was 6.92% compared to 6.93% during the same period in 2006. The decrease in the average yield on earning assets was partly due to the decline in market rates discussed above. A large portion of the Corporation's loan portfolio, as well as the Corporation's entire investment in federal funds sold and resell agreements were immediately impacted by the decline in market rates. The average yield on loans decreased 16 basis points from 7.98% during the three months ended September 30, 2006 to 7.82% during the three months ended September 30, 2007. The average yield on federal funds sold and resell agreements decreased 14 basis points from 5.31% during the three months ended September 30, 2006 to 5.17% during the three months ended September 30, 2007. The impact of the decline in the average yields on loans and federal funds sold and resell agreements was partly limited as the Corporation had a higher proportion of average interest earning assets invested in loans and a lower proportion of average interest earning assets invested in federal funds sold and resell agreements during 2007 relative to 2006. Additionally, the average yield on securities increased 25 basis points to 5.26% during the three months ended September 30, 2007 from 5.01% in during the three months ended September 30, 2006. The average cost of funds during the three months ended September 30, 2007 was 3.21% compared to 3.29% during the same period in 2006. The decrease in the cost of funds was primarily due to a decrease in the average cost of borrowed funds. The average cost of federal funds purchased and repurchase agreements decreased 62 basis points to 3.71% during the three months ended September 30, 2007 from 4.33% during the three months ended September 30, 2006, due to a reduction in the interest rate paid on customer repurchase agreements due to the aforementioned decrease in market rates. The Corporation also benefited from the redemption of higher-cost junior subordinated debentures and issuance of lower-cost subordinated notes during the first quarter of 2007 (see Note 9 - Borrowed Funds).

The average volume of earning assets for the nine months ended September 30, 2007 increased $1.3 billion compared to the same period in 2006. Over the same time frame, the net interest margin increased one basis point from 4.68% in 2006 to 4.69% in 2007. The increase in the average volume of interest earning assets was due in part to the aforementioned recent acquisitions. The increase in net interest margin was primarily due to an increase in the average yield on interest earning assets partly offset by an increase in the average cost of funds. The average yield on interest earning assets during the nine months ended September 30, 2007 was 6.95% compared to 6.72% during the same period in 2006. During 2006, market interest rates rose during each of the first two quarters while the reductions in market rates during 2007 did not occur until the latter part of the third quarter. Furthermore, the Corporation had a larger proportion of average interest earning assets invested in higher-yielding loans during the first nine months of 2007 relative to 2006. The positive impact of higher average market rates and the more favorable mix of interest earning assets on the net interest margin was mostly offset by a disproportionally higher increase in the average cost of funds compared to the increase in the average yield on interest-earning assets. The average cost of funds increased 27 basis points to 3.24% during the nine months ended September 30, 2007 from 2.97% during the same period in 2006. The increase in cost of funds was partly due to an increase in the relative proportion of average interest-bearing deposits, particularly higher-cost money market and time deposits, to 65.3% of total average deposits during the nine months ended September 30, 2007 from 63.6% of total average deposits during the same period in 2006.

Taxable-equivalent net interest income for the third quarter of 2007 increased $1.6 million, or 1.2%, from the second quarter of 2007. 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 2007 increased $92.2 million compared to the second quarter of 2007. Taxable-equivalent net interest income for the third quarter of 2007 included 92 days of interest accrual compared to 91 days for the second quarter of 2007. The additional day added approximately $1.5 million to taxable-equivalent net interest income during the third quarter of 2007. Excluding the impact of the additional day during the third quarter of 2007 results in an effective increase in taxable-equivalent net interest income of approximately $146 thousand compared to the second quarter of 2007. 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 three basis points from 4.72% in the second quarter of 2007 to 4.69% in the third quarter of 2007, in part due to the aforementioned decrease in market interest rates.

The average volume of loans, the Corporation's primary category of earning assets, increased $960.7 million during the first nine months of 2007 compared to the same period in 2006. The increase in the average volume of loans was due in part to the recent acquisitions. The average yield on loans was 7.86% during the first nine months of 2007 compared to 7.70% during the same period in 2006. As stated above, the Corporation had a larger proportion of average earning assets invested in loans during the first nine months of 2007 compared to the first nine months of 2006. 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 $287.0 million during the first nine months of 2007 compared to the same period in 2006. The average yield on securities was 5.22% during the first nine months of 2007 compared to 4.97% during the first nine months of 2006. Average federal funds sold and resell agreements during the first nine months of 2007 increased $2.6 million compared to the same period in 2006. The average yield on federal funds sold and resell agreements was 5.27% during the first nine months of 2007 compared to 4.98% during the first nine months of 2006.

Average deposits increased $1.1 billion during the first nine months of 2007 compared to the same period in 2006. The increase in the average volume of deposits was due in part to the recent acquisitions. Average interest-bearing deposits for the first nine months of 2007 increased $899.3 million compared to the same period in 2006. The ratio of average interest-bearing deposits to total average deposits was 65.3% for the first nine months of 2007 compared to 63.6% during the first nine months of 2006. The average cost of interest-bearing deposits and total deposits was 2.95% and 1.93% during the first nine months of 2007 compared to 2.55% and 1.62% during the first nine months of 2006. 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 higher average market interest rates combined with an increase in the relative proportion of higher-cost money market and time deposits.

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 3.71% during the first nine months of 2007 compared to 3.75% during the first nine months of 2006. 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 11 - 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 $5.8 million and $11.1 million for the three and nine months ended September 30, 2007 compared to $1.7 million and $10.8 million for the three and nine months ended September 30, 2006. 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, 2007	June 30, 2007	September 30, 2006	September 30, 2007	September 30, 2006
Trust fees	$ 17,749	$ 17,694	$ 15,962	$ 52,350	$ 47,460
Service charges on deposit accounts	20,696	20,147	19,301	59,674	57,974
Insurance commissions and fees	7,695	6,545	7,204	24,868	22,323
Other charges, commissions and fees	10,772	6,979	7,228	24,609	22,096
Net loss on securities transactions	-	-	-	-	(1)
Other	13,844	12,655	10,871	40,347	32,495
Total	$ 70,756	$ 64,020	$ 60,566	$ 201,848	$ 182,347

Total non-interest income for the three and nine months ended September 30, 2007 increased $10.2 million, or 16.8%, and $19.5 million, or 10.7%, compared to the same periods in 2006. Total non-interest income for the third quarter of 2007 increased $6.7 million, or 10.5%, compared to the second quarter of 2007. 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, 2007 increased $1.8 million, or 11.2%, and $4.9 million, or 10.3%, compared to the same periods in 2006. Investment fees are the most significant component of trust fees, making up approximately 71% and 69% of total trust fees for the first nine months of 2007 and 2006, 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 $1.8 million increase in trust fee income during the three months ended September 30, 2007 compared to the same period in 2006 was primarily the result of increases in investment fees (up $1.4 million) and real estate fees (up $254 thousand). The $4.9 million increase in trust fee income during the nine months ended September 30, 2007 compared to the same period in 2006 was primarily the result of increases in investment fees (up $4.3 million), real estate fees (up $427 thousand) and securities lending income (up $312 thousand). This increase was slightly offset by a decrease in oil and gas fees (down $238 thousand). The increases in investment fees were primarily due to higher equity valuations during the first nine months of 2007 compared to the same period in 2006 and growth in overall trust assets and the number of trust accounts.

Trust fee income for the third quarter of 2007 did not significantly fluctuate compared to the second quarter of 2007. Increases in real estate fees (up $479 thousand), oil and gas trust management fees (up $144 thousand) and investment fees (up $130 thousand), were mostly offset by a decrease in tax fees (down $749 thousand), which are seasonally higher during the second quarter.

At September 30, 2007, trust assets, including both managed assets and custody assets, were primarily composed of fixed income securities (41.2% of trust assets), equity securities (39.6% of trust assets) and cash equivalents (12.8% of trust assets). The estimated fair value of trust assets was $24.7 billion (including managed assets of $10.4 billion and custody assets of $14.3 billion) at September 30, 2007, compared to $23.2 billion (including managed assets of $9.3 billion and custody assets of $13.9 billion) at December 31, 2006 and $22.6 billion (including managed assets of $8.9 billion and custody assets of $13.7 billion) at September 30, 2006.

Service Charges on Deposit Accounts. Service charges on deposit accounts for the three and nine months ended September 30, 2007 increased $1.4 million, or 7.2%, and $1.7 million, or 2.9%, compared to the same periods in 2006. During the three months ended September 30, 2007 increases in overdraft/insufficient funds charges on consumer accounts (up $1.4 million) and commercial accounts (up $420 thousand) were partly offset by decreases in service charges on commercial accounts (down $427 thousand). During the nine months ended September 30, 2007 increases in overdraft/insufficient funds charges on consumer accounts (up $2.7 million) and commercial accounts (up $1.3 million) were partly offset by decreases in service charges on commercial accounts (down $2.4 million). 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 is the value given to deposits maintained by treasury management customers. Because average interest rates are higher compared to the first nine months of 2006, deposit balances have become more valuable and are yielding a higher earnings credit rate. 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.

Service charges on deposit accounts for the third quarter of 2007 increased $549 thousand, or 2.7%, compared to the second quarter of 2007. The increase was primarily due to an increase in overdraft/insufficient funds charges on consumer accounts (up $396 thousand), which was partly the result of normal seasonal variation.

Insurance Commissions and Fees. Insurance commissions and fees for the three and nine months ended September 30, 2007 increased $491 thousand, or 6.8%, and $2.5 million, or 11.4%, compared to the same periods in 2006. The increase for the three months ended September 30, 2007 was primarily related to higher commission income (up $494 thousand). The increase for the nine months ended September 30, 2007 was primarily related to higher commission income (up $2.0 million) and an increase in contingent commissions (up $573 thousand).

Insurance commissions and fees include contingent commissions totaling $45 thousand and $3.6 million during the three and nine months ended September 30, 2007 and $48 thousand and $3.1 million during the three and nine months ended September 30, 2006. 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 $3.3 million and $2.7 million during the nine months ended September 30, 2007 and 2006. 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 $43 thousand and $317 thousand during the three and nine months ended September 30, 2007 and $41 thousand and $348 thousand during the three and nine months ended September 30, 2006.

Insurance commissions and fees for the third quarter of 2007 increased $1.2 million, or 17.6%, compared to the second quarter of 2007. The increase was primarily related to higher commission income (up $1.3 million) due to normal variation in the timing of renewals and in the market demand for insurance products.

Other Charges, Commissions and Fees. Other charges, commissions and fees for the three and nine months ended September 30, 2007 increased $3.5 million, or 49.0%, and $2.5 million, or 11.4%, compared to the same periods in 2006. The increase during the three months ended September 30, 2007 was primarily related to an increase in investment banking fees related to corporate advisory services (up $2.4 million). These fees are transaction based and can vary significantly from quarter to quarter. Approximately $2.9 million of the total $3.7 million of investment banking fees related to corporate advisory services recognized during the third quarter of 2007 was related to a single transaction. The Corporation also recognized account management fees totaling $323 thousand related to a line of business acquired in connection with the acquisition of Summit during the fourth quarter of 2006. The increase in other charges, commissions and fees during the nine months ended September 30, 2007 was primarily related to increases in commission income related to the sale of money market accounts (up $909 thousand) and mutual funds (up $756 thousand). The Corporation also recognized account management fees totaling $939 thousand related to the aforementioned line of business acquired in connection with the acquisition of Summit. This increase was partially offset by a decrease in investment banking fees related to corporate advisory services (down $724 thousand). During the nine months ended September 30, 2006, the Corporation recognized investment banking fees related to corporate advisory services totaling $4.5 million, which was primarily related to three separate transactions.

Other charges, commissions and fees for the third quarter of 2007 increased $3.8 million, or 54.4%, compared to the second quarter of 2007. The increase was primarily due to the aforementioned investment banking fees related to corporate advisory services recognized in the third quarter.

Net Gain/Loss on Securities Transactions. The Corporation sold available-for-sale securities with an amortized cost totaling $14.4 million and $25.7 million during the nine months ended September 30, 2007 and 2006. No gain or loss was realized on the 2007 sales. The Corporation realized a net loss of $1 thousand on the 2006 sales.

Other Non-Interest Income. Other non-interest income increased $3.0 million, or 27.4%, and $7.9 million, or 24.2%, for the three and nine months ended September 30, 2007 compared to the same periods in 2006. Contributing to the increase during the three months ended September 30, 2007 were increases in sundry income from various miscellaneous items (up $1.2 million), income from securities trading and customer derivative activities (up $844 thousand), income from check card usage (up $727 thousand) and lease rental income (up $342 thousand). These increases were partly offset by a decrease in gains on the sales of student loans (down $484 thousand). Contributing to the increase during the nine months ended September 30, 2007 were increases in sundry income from various miscellaneous items (up $2.8 million), income from check card usage (up $2.2 million), lease rental income (up $1.2 million), income from securities trading and customer derivative activities (up $748 thousand) and gains on sales of assets (up $678 thousand). These increases were partly offset by a decrease in gains on the sales of student loans (down $879 thousand). Sundry income from various miscellaneous items generally includes various one-time, non-recurring items. During the first nine months of 2007 significant components of sundry income included $2.0 million in income recognized from the collection of interest and other charges on loans charged-off in prior years and $995 thousand in income recognized in connection with settlements and other recoveries.

Other non-interest income for the third quarter of 2007 increased $1.2 million, or 9.4%, compared to the second quarter of 2007. Contributing to the increase were increases in sundry income from various miscellaneous items (up $645 thousand) and income from securities trading and customer derivative activities (up $634 thousand).

Non-Interest Expense

The components of non-interest expense were as follows:

	Three Months Ended	Nine Months Ended

	September 30, 2007	June 30, 2007	September 30, 2006	September 30, 2007	September 30, 2006
Salaries and wages	$ 52,996	$ 51,203	$ 48,743	$ 155,913	$ 142,312
Employee benefits	10,727	11,997	10,882	37,150	35,492
Net occupancy	9,509	9,483	8,964	28,626	25,909
Furniture and equipment	8,793	8,230	6,553	23,951	19,212
Intangible amortization	2,184	2,188	1,293	6,698	3,957
Other	29,358	29,541	27,175	95,958	77,876
Total	$ 113,567	$ 112,642	$ 103,610	$ 348,296	$ 304,758

Total non-interest expense for the three and nine months ended September 30, 2007 increased $10.0 million, or 9.6%, and $43.5 million, or 14.3%, compared to the same periods in 2006. Total non-interest expense for the third quarter of 2007 increased $925 thousand, or 0.8%, compared to the second quarter of 2007. 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, 2007 increased $4.3 million, or 8.7%, and $13.6 million, or 9.6%, compared to the same periods in 2006. The increases were primarily related to normal, annual merit increases and increases in headcount. The increases in headcount were primarily related to the recent acquisitions during the first and fourth quarters of 2006 (see Note 2 - Mergers and Acquisitions).

Salaries and wages expense for the third quarter of 2007 increased $1.8 million, or 3.5%, compared to the second quarter of 2007. The increase was partly related to normal, annual merit increases, incentive compensation related to higher investment banking fees from corporate advisory services and commissions related to higher insurance revenues. The increase was partly offset by a decrease in management incentive compensation accruals.

Employee Benefits. Employee benefits expense for the three and nine months ended September 30, 2007 decreased $155 thousand, or 1.4%, and increased $1.7 million, or 4.7%, compared to the same periods in 2006. The decrease during the three months ended September 30, 2007 was primarily related to a decrease in certain accruals for medical expense (down $1.0 million) as a result of lower projected medical costs and a decrease in expense related to the Corporation's defined benefit retirement and restoration plans (down $216 thousand). These decreases were partially offset by increases in expenses related to the Corporation's 401(k) and profit sharing plans (up $805 thousand) and payroll taxes (up $249 thousand). The increase during the nine months ended September 30, 2007 was primarily related to increases in expenses related to the Corporation's 401(k) and profit sharing plans (up $2.2 million) and payroll taxes (up $684 thousand). These increases were partially offset by decreases in medical costs (down $568 thousand) and expenses related to the Corporation's defined benefit retirement and restoration plans (down $562 thousand).

Employee benefits expense for the third quarter of 2007 decreased $1.3 million, or 10.6%, compared to the second quarter of 2007. The decrease is primarily due to decreases in certain accruals for medical expense (down $1.2 million) as a result of lower projected medical costs and payroll taxes (down $272 thousand). These decreases were partially offset by an increase in expenses related to the Corporation's 401(k) and profit sharing plans (up $351 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, 2007 increased $545 thousand, or 6.1%, and $2.7 million, or 10.5%, compared to the same periods in 2006. The increase during the three months ended September 30, 2007 was primarily related to an increase in lease expense (up $286 thousand) and property tax expense (up $130 thousand). The increase during the nine months ended September 30, 2007 was primarily due to an increase in lease expense (up $1.1 million), service contracts expense (up $436 thousand), property tax expense (up $417 thousand) and building maintenance (up $326 thousand). The increases in various occupancy expenses were partly related to the additional facilities added in connection with recent acquisitions during the first and fourth quarters of 2006. Net occupancy expense for the third quarter of 2007 did not significantly fluctuate compared to the second quarter of 2007.

Furniture and Equipment. Furniture and equipment expense for the three and nine months ended September 30, 2007 increased $2.2 million, or 34.2%, and $4.7 million, or 24.7%, compared to the same periods in 2006. The increase during the three months ended September 30, 2007 was primarily related to increases in software maintenance expense (up $1.0 million), depreciation expense related to furniture and fixtures (up $647 thousand) and software amortization expense (up $456 thousand). The increase during the nine months ended September 30, 2007 was primarily related to increases in software maintenance expense (up $2.4 million), depreciation expense related to furniture and fixtures (up $1.3 million) and software amortization expense (up $532 thousand). The increases in various furniture and equipment expenses were partly related to the recent acquisitions during the first and fourth quarters of 2006. Additionally, the Corporation entered into software maintenance contracts in connection with new operating platforms related to retail delivery during the second quarter of 2007. Furniture and equipment expense for the third quarter of 2007 increased $563 thousand, or 6.8%, compared to the second quarter primarily due to increases in software amortization expense (up $327 thousand), software maintenance expense (up $231 thousand) and depreciation expense related to furniture and fixtures (up $172 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 $2.2 million and $6.7 million for the three and nine months ended September 30, 2007 compared to $1.3 million and $4.0 million during the same periods in 2006 and $2.2 million during the second quarter of 2007. The increases in intangible amortization in 2007 compared to 2006 were primarily due to the amortization of new intangible assets acquired in connection with recent acquisitions during the first and fourth quarters 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, 2007 increased $2.2 million, or 8.0%, and $18.1 million, or 23.2%, compared to the same periods in 2006. Significant components of the increase during the three months ended September 30, 2007 included amortization of net deferred costs related to loan commitments (up $369 thousand), advertising/promotions expense (up $348 thousand), losses on sales of assets (up $325 thousand), stationery printing and supplies expense (up $303 thousand), donations expense (up $297 thousand) and leased property depreciation (up $256 thousand). These increases were partially offset by decreases in losses on sales and write-downs of foreclosed assets (down $916 thousand) and fraud losses (down $253 thousand).

Significant components of the increase during the nine months ended September 30, 2007 included increases in sundry expense from various miscellaneous items (up $7.6 million), advertising/promotions expenses (up $2.6 million), amortization of net deferred costs related to loan commitments (up $1.6 million), professional service expense (up $1.1 million) and leased property depreciation (up $986 thousand). Included in sundry expense from various miscellaneous items was $5.3 million in expense recognized during the first quarter of 2007 related to a prepayment penalty and the write-off of the unamortized debt issuance costs incurred in connection with the redemption of $103.1 million of 8.42% junior subordinated deferrable interest debentures. Also included was $1.4 million in expense related to a contribution for previously unmatched employee contributions to the Corporation's 401(k) plan, $250 thousand in expense related to the reimbursement of certain expenses previously paid by the Corporation's defined benefit pension plan and $275 thousand in expense related to a settlement.

Total other non-interest expense for the third quarter of 2007 decreased $183 thousand, or 0.6%, compared to the second quarter of 2007. Significant components of the decrease included sundry expense from various miscellaneous items, (down $399 thousand) and fraud losses (down $378 thousand). These decreases were offset by increases in losses on sales of assets (up $339 thousand) and donations expense (up $329 thousand).

Results of Segment Operations

The Corporation's operations are managed along two operating segments: Banking and the Financial Management Group (FMG). A description of each business and the methodologies used to measure financial performance is described in Note 16 - Operating Segments in the accompanying notes to consolidated financial statements included elsewhere in this report. Net income (loss) by operating segment is presented below:

	Three Months Ended			Nine Months Ended	
	September 30, 2007	June 30, 2007	September 30, 2006	September 30, 2007	September 30, 2006
Banking	$ 51,904	$ 50,179	$ 47,109	$ 150,603	$ 138,557
Financial Management Group	7,435	6,579	6,089	19,541	16,447
Non-Banks	(2,876)	(3,129)	(3,196)	(12,773)	(9,775)
Consolidated net income	$ 56,463	$ 53,629	$ 50,002	$ 157,371	$ 145,229

Banking

Net income for the three and nine months ended September 30, 2007 increased $4.8 million, or 10.2%, and $12.0 million, or 8.7%, compared to the same periods in 2006. The increase during the three months ended September 30, 2007 was primarily the result of a $12.1 million increase in net interest income and a $7.1 million increase in non-interest income partly offset by a $9.0 million increase in non-interest expense, a $4.1 million increase in the provision for possible loan losses and a $1.5 million increase in income tax expense. The increase during the nine months ended September 30, 2007 was primarily the result of a $39.5 million increase in net interest income and an $11.1 million increase in non-interest income partly offset by a $33.4 million increase in non-interest expense and a $4.7 million increase in income tax expense.

Net interest income for the three and nine months ended September 30, 2007 increased $12.1 million, or 10.4%, and $39.5 million, or 11.5%, from the comparable periods in 2006. The increases were primarily the result of growth in the average volume of earning assets. See the analysis of net interest income included in the section captioned "Net Interest Income" included elsewhere in this discussion.

The provision for possible loan losses for the three and nine months ended September 30, 2007 totaled $5.8 million and $11.2 million compared to $1.7 million and $10.7 million for the same periods in 2006. See the analysis of the provision for possible loan losses included in the section captioned "Allowance for Possible Loan Losses" included elsewhere in this discussion.

Non-interest income for the three and nine months ended September 30, 2007 increased $7.1million, or 17.6%, and $11.1 million, or 9.0%, compared to the same periods in 2006. The increases were due to increases in other non-interest income, insurance commissions and service charges on deposits during both the three and nine months ended September 30, 2007. Additionally, during the three months ended September 30, 2007, the increase in non-interest income was also partly due to an increase in other charges, commissions and fees. See the analysis of other non-interest income, service charges on deposit accounts, insurance commissions and other charges, commissions and fees included in the section captioned "Non-Interest Income" included elsewhere in this discussion.

Non-interest expense for the three and nine months ended September 30, 2007 increased $9.0 million, or 10.4%, and $33.4 million, or 13.2%, compared to the same periods in 2006. The banking segment experienced increases in nearly all categories of non-interest expense during the comparable periods. Combined, salaries and wages and employee benefits increased $3.2 million and $12.3 million during the three and nine months ended September 30, 2007 compared to the same periods in 2006. These increases were primarily the result of normal, annual merit increases, increases in headcount, incentive compensation related to higher investment banking fees from corporate advisory services, commissions related to higher insurance revenues, increases in expenses related to the Corporation's employee benefit plans and payroll taxes. Other non-interest expense increased $2.0 million and $11.0 million during the three and nine months ended September 30, 2007 compared to the same periods in 2006. Other non-interest expense was most significantly impacted by certain non-recurring sundry charges incurred during the nine months ended September 30, 2007. Other non-interest expense during the three and nine months ended September 30, 2007 also included increases in advertising/promotions expenses, amortization of net deferred costs related to loan commitments, professional service expense and leased property depreciation, among other items. Increases in net occupancy expense were due to an increase in lease expense, service contracts expense, property tax expense and building maintenance. Increases in furniture and equipment expense were primarily due to increases in software maintenance expense, depreciation expense related to furniture and fixtures and software amortization expense. The increases in occupancy and furnitures and fixtures expense were partly related to the additional facilities added in connection with recent acquisitions during the first and fourth quarters of 2006. Increases in intangible amortization were primarily due to the amortization of new intangible assets acquired in connection with the aforementioned acquisitions. See the analysis of these items included in the section captioned "Non-Interest Expense" included elsewhere in this discussion.

Frost Insurance Agency, which is included in the Banking operating segment, had gross commission revenues of $7.7 million and $25.0 million during the three and nine months ended September 30, 2007 and $7.2 million and $22.4 million during the same periods in 2006. Insurance commission revenues increased $490 thousand, or 6.8%, and increased $3.0 million, or 11.3%, during the three months and nine months ended September 30, 2007 compared to the same period in 2006. The increases during the three and nine months ended September 30, 2007 are primarily related to higher commission income. See the analysis of insurance commissions and fees included in the section captioned "Non-Interest Income" included elsewhere in this discussion.

Financial Management Group (FMG)

Net income for the three and nine months ended September 30, 2007 increased $1.3 million and $3.1 million compared to the same periods in 2006. The increase during the three months ended September 30, 2007 was primarily due to a $3.2 million increase in non-interest income offset by a $471 thousand decrease in net interest income, a $678 thousand increase in non-interest expense and a $714 thousand increase in income tax expense. The increase during the nine months ended September 30, 2007 was primarily due to a $8.5 million increase in non-interest income partly offset by a $4.0 million increase in non-interest expense and a $1.7 million increase in income tax expense.

Net interest income for the three months ended September 30, 2007 decreased $471 thousand, or 7.5%, compared to the same period in 2006. The decrease was primarily related to a decrease in average market interest rates during the third quarter of 2007 relative to the third quarter of 2006, which impacted the funds transfer price paid on FMG's repurchase agreements. Net interest income for the nine months ended September 30, 2007 increased $141 thousand, or 0.9%, compared to the same period in 2006. The increase was primarily due to higher average market interest rates during the nine months ended September 30, 2007 relative to 2006, which impacted the funds transfer price paid on FMG's repurchase agreements.

Non-interest income for the three and nine months ended September 30, 2007 increased $3.2 million, or 16.2%, and $8.5 million, or 14.5% from the comparable periods in 2006. The increase during the three months ended September 30, 2007 was primarily due to increases in trust fees (up $1.8 million), other charges, commissions and fees (up $1.0 million) and other income (up $444 thousand). The increase during the nine months ended September 30, 2007 was primarily due to increases in trust fees (up $5.0 million), other charges, commissions and fees (up $2.8 million) and other income (up $898 thousand).

Trust fee income is the most significant income component for FMG. Investment fees are the most significant component of trust fees, making up approximately 71% and 69% of total trust fees for the first nine months of 2007 and 2006, 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. FMG experienced an increase in investment fees in the first nine months of 2007 compared to the same period in 2006 primarily due to higher equity valuations during the first nine months of 2007 compared to the same period in 2006 and growth in overall trust assets and the number of trust accounts. See the analysis of trust fees included in the section captioned "Non-Interest Income" included elsewhere in this discussion.

The increases in other charges, commissions and fees during the nine months ended September 30, 2007 compared to the same period in 2006 was primarily due to increases in commission income related to the sales of money market accounts, mutual funds and annuity products. The increase in other income during the nine months ended September 30, 2007 compared to the same period in 2006 was primarily due to increases in income from securities trading and customer derivative activities as well as other miscellaneous income.

Non-interest expense for the three and nine months ended September 30, 2007 increased $678 thousand, or 4.1%, and $4.0 million, or 8.0%, compared to the same periods in 2006. The increase during the three months ended September 30, 2007 was primarily due to an increase in salaries and wages and employee benefits (combined up $900 thousand). The increase during the nine months ended September 30, 2007 was primarily due to salaries and wages and employee benefits (combined up $3.3 million) and an increase in other non-interest expense (up $633 thousand). The increase in salaries and wages and employee benefits was primarily the result of normal, annual merit increases and increases in expenses related employee benefit plans and payroll taxes. The increase in other non-interest expense was primarily due to general increases in the various components of other non-interest expense, including cost allocations.

Non-Banks

The net loss for the Non-Banks operating segment decreased $320 thousand and increased $3.0 million for the three and nine months ended September 30, 2007 compared to the same periods in 2006. The increase during the nine months ended September 30, 2007 was primarily due to $5.3 million in expense recognized during the first quarter of 2007 related to a prepayment penalty and the write-off of the unamortized debt issuance costs incurred in connection with the redemption of $103.1 million of 8.42% junior subordinated deferrable interest debentures.

Income Taxes

The Corporation recognized income tax expense of $25.6 million and $73.1 million, for effective tax rates of 31.2% and 31.7% for the three and nine months ended September 30, 2007 compared to $23.8 million and $69.5 million, for effective tax rates of 32.2% and 32.4% for the three and nine months ended September 30, 2006. The effective income tax rates differed from the U.S. statutory rate of 35% during the comparable periods primarily due to the effect of tax-exempt income from loans, securities and life insurance policies.

Average Balance Sheet

Average assets totaled $13.0 billion for the nine months ended September 30, 2007 representing an increase of $1.6 billion, or 13.9%, compared to average assets for the same period in 2006. The increase was primarily reflected in earning assets, which increased $1.3 billion, or 12.5%, during the first nine months of 2007 compared to the first nine months of 2006. The increase was primarily due to a $960.7 million, or 14.8%, increase in average loans. Total deposits averaged $10.2 billion for the first nine months of 2007, increasing $1.1 billion, or 12.5%, compared to the same period in 2006. Average interest-bearing accounts increased from 63.6% of average total deposits in 2006 to 65.3% of average total deposits in 2007. Growth in average loans and average deposits was due in part to recent acquisitions (see Note 2 - Mergers and Acquisitions). The Corporation acquired $289.6 million of loans and $381.6 million of deposits in connection with the acquisitions of Texas Community Bancshares, Inc. and Alamo Corporation of Texas during the first quarter of 2006 and $824.5 million of loans and $973.9 million of deposits in connection with the acquisition of Summit Bancshares during the fourth quarter of 2006.

Loans

Loans were as follows as of the dates indicated:

	September 30, 2007	June 30, 2007	March 31, 2007	December 31, 2006	September 30, 2006
Commercial and industrial:					
Commercial	$ 3,234,509	$ 3,258,083	$ 3,291,148	$ 3,229,570	$ 2,852,027
Leases	182,553	181,313	175,372	174,075	165,465

Asset-based	35,879	30,636	35,708	33,856	46,387
Total commercial and industrial	3,452,941	3,470,032	3,502,228	3,437,501	3,063,879
Real estate:					
Construction:					
Commercial	580,865	643,182	659,842	649,140	607,749
Consumer	73,209	87,459	108,995	114,142	104,781
Land:					
Commercial	390,796	418,951	419,218	407,055	352,775
Consumer	3,631	3,222	4,872	5,394	4,323
Commercial mortgages	1,892,456	1,784,307	1,772,347	1,766,469	1,494,114
1-4 family residential mortgages	104,073	110,358	116,508	125,294	97,453
Home equity and other consumer	559,860	527,939	509,135	508,574	470,088
Total real estate	3,604,890	3,575,418	3,590,917	3,576,068	3,131,283
Consumer:					
Indirect	2,324	2,713	3,075	3,475	2,150
Student loans held for sale	71,100	52,113	64,748	47,335	53,428
Other	317,045	309,714	305,708	310,752	276,219
Other	41,863	30,663	22,083	27,703	19,188
Unearned discount	(29,408)	(28,493)	(29,503)	(29,450)	(29,891)
Total loans	$ 7,460,755	$ 7,412,160	$ 7,459,256	$ 7,373,384	$ 6,516,256

Loans totaled $7.5 billion at September 30, 2007, an increase of $87.4 million, or 1.2%, compared to December 31, 2006. The Corporation stopped originating mortgage and indirect consumer loans during 2000, and as such, these portfolios are excluded when analyzing the growth of the loan portfolio. Student loans are similarly excluded because the Corporation primarily originates these loans for resale. Accordingly, student loans are classified as held for sale. Excluding 1-4 family residential mortgages, the indirect lending portfolio and student loans, loans increased $86.0 million, or 1.2%, from December 31, 2006.

The majority of the Corporation's loan portfolio is comprised of commercial and industrial loans and real estate loans. Commercial and industrial loans made up 46.3% and 46.6% of total loans while real estate loans made up 48.3% and 48.5% of total loans at September 30, 2007 and December 31, 2006, respectively. Real estate loans include both commercial and consumer balances.

Commercial and industrial loans increased $15.4 million, or 0.5%, from December 31, 2006 to September 30, 2007. The Corporation's commercial and industrial loans are a diverse group of loans to small, medium and large businesses. The purpose of these loans varies from supporting seasonal working capital needs to term financing of equipment. While some short-term loans may be made on an unsecured basis, most are secured by the assets being financed with collateral margins that are consistent with the Corporation's loan policy guidelines. The commercial and industrial loan portfolio also includes the commercial lease and asset-based lending portfolios.

Purchased shared national credits ("SNC"s) are participations purchased from upstream financial organizations and tend to be larger in size than the Corporation's originated portfolio. The Corporation's purchased SNC portfolio totaled $362.7 million at September 30, 2007, increasing $2.6 million, or 0.7%, from $360.1 million at December 31, 2006. At September 30, 2007, 62.3% of outstanding purchased SNCs was related to the energy industry. The remaining purchased SNCs were diversified throughout various other industries, with no other single industry exceeding more than 10% of the total purchased SNC portfolio. Additionally, almost all of the outstanding balance of purchased SNCs was included in the commercial and industrial portfolio, with the remainder included in the commercial real estate category. SNC participations are originated in the normal course of business to meet the needs of the Corporation's customers. As a matter of policy, the Corporation generally only participates in SNCs for companies headquartered in or which have significant operations within the Corporation's market areas. In addition, the Corporation must have direct access to the company's management, an existing banking relationship or the expectation of broadening the relationship with other banking products and services within the following 12 to 24 months. SNCs are reviewed at least quarterly for credit quality and business development successes.

Real estate loans totaled $3.6 billion at September 30, 2007 increasing $28.8 million, or 0.8%, from December 31, 2006. Real estate loans include both commercial and consumer balances. Excluding 1-4 family residential mortgage loans, which are discussed below, total real estate loans increased $50.0 million, or 1.5%, from December 31, 2006. Commercial real estate loans totaled $2.9 billion at September 30, 2007 and represented 79.5% of total real estate loans. The majority of this portfolio consists of commercial real estate mortgages, which includes both permanent and intermediate term loans. The Corporation's primary focus for its commercial real estate portfolio has been growth in loans secured by owner-occupied properties. These loans are viewed primarily as cash flow loans and secondarily as loans secured by real estate. Consequently, these loans must undergo the analysis and underwriting process of a commercial and industrial loan, as well as that of a real estate loan. At September 30, 2007, approximately 60% of the outstanding principal balance of the Corporation's commercial real estate loans was secured by owner-occupied properties.

The consumer loan portfolio, including all consumer real estate, increased $16.3 million, or 1.5%, from December 31, 2006. Excluding 1-4 family residential mortgages, indirect loans and student loans, total consumer loans increased $14.9 million, or 1.6%, from December 31, 2006.

As the following table illustrates as of the dates indicated, the consumer loan portfolio has five distinct segments, including consumer real estate, consumer non-real estate, student loans held for sale, indirect consumer loans and 1-4 family residential mortgages.

	September 30, 2007	June 30, 2007	March 31, 2007	December 31, 2006	September 30, 2006
Consumer real estate:					
Construction	$ 73,209	$ 87,459	$ 108,995	$ 114,142	$ 104,781
Land	3,631	3,222	4,872	5,394	4,323

Home equity loans	272,428	253,528	243,113	241,680	227,579
Home equity lines of credit	88,223	85,887	86,183	87,103	75,087
Other consumer real estate	199,209	188,524	179,839	179,791	167,422
Total real estate	636,700	618,620	623,002	628,110	579,192
Consumer non-real estate	317,045	309,714	305,708	310,752	276,219
Student loans held for sale	71,100	52,113	64,748	47,335	53,428
Indirect	2,324	2,713	3,075	3,475	2,150
1-4 family residential mortgages	104,073	110,358	116,508	125,294	97,453
Total	$1,131,242	$1,093,518	$1,113,041	$1,114,966	$1,008,442

The consumer non-real estate loan portfolio primarily consists of automobile loans, unsecured revolving credit products, personal loans secured by cash and cash equivalents and other similar types of credit facilities. The Corporation also discontinued originating 1-4 family residential mortgage loans and indirect consumer loans in 2000.

Non-Performing Assets

Non-performing assets and accruing past due loans are presented in the table below. The Corporation did not have any restructured loans as of the dates presented.

	September 30, 2007	June 30, 2007	March 31, 2007	December 31, 2006	September 30, 2006
Non-accrual loans:					
Commercial and industrial	$ 12,937	$14,727	$17,058	$20,813	$22,864
Real estate	7,273	29,103	28,197	29,580	5,722
Consumer and other	1,146	1,673	1,514	1,811	1,459
Total non-accrual loans	21,356	45,503	46,769	52,204	30,045
Foreclosed assets:					
Real estate	4,278	3,630	3,120	5,500	4,940
Other	745	592	595	45	31
Total foreclosed assets	5,023	4,222	3,715	5,545	4,971
Total non-performing assets	$ 26,379	$49,725	$50,484	$57,749	$35,016
Non-performing assets as a percentage of:					
Total loans and foreclosed assets	0.35 %	0.67 %	0.68 %	0.78 %	0.54 %

Total assets	0.20	0.38	0.38	0.44	0.30
Accruing past due loans:					
30 to 89 days past due	$ 54,747	$ 60,324	$ 51,734	$ 56,836	$ 46,759
90 or more days past due	10,940	12,561	9,050	10,917	7,906
Total accruing loans past due	$ 65,687	$ 72,885	$ 60,784	$ 67,753	$ 54,665
Accruing past due loans as a percentage of total loans:					
30 to 89 days past due	0.73 %	0.81 %	0.69 %	0.77 %	0.72 %
90 or more days past due	0.15	0.17	0.12	0.15	0.12
	0.88 %	0.98 %	0.81 %	0.92 %	0.84 %

Non-performing assets include non-accrual loans and foreclosed assets. Generally, loans are placed on non-accrual status if principal or interest payments become 90 days past due and/or management deems the collectibility of the principal and/or interest to be in question, as well as when required by regulatory requirements. Once interest accruals are discontinued, accrued but uncollected interest is charged to current year operations. Subsequent receipts on non-accrual loans are recorded as a reduction of principal, and interest income is recorded only after principal recovery is reasonably assured. The decrease in non-accrual loans during the third quarter of 2007 was primarily related to a single credit relationship totaling $23.1 million. The properties securing this credit relationship were sold at auction during the third quarter. Due to the shortfall in the proceeds from the sale of the properties, the Corporation recognized charge-offs totaling $6.3 million, as further discussed below in the section captioned "Allowance For Possible Loan Losses."

Foreclosed assets represent property acquired as the result of borrower defaults on loans. Foreclosed assets are recorded at estimated fair value, less estimated selling costs, at the time of foreclosure. Write-downs occurring at foreclosure are charged against the allowance for possible loan losses. On an ongoing basis, properties are appraised as required by market indications and applicable regulations. Write-downs are provided for subsequent declines in value and are included in other non-interest expense along with other expenses related to maintaining the properties.

Potential problem loans consist of loans that are performing in accordance with contractual terms but for which management has concerns about the ability of an obligor to continue to comply with repayment terms because of the obligor's potential operating or financial difficulties. Management monitors these loans closely and reviews their performance on a regular basis. At September 30, 2007 and December 31, 2006, the Corporation had $14.0 million and $12.7 million in loans of this type that were not included in either of the non-accrual or 90 days past due loan categories. At September 30, 2007, potential problem loans consisted of seven credit relationships. Of the total outstanding balance at September 30, 2007, approximately 52.6% related to a customer in the insurance industry, approximately 15.4% related to a customer that operates as a retailer of musical instruments and approximately 13.1% related to a customer in the funeral services industry. Weakness in these companies' operating performance has caused the Corporation to heighten the attention given to these credits.

The after-tax impact (assuming a 35% marginal tax rate) of lost interest from non-performing loans was approximately $537 thousand and $2.0 million for the three and nine months ended September 30, 2007, compared to $541 thousand and $1.6 million for the same periods in 2006.

Allowance for Possible Loan Losses

Activity in the allowance for possible loan losses is presented in the following table.

	Three Months Ended			Nine Months Ended	
	September 30, 2007	June 30, 2007	September 30, 2006	September 30, 2007	September 30, 2006
Balance at beginning of period	$ 96,071	$ 96,144	$ 85,552	$ 96,085	$ 80,325
Provision for possible loan losses	5,784	2,650	1,711	11,084	10,750
Allowance for possible loan losses acquired	-	-	-		2,373
Charge-offs:					
Commercial and industrial	(2,124)	(2,233)	(1,781)	(5,604)	(8,652)
Real estate	(7,535)	(233)	(14)	(8,696)	(308)
Consumer and other	(2,080)	(1,672)	(1,642)	(5,577)	(4,838)
Total charge-offs	(11,739)	(4,138)	(3,437)	(19,877)	(13,798)
Recoveries:					
Commercial and industrial	966	383	715	1,666	2,299
Real estate	120	40	16	250	442
Consumer and other	1,061	992	1,110	3,055	3,276
Total recoveries	2,147	1,415	1,841	4,971	6,017
Net charge-offs	(9,592)	(2,723)	(1,596)	(14,906)	(7,781)
Balance at end of period	$ 92,263	$ 96,071	$ 85,667	$ 92,263	$ 85,667
Ratio of allowance for possible loan losses to:					
Total loans	1.24 %	1.30 %	1.31 %	1.24 %	1.31 %
Non-accrual loans	432.02	211.13	285.14	432.02	285.14

Ratio of annualized net charge-offs to average total loans	0.51	0.15	0.10	0.27	0.16

The allowance for possible loan losses is maintained at a level considered appropriate by management, based on estimated probable losses within the existing loan portfolio. The Corporation's allowance for possible loan loss methodology is based on guidance provided in SEC Staff Accounting Bulletin No. 102, "Selected Loan Loss Allowance Methodology and Documentation Issues," and includes allowance allocations calculated in accordance with SFAS No. 114, "Accounting by Creditors for Impairment of a Loan," as amended by SFAS 118, and allowance allocations calculated in accordance with SFAS No. 5, "Accounting for Contingencies." Accordingly, the methodology is based on historical loss experience by type of credit and internal risk grade, specific homogeneous risk pools, and specific loss allocations, with adjustments for current events and conditions. The Corporation's process for the determination of the appropriate level of the allowance for possible loan losses is designed to account for credit deterioration as it occurs. The provision for possible loan losses reflects loan quality trends, including the levels of and trends related to non-accrual loans, past due loans, potential problem loans, criticized loans and net charge-offs or recoveries, among other factors. The provision for possible loan losses also reflects the totality of actions taken on all loans for a particular period. In other words, the amount of the provision reflects not only the necessary increases in the allowance for possible loan losses related to newly identified criticized loans, but it also reflects actions taken related to other loans including, among other things, any necessary increases or decreases in required allowances for specific loans or loan pools.

The provision for possible loan losses totaled $5.8 million and $11.1 million for the three and nine months ended September 30, 2007, compared to $1.7 million and $10.8 million for the three and nine months ended September 30, 2006. The increase in the provision for possible loan losses for the three and nine months ended September 30, 2007 was primarily due to an increase in net charge-offs as well growth in the loan portfolio. During the third quarter of 2007, the Corporation recognized charge-offs totaling $6.3 million related to a single credit relationship. At the time of the charge-off, the Corporation had a specific valuation allowance totaling $3.8 million allocated to this credit relationship. This valuation allowance was accumulated through prior provisions as the credit relationship deteriorated and moved through the Corporation's problem loan classification and reporting process. The amount by which charge-offs related to this credit relationship exceeded the specific valuation allocated to this credit relationship was recognized as additional provision during the third quarter of 2007. The ratio of the allowance for possible loan losses to total loans at September 30, 2007 decreased six basis points from December 31, 2006 in part because net charge-offs exceeded the provision for possible loan losses by $3.8 million. Despite the decline in this ratio, management believes the level of the allowance for possible loan losses continues to remain adequate. Should any of the factors considered by management in evaluating the adequacy of the allowance for possible loan losses change, the Corporation's estimate of probable loan losses could also change, which could affect the level of future provisions for possible loan losses.

Capital and Liquidity

Capital. At September 30, 2007, shareholders' equity totaled $1.4 billion compared to $1.4 billion at December 31, 2006 and $1.1 billion at September 30, 2006. In addition to net income of $157.4 million, other significant changes in shareholders' equity during the first nine months of 2007 included $109.4 million in treasury stock purchases, $67.4 million of dividends paid, $18.5 million in proceeds from stock option exercises and the related tax benefits of $6.4 million and $7.5 million related to stock-based compensation. The accumulated other comprehensive loss component of shareholders' equity totaled $58.0 million at September 30, 2007 compared to $54.9 million at December 31, 2006. This fluctuation was primarily related to the after-tax effect of changes in the unrealized gain/loss on securities available for sale. Under regulatory requirements, amounts reported as accumulated other comprehensive income/loss related to the net unrealized gain or loss on securities available for sale and the funded status of the Corporation's defined benefit post-retirement benefit plans do not increase or reduce regulatory capital and are not included in the calculation of risk-based capital and leverage ratios. Regulatory agencies for banks and bank holding companies utilize capital guidelines designed to measure Tier 1 and total capital and take into consideration the risk inherent in both on-balance sheet and off-balance sheet items. See Note 10 - Regulatory Matters and Shareholders' Equity in the accompanying notes to consolidated financial statements included elsewhere in this report.

The Corporation paid quarterly dividends of $0.34, $0.40 and $0.40 per common share during the first, second and third quarters of 2007 and quarterly dividends of $0.30, $0.34 and $0.34 per common share during the first, second and third quarters of 2006. This equates to a dividend payout ratio of 41.4% and 42.8% during the three and nine months ended September 30, 2007 and 37.9% and 37.4% during the three and nine months ended September 30, 2006.

The Corporation has maintained several stock repurchase plans authorized by the Corporation's board of directors. In general, stock repurchase plans allow the Corporation to proactively manage its capital position and return excess capital to shareholders. Shares purchased under such plans also provide the Corporation with shares of common stock necessary to satisfy obligations related to stock compensation awards. Under the current plan, which was approved on April 26, 2007, the Corporation was authorized to repurchase up to 2.5 million shares of its common stock from time to time over a two-year period in the open market or through private transactions. Under the plan, the Corporation repurchased 1.2 million shares at a total cost of $65.6 million during the second quarter of 2007 and 854 thousand shares at a total cost of $43.8 million during the third quarter of 2007. No shares were repurchased under stock repurchase plans during 2006. Also see Part II, Item 2 - Unregistered Sales of Equity Securities and Use of Proceeds, included elsewhere in this report.

Liquidity. Liquidity measures the ability to meet current and future cash flow needs as they become due. The liquidity of a financial institution reflects its ability to meet loan requests, to accommodate possible outflows in deposits and to take advantage of interest rate market opportunities. The ability of a financial institution to meet its current financial obligations is a function of its balance sheet structure, its ability to liquidate assets, and its access to alternative sources of funds. The Corporation seeks to ensure its funding needs are met by maintaining a level of liquid funds through asset/liability management.

Asset liquidity is provided by liquid assets which are readily marketable or pledgeable or which will mature in the near future. Liquid assets include cash, interest-bearing deposits in banks, securities available for sale, maturities and cash flow from securities held to maturity, and federal funds sold and resell agreements.

Liability liquidity is provided by access to funding sources which include core deposits and correspondent banks in the Corporation's natural trade area that maintain accounts with and sell federal funds to Frost Bank, as well as federal funds purchased and repurchase agreements from upstream banks.

Since Cullen/Frost is a holding company and does not conduct operations, its primary sources of liquidity are dividends upstreamed from Frost Bank and borrowings from outside sources. Banking regulations require the maintenance of certain capital and net income levels that may limit the amount of dividends that may be paid by the Corporation's bank subsidiary. Approval by regulatory authorities is required if the effect of dividends declared would cause the regulatory capital of the Corporation's bank subsidiary to fall below specified minimum levels. Approval is also needed if dividends declared exceed the net profits for that year combined with the retained net profits for the two preceding years. These limitations do not currently prevent the Corporation's bank subsidiary from paying normal dividends to Cullen/Frost. At September 30, 2007, Cullen/Frost had liquid assets, including cash and securities purchased under resell agreements, totaling $48.3 million. Cullen/Frost also had outside funding sources available, including a $25.0 million short-term line of credit with another financial institution. The line of credit matures annually and bears interest at a fixed LIBOR-based rate or floats with the prime rate. There were no borrowings outstanding on this line of credit at September 30, 2007.

The liquidity position of the Corporation is continuously monitored and adjustments are made to the balance between sources and uses of funds as deemed appropriate. Management is not aware of any events that are reasonably likely to have a material adverse effect on the Corporation's liquidity, capital resources or operations. In addition, management is not aware of any regulatory recommendations regarding liquidity, which if implemented, would have a material adverse effect on the Corporation.

The Corporation's operating objectives include expansion, diversification within its markets, growth of its fee-based income, and growth internally and through acquisitions of financial institutions, branches and financial services businesses. The Corporation seeks merger or acquisition partners that are culturally similar and have experienced management and possess either significant market presence or have potential for improved profitability through financial management, economies of scale and expanded services. The Corporation regularly evaluates merger and acquisition opportunities and conducts due diligence activities related to possible transactions with other financial institutions and financial services companies. As a result, merger or acquisition discussions and, in some cases, negotiations may take place and future mergers or acquisitions involving cash, debt or equity securities may occur. Acquisitions typically involve the payment of a premium over book and market values, and, therefore, some dilution of the Corporation's tangible book value and net income per common share may occur in connection with any future transaction.

On February 15, 2007, the Corporation issued $100 million of 5.75% fixed-to-floating rate subordinated notes. The proceeds of the notes were used to partly fund the redemption of $103.1 million of 8.42% junior subordinated deferrable interest debentures, held of record by Cullen/Frost Capital Trust I. As a result of the redemption, the Corporation incurred $5.3 million in expense during the first quarter of 2007 related to a prepayment penalty and the write-off of the unamortized debt issuance costs. Concurrently, the $100 million of 8.42% trust preferred securities issued by Cullen/Frost Capital Trust I were also redeemed. See Note 9 - Borrowed Funds in the accompanying notes to consolidated financial statements included elsewhere in this report for additional information.

Recently Issued Accounting Pronouncements

See Note 17- New Accounting Standards in the accompanying notes to consolidated financial statements included elsewhere in this report for details of recently issued accounting pronouncements and their expected impact on the Corporation's financial statements.

Consolidated Average Balance Sheets and Interest Income Analysis - Year-to-Date

(dollars in thousands - taxable-equivalent basis)	September 30, 2007			September 30, 2006		
	Average Balance	Interest Income/ Expense	Yield/ Cost	Average Balance	Interest Income/ Expense	Yield/ Cost
Assets:						
Interest-bearing deposits	$ 6,935	$ 272	5.25 %	$ 4,332	$ 153	4.73 %

Federal funds sold and resell agreements	647,525	25,529	5.27	644,915	24,027	4.98
Securities:						
Taxable	2,845,939	110,271	5.06	2,668,654	99,159	4.83
Tax-exempt	380,192	18,366	6.41	270,444	13,037	6.46
Total securities	3,226,131	128,637	5.22	2,939,098	112,196	4.97
Loans, net of unearned discounts	7,431,707	436,988	7.86	6,471,045	372,794	7.70
Total Earning Assets and Average Rate Earned	11,312,298	591,426	6.95	10,059,390	509,170	6.72
Cash and due from banks	612,942			618,172		
Allowance for possible loan losses	(96,261)			(83,891)		
Premises and equipment	220,150			197,342		
Accrued interest and other assets	951,851			625,276		
Total Assets	$ 13,000,980			$ 11,416,289		
Liabilities:						
Non-interest-bearing demand deposits:						
Commercial and individual	$ 3,244,814			$ 2,967,300		
Correspondent banks	241,767			287,456		
Public funds	51,406			49,763		
Total non-interest-bearing demand deposits	3,537,987			3,304,519		
Interest-bearing deposits:						
Private accounts						
Savings and interest checking	1,358,534	5,099	0.50	1,280,416	3,350	0.35
Money market deposit accounts	3,508,423	83,964	3.20	2,959,019	65,374	2.95
Time accounts	1,370,162	44,706	4.36	1,091,983	29,632	3.63
Public funds	425,629	13,128	4.12	432,073	11,603	3.59
Total interest-bearing deposits	6,662,748	146,897	2.95	5,763,491	109,959	2.55
Total deposits	10,200,735			9,068,010		
Federal funds purchased and repurchase agreements	849,814	24,453	3.85	757,106	23,008	4.06
Junior subordinated deferrable interest debentures	158,436	8,740	7.36	229,230	12,845	7.47
Subordinated notes payable and other notes	233,516	11,511	6.57	150,000	7,380	6.56
Federal Home Loan Bank advances	26,243	899	4.58	25,715	859	4.46
Total Interest-Bearing Funds and Average						

Rate Paid	7,930,757	192,500	3.24	6,925,542	154,051	2.97
Accrued interest and other liabilities	148,803			153,920		
Total Liabilities	11,617,547			10,383,981		
Shareholders' Equity	1,383,433			1,032,308		
Total Liabilities and Shareholders' Equity	$ 13,000,980			$ 11,416,289		
Net interest income		$ 398,926			$ 355,119	
Net interest spread			3.71 %			3.75 %
Net interest income to total average earning assets			4.69 %			4.68 %

For these computations: (i) average balances are presented on a daily average basis, (ii) information is shown on a taxable-equivalent basis assuming a 35% tax rate, (iii) average loans include loans on non-accrual status, and (iv) average securities include unrealized gains and losses on securities available for sale while yields are based on average amortized cost.

Consolidated Average Balance Sheets and Interest Income Analysis-By-Quarter

(dollars in thousands - taxable-equivalent basis)	September 30, 2007			June 30, 2007		
	Average Balance	Interest Income/ Expense	Yield/ Cost	Average Balance	Interest Income/ Expense	Yield/ Cost
Assets:						
Interest-bearing deposits	$ 8,749	$ 99	4.49 %	$ 7,911	$ 106	5.37 %
Federal funds sold and resell agreements	713,418	9,288	5.17	498,193	6,623	5.33
Securities:						
Taxable	2,733,002	35,675	5.08	2,918,801	37,767	5.09
Tax-exempt	449,162	7,312	6.42	367,684	5,896	6.41
Total securities	3,182,164	42,987	5.26	3,286,485	43,663	5.24
Loans, net of unearned discounts	7,435,690	146,580	7.82	7,455,208	146,204	7.87
Total Earning Assets and Average Rate Earned	11,340,021	198,954	6.92	11,247,797	196,596	6.98
Cash and due from banks	602,798			595,943		
Allowance for possible loan losses	(95,992)			(96,613)		
Premises and equipment	220,926			219,288		
Accrued interest and other assets	957,770			956,338		

Total Assets	$ 13,025,523			$ 12,922,753		
Liabilities:						
Non-interest-bearing demand deposits:						
Commercial and individual	$ 3,269,084			$ 3,226,530		
Correspondent banks	247,372			230,383		
Public funds	50,614			48,271		
Total non-interest-bearing demand deposits	3,567,070			3,505,184		
Interest-bearing deposits:						
Private accounts						
Savings and interest checking	1,325,966	1,776	0.53	1,365,463	1,896	0.56
Money market deposit accounts	3,630,638	29,072	3.18	3,449,291	27,305	3.18
Time accounts	1,363,571	15,023	4.37	1,344,221	14,582	4.35
Public funds	364,681	3,570	3.88	433,652	4,587	4.24
Total interest-bearing deposits	6,684,856	49,441	2.93	6,592,627	48,370	2.94
Total deposits	10,251,926			10,097,811		
Federal funds purchased and repurchase agreements	852,338	7,981	3.71	859,511	8,251	3.85
Junior subordinated deferrable interest debentures	139,177	2,548	7.32	139,177	2,499	7.18
Subordinated notes payable and other notes	250,000	4,079	6.53	250,000	4,080	6.53
Federal Home Loan Bank advances	16,467	201	4.84	26,299	301	4.59
Total Interest-Bearing Funds and Average Rate Paid	7,942,838	64,250	3.21	7,867,614	63,501	3.24
Accrued interest and other liabilities	152,953			153,522		
Total Liabilities	11,662,861			11,526,320		
Shareholders' Equity	1,362,662			1,396,433		
Total Liabilities and Shareholders' Equity	$ 13,025,523			$ 12,922,753		
Net interest income		$ 134,704			$ 133,095	
Net interest spread			3.71 %			3.74 %
Net interest income to total average earning assets			4.69 %			4.72 %

For these computations: (i) average balances are presented on a daily average basis, (ii) information is shown on a taxable-equivalent basis assuming a 35% tax rate, (iii) average loans include loans on non-accrual status, and (iv) average securities include unrealized gains and losses on securities available for sale while yields are based on average amortized cost.

Consolidated Average Balance Sheets and Interest Income Analysis-By-Quarter

(dollars in thousands - taxable-equivalent basis)	March 31, 2007			December 31, 2006		
	Average Balance	Interest Income/ Expense	Yield/ Cost	Average Balance	Interest Income/ Expense	Yield/ Cost
Assets:						
Interest-bearing deposits	$ 4,093	$ 67	6.65 %	$ 3,016	$ 98	12.90 %
Federal funds sold and resell agreements	731,158	9,618	5.33	938,643	12,523	5.29
Securities:						
Taxable	2,887,714	36,829	5.01	2,716,469	34,025	4.93
Tax-exempt	322,337	5,158	6.43	290,180	4,647	6.48
Total securities	3,210,051	41,987	5.15	3,006,649	38,672	5.08
Loans, net of unearned discounts	7,403,874	144,204	7.90	6,680,754	133,469	7.93
Total Earning Assets and Average Rate Earned	11,349,176	195,876	6.95	10,629,062	184,762	6.88
Cash and due from banks	640,498			608,002		
Allowance for possible loan losses	(96,164)			(88,441)		
Premises and equipment	220,228			207,917		
Accrued interest and other assets	944,167			714,180		
Total Assets	$ 13,057,905			$ 12,070,720		
Liabilities:						
Non-interest-bearing demand deposits:						
Commercial and individual	$ 3,238,492			$ 3,120,087		
Correspondent banks	247,549			247,287		
Public funds	55,386			55,214		
Total non-interest-bearing demand deposits	3,541,427			3,422,588		
Interest-bearing deposits:						
Private accounts						
Savings and interest checking	1,384,819	1,427	0.42	1,293,963	1,229	0.38
	3,443,281	27,587	3.25	3,212,325	26,700	3.30

Money market deposit accounts						
Time accounts	1,403,127	15,101	4.36	1,214,957	13,175	4.30
Public funds	479,820	4,971	4.20	385,924	4,027	4.14
Total interest-bearing deposits	6,711,047	49,086	2.97	6,107,169	45,131	2.93
Total deposits	10,252,474			9,529,757		
Federal funds purchased and repurchase agreements	837,430	8,221	3.98	785,144	8,159	4.12
Junior subordinated deferrable interest debentures	197,596	3,693	7.48	232,991	4,557	7.82
Subordinated notes payable and other notes	200,000	3,352	6.70	150,000	2,611	6.96
Federal Home Loan Bank advances	36,181	397	4.45	25,155	287	4.53
Total Interest-Bearing Funds and Average Rate Paid	7,982,254	64,749	3.28	7,300,459	60,745	3.30
Accrued interest and other liabilities	142,692			151,554		
Total Liabilities	11,666,373			10,874,601		
Shareholders' Equity	1,391,532			1,196,119		
Total Liabilities and Shareholders' Equity	$ 13,057,905			$ 12,070,720		
Net interest income		$ 131,127			$ 124,017	
Net interest spread			3.67 %			3.58 %
Net interest income to total average earning assets			4.65 %			4.62 %

For these computations: (i) average balances are presented on a daily average basis, (ii) information is shown on a taxable-equivalent basis assuming a 35% tax rate, (iii) average loans include loans on non-accrual status, and (iv) average securities include unrealized gains and losses on securities available for sale while yields are based on average amortized cost.

Consolidated Average Balance Sheets and Interest Income Analysis-By-Quarter

(dollars in thousands - taxable-equivalent basis)

	September 30, 2006		
	Average Balance	Interest Income/ Expense	Yield/ Cost
Assets:			

Interest-bearing deposits	$ 4,680	$ 61	5.17 %
Federal funds sold and resell agreements	755,366	10,114	5.31
Securities:			
Taxable	2,581,825	32,404	4.86
Tax-exempt	274,018	4,411	6.46
Total securities	2,855,843	36,815	5.01
Loans, net of unearned discounts	6,564,689	131,984	7.98
Total Earning Assets and Average Rate Earned	10,180,578	178,974	6.93
Cash and due from banks	580,673		
Allowance for possible loan losses	(85,941)		
Premises and equipment	202,770		
Accrued interest and other assets	644,020		
Total Assets	$ 11,522,100		
Liabilities:			
Non-interest-bearing demand deposits:			
Commercial and individual	$ 3,021,123		
Correspondent banks	239,895		
Public funds	47,878		
Total non-interest-bearing demand deposits	3,308,896		
Interest-bearing deposits:			
Private accounts			
Savings and interest checking	1,260,385	1,136	0.36
Money market deposit accounts	3,044,314	25,612	3.34
Time accounts	1,137,698	11,579	4.04
Public funds	386,750	3,950	4.05
Total interest-bearing deposits	5,829,147	42,277	2.88
Total deposits	9,138,043		
Federal funds purchased and repurchase agreements	764,857	8,353	4.33
Junior subordinated deferrable interest debentures	229,898	4,439	7.72
Subordinated notes payable and other notes	150,000	2,558	6.82
Federal Home Loan Bank advances	22,187	254	4.54
Total Interest-Bearing Funds and Average Rate Paid	6,996,089	57,881	3.29
Accrued interest and other liabilities	148,443		

Total Liabilities	10,453,428		
Shareholders' Equity	1,068,672		
Total Liabilities and Shareholders' Equity	$ 11,522,100		
Net interest income		$ 121,093	
Net interest spread			3.64 %
Net interest income to total average earning assets			4.69 %

For these computations: (i) average balances are presented on a daily average basis, (ii) information is shown on a taxable-equivalent basis assuming a 35% tax rate, (iii) average loans include loans on non-accrual status, and (iv) average securities include unrealized gains and losses on securities available for sale while yields are based on average amortized cost.

Item 3. Quantitative and Qualitative Disclosures About Market Risks

The disclosures set forth in this item are qualified by the section captioned "Forward-Looking Statements and Factors that Could Affect Future Results" included in Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations of this report and other cautionary statements set forth elsewhere in this report.

Refer to the discussion of market risks included in Item 7A. Quantitative and Qualitative Disclosures About Market Risks in the 2006 Form 10-K. There has been no significant change in the types of market risks faced by the Corporation since December 31, 2006.

The Corporation utilizes an earnings simulation model as the primary quantitative tool in measuring the amount of interest rate risk associated with changing market rates. The model quantifies the effects of various interest rate scenarios on projected net interest income and net income over the next 12 months. The model was used to measure the impact on net interest income relative to a base case scenario of rates increasing 100 and 200 basis points or decreasing 100 and 200 basis points over the next 12 months. These simulations incorporate assumptions regarding balance sheet growth and mix, pricing and the repricing and maturity characteristics of the existing and projected balance sheet. The impact of interest rate derivatives, such as interest rate swaps, caps and floors, is also included in the model. Other interest rate-related risks such as prepayment, basis and option risk are also considered.

As of September 30, 2007, the model simulations projected that 100 and 200 basis point increases in interest rates would result in positive variances in net interest income of 1.1% and 1.6%, respectively, relative to the base case over the next 12 months, while decreases in interest rates of 100 and 200 basis points would result in negative variances in net interest income of 1.7% and 3.9%, respectively, relative to the base case over the next 12 months. As of September 30, 2006, the model simulations projected that 100 and 200 basis point increases in interest rates would result in positive variances in net interest income of 2.0% and 3.3%, respectively, relative to the base case over the next 12 months, while decreases in interest rates of 100 and 200 basis points would result in negative variances in net interest income of 2.1% and 4.7%, respectively, relative to the base case over the next 12 months.

The impact of hypothetical fluctuations in interest rates on the Corporation's derivative holdings was not a significant portion of these variances in any of the reported periods. As of September 30, 2007, the effect of a 200 basis point increase in interest rates on the Corporation's derivative holdings would result in a 0.2% positive variance in net interest income. The effect of a 200 basis point decrease in interest rates on the Corporation's derivative holdings would result in a 0.2% negative variance in net interest income.

The effects of hypothetical fluctuations in interest rates on the Corporation's securities classified as "trading" under SFAS 115, "Accounting for Certain Investments in Debt and Equity Securities," are not significant, and, as such, separate quantitative disclosure is not presented.

As discussed in Note 18 - Subsequent Event in the accompanying notes to consolidated financial statements included elsewhere in this report, on October 23, 2007, the Corporation entered into three interest rate swap contracts with a total notional amount of $1.2 billion. The interest rate swap contracts were designated as hedging instruments in cash flow hedges with the objective of protecting the overall cash flows from the Corporation's monthly interest receipts on a rolling portfolio of $1.2 billion of variable-rate loans outstanding throughout the 84-month period beginning on October 25, 2007 and ending on October 25, 2014 from the risk of variability of those cash flows such that the yield on the underlying loans would remain constant at 7.559% to 8.559%, depending upon the applicable floor contract. In conjunction with entering into the interest rate swap contracts, the Corporation terminated its three interest rate floor contracts, which had a total notional amount of $1.3 billion.

In light of the new interest swap contracts and the termination of the interest rate floor contracts, the Corporation updated the model simulations as of September 30, 2007 to reflect the impact of these events. The revised model simulations projected that a 100 point increase in interest rates would result in a negative variance in net interest income of 0.1% and a 200 basis point increase would result in a positive variance in net interest income of 0.3%, relative to the base case over the next 12 months, while decreases in interest rates of 100 and 200 basis points would result in negative variances in net interest income of 0.5% and 1.7%, respectively, relative to the base case over the next 12 months. The effect of a 200 basis point increase in interest rates on the Corporation's derivative holdings would result in a 2.0% negative variance in net interest income. The effect of a 200 basis point decrease in interest rates on the Corporation's derivative holdings would result in a 2.0% positive variance in net interest income.

Item 4. Controls and Procedures

As of the end of the period covered by this Quarterly Report on Form 10-Q, an evaluation was carried out by the Corporation's management, with the participation of its Chief Executive Officer and Chief Financial Officer, of the effectiveness of the Corporation's disclosure controls and procedures (as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934). Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the disclosure controls and procedures were effective as of the end of the period covered by this report. No change in the Corporation's internal control over financial reporting (as defined in Rule 13a-15(f) under the Securities Exchange Act of 1934) occurred during the last fiscal quarter that materially affected, or is reasonably likely to materially affect, the Corporation's internal control over financial reporting.

Part II. Other Information

Item 1. Legal Proceedings

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.

Item 1A. Risk Factors

There has been no material change in the risk factors previously disclosed under Item 1A. of the Corporation's 2006 Form 10-K.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

The following table provides information with respect to purchases made by or on behalf of the Corporation or any "affiliated purchaser" (as defined in Rule 10b-18(a)(3) under the Securities Exchange Act of 1934), of the Corporation's common stock during the three months ended September 30, 2007.

Period	Total Number of Shares Purchased	Average Price Paid Per Share	Total Number of Shares Purchased as Part of Publicly Announced Plan (1)	Maximum Number of Shares That May Yet Be Purchased Under the Plan at the End of the Period
July 1, 2007 to July 31, 2007	-	$ -	-	1,258,190
August 1, 2007 to August 31, 2007	854,426	51.26	854,426	403,764
September 1, 2007 to September 30, 2007	-	-	-	403,764
Total	854,426	$ 51.26	854,426	

(1) The Corporation maintains a stock repurchase plan that was authorized by the Corporation's board of directors on April 26, 2007. Under the plan, the Corporation was authorized to repurchase up to 2.5 million shares of its common stock from time to time over a two-year period ending April 26, 2009 at various prices in the open market or through private transactions.

Item 3. Defaults Upon Senior Securities

None.

Item 4. Submission of Matters to a Vote of Security Holders

None.

Item 5. Other Information

None.

Item 6. Exhibits

(a) Exhibits

Exhibit Number	Description
31. 1	Rule 13a-14(a) Certification of the Corporation's Chief Executive Officer
31. 2	Rule 13a-14(a) Certification of the Corporation's Chief Financial Officer
32. 1+	Section 1350 Certification of the Corporation's Chief Executive Officer
32. 2+	Section 1350 Certification of the Corporation's Chief Financial Officer

\+ This exhibit shall not be deemed "filed" for purposes of Section 18 of the Securities Exchange Act of 1934, or otherwise subject to the liability of that section, and shall not be deemed to be incorporated by reference into any filing under the Securities Act of 1933 or the Securities Exchange Act of 1934.

Signatures

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Cullen/Frost Bankers, Inc.
(Registrant)

Date: October 24, 2007

By: /s/ Phillip D. Green
Phillip D. Green
Group Executive Vice President
and Chief Financial Officer
(Duly Authorized Officer, Principal Financial
Officer and Principal Accounting Officer)